First Merchants Bank
P.O. BOX 792 MUNCIE, IN 47308

Michael C. Rechin
President
Chief Executive Officer

October 5, 2012

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

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

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

RE: ***Basel III Capital Proposals***

Ladies and Gentlemen:

I appreciate the opportunity to provide comment on the Basel III proposals that were recently proposed by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

I am in support of increasing the capital requirements for banks in our country to ensure that our industry can weather the storms that will come our way in the future. I think we all have that common goal. However, I do have concerns about the proposals that have been proposed by the agencies and placed out for comment.

First Merchants Bank, N. A. (formerly The Merchants National Bank of Muncie, Indiana) was formed in 1893 in Muncie, Indiana. Our financial holding company was formed in 1982. Since its organization in 1982, the Corporation has grown to include banks with 79 locations in 24 Indiana and 2 Ohio counties, a trust company, and a multi-line insurance company. As of June 30, 2012, total asset size of First Merchants Corporation was $4.2 billion. First Merchants Bank is a community bank with banking divisions to serve its customers:

1. *First Merchants Bank N.A.,* in Adams, Delaware, Fayette, Hamilton, Henry, Howard, Jay, Miami, Randolph, Union, Wabash, Wayne, Brown, Hendricks,

2. Johnson, Madison, Morgan and Shelby counties in Indiana and Butler County, Ohio
3. *Lafayette Bank and Trust Company, A Division of First Merchants Bank N.A.,* in Carroll, Clinton, Jasper, Montgomery, Tippecanoe and White counties
4. *Commerce National Bank, A Division of First Merchants Bank N.A.,* in Franklin County, Ohio
5. *First Merchants Trust Company,* A Division of First Merchants Bank, N.A., represents one of the largest trust companies in the state of Indiana.

We, like most other community banks in our country, want to make sure we are able to continue serving our communities in the way we have in the past. A strong economy is dependent on job growth and job growth is dependent on availability of capital to fund the small businesses that produce most of the jobs. We want to ensure that the new rules do not reduce the ability of our community banks to provide this capital.

The following items are the areas of the proposal in which I have concerns:

1. **Elimination of Trust Preferred Securities**

Our bank has held about $60 million in Trust Preferred Securities for about 5 years. This is not a large portion of our capital, but is a very cost effective source of capital for us and has allowed us to grow our bank and as a result, to better serve our customers. The elimination of this source of capital will reduce our ability to grow our balance sheet by about $400 million. This will reduce the amount of loans we will be able to provide to our communities to support job growth. When you multiply this affect across the country, the potential reduction in loan availability is significant. This proposal is in direct contradiction of the country's goal to spur job growth.

Trust Preferred Securities were grandfathered under Dodd – Frank, but are now being eliminated by the new capital proposal. Community banks have much more limited sources of capital than the large banks do and this rule is an additional strike against community banks.

2. **Requirement that gains and losses on available for-sale securities must flow through to regulatory capital.**

Our country is in an unprecedented period of low interest rates. Most banks have significant gains in their investment portfolios. This proposal would serve to increase regulatory capital in the short term. As interest rates begin to rise, this inflated capital would be quickly reversed and could move very dramatically in the other direction. While nothing will have changed in a bank's equity, their regulatory capital ratios could change very dramatically. This proposal will introduce a significant amount of cyclicality and volatility into the system which is opposite of what I believe the goal should be.

Our bank and others could be forced to reduce the size of our balance sheets as the economy begins to improve, simply because interest rates begin to rise. This could serve to undermine an economic recovery as banks reduce lending and concentrate on pulling back to maintain capital ratios. Our small business customers and consumer customers will be impacted by the reduced availability of credit under this scenario.

3. **Requirement to hold capital for credit enhancing representations and warranties on 1-4 family residential home loans, which have been sold into the secondary market.**

My first concern about this section of the proposal is that it is ambiguous. I am unclear as to what reps and warranties would cause our bank to set aside capital on a loan we have sold and for how long. Some of the reps and warranties in our correspondent contracts as they relate to fraud, misrepresentation or later identified deficiencies in underwriting are considered life of the loan reps and warranties. Since our bank has sold well over $1 billion in loans over the last 10 years, we could be required to set aside $85 to $100 million in capital for loans which have been sold for a long period of time. This would place us in a capital deficient position we could never recover from.

The reps and warranties which refer to early default or premium refund clauses do not subject the bank to the repurchase of the loan. Our only liability would be to refund the premium we earned along with a processing fee. For example, on a $275,000 government guaranteed loan, the premium earned could be around $6,950 and the processing fee would be $2,500. This would represent the bank's only liability for early default on the loan. The rule presently seems to state that the bank would have to maintain capital for 100% of the loan vs. the actual liability of $9,450. It seems to me that the capital we maintain should be commensurate with the amount of risk we are assuming.

This rule, as presently drafted, threatens to drive every community bank out of the mortgage lending business. It probably means that all of the business would move to the big banks assuming they have a way around the rule. I can't bring myself to believe that is what is intended.

In conclusion, the proposal as it is currently written will greatly impact our bank in the following ways:

1. It will significantly increase the amount of capital we will need to hold above and beyond the increase which would occur as a result of the increased "capital ratios". Each item I have detailed above will either increase our risk-based assets or it will decrease the amount of capital we have. This is with no change in the way we do business.

2. I have no way at this time to ascertain the full impact on our bank because of the amount of work that we will need to undertake to understand the rules, train our staff on how to apply the rules to our balance sheet, implement the coding of each individual loan in our portfolio with the new risk weights, reprogram our core processing software to handle the new coding requirements and then create the necessary reports to analyze the

data. It would not be unlikely if we would be required to hire a consultant to help us work through the front-end of the process to assure that we have accurate data and to assure that our staff fully understands how to code the loans properly.
As stated in the opening of this letter, I am not opposed to increasing the minimum capital requirements. I also acknowledge that each bank can have different risk profiles and should have sufficient capital to provide the safeguards needed. I also think our examiners have done a reasonably good job identifying problem areas and management deficiencies. Having been in the banking industry for 30+ years, I have seen several severe business cycles and I can tell you that in some cases having more capital would not have helped. When you have values chopped in half over night, you are going to lose some banks. Basel III was meant for large complex banking structures, not smaller community banks. The proposed restrictions are too punitive and the timing could not be worse. Right now we need banks to lend, not restrict lending.

While I fully support an increase at some level in the amount of capital that banks hold, the cumulative effect of each of the items reflected above will have a severe impact on most of the community banks in this country. I strongly urge you to consider this impact and to consider a possible exemption for most of our community banks from the bulk of these rules. Our nation's community banks need to be able to continue serving our communities and helping to strengthen our local economies.

In summary, the implementation of Basel III as proposed would significantly and negatively alter the way community banks serve their customers and communities and is unacceptable as we strive to improve and grow the American economy. Thank you for your time and consideration.

Respectfully submitted,

Michael C Rechin

Michael C. Rechin
President and Chief Executive Officer
First Merchants Bank, N. A.

pc: Senator Daniel Coats
Senator Richard Lugar
Representative Dan Burton
Representative Mike Pence