

October 19, 2012

The Honorable Ben Bernanke
Chairman
The Federal Reserve System
20th Street and Constitution Ave, NW
Washington, DC 20429

The Honorable Tom Curry
Comptroller
Office of the Comptroller of the Currency
250 E. Street, SW
Washington, DC 20219

The Honorable Marty Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Dear Chairman Bernanke, Comptroller Curry and Acting Chairman Gruenberg:

The Subchapter S Bank Association is primarily an educational association for banks and thrifts who have made or are considering making an election to be taxed under Subchapter S of the Internal Revenue Code (“IRC”), which Congress permitted by amending the Code in 1996. Since adoption over 2500 or one third of the banks in the US have made the election. Almost all are “smaller institutions” with less than \$5 billion in total assets as that term is defined in Section 171 of Dodd Frank Act.

Section 171 also known as the Collins Amendment exempted smaller institutions from many of the capital provisions enacted, especially those relating to companies utilizing trust preferred securities as capital instruments. Section 171 also mandated that the General Accounting Office study smaller depository institution access to capital and report to Congress with recommendations that would enhance the access to capital of smaller depository institutions in a manner consistent with safe and sound banking operations.

Unfortunately, we believe the report failed in its Congressional mandate. It contained no such recommendations, but sought to make the case that hybrid capital instruments such as trust preferred securities and potentially preferred stock should be eliminated from the menu of capital instruments available to all depository institutions. This certainly flies in the face of Dodd Frank’s exception permitting banks subject to the Board’s Small Bank Holding Company Policy Statement (SBHCP) to continue to hold trust preferred equity capital instruments.

Common equity tier 1 restricts bank capital access unnecessarily

Basel III’s establishment of “Common Equity Tier 1 Capital” would dramatically limit the access of smaller depository institutions to capital. Trust Preferred Securities created an important way for smaller institutions to access capital and while the current market availability is questionable, we strongly oppose application of Basel III to smaller depository institutions and in particular, those under 500MM and subject to the SBHCP. We believe the regulatory authorities should be

encouraging ways for banks to access capital not limiting such access. Banks that are subject to the SBHCP can issue debt, and provide common equity to subsidiary banks, in effect what TRUPS did for such institutions.

In addition, we believe banks should be permitted to issue preferred stock and have that equity treated on par with “common equity”. The opening summary statement of the GAO study that “Tier 1 hybrid capital instruments particularly trust preferred securities are not as effective in absorbing losses as traditional forms of Tier 1 capital such as common equity” is inexplicable in the context of bank risk and the quality of capital. A dollar of bank capital generated by a bank holding company issuance of preferred stock, trust preferred or other instruments yields the same benefit as common equity at the bank level.

Sub S banks presently can only issue one class of stock under the provisions of the IRC; however, their holding companies can borrow or issue trust preferred securities, though such ability would effectively be eliminated under Basel III. The Communities First Act (HR 1697 and S.1600) would amend the IRC to permit Sub S banks and their holding companies to issue preferred stock. We encourage the Agencies to support this measure as a way to increase access to capital by Sub S banks.

Including unrealized gains or losses creates unmanageable capital swings especially for Sub S banks

Basel III’s requirement to include unrealized gains or losses on investment securities classified as available for sale will introduce significant volatility to capital levels at smaller institutions which do not have the knowledge or ability to hedge such interest rate risks. For Sub S banks it will have an even more pronounced impact and result in more volatility, because such gains or losses are not “tax effected” for Sub S banks as they are for C corp banks. In effect a \$1MM loss in value would be recorded as a \$650K loss by a C corp bank but a Sub S bank would have to reduce its capital by the entire \$1MM.

Basel III complexity is too much for smaller institutions

We believe that smaller insured depository institutions as defined by Dodd Frank should be exempted from Basel III, but it is critically important for institutions \$500MM and below to be exempted because most simply do not have the ability to handle the increased regulatory burden required to understand, implement and continually comply with all the complexity. With all the challenges community banks face in the current environment, the issuance of 753 pages of new rules is truly unthinkable on the part of the federal bank regulatory agencies. Our community banking industry in the US is clearly unique and must be preserved or else access to credit and other financial products will have a significant and irreversibly negative effect on rural America. These institutions will simply be forced out of existence and will not be replaced because the big banks don’t want to be in rural America.

Agencies should treat Sub S dividends for taxes differently

We strongly urge the regulatory agencies to re-examine their position regarding the payment of dividends to shareholders in an amount necessary to permit the shareholder to pay federal income tax resulting from shareholder’s recognition of their prorata share of Sub S bank income. Since the adoption of Sub S for banks, the agencies have declined to make a distinction between a distribution to pay taxes and any dividend. This has led many Sub S banks to terminate their election and return to

the C corp tax regime, because they couldn't pay their taxes resulting from recognition of their share of the bank's net income. This is grossly unfair because the same bank taxed under C Corp rules would have been required to pay federal income tax directly. Basel III capital increases and the potential volatility occasioned by other requirements such as the unrealized gain proposal discussed above creates an even larger burden on Sub S banks and will either force them to terminate their election or hold extraordinarily high levels of capital, thereby reducing income, reducing lending ability and choking off any potential investment attractiveness in owning bank stock.

Risk-weighting rules will cut off mortgage financing for rural communities

The risk-weighting rules in the proposal, particularly with respect to 1-4 family mortgages will have the effect of cutting off credit to rural and many smaller communities who rely on their community banks for mortgage financing. Most community banks make balloon mortgage loans which will automatically put them into Category 2 and community banks who know their customers need the underwriting flexibility to provide appropriate access to credit without the risk of having to hold four times the amount of capital they currently hold for residential mortgages. In addition, community banks do not have the time or resources to comply with all the record keeping involved in establishing and maintaining risk-weighting data required.

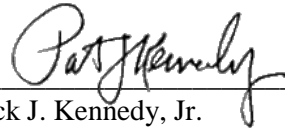
Risk-weighting rules combined with allowance is double counting

The increased risk-weighting on mortgage loans and commercial loans will in effect result in "double counting" because the risk of those loans will have already been accounted for in the general allocations under the current loan loss reserve calculation methodology.

We appreciate the opportunity to comment and re-urge our request that smaller institutions as defined under Dodd Frank be exempted to these rules.

Very truly yours,

SUBCHAPTER S BANK ASSOCIATION

By: 
Patrick J. Kennedy, Jr.
President