American Bankers Association

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September 23, 2014

The Honorable Janet L. Yellen
Chair
Board of Governors of the Federal Reserve
20th Street and Constitution Avenue, NW
Washington, DC 20551

Dear Chair Yellen,

I'm writing you once again to urge the Federal Reserve Board to permit any profitable bank organized under Subchapter S to provide a limited dividend equal to the tax liability it faces regardless of its capital levels within the capital conservation buffer. Doing so would make the tax treatment of similarly-sized Sub S and C-corp banks the same under the Basel III capital conservation buffer rules. It would eliminate the disincentives to building capital before times of stress ***and*** during times of stress--which is a primary objective of strong capital rules.

As you know, Sub S banks are typically small banks that have limited access to sources of capital. In fact, the Fed regulates 281 Sub S banks--equal to one-third of all the banks directly supervised by the Fed. The median asset size of these banks is $157 million--smaller than the median-sized bank the Fed supervises which has assets of $228 million. Thus, this issue is very important for a large segment of the institutions your agency supervises, and smaller banks in particular.

We share the view that strong capital and positive incentives for holding sufficient capital are important. But this rule works counter to these goals. If Sub S shareholders know that they may be required to dig into their own pockets to pay taxes on earnings without having any distribution to cover that liability, they have incentives to invest less than they would otherwise in that bank in the first place--even in good times. More importantly, in times of stress, the Sub S shareholders would be very unlikely to inject new capital knowing they may not have dividends to pay taxes once the bank recovers and is profitable.

Thus, despite the obvious differences regarding how this rule would apply to Sub S banks, and despite the incentives that reduce rather than encourage capital formation, the Board has chosen to apply the rule in exactly the same way regardless of Sub S or C-corp organizational structure. But the notion of applying the conservation buffers "identically" does ***not*** lead to identical results in practice. The Fed should develop and implement rules that have the ***same*** impact. Not doing so places Sub S banks at an economic disadvantage relative to non-Sub S banks.

The decision of the Board ***not*** to address this clear disparity in impact (despite many letters by Sub S banks describing the perverse nature of the rule) struck me as completely at odds with the testimony recently given by Maryann Hunter, the Board's Deputy Director of Banking Supervision and Regulation. In her testimony, she emphasized the importance of small banks, acknowledged that one-size-fits-all does not work, and spoke about the willingness to listen to concerns of community banks, thoroughly investigate the issue, and take action so as not to subject community banks to requirements that would be unnecessary or unduly burden the bank. If this is truly a statement of intent by the Board to recognize the unique characteristics of community banks and to act accordingly, the one-size-fits-all treatment of Sub S and C-corp under this rule should be addressed and corrected.

Sincerely,

Frank Keating