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First Midwest

October 18, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

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:

We appreciate 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.

Please understand that we are fully in support of setting the capital requirements for all banks in our country at levels sufficient to withstand turbulent economic times as well commensurate with the underlying risks inherent in any given institution's business activities. However, we do have serious concerns about the proposals which have been approved by the agencies and placed out for comment.

First Midwest was formed in 1983 as a combination of 20 separate affiliated community banks serving the needs of suburban Chicago, central Illinois, and the Quad Cities of Illinois and Iowa. Today we are an $8 billion regional community bank based in Itasca, Illinois, serving approximately a quarter of a million consumer households and thousands of small and middle market commercial clients. We are also a significant agricultural lender in our markets. Virtually all of our lending is within these markets, illustrating our dedication and ongoing commitment to serving the needs of these communities and customers.

We, like most other community banks in our country, serve an important role in the economic vibrancy of the communities in which we operate. A strong economy is dependent on job growth and the availability of capital to fund the businesses within our communities that produce this growth. We believe it is critical that the proposed capital rules do not reduce or restrict our ability to serve this role, resulting in unintended consequences that harm the consumers and small businesses within our communities.

The following items are the areas of the proposal in which we have concerns:

**I. Requirement that gains and losses on available-for-sale securities must flow through and be charged to regulatory capital**

Our country is in an unprecedented and extended period of low interest rates. Most banks have significant gains in their available-for-sale ("AFS") investment portfolios. In the short term, this proposal would serve to increase regulatory capital. However, as interest rates rise, this inflated capital would be quickly reversed and could move very dramatically in the other direction resulting in an equally dramatic impact on regulatory capital. Further, in either a low or high interest rate scenario, the focus on the change in value of only the AFS investment portfolio fails to recognize the inherent value of other portions of an institution's balance sheet. In our judgment, this proposal will introduce a significant amount of cyclicality and volatility into the system which is opposite of what we believe the goal should be.

In reaction to this, banks would be forced to reduce the size of their balance sheets or increase the cost of borrowing as the economy begins to improve, simply because interest rates begin to rise. This would serve to undermine an economic recovery as banks reduce their lending efforts to concentrate on maintaining capital ratios, reducing the availability of credit or increasing the cost of credit to small and middle market business customers as well as consumer customers.

We believe, and would recommend, that the proposed rule should be revised so that unrealized gains and losses on AFS securities that reside in accumulated other comprehensive income do not flow through capital. This would continue to allow those losses due to credit impairment to be appropriately reflected in capital, but would exclude the impact of temporary changes in interest rates.

## II. Elimination of trust preferred securities

The proposed Basel III capital rule does not provide for the grandfathering of trust preferred securities for institutions between $500 million and $15 billion in assets and therefore is inconsistent with the Collins amendment to Dodd-Frank. Basel III as proposed requires the phase-out of these instruments for bank holding companies in this asset group, permitting the inclusion of 90% of such instruments in 2013, with annual 10% decreases over the ensuing 9 years.

First Midwest has approximately $50 million in trust preferred securities. While this is not a large portion of our capital, for us and the industry as a whole, it remains a very cost effective, long-term source of capital, furthering the ability to grow and better serve our customers and communities. The elimination of this source of capital, in our case, will reduce our ability to grow our balance sheet by about $500 million. Multiplying this affect across the country, the potential reduction in loan availability would be significant and appears to directly contradict the goal to spur job growth.

We would ask that the proposed rule be revised to fully recognize the intent of the Collins amendment by permanently grandfathering outstanding trust preferred securities for institutions between $500 million and $15 billion in assets.

## III. Increased risk weighting for residential mortgage loans

Regulators are proposing new methodologies for residential mortgages that can increase assigned capital risk weights up to 200%. The determination of the appropriate risk weighting would be largely dependent on the collection of consumer data at the point of origination. As proposed, however, these new methodologies apply not only to new mortgages but existing mortgages that were underwritten and priced based on capital standards existing at the time.

Since these mortgage requirements did not exist at the time we originated these mortgages, at least some, if not a significant amount of the underwriting data necessary to risk weight these loans under the new methodology was not captured. Subsequently obtaining this information for loans that are now seasoned and long outstanding would be very difficult or nearly impossible to attain. Certainly a considerable amount of resources and expense would be required to comply as bank staff would have to comb through, in some cases, decades-old loan files to determine appraisal values and borrower characteristics.

While banks can adjust their lending practices on a go forward basis to avoid some of the more punitive risk weights, they cannot do so with respect to mortgages already made. And, in our particular case, First Midwest has never offered the kinds of mortgages (sub-prime or Alt A) that proved to be the primary driver of the mortgage collapse.

We would ask that any rule grandfather all existing mortgage exposures, assigning the risk weights as then required under the risk-based capital requirements. We feel this is appropriate for the following reasons:

- First, many banks will not have the data necessary to assign mortgage categories under the proposal.
- Second, even if a bank has the data necessary to calculate the risk weights applicable to each mortgage, it would be extremely burdensome for many community banks.
- Third, given the substantial increase in capital that would be required for certain mortgages under the new requirements, which may constitute a substantial amount of assets on a bank's balance sheet, retroactive application could be extremely severe. Given that the Basel III notice of proposed rulemaking is already substantially increasing required minimum levels of capital for the industry, the need for retroactive application of the new requirements is already significantly mitigated.

**IV. Proposal to increase risk weights on delinquent loans**

Our concern with the proposal to increase risk weighted capital levels for delinquent loans stems from its relationship to already existent loan loss reserves set aside for these same loans. By increasing the amount of capital we hold based on a borrowers past due status, we are effectively being required to set aside capital two times. We feel that the risk related to problem loans should continue to be managed through the loan loss reserve guidance and not by adding an additional capital requirement.

Implementation of such a rule would incent a more aggressive work out of loans that become 90 days past due and, by extension, reduce or completely eliminate a bank's willingness to work with its borrows to resolve these issues.

In conclusion, the proposal as presented would result in a significant increase in the amount of capital needed to be held by our industry, with such levels likely to be above and beyond the expected increase resulting from the higher capital ratios already suggested by Basel III. Each item detailed above serves to illustrate an increase in risk based assets or a decrease in the amount of capital, thereby limiting the capital available to all banks.

It is our view that sufficient time has not been afforded to weigh the collective impact of the proposal on our bank, all community banks, and the financial services industry and, by extension, the markets we serve. I am not aware of any such assessment being made on a national scale while at the individual bank level such an assessment is complicated by the magnitude and scope of the proposed changes. The amount of work that is needed to be undertaken by an individual bank to understand the rules, train staff on how to apply the rules, implement the coding of each individual loan in the portfolio with the new risk weights, re-program important core processing software to handle the new coding requirements, and then create the necessary reports to accurately analyze the data is daunting

The cumulative or individual effect of each of the items reflected above could have a severe impact on community banks across the country and the customers and communities they serve. We would strongly urge you to afford more time to consider this impact and the suggestions we have offered to lessen this burden and help the banking industry facilitate, not hinder, local economic vitality.

Thank you for your thoughtful consideration of this important matter.

Sincerely,

Michael L. Scudder
President, Chief Executive Officer
First Midwest Bank
Chief Executive Officer
First Midwest Bancorp, Inc.