



German American Bancorp®

*Strong Ties.
Strong Solutions.*

October 21, 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 proposals¹ 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. There are numerous components of the proposal regarding Basel III that will create significant issues for the community banking industry, including German American Bancorp.

Incorporating AOCI as Part of Regulatory Capital

Of particular concern to German American is the inclusion of accumulated other comprehensive income (AOCI) in capital for community banks which will result in increased volatility in regulatory capital levels under certain economic conditions. AOCI for most community banks, including German American, represents unrealized gains and losses on investment securities held available-for-sale. Because these securities are held at fair value, any gains or losses due to changes in interest rates are captured in the valuation. Recently, both short-term and long-term interest rates have fallen to historic lows generating unprecedented unrealized gains for most investment securities. Additionally, demand for many implicitly and explicitly government guaranteed securities has risen due to a flight to safety and government intervention in the capital markets. This increased demand has caused credit spreads to tighten further increasing bond valuations.

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.*

Interest rates have fallen to levels that are unsustainable long-term once an economic recovery accelerates. As interest rates rise, fair values will fall causing the balance of AOCI to decline and become negative. This decline will have a direct, immediate impact on common equity, tier 1, and total capital as the unrealized losses will reduce capital balances. At my bank, for instance, if interest rates increased by 300 basis points, my bank's bond portfolio market value would decline from today's market value gain of approximately \$20 million to a paper loss of nearly \$50 million, a variation of approximately \$70 million. This would mean that my bank's tier one ratio would drop by nearly 20%.

Large financial institutions have the ability to mitigate the risks of capital volatility by entering into qualifying hedge accounting relationships for financial accounting purposes with the use of interest rate derivatives like interest rate swap, option, and futures contracts. It's difficult for community banks, even the larger community banking institutions the size of German American, to have the knowledge or expertise on staff to engage in these transactions and manage their associated risks, costs, and barriers to entry.

Further, since community banks generally hold debt securities to maturity, any interim valuation changes are temporary in nature as all these securities will mature at par value. Therefore, community banks, like German American, should continue to exclude AOCI from capital measures as they are currently required to do today.

Capital Conservation Buffers

Implementation of the capital conservation buffers for community banks will be difficult to achieve under the proposal and therefore should not be implemented. Many community banks will need to build additional capital balances to meet the minimum capital requirements with the buffers in place. Community banks do not have ready access to capital that the larger banks have through the capital markets.

Even publicly-traded community banking organizations, like German American, that have limited access to the capital markets would likely find it very difficult to raise additional capital through the capital markets during difficult economic times. Further, the only way for non publicly-traded community banks to increase capital is through the accumulation of retained earnings over time. Due to the current ultra low interest rate environment, community bank profitability has diminished further hampering their ability to grow capital.

New Risk Weights

The proposed risk weight framework under Basel III is very complicated and will be an onerous regulatory burden that will penalize community banks and jeopardize the housing recovery. Increasing the risk weights for residential balloon loans, interest-only loans, and second liens will penalize community banks who offer these loan products to their customers and deprive customers of many financing options for residential property.

Second lien loans will either become more expensive for borrowers or disappear altogether as banks will choose not to allocate additional capital to these balance sheet exposures. Community banks should be allowed to stay with the current Basel I risk weight framework for

residential loans. Furthermore, community banks will be forced to make significant software upgrades and incur other operational costs to track mortgage loan-to-value ratios in order to determine the proper risk weight categories for mortgages.

Proposed Phase-out of Trust Preferred Securities

We object to the proposed ten year phase-out of the tier one treatment of instruments like trust preferred securities (TRUPS) because it is reliable source of capital for community banks that would be very difficult to replace. We believe it was the intent of the Collins amendment of the Dodd-Frank Act to permanently grandfather tier one treatment of TRUPS issued by bank holding companies between \$500 million and \$15 billion.

While we applaud the fact that TRUPS issued by bank holding companies under \$500 million would not be impacted by the proposal, consistent with the Collins Amendment, we urge the banking regulators to continue the current tier one treatment of TRUPS issued by those bank holding companies with consolidated assets between \$500 million and \$15 billion in assets.

Applicability of Basel III to Community Banks

Community banks operate on a relationship-based business model that is specifically designed to serve customers in their respective communities on a long-term basis. This model contributes to the success of community banks all over the United States through practical, common sense approaches to managing risk. The largest banks operate purely on transaction volume and pay little attention to the customer relationship. This difference in banking models demonstrates the need to place tougher capital standards exclusively on the largest banks to better manage the ability to absorb losses, but that same approach isn't needed for the community banking industry.

Basel III was designed to apply to the largest, internationally active, banks and not community banks. Community banks did not engage in the highly leveraged activities that severely depleted capital levels of the largest banks and created panic in the financial markets. Therefore, given the significant adverse impact on community banks from the Basel III proposals and the fundamental differences between community banks and the largest banking organizations, community banks should be allowed to continue using the current Basel I framework for computing their capital requirements.

Sincerely,



Mark A. Schroeder
Chairman & CEO
German American Bancorp