ILLINOIS BANKERS ASSOCIATION
Leading the way

October 11, 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 17th Street, N.W.
Washington, D.C. 20429

Mr. Thomas J. Curry
Comptroller
Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, D.C. 20219

Dear Mr. Curry, Ms. Johnson and Mr. Feldman:

We are writing on behalf of the Illinois Bankers Association (IBA) and our more than 600 Illinois banks and savings banks to respectfully express our strong objections to several elements of the proposed Basel III capital requirements. We have talked with hundreds of community bankers across Illinois who believe that the Basel III proposals would drastically harm their businesses and their ability to continue effectively serving their communities.

Bankers are telling us that these capital proposals would give them no choice but to make fewer residential mortgage loans, commercial real estate loans, and loans to higher risk industries, among other types of loans. And that the proposed higher capital levels, extreme risk-weighting of assets, complete elimination of Trust Preferred Securities (TruPS), and increased costs of compliance, all would cause investors to discount community bank stock immediately, notwithstanding the proposed phased-in effective dates. Inevitably, many Illinois community banks would have no choice but to sell off some of their best assets, and, for many, ultimately to sell their banks to larger institutions.

This would be devastating to many communities across Illinois, and it would stifle economic growth across our state. Access to credit would be reduced, there would be fewer financial institutions serving local communities and small businesses, and even local charitable organizations serving Illinois' communities and people of need would suffer as a consequence.

Accordingly, we respectfully request you to consider our following concerns:

The proposals are too inflexible to address an evolving economy. Because the proposals follow a rigid prescriptive approach, rather than a principle-based approach that recognizes the need for flexibility in

524 South Second Street • Suite 600 • Springfield, IL 62701 • 217-789-9340
194 East Delaware Place • Suite 500 • Chicago, IL 60611 • 312-347-3400

a continuously evolving economy, they would inadequately address emerging technologies, changing asset classes, new types of funding needs, and new products and services.

A one-size-fits-all approach won't work. Calculations of assets and capital should be adjusted according to an institution's size, complexity, and risk. These proposals apply the same capital standards to institutions of all sizes, which would result in too much capital for some and too little for others. The proposals also apply a one-size-fits-all approach to assets, giving similar classes of assets similar risk weightings without regard to the bank's underwriting standards, which, ironically, actually could encourage excessive risk-taking. If the proposals are going to take a "granular" approach to capital and asset calculations, they at least should take into consideration the different risks that different institutions present to the financial system.

Higher capital requirements would reduce credit availability. Even though banks and thrifts already have raised record levels of capital in the aftermath of the financial crisis, according to the Federal Reserve these proposals would require them to raise $60 billion more in new capital — which could lead to a $600 billion reduction in lending. On the ground, that means that a small community bank with assets of $100 million could see a net capital increase of 2%, which could decrease its lending by $20 million.

Residential lending would be hit particularly hard. New asset calculations for residential loans would increase the risk weighting for mortgage loans currently on the books of banks and thrifts, heightening the need for even more capital and decreasing liquidity. And the new calculations would be based on loan-to-value ratios, without taking into consideration other factors that historically have been taken into account to reduce the risks of specific loans (such as the existence of private mortgage insurance).

A perfect example of the unintended consequences of the proposed new standards for risk weighted assets is the doubling of the capital requirement for a 1 – 4 family real estate loan with a balloon feature from 50% to 100%. Today, the vast majority of community banks real estate loans are written with a balloon feature to mitigate interest rate risk without any adverse effect on the bank or its customers. Arbitrarily doubling the capital requirement for this type of loan would be devastating for many community banks, as well as for their customers, many of whom might not otherwise qualify for conforming mortgages. These proposals continue a trend of over-regulation that is more than just a perception; it is pushing a growing number of banks out of residential lending altogether.

The proposals' mark-to-market approach is misguided. Including unrealized gains and losses on Available-for-Sale (AFS) securities in Tier 1 capital (the "mark-to-market" approach) is a fundamentally flawed way to measure capital. Capital calculations simply should not be based on a theoretical liquidation of a bank's entire balance sheet. Doing so would introduce massive volatility into the banking system, particularly in an environment of rising interest rates. Many banks would be forced to raise capital well above the levels required by Basel III as a buffer against fluctuations in value. Rather than requiring marking-to-market, the rules should call for reasonable capital buffers under a "going concern" approach on a consistent basis across all classes of investments.

Phasing out TruPS would hurt community banks. The Basel III proposals would permanently phase out the use of TruPS for *all* banks, even though the Collins amendment to the Dodd-Frank Act permits banks under $500 million in assets to continue issuing and holding these instruments in their capital (as well as grandfathering existing TruPS for organizations between $500 and $15 billion in size). Removing this vital source of capital would hurt smaller community banks especially hard, many of which have few other options for raising capital. If TruPS are removed from their capital calculations, these banks would be forced to sell off substantial assets and further reduce their lending.

The proposals would make banks unattractive to investors. Increased capital requirements would decrease investors' returns at the very time when financial institutions would need to attract more investment capital. Meanwhile, the complexity of the proposed rules would make it difficult, and expensive, for investors and others to understand and evaluate a bank's capital condition. There would be other new and unduly expensive costs as well, particularly in relation to the requirements for banks to collect and report more information on a more frequent basis for each and every loan on their books, ranging from underwriting features to loan-to-value ratios to other due diligence matters.

The proposals would make Sub S banks especially unattractive to investors. An important point to note is that Illinois is home to over 200 Subchapter S Corporations. If a Sub S bank's capital was to drop below any one of the three proposed ratios, that bank would be prohibited from distributing any dividends. But even if no dividends were to be distributed, the bank's income still would be considered to have been passed through to the shareholders based on the number of shares each of them owns. These amounts would be subject to the shareholders' individual tax rates; meanwhile, no dividends actually would have been distributed to offset these tax obligations. This outcome raises the added question of whether anyone would want to be an investor in any of Illinois' 200-plus Sub S banks if the proposed rules are adopted.

The proposals would force many community banks out of the industry. As discussed above, many smaller banks would be unable to raise new capital under Basel III and would shed otherwise desirable assets instead. Even many larger banks would likely need to sell valuable assets. However, only so many assets can be sold. Inevitably, the proposals would lead to accelerated consolidation of the banking industry, possibly even leading to more perilously large, too-big-to-fail institutions.

Nonbanks would fill the void. By reducing access to credit through the traditional banking system, the proposals would breathe new life into the "shadow banking" system, which was the principal cause of the recent financial crisis. Many borrowers with unfulfilled credit needs would be forced to deal with more lightly-regulated nonbanks, encouraging the growth of these outliers in the financial industry sector.

Thank you for this opportunity to comment on the proposals. The IBA shares your desire to strengthen our financial system and avert another financial crisis. But the proposed rules go far beyond the original intent of the Basel III accords, and we respectfully urge you to carefully reconsider the unintended consequences of these proposals on our state's community banking system and on our communities.

Respectfully Submitted,

Marty L. Davis
President and CEO
Murphy-Wall State Bank and Trust Company
Chairman
Illinois Bankers Association

Linda Koch
President and CEO
Illinois Bankers Association

The Illinois Bankers Association is a full-service trade association dedicated to creating a positive business climate that benefits the entire banking industry and the communities they serve. Founded in 1891, the IBA brings together state and national banks, savings banks, and savings and loan associations of all sizes in Illinois. Over 20% of IBA members are community banks with less than $50 million in assets, and over 80% of IBA members are community banks with less than $500 million in assets. Collectively, the IBA represents nearly 90% of the assets of the Illinois banking industry, which employs more than 100,000 men and women in over 5,000 offices across the state.