INDIANA BANKERS™
ASSOCIATION

October 22, 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 Corp.
550 17th Street, N.W.
Washington, D.C. 20429

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, D.C. 20219

Re: Basel III Proposals

Ladies and Gentlemen:

This letter is submitted in response to your request for comments on the proposed capital rules, commonly known as "Basel III", released by the federal banking agencies in June 2012.

The Indiana Bankers Association is a trade association representing the interests of banks located or headquartered in the state of Indiana. We are submitting this letter on behalf of the members of the Indiana Bankers Association, which include 157 member banks and approximately 170 associate members, based upon comments and concerns raised by those banks.

The vast majority of the banks headquartered in the state of Indiana are community banks, with an average asset size of $200 million. There are 37 banks headquartered in Indiana with less than $100 million in assets. The largest bank headquartered in Indiana has an asset size of just under $10 billion. To date, of the 435 banks which have failed during the recent financial crisis, only 3 have been headquartered in the state of Indiana.

Neither we nor the bankers in Indiana are unaware of the serious problems the banking industry has faced during the past few years. Nor are we or the bankers unaware of the actions taken by certain members of the banking industry to cause, or in some cases exacerbate, the financial crisis. We share the desire of regulators to take steps to ensure the financial industry is safe and sound and able to withstand changes in economic conditions. We disagree, however, that Basel III is the answer to these concerns.

As you well know, Basel III was never intended to apply to community banks; it was only meant to apply to those financial institutions which are internationally active. As a result, we urge you to exempt all banks from its application which do not participate in international transactions because these banks do not, and have never, participated in the activities which initially gave rise for the need to have Basel III. In other words, Basel III does not "fit" the community bank business model and never will.

The application of the Act's complexities to community banks will have a disproportionate effect on those banks both because of their size and because of the types of products they offer. It will further disadvantage community banks because their primary competitors, credit unions and farm credit services, are not subject to Basel III. The result will be a decline in the size and health of community banks (as banks shrink to raise their capital ratios), a decline in lending to the small towns and communities currently served by community banks and a decline in the ability of community banks to attract and retain talented personnel. Discussed below in more detail are certain of the specific concerns raised by our community bank members.

1. Capital Treatment of Gains and Losses on AFS Securities.

BASEL III contemplates that unrealized gains and losses on an institution's Available-for-Sale ("AFS") securities flow through to common equity Tier 1 Capital. Gains and losses would be included in the capital computation even if the losses occurred as a result of a change in interest rates, as opposed to a change resulting from credit risk. Currently, unrealized gains and losses on accumulated other comprehensive income on AFS debt securities and unrealized losses on AFS equity securities are not included in regulatory capital.

The immediate effect of this change is that the capital ratios of institutions in a rising interest rate environment will be decreased by unrealized losses on AFS securities, even though those securities have not suffered any actual losses or increased risk of loss. The decreasing capital levels will in turn lower banks' lending limits, suppressing further lending activity. Further, as a result of the volatility this change will introduce into capital requirements, institutions will need to constantly monitor capital levels, which will result in additional expense, and may decide to permanently maintain higher levels of capital than would otherwise apply, in order that the "capital conservation buffer" sanctions are not imposed. To avoid market swings, banks or institutions may also go short on investments, which would result in lower yields and lower earnings.

Similarly, a downgrade in government bond ratings could have an adverse impact on capital without a corresponding increase in risk in the securities portfolio. Institutions may be forced to reclassify their securities as "held to maturity," thereby impacting liquidity ratios. By reclassifying investments as "held to maturity" or shrinking investment portfolios, institutions would lose the ability to manage their investment portfolios through different interest rate and economic cycles.

In sum, the inclusion of gains and losses on AFS securities in the computation of capital does not provide a more transparent measure of an institution's capital; rather, the proposal will introduce a significant amount of volatility into the system and cause banks to plan for this volatility by hoarding capital versus lending to their communities.

To avoid this result, unrealized gains and losses on an institution's AFS securities should not flow through to common equity Tier 1 Capital. As an alternative, if unrealized gains and losses on an institution's AFS securities are required to flow through to common equity Tier 1 Capital, unrealized gains and losses resulting from changes in interest rates, as opposed to credit risk, should be excluded.

2. Phaseout of Trust Preferred Securities.

The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") specifically excluded institutions less than $15 billion in assets from the phase-out of trust preferred securities in capital. BASEL III ignores completely this legislation, and mandates the exclusion of trust-preferred securities as capital instruments for all institutions. The impact of this exclusion will be much greater in community banks than larger banks, as community banks have fewer sources of capital to replace the trust preferred. It is for this reason that Congress specifically exempted smaller banks from the exclusion provision.

Indiana banks will particularly feel the effects of the trust preferred phase-out. Of the136 institutions headquartered in Indiana, only 21 are publicly traded. The remaining institutions, many of which have trust preferred securities on their books, will need to find private sources of capital. This capital will be particularly hard to find since it is replacement capital, rather than capital to support growth (which is of interest to many investors). In the absence of replacement capital, banks will be forced to shrink their balance sheets to increase capital levels, thereby reducing the ability of the banks to make loans. This will create a negative cycle which will be harmful to the economy and the earnings of the individual institutions.

Based on the foregoing, we strongly encourage you to permanently grandfather trust preferred securities in smaller institutions consistent with Dodd-Frank.

3. Risk Weighting of Mortgage Servicing Rights.

The current capital rules limit the value of intangible assets, including mortgage servicing rights, to 100% of tier 1 capital. The proposed capital rules require an institution to deduct the value of all mortgage servicing assets (net of deferred tax liabilities) that exceed 10% of its common equity tier 1 capital (or 15%, when aggregated with deferred tax assets and investments in common stock of an unconsolidated financial entity). In addition, under the proposed rules the amount of the mortgage servicing assets below the 10% threshold will be assigned a 100% risk weight, increasing to 250% in 2018.

The business model of many community financial institutions contemplates the retention of the mortgage servicing rights in order to generate additional fee income and maintain the relationships with their customers, which results in many cases in the holding of a mortgage servicing asset in excess of the proposed 10% threshold. The required deduction of mortgage servicing assets in excess of the 10% threshold, and the high assigned risk weight to the amount not deducted, will likely decrease many institutions' capital levels. This decrease in capital, combined with the restrictions imposed on an institution if it fails to meet the requirements of the proposed capital conversation buffer, may result in an institution exiting the mortgage serving business. Institutions that exit or reduce their mortgage servicing business will suffer a reduction in fee income at a time when they need to generate additional capital, and may see a negative impact on their customer relationships at a time when loan portfolios of community banks need to grow and communities need additional sources of loans.

Because of these unintended consequences, we recommend that existing mortgage servicing assets be grandfathered and that the risk weighting assigned to mortgage servicing assets not be increased.

4. Application of the Capital Conservation Buffer.

The proposed capital conservation buffer requires a financial institution to maintain additional capital of 2.5% of risk-weighted assets in excess of the minimum capital requirements by January 1, 2019. Failure to maintain this capital buffer will limit an institution's ability to repurchase shares, pay dividends and make discretionary bonus payments to executive officers. In many ways this proposal disproportionately impacts community banks. For example, community banks will need to build additional capital balances to meet the minimum capital requirements with the buffers in place. Community banks do not have ready access to capital that the larger banks have through the capital markets. Instead, the primary way for community banks to increase capital is through the accumulation of retained earnings over time.

Additionally, the definition of "executive officers" in the proposed rule, which is based on job title and function and does not vary based on an institution's size, will disproportionately impact community banks. The same number of person holding these roles or titles will be affected at all institutions, but at a community bank this number represents a much larger percentage of employees than a large institution.

Finally, the imposition of the capital conservation buffer on community banks, and the threat of the restrictions associated with the buffer, will have many unintended consequences. Because of the uncertainty this imposes on the potential for the payment of bonuses, a community bank will be severely hindered in its ability to attract and retain qualified management. For example, an institution could have a tremendous year in loan growth and profits, but under the capital conservation restrictions be unable to pay bonuses. Smaller banks' asset and loan growth will be limited due to depressed margins, and the banks' ability to raise new capital will be adversely impacted because of the uncertainty of dividend payments and stock repurchases.

All of these unintended effects on growth, dividends, and bonuses, will harm our community banks' ability to generate long-term earnings, raise new capital, and attract and retain quality personnel. This, in turn, will harm the communities our members serve. Accordingly, community banks should be exempt from the proposed capital conservation buffer.

5. Risk Weighting of Mortgage Loans.

BASEL III contemplates changes to the risk weighting of mortgage loans, which may have numerous unintended consequences for financial institutions and the customers and communities which they serve.

Under the proposal, the sole basis for risk weighting mortgage loans is the loan's loan-to-value ratio. Using this criteria as the sole basis for determining risk is inappropriate, as it ignores many of the factors currently used to establish risk, many of which are much better predictors of the likelihood a loan will be repaid. For example, banks currently look at many sources of information, including net worth and cash flow of the borrower, net worth and cash flow of any guarantors, credit history of the borrower and guarantors, local economic conditions, character of the borrower, and many other factors. The value of the collateral is only one of many relevant factors.

Further, use of loan-to-value ratios calculated at the time of loan origination ignores the effect of loan seasoning, as loan balances decline over time and borrowers establish a history of making payments, and ignores changes in collateral values, including changes resulting from improvements to collateral. The calculation also grossly overemphasizes the role of a single appraisal, which in the course of the recent economic downturn has proven to be very unreliable. As the economy weakened, appraisals remained high because they were based in large part on prior sales prices. Now, as the economy improves, appraisals are artificially low in many cases for the same reason, and because some of the comparable sales represent foreclosures or short sales. In Indiana the state has mandated an appraisal process that is intended to assure appraisers are not handpicked by borrowers or lenders, with lenders choosing randomly from a state appraiser pool. Our member banks are reporting many problems with this process, including the requirement of using appraisers who are unfamiliar with the communities in which they are working. It would be a gross inequity to have banks' capital levels tied solely to this process.

The imposition of this single criteria will also increase the cost for community banks, and the cost of the loan for the consumer. For existing loans, community bank systems typically do not have original loan-to-value information readily available. In order to generate this information and determine the proper risk weight categories for mortgages, community banks may need to upgrade software and/or incur other operational costs to track mortgage loan-to-value ratios. Additionally, many banks will refrain from future lending on high loan-to-value loans, even if credit enhancement exists.

The proposal will also discourage banks from offering balloon or adjustable-rate mortgages to consumers because of the higher risk weights assigned to those products, and will encourage banks to charge consumers much higher rates for those products. Requiring higher risk weights on loans which are either adjustable-rate (beyond certain parameters) or balloons requires more capital, which will increase the cost of the credit and reduce the availability of the credit. Instead, banks will originate predominantly 15 to 30 year mortgages, which will make balance sheets more sensitive to changes in long-term rates. As a result, many banks may either exit the residential market or originate only those loans which qualify for sale to a GSE.

Finally, we note that the proposed risk weighting for loans 90 days or more past due or on nonaccrual status is unnecessary, as it duplicates the purposes of the allowance for loan loss and further decreases capital. Based on these considerations we believe the risk weighting for mortgage loans should not be changed.

Conclusion

The foregoing represents only a small portion of the concerns and problems we see with the proposed capital rules of Basel III. These rules, which were not drafted with the intention of applying to community banks, would result in significant unintended consequences to those banks. The effects would be disproportionate on smaller banks, and would harm both those banks and the communities in which they operate. Community banks play a significant role in Indiana's and the nation's economic prosperity, as these banks in many cases are lending to people and businesses and to communities deemed too small for the larger regional or national banks. Further, the imposition of these rules and restrictions on community banks will not serve to address the real cause of the recent financial crisis, as it was not the risky lending and products offered by community banks that led to the problems.

Thank you for the opportunity to provide our thoughts.

Sincerely,

S. Joe DeHaven

S. Joe DeHaven, President and CEO
Indiana Bankers Association