MutualBank
Go ahead...live a better life!

October 19, 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[1] that were recently issued for public comment by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation. We are fully supportive of creating standards that will ultimately reduce the possibility of another financial crisis. We are however concerned with certain sections of these Basel III proposals that may have unintended consequences for Community Banks.

MutualBank was chartered in 1889, and now has 32 financial center locations. MutualBank has always been a conservative lender and has managed through many difficult economic times including the Great Depression, the Savings and Loan Crisis, and the latest Great Recession. MutualBank has grown to assets of approximately $1.5 billion and has proudly served central to north central Indiana for 123 years. MutualBank has been a leader in originating one-to four-family residential mortgage loans in all of its markets and continues to have approximately 50% of its loan portfolio in these assets. We are proud to provide the opportunity for home ownership to qualified applicants and we plan to originate approximate $175 million in mortgage loans in 2012. We do believe some of the recommended requirements in Basel III could discourage lending to consumers.

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[1] The proposals are titled: *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions*; *Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements; and Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rules; Market Risk Capital Rule.*

David W. Heeter, Chief Executive Officer
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bankwithmutual.com

Like many community banks, MutualBank has also found itself in a higher liquidity position over the last few years as many clients have paid down loans and increased deposits. This has allowed us to increase our investment portfolio to approximately 25% of our assets. Our goal is to reduce the level of investments held in our portfolio as loan demand increases through the amortization of securities in our investment portfolio. This additional level of securities make the recommended requirements in BASEL III concerning because application to our investment portfolio may have a significant impact on our regulatory capital. We are concerned this change could have counter cyclical regulatory capital implications. The following further describes our concerns.

Risk-Weighted Assets

We have been and continue to be a leader in providing residential mortgage loans to all of our markets in Indiana. The proposed Basel III requires mortgage loans over 80% to be risk weighted above 50%. This may require most lenders like MutualBank to raise interest rates to offset the increased exposure from a regulatory capital perspective, slowing the ability for many to become homeowners. We have reduced our risk by requiring private mortgage insurance on loans originated over 80%. The increase in risk weighting on loans above 80% loan to value seems unreasonable if private mortgage insurance is purchased. Private mortgage insurance protects the bank from losses above the 80% loan to value, so not allowing one-to four-family residential mortgage loans over 80% loan to value with PMI to be risk weighted the same as a loan at an 80% loan to value seems irrational. We have had very little issue with PMI companies when submitting claims and believe that PMI works appropriately. We understand that the stress in the industry over the past few years raised many questions, but our opinion is that utilizing PMI insurance is an acceptable way to reduce the bank's risk on a one-to four-family loan over 80% loan to value. This exclusion could also encourage banks to forgo purchasing PMI when necessary, which actually could increase risk.

Available for Sale Securities

It has been our experience that our investment portfolio provides liquidity to fund loan demand. While we mark most of our investments as available for sale, more times than not we hold until maturity. If the bank decided to change the classification of investment portfolio to held to maturity, there would not be unrealized gains/losses that would flow through the balance sheet for regulatory purposes or otherwise. The implication is that two banks with identical financial statements could have very different capital ratios due to accounting classifications. An investment portfolio that is classified as held to maturity can still have securities sold out of it and only then would the bank with the held to maturity classification see a gain/loss in capital. Since we hold many securities to maturity, MutualBank would rarely see an unrealized gain or loss. While the unrealized gain/loss is an indication of future earnings compared to the current market, we do not try to project future earnings into capital for anything else on our balance sheet. In our analysis, an instantaneous increase in rates of 300 basis points would reduce our regulatory capital 315 bp. While we agree if we sold these securities the value would be less and the loss would run through capital, the same would be true in our loan portfolio and any long-term asset. But the losses would only be realized if the assets were sold.

The addition of unrealized gain/loss into the regulatory capital ratio seems to be counter cyclical. When rates fall, typically we see an increase in the value of our investment portfolio. Historically, as the economy slows, rates are reduced to help stimulate the slowing economy. As the rules are written, a slowing economy will generate more capital that may or may not materialize with gains in the investment portfolio. It would seem that in a slowing economy capital may need to be strengthened, but increasing unrealized gain seems like smoke and mirrors instead of true capital. Also as rates increase, it would seem that the economy is on better footing, which probably will create losses in our investment portfolio, which will reduce capital. Since we do not present value future cash flows against current rates on any other balance sheet segment, it seems illogical to on investments.

We have concentrated on building our investment portfolio with safe investments that provide an adequate return without taking on undue risk. By doing this, we allow for our capital to grow quicker than if the bank held all liquidity in cash. The punitive nature of changing interest rates on the investment portfolio would reduce future earnings, which reduces future organic capital, if cash is utilized for a larger portion of liquidity.

In conclusion, while we support the idea to strengthen the financial industry, we believe that Basel III being applied to Community Banks and in particular, MutualBank, will create unintended consequences that will create increased loan costs to consumers, a reduction in available credit, reduced liquidity in banks, and reduced organic capital growth through earnings.

Thank you for your consideration.

Sincerely,

David W. Heeter
CEO