October 19, 2012

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

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20219

Re: Regulatory Capital Rules: Regulatory Capital Implementation, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action

Dear Ms. Johnson and Mr. Feldman:

Thank you for the opportunity to comment on the Basel III proposals published by the Federal Reserve Board of Governors, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively the "agencies").

Tower Bank & Trust Company ("Tower") is a $650 million Indiana chartered bank with depository accounts insured by the Federal Deposit Insurance Corporation ("FDIC") and is a member of the Federal Reserve System. We were incorporated in Indiana in 1998 and our parent company's stock is traded on the NASDAQ Global Market System under the ticker symbol TOFC. We are considered a community bank that provides a range of commercial and consumer banking services focusing on commercial and commercial mortgage loans and, to a lesser extent, on consumer and residential mortgage loans. We offer a broad array of deposit products, including checking, savings, and money market accounts, certificates of deposit and direct deposit services. Trust investment and management services are offered by the Trust Company, which is a wholly owned subsidiary of the Bank.

While there are several items associated with Basel III that will impact most community banking organizations, we have identified a few specific changes that would most likely have a substantial impact on how we conduct business in the future. The items we have determined as having the biggest impact are the changes in risk weights assigned to securitization exposure, the addition of Accumulated Other Comprehensive Income (AOCI) in Common Equity Tier 1 Capital, and risk-weighting for residential mortgage loans by category. These specific components in the new capital rules could significantly change management decisions, which could cause additional, unnecessary risks with regard to asset-liability management when it comes to investment allocations/options, interest rate risk, and liquidity.

With the increased regulatory requirements, we should remain well capitalized, but other community banks may not have the same outcome once they apply the proposed requirements to their current capital position. Another obstacle that will need to be overcome is the readiness of the information to complete the entire calculation. If passed, Basel III could be implemented as early as 2013, but a considerable investment of time and resources will be necessary for most community banking organizations before implementation to be able to produce the information required to complete the capital calculation.

A comprehensive discussion on each item and its impact to both Tower and community banking organizations is listed below.

Securitization exposure

The proposal states that the agencies are not comfortable with the complexity of certain types of asset backed securities. In response, they have designed a framework to address credit risk of exposures that involve tranching of the credit risk of one or more underlying financial exposures. By not relying exclusively on credit ratings and the "first dollar of loss methodology", securities would be judged on the characteristics of the underlying loan exposures, allowing for greater risk-weight alignment between securities and loans held on a portfolio basis. What this means for Tower is that certain asset-backed securities will need to be individually evaluated to determine what the risk weighting needs to be.

There are two methods that can be used, the Gross-up or the Simplified Supervisory Formula Approach (SSFA). These methods replace the current ratings-based approach with an approach that factors in the underlying assets of the security and the relative position in the structure (i.e. super-senior, senior, mezzanine, equity, etc). That said, both the gross-up approach and the SSFA overlook key structural features to securitizations that provide credit enhancement, including the purchase price or carrying value of a security.

The NPR states that if an organization is unable to *demonstrate to the satisfaction of its primary federal supervisor* a comprehensive understanding of the features of the security in question, the banking organization would be required to assign the 1,250% risk weighting. This causes concern that even though the bank fully understands the security, if the examiner doesn't understand it, the bank can be penalized. Additionally it could create an uneven playing field among other financial institutions (i.e. large banks, small banks, credit unions, etc.) by allowing two different institutions to risk weight the exact same security differently depending on who their regulator is and the sophistication of their staff.

Accumulated Other Comprehensive Income ("AOCI")

As part of the proposal, unrealized gains and losses on all AFS securities would flow through to common equity tier 1 capital. This would include those unrealized gains and losses related to debt securities whose valuations primarily change as a result of fluctuations in a benchmark interest rate, as opposed to changes in credit risk (for example, U.S. Treasuries and U.S. government agency debt obligations). The agencies believe this proposed treatment would better reflect an institution's actual risk.

The agencies recognize that including unrealized gains and losses related to certain debt securities whose valuations primarily change as a result of fluctuations in a benchmark interest rate could introduce substantial volatility in a bank's regulatory capital ratios. Likewise, the proposal could ultimately lead to flawed, uneconomic, and even unsound decisions regarding an institutions asset-liability management and investment options, such as:

- Moving investments currently labeled as Available for Sale ("AFS") to Held to Maturity ("HTM") status. While the move to the HTM account would no longer require gains and losses on those securities to be recorded in Tier 1 capital, the operational restrictions imposed on the HTM account would greatly reduce management's ability to properly adjust its portfolio for liquidity and funds management purposes. Additionally, when different institutions place identical securities in AFS or HTM, it creates differing capital treatments even though the relative risks involving the securities are the same.
- Shortening the life of the portfolio to decrease volatility in market value and increase liquidity. This will help reduce market risk, but it will also reducc the ability of the investment portfolio to produce income and generate capital appreciation.
- Pursuing other asset classes with higher levels of credit risk and/or greater levels of unrecorded market volatility (i.e. loans, structured liabilities, or HTM securities). Other balance sheet components that are economically very similar do not receive the same treatment. We find two difficulties in this treatment not being equivalent.
  - First, this appears to violate the basic accounting principle of consistency.
  - Second, it would, in effect, weaken an institution's asset-liability management; specifically, it adds a potential capital penalty on using the securities portfolio, the most flexible tool at ALCO's disposal, to reduce overall asset sensitivity while leveling no such penalty on any other balance sheet component.

We do not feel that Tower or any other community bank should receive unnecessary benefit or penalty based on the fluctuation of AOCI, which has no real bearing on current financial condition. For example, we hold approximately 45% of our securities portfolio in municipal bonds. If and when interest rates rise, these bonds may have an unrealized market loss. However that is only in the event that we would sell them prior to maturity. If our financial condition is satisfactory we would have no reason or cause to sell these securities at a loss.

Therefore, reducing our tier 1 capital for something that would not occur, other than in the event of failure, would be unduly penalizing us from a capital standpoint. Conversely, we are not asking to be given credit when are portfolio experiences a market value increase. Any permanent decline in the portfolio are already captured through Other Than Temporary Impairment (OTTI) and are, therefore, included in tier 1 capital as that time.

Residential Mortgage Loans

The proposals currently create a set of criteria differentiating between Category 1 and 2 loans (with their respective LTV risk weight buckets). There are two rather impactful and perhaps unintended consequences of the definition as written. The first item relates to the following requisite characteristic of a category 1 loan:

"The terms of the mortgage loan provide for regular periodic payments that do not:

a. Result in an increase of the principal balance

b. Allow the borrower to defer repayment of principal of the residential mortgage exposure

c. Result in a balloon payment"

This last item is particularly troublesome as certain institutions have a preponderance of residential mortgage loans that were originated with balloon payment features. However, these loan contracts did not have the other contractual terms listed in item a or b above. We question the applicability, in isolation, of this clause. It seems clear that the intent of this paragraph was to apply a more capital intensive charge to loans commonly referred to as option loans (e.g., Option ARMs). However, these loans exhibit most frequently all three of the characteristics cited above (or at least two of the three). Commonplace within the industry, residential loans exist that only exhibit the balloon payment portion and which are otherwise underwritten with standard loan terms. We would argue that the default/loss profile of these loans has been much lower over the crisis than the loans (e.g., Option ARMs) that appear to be the intent of this section.
As such, we would request a more explicit ruling that requires satisfaction of all three of the criteria (or at least two of the three) listed simultaneously in order to be disqualified as a Category 1 loan. However, if the agencies' conclusion is to leave this portion of the proposal unchanged, we ask for existing loans to be grandfathered as Category 1 and all new originations of balloon loans after implementation date be held to this new standard. This will allow for the industry to adjust structure or pricing effectively in light of the higher capital requirement.

The second noteworthy item within the residential mortgage loan proposals relates to periodic and lifetime caps. According to the NPR, a residential mortgage loan would be disqualified as a Category 1 loan if:

"The terms of the residential mortgage loan allow the annual rate of interest to increase no more than two percentage points in any twelve month period and no more than six percentage points over the life of the loan"

Practically applying this definition within the HELOC market, as most all of the existing HELOC contracts were not written with either periodic or lifetime caps, results in an overwhelmingly immediate classification into the Category 2 bucket. Once again, we are not entirely sure that this was the intention of the rule (immediate punitive treatment of HELOC portfolios), we therefore ask for an exemption of HELOCs. However, if the agencies' conclusion is to leave this portion of the proposal unchanged, we ask for existing loans to be grandfathered and classified into Category 1 or 2 subject to the remaining components of the definitions (excluding this particular stipulation). Once again, this will allow for the industry to adjust structure or pricing effectively in light of the higher capital requirement.

The removal of the exception relating to the 120 day recourse programs on sold 1-4 family loans (liquidating into GSE programs) will have damaging effects on institutions with larger mortgage banking departments that routinely sell into secondary markets. We would ask the agencies to consider maintaining the current 120 day grace period exception so as to not disturb the pipeline of residential mortgage credit and the corresponding ancillary effects that would be felt in the housing market.

Lastly, with regard to the loan to value assessments of each loan, we do not see any provision for periodic review of these values as the loan amortizes. Thus, the loan is always risk-weighted based on its original LTV.

Tower, as well as other community banks, has a large private banking practice. Loan to value exceptions are based on these individuals credit worthiness and income earning base. This proposal would have a negative impact on these types of loan relationships.

In conclusion, the items listed above are the primary concerns of Tower and most community banking organizations. By passing this proposal "as-is", the agencies will force community banking organizations to flawed, uneconomic, and even unsound decisions to preserve capital. We appreciate having the opportunity to provide comments on this topic and look forward to working with the agencies to find a solution that will truly fulfill the agencies' intent of strengthening the capital positions within the financial institution industry.

Respectfully submitted,

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