Iowa
State
Savings
Bank
Member FDIC

October 17, 2012

The Honorable Martin J. Gruenberg, Acting Chairman
Members of the Board of Directors
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Ladies and Gentlemen:

I write to represent the interests of Iowa State Savings Bank, a $200 million bank headquartered in Creston, Iowa, and Iowa Community Bancorp, Inc., the one bank holding company that owns Iowa State Savings Bank, and share our deep concerns regarding Basel III risk-based capital standards recently approved by the Federal Reserve Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency. Thank you for the opportunity to comment on this proposal.

I have serious concerns that if implemented, Basel III, including the "Standardized Approach" to risk-based capital, will adversely affect our bank's ability to consistently maintain adequate regulatory risk-based capital while diversifying risk and meeting the convenience and needs of the communities we serve. If Basel III rules are implemented, I project we will of necessity discontinue certain here-to-fore important lines of business resulting in loss of credit availability for many customers and a reduction in our ability to help people accomplish their goals. Among other likely unintended adverse consequences, we might have to shrink in order to hold fewer investment securities so as to lessen risk-based capital volatility resulting from quarterly Basel III "flow through" adjustments to common equity tier 1 capital. This component alone will decrease bank liquidity and subject this and other banks to higher risk if liquidity were to become an issue at some particular moment in time.

I believe the Basel III standards will affect similar, community-based banks similarly and consequentially, such that these here-to-fore vital and locally significant participants in thousands of communities will become less able to contribute with needed lending services and in other tangible and intangible ways; and in a not-very-distant future, to remain independent businesses. With community banks subject to Basel III, if and as community banks' services are supplemented by GSEs, credit unions or other less effectively regulated entities, the benefits for communities provided by banking regulations will diminish as these banks become less essential parts of our communities. Alternatively, business formerly conducted by small, community-based banks will be done by behemoth financial institutions,

Main Bank | 401 West Adams Street • Creston, Iowa 50801 • 641-782-1000 • 888-508-0142 *(toll-free)* • 641-782-1084 *(fax)*
Express Banking Center | Corning | Diagonal | Highway 34 | Lenox

EQUAL HOUSING LENDER

Iowa State Savings Bank
Member FDIC

which have shown themselves more willing to bend rules and innovate around regulations, and less responsive to customers than local banks.

In addition to the Basel III capital standards themselves, the implementation schedule for the proposal is unreasonable and arbitrary. Consider that the proposal does not grandfather existing residential mortgages with regard to the Standardized Risk Weighting Approach, or grandfather existing investment securities with regard to “flowing through” securities gains and losses to common equity tier 1 capital. These will have capricious effect on balance sheets bankers have assembled and carefully managed through highly competitive and very difficult circumstances. In addition, the “flow through” provisions will have substantially disparate impact on “C” and “S” corporations.

Basel III appears reactionary to recent economic events rather than to comprise an approach considered in the context of the long history that underwrites pre-Basel capital rules. Basel III has not been shown through adequate study publically disclosed and considered to be beneficial or necessary to the industry, the economy or the nation. Such radical changes as included in the Basel III Capital Rules should have empirical support and be vetted through an open and thorough process before being imposed.

My experience in banking, bank examination and bank liquidations extends through several decades in more than one region of the United States and involves hundreds of community or regional banks. Even considering the many failed banks I helped close and liquidate, I found as an examiner and as a banker that locally-based, community banks are generally well-regulated and responsive to regulatory authority. Many of the concerns Basel III appears designed to address are now managed through risk management systems and the regulatory and supervisory processes. While higher levels of capital generally might be desirable, increasing the complexity of capital as Basel III would add disproportionate unproductive overhead burden to small, community-based banks. These costs will adversely affect these banks ability to compete with banks with national or international scale, with large and small, untaxed and less effectively regulated credit unions and with untaxed and less effectively regulated GSEs.

The overall goals of the 20-year old Basel process may be appropriate for internationally significant banks and for nationally significant banks. They are neither necessary nor appropriate for small, community-based, U. S. banks whose individual successes or failures are important locally but are otherwise inconsequential. The effective FDIC deposit insurance system and bank liquidation processes mean that Individual failures of small banks are consequential primarily to shareholders in these banks and to large depositors and some borrowers depending on successor institutions through Purchase and Assumption agreements. Even in the aggregate, as in the S&L and ag crises in the 1970’s and 1980’s, or the

Main Bank | 401 West Adams Street • Creston, Iowa 50801 • 641-782-1000 • 888-508-0142 *(toll-free)* • 641-782-1084 *(fax)*
Express Banking Center | Corning | Diagonal | Highway 34 | Lenox
EQUAL HOUSING LENDER

recent recession that began with a developed-world real estate bubble, the consequences for the international monetary system or the national economy of many small bank failures is nothing in comparison to what would happen if one of the super mega banks were to fail.

Strong capital is one component of healthy banks and a healthy banking system. However, asset quality, earnings, liquidity management, management of safe and secure systems, fair and clear operations with regard to lending and deposit-taking functions, constancy and continuity in delivery of products, presence and performance are also important for the health of banks and the banking system, and for the benefit of communities banks serve. If enacted, the Basel III proposals might strengthen risk-based capital but at great cost in disruption of business models. Other adverse consequences will follow from bank boards and management adjusting business models to assure they remain 'well-capitalized' through cyclical volatility contingencies as Basel III risk-based capital rules will be anticipated to cause temporary spikes and troughs in (especially) the denominators of the risk-based capital calculation. Implementation of Basel III capital calculation systems and processes and quarterly calculations thereafter will be costly and unproductive. Banks will reduce lending under Basel III with adverse consequences for the U.S. economy, tallied community by community.

The proposed Basel III rules in their entirety may be appropriate for large complex financial institutions competing in a global marketplace. They are not needed and potentially very harmful to the business practices of local bank and similar institutions across America. I join with thousands of other bankers, with the Conference of State Bank Supervisors and with many others who have studied the Basel III proposal who ask that the Basel III and Standardized Approach proposals be repealed with regard to community banks serving localized communities. My analysis of the impact of a few specific components of the proposals follows.

Under current law, most prudently underwritten residential mortgages are risk weighted at 50%. We hold about 10% of total assets in 5-year balloon mortgages, and an additional 4% in second mortgages. Under Basel III risk weighting of these existing assets (and the balances on non-balloon first mortgages) would at least treble. We make these loans on up-to-30-year amortizations, and write the balloons to protect the bank against rising interest rates. We offer this product as an alternative for customers who do not want annually variable rate products and also either want to keep their loan local or cannot qualify for secondary market loans. We have very low loss history with these loans. We also have a history of working with our customers who have financial difficulties to achieve better outcomes than foreclosures or other negative endings.

The proposed risk-based treatment of home equity and second lien loans will have a significant impact on our ability to continue in these lines of business. In addition,

Iowa
State
Savings
Bank
Member FDIC

because the rules would 'drag' first mortgage balances with seconds into higher risk weights in many instances, the proposed rules and implementation schedule will have an even larger impact. The exception where both mortgages could be placed into a category 1 mortgage is too narrow. If we determine that we can no longer offer home equity loans, many of our customers will be cut off from a significant source of credit – or be forced to find another lender.

The Basel III proposed rules for a "Qualified Residential Mortgage" (QRM) do not at all recognize private mortgage insurance (PMI) for purposes of reducing loan-to-value requirements, subjecting mortgages to higher risk weights even if PMI reduces the risk on these loans. This will significantly effect how we look at first time homebuyers in particular, as PMI has been one of the tools we have used to help this group of customers qualify for mortgages. As with balloon mortgages, through careful underwriting and responsive customer service, our loss experience with PMI loans has been minimal for a very long time.

Basel III's required continual asset-by-asset risk-based capital recalculation will be an enormous burden for our limited staff. We currently spend substantial time and effort in a quarterly Loan Loss Reserve assessment. Adjusting risk-based capital is unnecessary where reserve calculations and provisions are adequate by banks' historical performances.

Adjusting risk-based capital for delinquencies is similarly unnecessary and will have unintended adverse consequences. We have historically worked with borrowers with apparently transient problems that contribute to loan delinquencies. Our loss history supports that we have done this effectively. Customers we have worked with in this way often remain customers and have often been able to resurrect their personal, family or business operations completely in no small part due to the bank's forbearance. If such forbearance has immediate regulatory capital consequences of the amplitude proposed in Basel III, we may not be as able to accommodate at-risk individuals, families and businesses that in our considered and well-founded judgment, might otherwise, with forbearance, survive, recover and prosper. Moreover, we have experienced periods of time when economic conditions caused significantly higher rates of delinquency. In a few of these instances, we experienced higher loan losses which were offset by loan loss reserves. In other instances improved economic conditions enabled customers to recover and catch up delinquencies. The proposed drastic increase in risk-weighted capital for delinquent loans is essentially a double accounting risk already offset in the Loan Loss Reserve.

As we are already challenged by tough markets and changing regulations, we do not have the time to fully evaluate the full impact of this complex and massive proposal. The work would overwhelm already fully deployed and limited resources. Moreover, our assets are not coded in such a way as to enable a ready analysis of the particular impact on us of significant parts of the proposal.

Main Bank | 401 West Adams Street • Creston, Iowa 50801 • 641-782-1000 • 888-508-0142 *(toll-free)* • 641-782-1084 *(fax)*
Express Banking Center | Corning | Diagonal | Highway 34 | Lenox

I am sure that if Basel III is implemented, we will be challenged to understand how the rules apply, to make the required calculations and to adjust lending and other aspects of our now stable banking business to the new rules. Clearly implementation will require a lengthy and disruptive process involving substantial training and use of advisors, all at considerable expense. I can hardly contemplate the time, expertise and expense to be incurred through our core vendor for re-programing software, of our staff for coding assets and in officers' analysis. I know our community will not understand our withdrawal of products and tighter lending, and I am pretty sure people will not be as readily able to optimize their lives and business as a result.

In conclusion, I am not unlike thousands of bankers who have dedicated their careers and significant parts of their lives to building an organization that helps build their communities. Many bankers have similarly engaged their fortunes in this noble enterprise. Application of Basel III will radically alter the way community banks do business, and not in a good way. In my opinion, it will result in substantially fewer community banks in relatively short order and possibly eviscerate franchise value in short order.

One definition of a "dual banking system" contrasts the combination of large and very large banks doing business nationally and internationally, and large, U. S. banks doing business regionally with small banks that serve localized geographic markets. The different economies of scale attaining to each group, access to capital markets, complexity or simplicity of business plans and absolute size are so undeniably distinguishing that it is as if the entities are in different businesses. (They are.) The Basel III approach may be appropriate for large, multi-billion dollar, complex global, national or nationally important financial businesses. Their business models are beyond my experience and their importance for the U.S. and world economies vastly greater than that of this bank and all the banks like us. The overall goal of the Basel process is good: that the U.S. financial system is well capitalized and has enhanced ability to withstand adverse contingencies. It is not appropriate, necessary or helpful for community banks that stick to their markets, in my opinion. It is possibly destructive for these banks. I join with the entire community bank industry, the Conference of State Bank Supervisors and many other informed and knowledgeable experts and interested parties in urging the FDIC to repeal this proposal and support repeal through the FFIEC so community banks may continue serving our communities and strengthening local economies.

Sincerely yours,

Karl W. Knock, Chief Executive Officer
Iowa State Savings Bank
President
Iowa Community Bancorp, Inc.