Hawthorn
BANK
MEMBER FDIC

October 12, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219

Re: Basel III Capital Proposals

Thank you for the opportunity to comment on the proposed capital adequacy framework. As a former commissioned FDIC examiner for 5 years, I fully support the need for adequate capital. I also fully support the need for higher minimum capital levels than currently prescribed in regulation. While our goals are consistent, I view the Basel III framework as a highly counterproductive means to achieving the same end result – which is higher capital. Please give strong consideration to raising the capital standards in a much more simplified and understandable method. Just add 200 to 250 basis points to the tangible capital calculation and be done with it.

When overly concerned with the details, it is all too easy to lose sight of the big picture. Such is the case with the Basel III framework! Likely scenarios will occur where bank management and regulators focus on appropriately slotting Basel III inputs only to arrive at a risk based capital ratio of "x – with a footnote". The "footnote" would reflect adjustments for "category 1" and "category 2" inputs which are not readily determinable.

I have worked for Hawthorn Bank ($1.2 billion in total assets) for over 20 years and have seen our monthly loan loss reserve adequacy analysis greatly increase in granularity. Years ago, loan loss reserve adequacy was easily calculated by 1 employee in less than 4 hours. The majority of the 4 hours was used to analyze the historical loss ratio applied to "pass and watch list credits". Loss ratios for "classified credits" were provided by regulators and industry standards. Today's loan loss reserve methodology is much more granular as specific reserve calculations are performed for each "impaired" loan along with a robust migration analysis performed for the "non-impaired" loans. Today, approximately 220 employee hours are spent by Hawthorn Bank each quarter in determining loan loss reserve adequacy. The increased hours are due to accounting staff's migration analysis, our chief credit officer's impairment analysis for each impaired loan, and due to reviews by our chief risk officer, internal auditor (for compliance with the Sarbanes-Oxley Act), chief financial officer and lastly by our chairman.

Getting back to Basel III...for community banks such as Hawthorn Bank, credit risk is the greatest risk to our capital account. If regulators continue to exam banks by focusing on loan quality and loan loss reserve adequacy, then the complexity of Basel III is not necessary. With the complexity around the loan risk rating guidelines, unintended consequences will certainly transpire as innovative lending practices will give way to non-complex lending practices which require lower risk ratings.

With regards to investment security gains and losses, consideration should also be given to leaving the "line item" notation in the capital account without having the gains/losses flow through the capital adequacy calculation. While I fully support mark to market accounting, banks will likely transition to classifying investments as "held to maturity" to address the volatility around this accounting treatment. As each of you knows, community banks do not actively trade within the investment portfolio and it certainly appears appropriate to leave the "line item" notation in the capital account without having it flow into the risk based capital calculation.

Sincerely,

Kathleen L. Bruegenhemke

Kathleen L. Bruegenhemke
Chief Risk Officer