Lake City Bank
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MICHAEL L. KUBACKI
Chairman and Chief Executive Officer

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

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

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

Re: Basel III Capital Proposals

Ladies and Gentlemen:

Thank you for the opportunity to provide comment on the Basel III proposals that were issued earlier this year for public comment by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation. We have considered the various aspects of the Basel III proposals and have evaluated the potential impact on our bank by applying the standards of the Basel III proposals to both our current and historical financial statements. The comments included with this letter are based on that analysis.

Lake City Bank is the third oldest financial institution in the state of Indiana, founded in 1872 in Warsaw, Indiana by local businessmen with $60,000 in assets and a desire to serve the banking needs of the Warsaw community. Lake City Bank is now a thriving community bank with $2.9 billion in assets and 45 branches serving communities throughout northern and central Indiana. As such, Lake City Bank and community banks like Lake City Bank have proven to be an engine for growth and prosperity in the region by providing mortgage, consumer and commercial financing. A strong local economy is dependent on the availability of capital to fund the businesses and individuals of the community.

Lake City Bank is committed to ensuring that it can continue to meet those funding needs to serve its communities and customers as it has for the past 140 years. All prudent bankers share the desire to strengthen the financial system by ensuring that banks maintain adequate capital levels. Lake City Bank believes that it is critical to achieve that objective without reducing the ability of community banks to provide capital financing to its communities. The current Basel

Ill proposals imperil the ability of community banks to serve their respective communities, which would have a devastating impact on local economies and ultimately threaten the health of the banking sector and the American economy.

In general, the Board of Directors and management of Lake City Bank are concerned that the Basel III proposals will have an adverse impact on the profitability of the bank and on the ability of the bank to continue its long tradition of serving the credit needs of its customers. Unquestionably, the amount of capital required will increase, and this capital will become more volatile. Adhering to a strategic vision without a clear sense of future capital levels presents clear challenges. Additionally, the full impact of Basel III proposals cannot be fully ascertained without the dedication of significant resources as significant efforts would be required to code the entire loan portfolio to assign proper risk weights, understand how to apply the proposed rules to the balance sheet and properly analyze the data. These proposals, therefore, certainly present implications to Lake City Bank that are not yet fully understood.

The Board of Directors and management of Lake City Bank respectfully request that you consider our specific concerns as follows:

1. **Applicability of Basel III to Community Banks.**

   Community banks should be allowed to continue using the current Basel I framework for computing capital requirements. Basel III was intended to apply to the largest banks with international operations. Large banks seem to utilize a high-volume model, and those highly-leveraged activities depleted capital levels and caused the financial panic of 2008. Community banks, in contrast, operate on an entirely different business model that is focused on relationships with borrowers in local communities on a long-term basis. This model is essential to the success of community banks and small businesses and is governed by practical risk management approaches. As discussed below, we believe that the proposals will have a disparate impact on community banks, whose simple and traditional balance sheet compositions do not provide as much flexibility as the more complex balance sheet of larger banks. Moreover, the operational demands of managing volatility of community bank balance sheets will cause such banks to limit product offerings and to scale back lending in the local communities, both of which would have a tremendous adverse impact on the local economies.

2. **Incorporating Accumulated Other Comprehensive Income (AOCI) as Regulatory Capital.**

   Inclusion of AOCI as regulatory capital could rapidly decrease capital levels in a rising rate environment and will result in higher volatility in regulatory capital balances unrelated to a bank's overall financial condition. At Lake City Bank, AOCI primarily represents unrealized gains or losses on investment securities. These securities are held at fair value and are marked-to-market each month. Historically low short-term and long-term interest rates have generated significant unrealized gains for many investment securities, and a higher demand for agency securities has caused valuations to rise as investors prefer these lower-risk instruments.

Interest rates at current levels are anticipated in the short-term, but banks must anticipate a rising rate environment over the medium- and long-term. As rates rise, fair values will decline and banks now reflecting AOCI gains will begin to see losses. Under the Basel III scenarios, the decline will have a direct impact on regulatory capital ratios.

By way of illustration, as of June 30, 2012, Lake City Bank had a risk-weighted Tier 1 capital ratio of 12.85% under current rules. If the Basel III proposals were adopted and interest rates were to increase by 300 basis points, the bank's risk-weighted Tier 1 capital ratio would immediately decrease to 10.5%. That decrease represents over $100 million shrinkage in capital available to support our lending activities.

All banks are charged with managing balance sheet risks as part of a well-managed risk approach. This regulatory approach has allowed banks to manage their balance sheets in a profitable, holistic and balanced way through volatile rate and economic cycles. The U.S. government, agency and GSE securities have proven to be a very effective tool for liquidity planning and balancing credit and interest rate risk. Lake City Bank purchases these securities without any intention of a quick sale. Forcing the realization of losses or profits on these securities on an ongoing basis by creating a capital impact could result in an immediate flight from these instruments, which would be detrimental to the banks and the overall economy.

Community banks, unlike the large banks, typically do not employ hedge accounting relationships with the use of derivatives to mitigate risk. A logical response of community banks under these conditions would be to scale back on lending to conserve capital. Retrenchment of bank capital would be devastating to businesses and consumers throughout our local communities and our nation.

We respectfully urge the proposed rule be revised so that unrealized gains and losses on available-for-sale securities that reside in AOCI do not flow through capital. At a minimum, unrealized gains and losses that predominantly result from changes in interest rate risk (as opposed to credit risk) should be excluded from capital. This approach would exclude from regulatory capital unrealized gains and losses resulting from low-risk securities like United States government, agency and GSE debt obligations.

3. **Elimination of Trust Preferred Securities.** Trust preferred securities have long been a reliable and cost-effective source of capital for community banks that would be difficult to replace. Lake City Bank currently has approximately $30 million in Trust Preferred Securities issued in 2003. While this amount is a relatively small portion of the bank's capital, it has allowed us to grow the bank and meet the credit needs of our communities. Phasing out this source of capital would reduce our ability to grow our balance sheet by approximately $300 million. That amount represents loans that Lake City Bank would not make in our communities to support economic growth. The impact of this provision across the banking system and across the nation will be very significant. While the largest banks have easier access to the capital markets for replacement capital, many

smaller banks will have difficulty replacing this capital and will therefore be forced to curtail lending.

We respectfully urge regulators to continue the current tier 1 treatment of Trust Preferred Securities issued by those bank holding companies with consolidated assets under $15 billion in assets, a level suggested by the Collins amendment of the Dodd-Frank Act.

4. **High Volatility Commercial Real Estate**. It is clear that high-risk commercial real estate exposures have devastated many financial institutions. There is, however, a need for soundly underwritten commercial real estate loans to borrowers with adequate debt service coverage ratios. Well-managed community banks already utilize many risk management techniques to mitigate the inherent risks in this portfolio. This proposal is restrictive and inflexible and all but the most liquid developers would be left without financing as banks cease funding construction and development projects. The expansion of the economy would be further restrained by such a provision. Under the proposal, Lake City Bank would have approximately $22 million less to lend due to the higher risk weighting.

5. **Capital Conservation Buffers**. Implementation of capital conservation buffers for community banks will present a significant challenge to those banks that do not already have ready access to capital markets. The only way for those institutions to grow capital (outside of securing private capital investment) is through retained earnings. Earnings challenges persist as a result of the margin pressure caused in part by current monetary policy. Lake City Bank's publicly-traded holding company, Lakeland Financial Corporation, presently has good relationships with investors and accessed the capital markets in late 2009. This proposal, therefore, does not cause Lake City Bank immediate concern. However, capital markets are volatile and there can be no assurance that those markets will be available in the future.

   Moreover, the existing regulatory framework includes appropriate restrictions on dividends. Regulatory agencies often require certain banks to obtain approval prior to payment of dividends when they become concerned about capital levels. In addition, supervisory measures exist to prevent the payment of excessive executive compensation at banks not in a safe and sound condition. The proposal's per se restriction on payment of executive compensation will prevent institutions from being able to retain good management, even when the need for strong and competent management is greatest.

   We therefore respectfully urge that the existing regulatory framework be left intact.

6. **Increased Risk Weights on Delinquent Loans.** Lake City Bank has experienced low levels of delinquencies relative to its peers. The proposed rule, therefore, would not have significant impact on Lake City Bank at this time. Economic conditions could, however, cause this to change. Lake City Bank is concerned that this proposal ignores the existing processed through which a bank accounts for its delinquent loans. The reserve for loan losses operates as an effective tool to set aside capital to absorb estimate losses. The proposal to increase risk weights on delinquent loans would cause banks to set aside

capital a second time, resulting in an unnecessary double-counting of the risk of these assets. The reserve for loan losses is an effective risk management mechanism, and this proposal is unnecessary. Lake City Bank would have approximately$16 million less to lend under the proposal due to the higher risk weighting.

7. **Mortgage Servicing Assets.**

Like most community banks, Lake City Bank retains a large mortgage servicing portfolio currently valued at $2 million. Borrowers benefit from the high-quality nature of community bank servicing, and Lake City Bank is proud of its diligent efforts to work with borrows to resolve payment problems and ultimately to achieve favorable outcomes possible for borrowers. Under the proposals, mortgage servicing assets (in excess of 10% of Common Equity Tier 1) will face new deductions from capital. Further, capital would be required against assets with credit enhancing representations and warranties, including Lake City Bank mortgages sold to Freddie Mac. The proposed treatment of this asset category is one more potential hurdle and expense that could impact the cost and availability of mortgages.

Lake City Bank believes that this proposal should be eliminated so there would be no deduction from capital for mortgage servicing rights. At a minimum, existing mortgage servicing portfolios should be grandfathered. Banks with large servicing asset portfolios could see their capital levels severely impacted merely because of a change in position of the Basel committee. While the impact to Lake City Bank is currently minimal, capital levels may not always be high enough to support an increasing mortgage servicing asset portfolio as a result of this proposal. In the future, such an impact could result in a strategic de-emphasis of the mortgage business to allocate capital in the most efficient manner.

8. **Non-qualifying First Liens and Junior Lien Mortgages.**

Assigning proper risk-weightings to various assets will be an expensive and time-consuming undertaking, which will require additional staff and expensive software. This will serve as a further disincentive to mortgage and real estate lending at community banks that lack the scale and operational capacity of larger banks. This will especially impair a bank's willingness to make loans retained in the bank's portfolio as is common in the community banking model. In particular, Lake City Bank objects to the punitive impact of changes to balloon mortgage loans and all second liens including home equity lines.

Currently, Lake City Bank's portfolio of affected loans totals $172 million. These loans provide solid financing alternatives to home loan borrowers in underserved and rural communities and play a large role in shaping the local economies of the communities in which the loans are originated. Additionally, community bank lending, which focuses on tailoring loan products to the specific needs of the customer, is a powerful force in small business formation and growth that fuels job creation. As relationship-based lenders, community banks possess the local expertise needed to complete quality underwriting for these loan products and provide forms of financing that larger banks have historically been

unable or unwilling to offer. Lake City Bank would have $26 million less to lend under this proposal due to the higher risk weighting.

After consideration of the impacts of the proposed Basel III capital rules, Lake City Bank strongly imposes the implementation of the proposals as drafted. Many of the Basel III proposals appear to be well-intentioned and appropriate for larger U.S. banks. However, there could not be a worse point in the economic cycle for regulatory policies that result in disincentives for community banks to fund properly underwritten loans. The proposals will result in increased market share and a high concentration of lending activities, particularly real estate exposures, in the nation's largest institutions. History has proven that that is simply not healthy for our economy. A strong community banking sector has funded growth of small businesses and consumers in local communities across the nation and is thus a vital element of American economic success.

The Board of Directors and management of Lake City Bank appreciate the opportunity to comment and ask that you give thoughtful consideration to our concerns.

Respectfully,

cc: The Honorable Daniel Coats
U.S. Senate

The Honorable Richard Lugar
U.S. Senate

The Honorable Joe Donnelly
U.S. House of Representatives

The Honorable Marlin Stutzman
U. S. House of Representatives

The Honorable Dan Burton
U. S. House of Representatives