Believing in the American Spirit

HERITAGE BANK
OF CENTRAL ILLINOIS

October 22, 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.

Heritage Bank of Central Illinois is a six-branch bank in Peoria, Illinois and nearby communities and has 92 employees. Like many community banks, we invest in and are very active in our community.

Applicability of Basel III to Community Banks

We understand the regulators' desire to increase the capital requirements over the levels that currently exist under Basel I, and we do not necessarily disagree with that goal. However, for community banks, we feel that a less onerous approach could be found to achieve that objective than is found in Basel III. Basel III was designed to address increasing risks with the largest banks and is now undeservedly being proposed to be applied to community banks. Our bank, and other community banks, did not engage in the highly leveraged activities that severely depleted the capital levels of the largest banks and created panic in the financial markets. We operate on a relationship-based business model that is specifically designed to serve customers in

[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.*

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our community on a long-term basis. This model provides a practical, common sense approach to managing risk. The difference in banking models demonstrates the need to place tougher capital standards exclusively on the largest banks and not on community banks. This proposal, added to other increasing regulatory burdens, will limit the resources that we can use to lend and reinvest in our community. This threatens not only community banks but also the communities that they support.

Incorporating AOCI as Part of Regulatory Capital

Inclusion of accumulated other comprehensive income (AOCI) in capital for our bank and other community banks will result in increased volatility in regulatory capital balances and could rapidly deplete capital levels under certain economic conditions. AOCI for our bank represents unrealized gains and losses on investment securities held available-for-sale. Because these securities are held at fair value, any gains or losses due to changes in interest rates are captured in the valuation. 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. This increased demand has caused credit spreads to tighten further increasing bond valuations. Interest rates have fallen to levels that are unsustainable long-term once an economic recovery accelerates. 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, even though it would be our continuing intention to not realize losses on these securities as we would hold them to maturity. *At our bank, for instance, if interest rates increased by 300 basis points, our bond portfolio would show a paper decline in market value of $2.3 million. This would mean that our bank's tier one ratio would drop by .26%. This volatility in capital stock ratios would be confusing and misleading to our Board members and to our local shareholders. Community banks should continue to exclude AOCI from capital measures as they are currently required to do today.*

Capital Conservation Buffers

Implementation of the capital conservation buffers for community banks will be difficult to achieve under the proposal and therefore should not be implemented. While we are working on increasing our risk management practices and stress testing, it will be an onerous regulatory burden for our bank and other community banks to quantify these calculations to justify adequate buffers.

Also, our growth is limited by our capital ratios. We do not have ready access to capital that the larger banks have through the capital markets. The only way for our bank and other community banks to increase capital is through the accumulation of retained earnings over time. Due to the current ultra low interest rate environment, our profitability has diminished further hampering our ability to grow capital. If the regulators are unwilling to exempt community banks from the capital conservation buffers, additional time should be allotted in order for those banks that need the additional capital to retain and accumulate earnings accordingly.

New Risk Weights

The proposed risk weight framework under Basel III is too complicated and will be an onerous regulatory burden that will penalize community banks and jeopardize the housing recovery.

Increasing the risk weights for residential balloon loans, interest-only loans, and second liens will force us to charge higher rates and/or scale back our residential lending. Balloon loans are utilized by thousands of community banks to mitigate interest rate risk for home loans that do not qualify for secondary market financing. For example, in rural areas, many properties do not qualify for conventional mortgage programs as a result of having too many acres or too many outbuildings. Also, since the secondary market does not accept co-signers as a credit enhancement as we are able to, we sometimes make and park these types of loans in our portfolio to give the primary borrowers time to remedy whatever nonconforming issues are preventing their use of conventional financing. As a result, in situations like these, a balloon loan is the only option these borrowers have available. It is also noteworthy that the default rate on these types of loans held by our bank has been no higher than the default rate on conventional loans.

Regarding Home Equity Lines of Credit (HELOC's) and Second Mortgages, most community banks have issued these types of loans sparingly to deserving customers. Again, our default rate on these types of loans has been very low. We also believe that when interest rates start to rise, the demand for HELOC's and Second Mortgages will rise, as people who have a need to do home improvements will not want to refinance their low-rate first mortgage to do it.

Additionally, adding a risk weight to lines of credit will force us to charge higher fees and scale back our underwriting of these facilities for our commercial customers, which will be detrimental to their operations and/or expansion efforts.

Community banks should be allowed to stay with the current Basel I risk weight framework for residential loans and for lines of credit.

The proposed regulations will require us to invest significant time and resources in tracking mortgage loan-to-value (LTV) ratios in order to determine their proper risk weight categories. It is our understanding that even though a loan's LTV drops as the loan pays down, it will remain, for risk-weighting purposes, in the original LTV category. This makes no sense. As a loan's LTV drops, its risk of default also drops – history has proven that.

Conclusion

Community banks did not create the problems that led up to the housing crisis that has unfolded over the last five years. If Basel III is approved as proposed, however, community banks will pay a heavy price for the missteps of others. Community banks are already being crushed by the weight of more and more governmental regulation as we are constantly forced to add resources to expand our compliance programs and upgrade our audit programs. The more resources we have to commit to complying with existing regulations and interpreting and implementing new regulations, the less we have available to serve our customers. Please consider exempting community banks from Basel III and crafting an simpler alternative that is appropriate to our business model and acknowledges that we are comprised of different risks and that we provide support and stability to the communities that we serve.

Thank you for considering our input. If you have any questions for us, or if there is any further information that we can provide, please feel free to call us at (309) 565-4261.

Sincerely,

M. Scott Hedden

M. Scott Hedden
President-Chief Executive Officer

Paul E. Heuerman

Paul E. Heuerman
EVP-Senior Business Development Officer

Mitch Borneman

Mitch Borneman
EVP-Chief Operating Officer

Jackie L. Overstreet

Jackie L. Overstreet
SVP-Chief Financial Officer