HOME FEDERAL BANK

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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

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:

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

I am in agreement on the recommendations to increase the capital requirements for banks in our country to ensure that the banking industry can weather any storms that will come our way in the future. Home Federal Bank has made a concerted effort to increase our capital ratios, which were already well above minimum guidelines, long before your recommendations were released. However, I do have concerns about the some of the proposals which have been approved by the agencies and placed out for comment.

Home Federal Bank was formed in 1920 in Middlesboro, Kentucky; since then we have expanded with branches into four other cities: Harlan, KY; New Tazewell, TN; Jacksboro, TN, and Harrogate, TN. We currently have just under $350 million in assets, and employ 95 people at all our locations. We are also publicly traded (Ticker: HFBA); although a thinly traded stock, most of our stockholders are our customers within our service areas. Our region grew substantially during the coal boom, and has suffered economically since this time; and especially since the recession began in 2008. Yet, Home Federal will lend out over $50 million in residential and commercial mortgages in 2012. We feel our industry plays a vital role in the Economic Recovery of America.

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 of our communities that produce most of the jobs. A strong economy is also dependent on growth in the housing sector, and growth in the housing sector is dependent on the availability of capital to provide financing. Our concern is, among other things, that the proposed new rules will 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:

I. Disproportionate impact on Community Banks

Community Banks had little to nothing to do with the recent economic crisis largely created by the misuse of sub-prime and Alt-A residential loans made primarily outside the banking system and securitized by large investment banks and lenders. According to the American Bankers Association (ABA) 94% of these loans were made outside the banking system. Further, the Community Bank model is far different than the larger and systemically important banks, and large foreign banks. Generally, Community Banks are far more familiar with their customers and the risks associated with lending to their local communities.

The scope and granularity of the proposed rules will require the collection and reporting of new information in order to calculate risk weights of individual loans for our institution. We likely will need to acquire new software and install new systems in order to comply with the very complex calculations. As an alternative, we may outsource the project to a third party. Either way, the proposed rules will cause our institution to incur new costs under this regulatory burden. I believe this area is already appropriately managed through the ALLL analysis; even if new proposals were needed regarding the ALLL analysis process, this would be a much more cost effective solution than that of the risk weighting as proposed.

The larger banks have the economies of scale, and infrastructure already in place to adapt to the increased costs of complying with the new regulatory burdens; whereas the Community Bank is already struggling with increased overhead from an already heavy regulatory burden. Community Banks had little, if anything, to do with the reason the problem the proposals are trying to correct, yet Community Banks represent over 98% of all the Banking entities in the United States. Thus, our Country's Community Banks will bear much of the burden of the proposals if implemented, representing much larger percentage of their income than that of the larger banks. I fear these guidelines will make it economically impractical for many Community Banks to continue operating; costing jobs, economic stability, and capital investment in the Communities which need it most.

II. 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 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 exactly opposite of what the intention to define Capital has always been. One way our bank can attempt to offset the effect this would have on capital in a rising rate environment will be to start placing investments in a "Held to Maturity" category. However, this will have a counterintuitive effect on our ability to properly manage Interest Rate Risk; again, just the opposite of what we have been encouraged to do by Regulatory Banking Agencies.

Our bank and others could be forced to reduce the size of our balance sheets (i.e. loans) 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 – at a time where growth in this area is vital to continue any recovery. Our small business customers and consumer customers will be impacted by the reduced availability of credit under this scenario.

III. Increased risk weighting for residential mortgage loans

Our bank provides a significant number of mortgages to people living in the five markets we serve. We are one of the largest community bank providers of mortgages in these markets. This proposal along with some of the proposals being considered by the Consumer Financial Protection Bureau threaten to significantly reduce the number of loans many banks can provide in this very important business segment.

Home Federal Bank has prided ourselves with conservative lending principals; our delinquencies and charge-offs are historically below that of our local and national peers. Our underwriting has been very strong as opposed to many of the non-bank mortgage lenders who were largely to blame for the housing crisis. This area is a perfect example of how Community Banks will be adversely affected by a remediation for a problem few of them ever had. Further, the new capital proposals relative to the risk weighting of residential mortgages are higher in many cases than other loan types that would be considered much riskier in our experience.

In addition to the effect on Community Banks' ability to lend, the change from assigning "risk weightings to asset classes" to assigning "risk weightings to individual loans" will create an administrative nightmare. We will have to add additional staff just to assign and maintain risk weightings on the classes of loans that are identified in the proposal. You will not be able to just assign a risk weighting when you book the loan, you will have to continually re-evaluate the risk weightings based on changes in collateral values, past due status and other risk factors. Further, I question the ability to truly examine a bank's performance in properly assigning risk weightings under this rule due to the amount of people and time it will take to review the data.

IV. Change in risk weighting for home equity and second lien loans

We presently hold about $30 million in second lien loans to customers in our markets. We have fewer delinquencies and practically no charge-offs at all in this category. Under the proposal, these loans would have a greater risk-weighting than some commercial loans; which is just simply not realistic. The additional risk weights represent unnecessary and redundant sources of capital allocation that will drive up the cost of credit to the consumer and restrict the availability of consumer credit. In essence, it will incent many Community Banks to significantly scale back on this type of lending, and participate in other types of lending that has proven to have more risk – yet have a lower risk weight under the proposals. This, again, only harms the consumer needlessly by restricting access to credit, and driving up the cost of credit that is available.

V. Proposal to increase risk weights on delinquent loans

We are fortunate to not have enough delinquencies at this time that would cause this rule to affect us significantly; for any Community Bank, that could change based on economic conditions. My concern with this rule is that we already set aside reserves for loans that fall into a past due status of this severity. By also increasing the amount of capital we hold based on the past due status, we are being required to set aside capital *twice* for each delinquent loan.

I feel that the risk related to problem loans should continue to be managed through the loan loss reserve guidance and not by adding an additional capital requirement. The impact on our bank to this rule will be to increase our aggressiveness in moving loans that become 90 days past due off the balance sheet. It will reduce our willingness to work as long with a borrower to remediate issues.

VI. New rules regarding "High Volatility Commercial Real Estate Loans"

Home Federal Bank generally does not consider the types of loans that fall in this category, therefore it would have little effect on us. My concern is similar to that expressed already in this letter. The burden of risk-weighting every loan, and throughout the life of the loan seems to be an arduous task that will be tremendously difficult to manage, yet alone regulate. Further, it appears the risk of these types of loans are better assessed in the ALLL analysis instead of both a risk-weight, and ALLL. Double punitive impacts on capital will result in these types of loans, which are more profitable in nature, going to the larger banks instead; in the past several Community Banks could have participated in the loan, diversifying the risk. The end result will simply be an indirect punishment on the Community Banks that are generally already better at assessing risk in these types of loans than the larger banks.

In conclusion, the results of the proposed Basel III rules may be needed for very large and foreign institutions that have historically been allowed to operate with less capital than community banks. It is widely recognized that the impact for most community banks as a result of Basel III, if implemented, will likely be minimal. However, what isn't considered will be the added cost of the rigorous and expensive exercise of the analysis and calculation required to identify, monitor, and document a banks portfolio of loans on an ongoing basis according to the standards proposed. At the time I write this letter, I can only estimate the impact on my institution 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, re-program our core processing software to handle the new coding requirements and then create the necessary reports to analyze the data. We will more than likely be required to hire a consultant to help us work through the front end of the process to assure we have accurate data and ensure we are coding the loans properly.

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 I've discussed above will have a severe impact on most community banks in our country. I again appreciate the opportunity to comment on the proposal; however urge you to consider the impact and consider a possible exemption for Community Banks from the bulk of these rules. Our nations Community Banks need to be able to continue serving our communities and helping strengthen our local economies.

Thank you for your consideration,

D. Alex Cook

D. Alex Cook,
President / CEO

cc: Senator Rand Paul
Senator Mitch McConnell
Senator Bob Corker
Senator Lamar Alexander
Congressman Harold Rogers
Congressman Charles Fleischmann
Congressman Scott DesJarlais