FARMERS STATE BANK

October 16, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551
Delivered via email regs.comments@federalreserve.gov

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
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Delivered via email comments@FDIC.gov

Office of Comptroller of the Currency
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RE: Basel III Capital Proposals

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 Agency Corporation.

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We are in support of increasing the capital requirements for banks in our country to ensure that our industry has sufficient capital to withstand future adversity. We believe most bankers share that common goal. However, we do have several concerns about the proposals which have been approved by the banking agencies and placed for comment.

Farmers State Bank is a $105 million community bank located in North Central Iowa. Our roots trace back 117 years serving our communities. We were one of the last banks in Iowa required to suspend business in 1933 per the Department of Banking, survived the "Ag Crisis" of the 1980s and have managed through the "Great Recession" better than most. In short, we have established a history of managing our problems through difficult times. We are proud to have a history of local closely-held ownership that has a vested interest in our communities. Our bank has locations in three rural communities and is considered an "Ag" bank. However, we are not just an "Ag" bank; we provide consumer, residential real estate, and commercial loans. The proposed Basel III regulation will have significant impacts to our ability to serve our communities and to our bank.

There are two areas of immediate concern we have with the proposed Basel III regulation; the Capital Proposal and the Standardized Approach Proposal. These proposals more narrowly define capital while simultaneously increasing the risk weighting of assets. This seems counterintuitive in a time when much of our industry growth has been pressed upon us, in large part attributed to our economy and monetary policy, coupled with deteriorating earnings potential that has not sufficiently allowed for capital growth at the same rate.

The provision embedded in the capital proposal that will require all banks to mark to market available for sale securities will cause greater volatility in our capital base and reduce our ability to manage the investment portfolio. Currently under the proposal we would have Common Tier 1 equity of 11.14% assuming our risk weighted assets remain unchanged. However, based on the proposed regulation our risk weighted assets are estimated to significantly increase causing our newly defined capital base to shrink to 7.4% slightly above the minimum threshold to avoid restrictions on distributions. Interest rates are at historical lows and we have a substantial gain in our securities portfolio even though we have a very short weighted average maturity in the portfolio. A 300 basis point increase in interest rate will cause our institution to have a loss of nearly $500,000 which represents 35% of our 2012 earnings and reduces our Common Tier 1 equity to 6.91% all else equal.

The implications of this proposal would place undue burdens on our customer, management and shareholders. The proposal would place strain on our ability to meet customer needs who routinely borrower near our lending limit, due to the newly created volatility, potentially causing them to seek a larger lender. We may also reduce purchasing long-term local municipal securities which help our communities fund needed infrastructure. The proposal may lead us to classify all securities as held to maturity to avoid this regulation which would limit our ability to manage the investment portfolio for liquidity, interest rate risk and collectively reduce our future earnings potential. Our bank rating would be decreased subjecting us to higher FDIC insurance premiums while also decreasing our ability to attract capital. Further complicated by the fact community banks do not have the same access to capital markets to raise additional capital. This will negatively affect shareholder value.

The provisions entrenched in the standardize approach proposal increasing the risk weighting for residential mortgages and delinquent loans will cause further strain to be placed on our organization. They threaten to significantly reduce or even drive our bank away from the residential mortgage business segment. Furthermore, our ability to manage delinquent loans will become greatly diminished as our willingness to work with borrowers through difficult circumstances is reduced.

Our bank provides a considerable number of residential mortgages to people living in the three communities we serve. On average nearly 80% of our origination volume is sold to the secondary market without servicing agreements while the remaining 20% is funded and owned by our bank. The customers that choose to have the bank originate and retain their mortgages do so for various reasons. Inevitably at the core of this rational is our ability to custom tailor a product that fits their individual needs that the secondary market does not offer. We would be required to risk weight the majority of these assets either at 100% or 150% as they fall under Category 2 mortgages. Our underwriting procedures are robust and are evident as we have historically incurred limited losses on our residential portfolio. Over the last five years our net losses have been 1.62% or .32% annum. 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 the change from assigning "risk weightings to asset classes" to assigning "risk weightings to individual loans" will create administrative difficulties that will become onerous for community banks. This granular asset by asset approach assign an initial risk weighting then continue to re-evaluate these assets on an ongoing basis will put enormous strains on our staff and budget. Furthermore I question the ability to examine a bank's performance in properly assigning risk weighting under this rule due to the amount of resources required to review the data.

Lastly changes to the risk weighting of delinquent loans poses additional strain to capital that is unwarranted in my opinion. The bank has historically addressed delinquent loans through the allowance for loan and lease losses. We use several methods, known as FAS 114 and FAS 5 defined under the Financial Accounting Standards Board, in determining how much we need to allocate to our loan loss reserve fund. Increasing the risk weights on delinquent loans is yet another redundant means of raising capital that is being addressed via allowance for loan and lease losses. Another issue that confuses and concerns me is the limitation of 1.25 percent of risk based assets in the loan loss reserve. This will undoubtely place greater burden to fund our loan loss reserve fund when we can least afford to.

The implications of the risk weighting proposal will place additional strain on our customers and management. The very nature in which many rural community banks operate leads to various loan concentrations within their portfolios. Our bank is heavily concentrated within the Ag industry which has been very prosperous as of late. We attempt to mitigate this exposure with vigorous underwriting criteria. Furthermore we have also generally strived to act in a countercyclical fashion, building reserves during good times. The proposed regulation will exacerbate potential capital deficiencies that are caused by a downturn in our local economy in part because of this concentration. Even though the individual loans maybe well secured with low LTV and have limited loss potential we would still be required to risk weight them at 150% provided they were 90 days delinquent. The impact of this proposed regulation will be to increase our aggressiveness in moving loans that become 90 days delinquent off the balance sheet. It will also impede our wiliness to provide workout solutions for our customers and instead proceed directly to foreclosure or sale.

In closing we are in full support of raising capital standards for the banking industry with strong consideration for institutions deemed systemic to the financial industry. However the cumulative effect of each of these items reflected above will have a severe impact on most community banks in this country which are systemic to each of their communities. We strongly urge you to consider this impact and consider a possible exemption for most community banks from the bulk of these rules. Our nation's community banks need to be able to continue serving our communities and helping to strengthen our local communities.

Thank you for your consideration.

Sincerely,

Sean Noonan
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Farmers State Bank

Jack Geelan
Chairman
Farmers State Bank

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