HEARTLAND BANK
CORPORATE OFFICE

October 16, 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 proposals[1] 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.

Community banks should be allowed to continue using the current Basel I framework for computing their capital requirements. 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. Community banks, such as Heartland Bank, operate on a relationship-based business model that is specifically designed to serve customers within their respective communities on a long-term basis. This model contributes to the success of community banks 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.

[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.*

Inclusion of accumulated other comprehensive income (AOCI) in capital for Heartland Bank and other community banks will result in immense volatility of regulatory capital balances and could quickly diminish capital levels under certain economic conditions. AOCI for most community banks represents unrealized gains and losses on investment securities classified as available-for-sale. Community banks generally have lower loan to asset ratios than larger institutions and rely on investment securities for yield, credit quality, and liquidity. Because these securities are held at fair value, any gains or losses due to changes in interest rates are captured in the valuation and included in AOCI.

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, causing credit spreads to tighten and bond valuations increase. The current low levels of interest rates are unsustainable long-term once an economic recovery accelerates and, 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 Heartland Bank, for instance, if interest rates increased by 300 basis points, the bond portfolio would show a paper loss of $11 million, causing our tier one ratio to drop by 15%. This is an unrealistic distortion of the impact of rate changes to the bank's equity. For community banks not participating in fair value accounting, AOCI does not include unrealized gains and losses of loans and deposits, which are designed to mitigate the impact of interest rate changes on capital levels. Community banks should continue to exclude AOCI from capital measures as they are currently required to do today.

Community banks, such as Heartland Bank, have not engaged in the high risk lending activities that caused failures at large banks, and created panic in the financial markets. The proposed risk weight framework under Basel III is too complicated and will be an onerous regulatory burden that will be costly and time consuming for Heartland Bank and other community banks. In order to determine the proper risk weight categories for mortgages, community banks will be forced to make significant software upgrades and incur other operational costs to track additional information, such as: mortgage loan-to-value ratios, well-underwritten vs. not well-underwritten, junior liens without the first lien position, balloon loans, and interest only loans. 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. Additionally, higher risk weights for balloon loans will further penalize community banks for mitigating interest rate risk in their asset-liability management. Community banks will be forced to originate only 15 or 30 year mortgages with durations that will make their balance sheets more sensitive to changes in long-term interest rates. Many community banks will choose to exit the residential loan market entirely or originate only those loans that can be sold to a GSE. Second liens will become more expensive for borrowers, or potentially disappear as banks choose not to allocate additional capital to these balance sheet exposures. As is clearly defined above, the new capital standards would hurt consumer mortgage lending.

Heartland Bank does not currently own mortgage servicing assets, but we are exploring this line of business. Penalizing mortgage servicing assets under the proposal is unreasonable and could cause community banks to cease these activities, and preclude community banks from entering into mortgage servicing activities in the future. Any mortgage servicing rights should be allowed to continue to follow the current risk weight and deduction methodologies.

Thank you, again for the opportunity to comment on the Basel III proposals, which if enacted will have a significant negative impact on Heartland Bank customers and the community banking industry. I appreciate your consideration of my comments, in the final legislation.

Sincerely,

G. Scott McComb
Chairman, President & CEO
Heartland Bank