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 issued for public comment by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

Heartland Bank and Trust Company is a $2 billion state chartered bank offering community banking services in central Illinois. With over 40 branches, our footprint includes Bloomington, Champaign, Peoria, Quincy and Macomb as well as a number of rural communities. In the last three years, we have been the successful bidder on three FDIC assisted acquisitions including two institutions in the Chicagoland area. We would like to provide comments on the following aspects of the proposal:

Subchapter S Community Banks

As a privately owned Subchapter S institution we are concerned about the new limitations on dividend distributions imposed by the **capital conservation buffers**. These restrictions could potentially conflict with our need to distribute tax dividends to shareholders so that they can pay income taxes on earned income. Our dividend policy is to distribute tax dividends quarterly to shareholders who make corresponding estimated tax payments to the Treasury. We make quarterly estimates of the taxable income generated by the bank which will be reported as earned income by shareholders through K-1's each year. Any limitation regarding our ability to distribute an appropriate tax dividend could result in a shareholder's inability to meet their

[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.*

federal and state tax obligations. We argue that banks organized under Subchapter S structure would need to be exempt from the capital conservation buffers to ensure that their shareholders do not violate the provisions of the Internal Revenue Code. We recommend that the capital conservation buffers be suspended to the extent that the bank generates taxable income for their shareholders.

Proposed Phase-out of Trust Preferred Securities

We object to the proposed ten year phase-out of the Tier 1 treatment of instruments like Trust Preferred Securities (TRUPS). Heartland has $32 million in TRUPS outstanding which counts as Tier 1 capital at our Holding Company. As of 6/30/12 our Holding Company Tier 1 Regulatory Capital Ratios were 9.36 Tier 1 Leverage and 14.84 Tier 1 RBC. Without our Tier 1 qualifying TRUPS, these ratios would drop to 7.72 Tier 1 Leverage and 12.24 Tier 1 RBC. While material declines, losing the TRUPS would not put our well capitalized status in jeopardy. However, at 8% Leverage, it would reduce our ability to acquire new assets by $400 million. At the time it was issued, the market allowed us to negotiate attractive pricing on this long term debt. Today, it would be impossible to replace the TRUPS in a cost effective manner with any other form of Tier 1 qualifying capital. We believe it was the intent of the Collins amendment of the Dodd-Frank Act to permanently grandfather Tier 1 treatment of TRUPS issued by bank holding companies with assets below $15 billion. Raising new Tier 1 capital by Subchapter S corporations is also restricted by maximum number shareholder limitations as well as their prohibitions against issuing different forms of stock such as Non-Cumulative Perpetual Preferred. Phasing out the Tier 1 treatment of TRUPS would be a particular burden for privately-held bank holding companies like Heartland Bancorp, Inc. Consistent with the Collins Amendment, we urge the banking regulators to continue the current Tier 1 treatment of TRUPS issued by those bank holding companies with consolidated assets between $500 million and $15 billion in assets.

Incorporating AOCI as Part of Regulatory Capital

Inclusion of accumulated other comprehensive income (AOCI) in capital for community banks will result in increased volatility in regulatory capital balances and could rapidly deplete capital levels as rates rise from current extremely low levels. As of September 30, 2012, Heartland had Accumulated OCI from Investments of over $26.2 million. Including this unrealized gain into Tier 1 Regulatory Capital would materially boost our current bank Tier 1 Capital of approximately $211.7 million. Our risk models show that this entire unrealized gain would be eliminated by an approximate 125 basis point rise in rates. A rise of 200 basis points would turn a $26.2 million unrealized gain into a $17.3 million unrealized loss. These forecasts demonstrate how this proposed change would introduce significant volatility into the Regulatory Capital Ratio's of community banks like Heartland.

Like most community banks, we manage the duration (and market value risk) of our investment portfolio to help mitigate interest rate risk in the rest of our balance sheet. Heartland has built an excellent core deposit funding base that will help our earnings in a rising rate environment. Choosing to count market value changes of a significant asset like the investment portfolio into regulatory capital, while not offsetting that with the change in value of our core deposit liabilities is inconsistent with our management of the portfolio. It would harm our ability to invest in a way that will minimize interest rate risk in our entire balance sheet. It may cause us to reduce market value risk in the investment portfolio, accept lower returns and reduce our income, which would lead to lower future capital levels. We believe that banks should continue to exclude AOCI from capital measures as they are currently required to do.

We appreciate the opportunity to comment on the proposals. If there are any questions or requests for additional information, please feel free to contact us.

Sincerely,

Fred Drake
Chairman and CEO