HORIZON BANCORP

October 17, 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 Corp.
550 17th Street, N.W.
Washington, D.C. 20429

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, D.C. 20219

Re: Basel III Capital Proposals

Ladies and Gentlemen:

I am writing to request that you reconsider 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.

Horizon Bank N.A. (Horizon) is a $1.8 billion community bank located in Michigan City, Indiana. Next year Horizon will be celebrating its 140th year in service to our local communities and we've reported record earnings for the past twelve consecutive years. In addition, Horizon has not lowered its quarterly dividend to shareholders in over twenty-five years. Horizon is a well-run and community focused bank.

The Basel III capital proposals will have a significant impact on the financial services Horizon offers to the communities we serve and will reduce the availability of credit. In addition, the proposed rules will add considerable costs to community banks as they increase staff and systems capability to account for all the required nuances of the proposed rules. This added burden along with the degree of complexity associated with the proposed capital rules will discourage new capital from entering the banking industry and destroy the economics of the United States community banking model.

In general, I support higher capital levels that will strengthen the United States banking system and hopefully minimize future bank failures. However, I am opposed to the proposed capital rules that are complex, create volatility and are costly to implement.

In this letter I will discuss in greater detail the availability of capital to community banks; how the elimination of trust preferred securities harms the industry; how the proposed capital treatment of comprehensive income / loss realized from the unrealized gains and losses on investment securities will create volatility and uncertainty in the markets; and how the proposed rules may create unintended consequences. In addition, at the end of my letter you will find several recommendations.

Availability of Capital:
In the joint statement of FAQs issued by the regulators a stated objective for the proposed capital rules is to improve the quality and quantity of capital. Neither one of these objectives will be met based on the assumption that the United States continues to operate efficient capital markets.

The capital supply and demand curve for community banks is working against the industry. As regulations eliminate available sources of capital for community banks, they are simultaneously increasing the need or demand for capital. A well informed market will price into the bank equity markets the elimination of TRUPs, the additional required capital buffer, the increase risk of reducing dividends and the risk associated with the volatile swings in capital due to the unrealized gains or losses from the securities portfolio.

The markets punitive nature to adverse information was exhibited over the past three years as banks were strongly encouraged to redeem TARP CCP preferred shares. Banks that raised capital to redeem TARP CPP incurred discounts to current book value on new issues. Banks that were unable to redeem the TARP CPP preferred shares suffered substantial reductions in market value. The reduction in capital alternatives and increased demand for capital will only increase the cost of capital to community banks. If you believe that capital flows to where it gets the best return for the associated risk, then the higher cost of capital and lower returns will reduce the availability of capital to community banks.

In addition to the limited capital alternatives, the large too big to fail banks operating under Basel II capital rules, have substantially reduced the availability of credit to community banks. This is evident in the reduction in fed fund lines of credit, holding company short term debt and capital loans provided by large banks to community banks. The big banks are vacating this lending space. Over the last five years Horizon has experienced or witnessed all of the above. Considering Horizon's exemplary and strong financial performance over this time period, I cannot imagine what was happening to the poor performing banks. This reduction in the availability of credit to community banks is forcing community banks to turn to the investment community, who is leveraging this opportunity to their benefit by offering to raise equity at substantial discounts to current price or issue debt securities at usurious interest rates. This higher cost of capital is happening at a time when there is excess liquidity or available cash to invest, which in theory should lower the cost of capital. This is just another example why the capital supply and demand curve is working against community banks.

Trust Preferred Securities ("TRUPs"):
The proposed phase out of TRUPs will further exasperate the capital supply and demand curve for community banks. TRUPs were a viable capital alternative to community banks and provided protection to the FDIC insurance fund. I have witnessed firsthand bank failures in the Midwest whereby the TRUP security holders lost everything to the benefit of the FDIC fund. I have also witnessed where current distressed Midwest community banks

have increased their probability of survival through the use of TRUPs. To say it another way, without TRUPs the number of bank failures today would be much higher. TRUPs have strengthened the community banking industry and provided protection to the FDIC fund.

Yes some banks used TRUPs to their fullest advantage to leverage their balance sheets and to place undue burdens on their holding company's cash flow requirements. However, the TRUP design did provide for interest deferral payments for up to five years, which did reduce risk and provide time for the troubled banks to find solutions to their problems. Regulators can deal with excess leverage simply by raising minimum capital levels; reducing eligible TRUPs as a percent of total capital that would qualify as tier 1 capital, and to require higher cash flow requirements at the holding company prior to obtaining regulatory approval to issue TRUPs.

It was disappointing that regulators took it upon themselves to override the intent of the Dodd Frank Act to grandfather current TRUPs. This change alone sent a shock wave through the community banking industry and created uncertainty in the investment community. Until the banking rules stabilize, it makes it extremely difficult to manage the complex operations of a community bank and the investment community cannot predict the stability of bank earnings, returns on investment or even determine if banks will require more capital. Uncertainty does not incent capital to return to the banking sector.

Unrealized Gains and Losses in the Investment Portfolio:
This proposal creates the most volatility to a community bank's capital levels and thereby lowers overall confidence in the banking system. To partially mark a community bank's balance sheet misrepresents the true economic value of a good performing bank by failing to take into consideration how management hedges or arbitrages its net interest income stream in its entirety.

In a 300 basis point simultaneous increase in interest rates Horizon would incur a sizeable swing in its valuation to its current investment portfolio, while at the same time our asset liability model reflects an increase in earnings. Given the historic lows in interest rates, a 300 basis point increase in interest rates has a high probability of occurrence. How would I as Horizon's Chief Executive Officer explain to the general public, investors, specifically fixed income investors (primarily retirees), that Horizon may have to cut its dividends, even though earnings improved?

Some possible unintended consequences for this provision are that banks may elect to hold a higher percentage of their investment portfolios in the held to maturity account; reduce the size of their investment portfolio thereby increasing liquidity risk; purchase fewer local or small issue tax exempt securities issued by rural America to shorten the duration in their investment portfolios; lower demand for municipal securities will increase the cost to small towns throughout America; and lower net interest income due to shorter maturities and an increase demand on shorter maturities that will drive yields down. Lowering the capacity to generate earnings does not appeal to investors and does not help to build capital.

Automatic Elimination or Reduction in Dividends and Incentive Compensation: This proposed rule lowers investor confidence by decreasing the reliability of their dividend stream. In the example mentioned above, Horizon could report an increase in earnings under GAAP, however may be required to eliminate or reduce its dividend and incentive compensation programs due to the proposed new capital standard. This would discourage investment and makes it very difficult to retain and attract good talent to the industry.

An automatic elimination of dividends and bonuses removes the ability of the board of directors to represent their shareholders and to retain key executives at a time when they are most needed. In addition, this unilateral standard does not take into consideration cash reserves maintained by banks to cover future uncertainty.

What's even more surprising is that the elimination of dividends and bonuses may occur even if the bank is above the new "well" capitalized standards and proposed capital buffer. This appears to be overreaching and once again confusing to investors.

Summary of Recommendations:

1. **Keep it simple** by simply increasing the current minimum capital levels and using the current calculation standards.

2. **Encourage and support investment in the community banking industry** by providing more capital alternatives, such as the limited use of TRUPs and minimizing regulatory surprises. Be consistent and deliberate in the administration of current rules and regulations.

3. **Eliminate the complexity** in the proposed rules, by eliminating the capital buffer; the 50 basis point phase-in penalty for elimination of dividends and bonuses; the risk weighting by loan type and loan to value ratios; an increase in the deduction for mortgage servicing rights and the volatile adjustment to capital through the recognition of unrealized gains and losses in the securities portfolio.

4. **Encourage an expansion in the allowance for loan & lease loss ("ALLL") Reserve:** The regulators need to work with the accounting standards board to encourage banks to build reserves during the good times and to establish and maintain robust ALLL analysis programs. The importance of a stable banking system far outweighs the expansion of complex accounting theory.

5. **Encourage and support regulators to use their current authority and powers** to eliminate dividends or require higher capital levels based on their on-going bank examinations and the risk profile of individual banks.

6. **Do not adopt a one size fits all approach for capital rules**. Community banks are not the same. They have different risk profiles, balance sheet structures and management experience. The Basel II accord realized the importance of this concept when it allowed the big banks to adopt their own robust capital allocation models.

7. **<u>Do not allow the unrealized gains and losses in the investment portfolio to affect the capital calculations</u>** until such time that banks are required to mark to market their entire balance sheets to reflect total economic value of the enterprise.

Thank you for the opportunity to present my thoughts and recommendations and we look forward to a bright and stable community banking industry.

Sincerely,

Craig M. Dwight

Craig M. Dwight
Chief Executive Officer