



BANK

October 18, 2012

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

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

Office of the Comptroller of the Currency  
230 E Street, SW  
Mail Stop 203  
Washington D.C. 20219

Re: Basel III Capital Proposals

Ladies and Gentlemen:

Thank you for the opportunity to provide comments on the Basel III proposals that were recently approved by your agencies.

Hawthorn Bancshares, Inc. is a financial bank holding company headquartered in Lee's Summit, Missouri and is the parent of Hawthorn Bank of Jefferson City with 24 Missouri locations. We are a \$1.2 billion community bank providing non-complex financial products typical of community banks.

We are a well-capitalized bank with a total risk based capital ratio of 16.90%, a tier 1 capital to risk weighted assets of 13.63% and a leverage ratio of 10.17%.

I am concerned, along with many of my fellow community bankers, that our ability to provide credit and services to our customers will be hampered by Basel III proposals that seem to have been fashioned in a one size fits all manner. We are proponents of strongly capitalized institutions, but the Basel III proposals make radical changes that I feel will tighten credit availability and threaten the weak economic recovery taking place in our region.

Let me point out just three things in Basel III that I feel will have an adverse effect on our bank. The first is the elimination of Trust Preferred as capital. When we issued our Trust Preferred Securities in 2004 and 2005, all of the regulators agreed that it would be treated as capital. Now with the 10 year phase out, we are changing the rules. If you want to phase out our Trust Preferred, then do it over the remaining life or over the final ten years

to maturity. Some of our Trust Preferred have over 23 years to maturity. I don't understand the logic in phasing it out over the next ten years.


The second item is the proposed rules regarding changes in the risk rating of our loan portfolios. In particular, the ratings change in non-conforming mortgages may force us to stop making loans that historically have been good for our bank and our customers. In some instances, an unsecured loan is risk rated less than a secured second mortgage. From a safety and soundness standpoint, this makes no logical sense.

Finally, the requirement of recognizing unrealized security gains and losses for available-for-sale securities in Tier 1 Common Equity has the potential to cause unnecessary volatility in our bank's capital account. The proposed change encourages held-for-sale accounting and investment in very short duration assets. Both of these encouraged practices limit our ability to manage the investment portfolio in a manner appropriate for earnings, liquidity and the management of interest rate risk. How can we engage in meaningful strategic planning when we don't know what our capital account is going to be? We won't know if we have capital for growth or if we should shrink the bank to increase capital because interest rates have increased and reduced the market value of our securities' portfolio.

In conclusion, the proposal as currently written will negatively impact our company by complicating our business, lowering our earnings through increased unproductive compliance costs, lowering our Tier 1 capital and restricting our ability to provide credit to the communities we serve. The proposal is ill-timed at this point in the economic recovery as it retards business activity and threatens to prolong the housing slump. I much prefer current FDIC Board member Thomas Hoenig's recommendation to replace the Basel III rules with a simplified tangible equity to tangible assets leverage ratio as a method to reduce the risk present in the financial system. In the absence of this, we request that TRUPS be grandfathered, OCI be excluded from regulatory capital and all other proposals allow for grandfathering existing loans by applying the new capital requirements prospectively.

Thank you for your consideration.

Sincerely,



David T. Turner  
Chairman, CEO, and President



BANK

October 12, 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 Corporation  
550 17<sup>th</sup> Street, N.W.  
Washington, DC 20429

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

Re: Basel III Capital Proposals

Thank you for the opportunity to comment on the proposed capital adequacy framework. As a former commissioned FDIC examiner for 5 years, I fully support the need for adequate capital. I also fully support the need for higher minimum capital levels than currently prescribed in regulation. While our goals are consistent, I view the Basel III framework as a highly counterproductive means to achieving the same end result – which is higher capital. Please give strong consideration to raising the capital standards in a much more simplified and understandable method. Just add 200 to 250 basis points to the tangible capital calculation and be done with it.

When overly concerned with the details, it is all too easy to lose sight of the big picture. Such is the case with the Basel III framework! Likely scenarios will occur where bank management and regulators focus on appropriately slotting Basel III inputs only to arrive at a risk based capital ratio of “x – with a footnote”. The “footnote” would reflect adjustments for “category 1” and “category 2” inputs which are not readily determinable.

I have worked for Hawthorn Bank (\$1.2 billion in total assets) for over 20 years and have seen our monthly loan loss reserve adequacy analysis greatly increase in granularity. Years ago, loan loss reserve adequacy was easily calculated by 1 employee in less than 4 hours. The majority of the 4 hours was used to analyze the historical loss ratio applied to “pass and watch list credits”. Loss ratios for “classified credits” were provided by regulators and industry standards. Today’s loan loss reserve methodology is much more granular as specific reserve calculations are performed for each “impaired” loan along with a robust migration analysis performed for the “non-impaired” loans. Today, approximately 220 employee hours are spent by Hawthorn Bank each quarter in determining loan loss reserve adequacy. The increased hours are due to accounting staff’s migration analysis, our chief credit officer’s impairment analysis for each impaired loan, and due to reviews by our chief risk officer, internal auditor (for compliance with the Sarbanes-Oxley Act), chief financial officer and lastly by our chairman.

Getting back to Basel III...for community banks such as Hawthorn Bank, credit risk is the greatest risk to our capital account. If regulators continue to exam banks by focusing on loan quality and loan loss reserve adequacy, then the complexity of Basel III is not necessary. With the complexity around the loan risk rating guidelines, unintended consequences will certainly transpire as innovative lending practices will give way to non-complex lending practices which require lower risk ratings.

With regards to investment security gains and losses, consideration should also be given to leaving the “line item” notation in the capital account without having the gains/losses flow through the capital adequacy calculation. While I fully support mark to market accounting, banks will likely transition to classifying investments as “held to maturity” to address the volatility around this accounting treatment. As each of you knows, community banks do not actively trade within the investment portfolio and it certainly appears appropriate to leave the “line item” notation in the capital account without having it flow into the risk based capital calculation.

Sincerely,

  
Kathleen L. Bruegenhemke  
Chief Risk Officer