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.

German-American State Bank is a $195 million community bank located in northwestern Illinois. We are heavily invested in the agriculture single-family housing sectors of our economy. Our business model can best be stated with our holding company's mission statement, "Community Building through Community Banking".

Our focus remains serving our community in both their financing and depository needs. With this commitment to serve locally we have throughout the years avoided involvement in the highly leveraged activities that severely depleted capital levels of the largest banks and created panic in the financial markets. Our goal is to serve our relationship-based customers via a business model that serves their needs on a long-term basis. We have been successful in this approach and through managed growth and retained earnings have maintained a very well capitalized bank over the years. Larger banks operate on transaction volume giving minimal credence to customer relationships. We feel this difference in approach warrants the need to place tougher capital standards exclusively on the largest banks to better manage their ability to absorb losses. It is our contention that community banks should be allowed to continue operating under the current Basel I framework for computing their capital requirements and Basel III as designed should apply to the largest, internationally active banks.

[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.*

AOCI

The inclusion of the accumulated other comprehensive income (AOCI) in capital for community banks will result in a high degree of potential volatility in regulatory capital balances and could very quickly erode capital levels under certain economic conditions. For our institution, AOCI represents unrealized gains and losses on investment securities held available-for-sale resultant from changes in interest rates. Currently, both short-term and long-term interest rates have fallen to historic lows, which have resulted in unprecedented unrealized gains for most investment securities. Other unusual and temporary factors such as the flight to safety and government intervention in the capital markets has created demand in certain securities causing credit spreads to tighten further increasing bond valuations.

The current level to which interest rates have fallen is not sustainable long-term once an economic recovery accelerates. As interest rates rise, fair values on securities will fall causing the balance of AOCI to decline and potentially 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 our bank, if interest rates increased by 300 basis points, our bank's bond portfolio will record a substantial paper loss and corresponding drop in tier 1 capital ratio.

Large institutions have the ability to mitigate the risks of capital volatility by entering into qualifying hedge accounting relationships for financial accounting purposes with the use of interest rate derivatives like interest rate swap, option and future contracts. Community banks, including ours, do not have the knowledge or expertise to engage in these transactions to manage their associated risks and costs and is an effective barrier to entry. We contend that community banks should continue to exclude AOCI from capital calculations as they are currently required to do today.

Capital Conservation Buffer

The implementation of the capital conservation buffers for community banks will be difficult to achieve under the proposal and as such, we feel should not be implemented. Community banks do not have easy access to capital that larger banks have through capital markets. The primary and often only method for community banks to increase capital is through the accumulation of retained earnings over time. In the present current ultra low interest rate environment, community bank profitability has been further diminished and hampers our ability to grow capital. If exemption of the capital conservation buffer is not allowed for community banks, we request consideration be given (at least five years beyond 2019) in order for those banks that need the additional capital to accumulate and retain earnings accordingly.

Expanded Risk-weight Framework

The proposed and much expanded risk weight framework under Basel III is extremely complicated and will be an onerous regulatory burden that will penalize community banks and potentially jeopardize the housing recovery. Increasing the risk weights for residential balloon loans, interest-only loans, and second liens will penalize community banks such as ours, which offer these products to their customers and deprive customers of many financing options for residential property ownership. We further believe the higher risk weights for balloon loans penalize community banks for mitigating interest rate risk in their asset-liability management and may force community banks to originate 15 or 30-year mortgages with durations that will make their balance sheets more sensitive to changes in long-term interest rates. If this risk framework remains in place, many community banks will either exit the residential loan market or only originate loans that can be sold

to a GSE. Second-lien loans will either become more expensive for borrowers or disappear altogether as banks will choose not to allocate additional capital to such balance sheet exposures. It is our contention that community banks should be allowed to stay with Basel I risk-weight framework for residential loans. If left intact, this expanded risk-weight framework will require community banks to make significant software upgrades and incur operational costs to track mortgage loan-to-value ratios in order to determine the proper risk weight categories for mortgages.

Additional Components

Three additional proposed components for Basel III not directly applicable to our bank but of concern for the community banking industry as a whole are the proposed phase-out of Trust Preferred Securities as a tier one capital component, mortgage servicing rights treatment for capital purposes and imposing distribution prohibitions on community banks with Subchapter S corporate structure. Trust Preferred Securities have consistently been a reliable source of capital for community banks that would be difficult to replace. We are pleased Trust Preferred Securities issued by bank holding companies under $500 million would not be impacted by the proposal. We believe that consistent with the Collins Amendment of the Dodd-Frank Act regulators should continue the current tier one treatment of Trust Preferred Securities issued by bank holding companies with consolidated assets between $500 million and $15 billion in assets.

Penalizing the existing mortgage servicing assets under the proposal, we consider unreasonable for those banks that have large portfolios of mortgage servicing rights. Existing mortgage servicing rights on community bank balance sheets should be allowed to continue to follow the current risk-weight and deduction methodologies.

We believe, although not relevant to our corporate structure, that the imposing of distribution prohibitions on community banks with a Subchapter S corporate structure conflicts with the requirement that shareholders pay income taxes on earned income. Banks with a Subchapter S capital structure would need to be exempt from the capital conservation buffers to ensure that their shareholders do not violate the provision of the Internal Revenue Code. We would recommend that the capital conservation buffers be suspended during those periods where the bank generates taxable income for the shareholder.

Thank you for your review and consideration of our comments and concerns. If you have any questions, please feel free to contact me at 815-239-1700 or jeff.gasb@ffgbank.net.

Sincerely,

Jeffrey M. Sterling
President & CEO