October 22, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
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Delivered via email: regs.comments@federalreserve.gov

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
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Office of the Comptroller of the Currency
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Re: Basel III Capital Proposals
Basel III OCC Docket ID OCC-2012-0008, 0009, and 0010
Basel III Docket No. R-1442 Federal Reserve Board
Basel III FDIC RIN 3064-AD95, RIN 3064-AD96, and RIN 3064-D97

Ladies and Gentlemen:

Thank you for 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.

Home State Bank/National Association is a $600 million commercial bank conducting business in our community of Crystal Lake, Illinois for 97 years, approximately 45 miles northwest of Chicago. We are a community bank that cares deeply about our customers and our 185 associates. The Bank has six offices all located within McHenry County. We are a major provider of small business loans and offer a variety of mortgage products to our community. Our bank presently has more than 10.5 percent tier 1 capital, risk-based capital of more than 15 percent, with a loan loss reserves over 2 percent of total loans. Our intentions are to hold capital well above the minimum required levels even as loan demand recovers. I am comfortable with the proposed increases in minimum capital requirements. However, several areas of the proposed Basel III rulemaking are troubling, and I believe unworkable, especially for community banks.

To begin, in general the capital requirement of Basel III, while they may be appropriate for very large domestic and foreign banks, are not appropriate for banks commonly referred to as "community banks". Community banks had little to do with the recent economic debacle. According to the American Bankers Association, approximately 94% of the sub-prime and Alt A residential loans that were originated and securitized by large investment banks, were made outside the banking system. The community bank model is fundamentally different than the larger and systemically too big to fail important banks and foreign banks. Community banks are not leveraged with material off balance sheet liabilities. Generally, community banks are far more familiar with understanding their customers and their businesses and the risks associated with the local community.

Mark to Market

Home State Bank, like many community banks, has a very conservative investment philosophy. Our security portfolio totals approximately $91.1 million, primarily consists of agency bonds, GSE mortgage backed securities, GSE collateral mortgage obligations and municipal bonds. These investments have little risk of loss but are subject to interest rate fluctuations which we closely monitor. At this time of historically low rates, we have a positive market value adjustment in our portfolio. However, when interest rates rise, as they will, under the current proposal, it would create negative capital adjustment. Our current portfolio in a mark to market rate shock scenario of up +200 or +300 bps would decrease from a positive $2.1 million market value to a negative $3.9 million. Banks would be left with little choice – either hold assets as "held to maturity" (which would impact liquidity) or shorten duration which would impact earnings. Either case would negatively impact the bank's ability to manage the investment portfolio in a manner appropriate for liquidity, earnings and Interest Rate Risk.

I strongly advocate that unrealized gains and losses that result from changes in market value should not be included in AOCI, and therefore capital. This approach would eliminate from regulatory capital unrealized gains and losses resulting from such low-risk securities as U.S. government and agency debt obligations and U.S. GSE debt obligations.

Risk Based Assets

I am concerned that the punitive risk weights on home equity loans, junior liens and residential mortgages is unnecessary, and already covered without the need of additional regulation. The buffer is not necessary in that the Allowance for Loan and Lease Losses includes risk analysis of all risk factors including the value of homes, the impact of credit scores, delinquencies, and local market conditions. The additional risk weights are unnecessary and redundant sources of capital allocation that will increase the cost of credit to the consumer and restrict the availability of consumer credit. The effects of Basel III on community banks will drive higher capital levels, which are already at historical high levels, and will reduce return on capital. Raising capital at the community bank level will be more difficult if not impossible

Deduction of Mortgage Servicing Assets

Lastly, there is also concern regarding the requirement that institutions deduct all mortgage servicing assets net of deferred tax liabilities that exceed 10% of its common equity Tier 1. In addition, the amount under the 10% threshold will receive a 100% risk weight, and eventually 250% beginning 2018. Community banks retain loan servicing so the customer can work with the local bank that originated the loan rather than the third party that owns the loan. These changes could severely impact some community banks, perhaps even lowering their capital levels below a "well capitalized" status. Some banks may choose to exit the mortgage servicing business impacting long standing customer relationships and reducing fee income. This has a negative impact on both the bank's customers and the local community. I would advocate that there be no deduction from capital for mortgage servicing rights. At a minimum, existing mortgage servicing assets should be grandfathered. It is fundamentally unfair to penalize banks with long standing mortgage servicing assets because of a change in position of the Basel committee.

The proposed Basel III rules are possibly needed for large and complex institutions that have historically been allowed to operate with less capital than community banks. I believe that the cumulative effect of each of the items above will have a detrimental impact on most of the community banks in this country. I strongly urge you to consider this impact and provide for an exemption for most of the country's community banks from the Basel III proposed rulemaking. Our nation's community banks need to be able to continue serving our community, and to strengthen our local economies.

Thank you for your consideration.

Very truly yours,

Steven L. Slack

Steven L. Slack
President and CEO

cc: Senator Richard J. Durbin
Senator Mark Kirk
Representative Donald A. Manzullo