

October 18, 2012

The Honorable Thomas J. Curry, Comptroller
Office of the Comptroller of the Currency
Regs.comments@occ.tres.gov
Docket ID OCC-2012 0008

The Honorable Ben S. Bernanke, Chairman
Board of Governors of the Federal Reserve System
Regs.comments@federalreserve.gov
Docket R-1442

The Honorable Martin J. Gruenberg, Acting Chairman
Federal Deposit Insurance Corporation
comments@FDIC.gov
RIN 3064-AD95

RE: Regulatory Capital, Implementation of Basel III

Heads of the Agencies:

I am writing on behalf of St. Charles Capital, an investment banking firm specializing in capital raising and merger and acquisition activity for commercial banks in the Rocky Mountain and High Plains States. Our firm and its predecessor have been involved in over 85 financings totaling \$1.2 billion. I have personally been an investment banker for the commercial banking industry for over 31 years. We specialize in community banking organizations generally from \$100 million to \$10 billion in total assets.

Although there are many troubling aspects of applying the proposed Basel III rules to smaller banks we would like to express our views specifically on the proposal to phase out the Tier 1 capital treatment for trust preferred securities ("Trups") in the amount of 10% per year beginning January 1, 2013. As experts in capital raising for community banks, we believe the change to Trups capital treatment will be extremely harmful to commercial banks and the customers that they serve.

Approximately 57% of the bank holding companies between \$500 million and \$15 billion have Trups that currently count as capital; for the typical bank, it constitutes about 20% of its capital. The elimination of 10% per year of Tier 1 capital will have a profoundly negative impact on capital formation for hundreds of banks. Banks between \$500 million and \$15 billion in assets in the annualized quarter ended June 30, 2012 had, on average, a return on average assets ("ROA") of 0.88%. The table below illustrated the impact of a 10% annual phase out of Trups for a typical \$1 billion bank with 10% Tier 1 capital ratio composed of

80% common stock and 20% Trups. The analysis assumes an average dividend payout ratio of 30%. Although the bank would have retained \$6.2 million of capital for growth UNDER current rules, we see after the proposed changes that the retained capital drops to \$4.2 million, a **33 percent decline** in Tier 1 capital. Furthermore, this **decline occurs in each year for ten full years**.

Impact on Capital Formation	
Assets:	\$1 billion
ROAA:	0.88%
Earnings:	\$8.8 million
Dividend payout ratio:	30%
Dividend:	\$2.6 million
Remaining capital:	\$6.2 million
Equity:	\$100 million
Trust Preferred:	\$20 million
10% capital loss:	\$2 million
Net annual capital retention:	\$4.2 million
Reduction in annual capital formation:	33%

The regulatory agencies may believe that by phasing out Trups over ten years, the impact is small. This view is wrong; as the illustration above shows, **the impact on capital formation is profound**. For small community banks, less capital will result in less growth and fewer loans to businesses and communities. This will especially hinder economic activity in communities where larger banks do not focus.

We believe that Trups are true risk capital and know of no failure of a bank where the Trups holders were not wiped out similar to the common shareholders. Most of the outstanding Trups for the community banks have more than 20 years remaining to maturity. We simply cannot understand why, by implementing this rule, the regulatory agencies would in effect be eliminating long-term capital that has been invested in the industry, where long-term risk capital is so very difficult to raise. The agencies should be doing everything possible to help the banking industry attract capital, not chase it away.

The loss of capital through the proposed Trups rule will force community banks to raise new capital through other means. There are several significant differences between banks in the smaller size range (less than \$15 billion in assets) and those of larger banks (over \$15 billion in assets) for whom the Basel III rules were originally intended.

First, large banks have the ability to issue non-common stock alternatives such as non-cumulative perpetual preferred stock and subordinated capital notes. Investors for such capital instruments are almost entirely large institutional investors that require rated securities. The rating agencies have a bias when rating debt instruments in favor of large banks because these rating agencies know that larger banks have better access to capital when something goes wrong. Therefore, ratings for smaller banks are typically much lower. Furthermore, large institutional investors want liquidity for their securities and only large

individual issue sizes can support the needed liquidity. As a result, very few smaller banks can ever issue non-common stock alternatives.

Second, for any bank, the returns on common stock required by investors are much higher than preferred stock or capital notes. For the reasons discussed above, smaller banks really only have one source of capital available: common stock. Therefore, smaller banks will be forced to build a capital structure of almost entirely common stock, the most expensive form of capital. The Basel III elimination of Trups removes the only effective leverage that smaller banks have and places them at a huge competitive disadvantage with larger banks.

Third, there is a significantly steep valuation discount for the common stock of smaller banks versus larger banks. The table below compares the average price-to-tangible book ratio for publicly traded banks in two different size groups: banks between \$500 million and \$15 billion in assets versus those larger than \$15 billion. To make sure we are comparing apples-to-apples, the banks are grouped into similar profitability buckets.

ROAA Range	Average Price Tangible Book Value		Percent Premium
	Assets less than \$15B	Assets greater than \$15B	
0.50% - 0.75%	103%	136%	33%
0.75% - 1.00%	128%	139%	11%
Greater than 1.00%	149%	174%	24%

Includes all publicly traded commercial banks with three month average daily trade volume over 1,000 shares; pricing as of 9/30/2012

It is clear that banks over \$15 billion trade at very material size premium. Through raising capital for various sized banks, we have learned that the smaller the bank, the lower their valuation, and the more costly their access to capital. This impact is especially significant for banks smaller than \$1 billion in assets. The table below shows the price-to-tangible-book ratio difference among publicly traded banks between \$500 million and \$1 billion in assets versus larger banks, and we see the differential is significant.

ROAA Range	Price/Tangible Book Value		Percent Higher Pricing
	Assets between \$500M and \$1B	Assets greater than \$1B	
0.50% - 0.75%	81%	120%	40%
0.75% - 1.00%	95%	140%	44%
Greater than 1.00%	112%	161%	50%

Includes all publicly traded commercial banks with three month average daily trade volume over 1,000 shares; pricing as of 9/30/2012

And of course most smaller banks are privately held; the resulting illiquidity discount required by investors drives prices for common equity even lower. All these factors result

in a considerably higher cost of capital for the smaller banks. The unintended impact of the proposed Basel III rules will be to markedly slow the retention of capital and to force banks into the market to replace capital who can least afford it and at costs that harm their ability to complete. If policymakers want to eliminate smaller community banks, raising their cost of capital is an efficient way to do it.

In the final Dodd Frank bill, Congress recognized these differences when it explicitly grandfathered outstanding Trups for banks under \$15 billion. We believe that you should respect these prior congressional actions.

If you insist upon going ahead with this ill-advised change, we do have one wording change that would improve the situation for community banks. Under the proposed rule, each year the amount of Trups that counts as Tier 1 capital declines by 10%, and the figure is calculated on the outstanding balance in that future year. For example, if the Trups outstanding for a bank on December 31, 2012 was \$10 million, in three years, only \$7 million of this capital would count as Tier 1 capital. Under the current proposed language, if the bank tried to pay off the \$3 million of expensive preferred stock that no longer counts as Tier 1 capital, it could not without further reducing its Tier 1 capital. For example if the bank paid off the \$3 million, the regulation as written says that if there is only \$7 million then outstanding, only 70% of \$7 million would count (\$4.9 million) as Tier 1 capital. This is particularly awkward and needlessly harmful to banks. A simple solution to fix this problem is to change the rule so that the amount of capital that counts as Tier 1 is the lesser of a) the remaining outstanding balance or b) the percentage decline factor times the balance outstanding at the time the rule went into place (assume December 31, 2012). In this form, in three years when only \$7 million counted as Tier 1 capital, the bank could pay off the \$3 million of expensive preferred that no longer counted as Tier 1 capital. This should give the regulators what they want, a declining amount of Trups that counts as capital, but would be a material practical improvement to the banking industry.

Sincerely,



Wesley A. Brown
Managing Director