

LEE R. GIBSON, CPA
SENIOR EXECUTIVE VICE-PRESIDENT
AND CHIEF FINANCIAL OFFICER

October 19, 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 S.W.
Mail Stop 2-3
Washington, D.C. 20219

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street N.W.
Washington, D.C. 02429

Re: Proposed Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (R-1442, Docket ID OCC-2012-0008, RIN 1557-AD46, RIN 3064-AD95)

Proposed Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements (R-1442, Docket ID OCC-2012-009, RIN 1557-AD46, RIN 3064-AD96)

Ladies and Gentlemen:

Southside Bancshares, Inc. and its wholly owned subsidiary Southside Bank ("Southside"), appreciates the opportunity to provide comment on the Basel III proposals (the "Proposals") that were recently approved by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively the "Agencies"). We are supportive of the Agencies' objective of further strengthening the safety and soundness of the United States banking system, which is already considered one of the strongest in the world.

Southside is a 52 year old State Charter bank headquartered in Tyler, Texas. Southside has assets of \$3.4 billion. Our primary federal regulator is the Federal Deposit Insurance Corporation ("FDIC"). Southside specializes in providing personalized community banking services to individuals and small to mid-size businesses. The services provided to our market areas include, among other things, residential mortgage, commercial loans, commercial real estate, consumer construction and municipal loan origination, deposit accounts, trust services and broker services. We are providing this letter to you to convey our comments on the Proposals.

We understand the concern of the banking agencies and the desire to ensure all of the banks have appropriate levels of capital and to find methods of strengthening the quantity and quality of each banks capital. After suffering through a crisis like the 2007 to 2009 crisis, it is understandable that the banking agencies would review capital adequacy. During the peak of the crisis, Southside was fortunate to have been able to significantly increase assets, post record earnings for 2008 and 2009 and significantly increase capital through the retention of earnings. We are concerned some of the proposals might negatively impact well run community banks.

Our specific comments are listed below by topic.

Proposed Rule: Accumulated Other Comprehensive income (AOCI) as a component of Tier 1 capital – The Agencies are proposing that AOCI, which includes all unrealized gains and losses on AFS securities, would flow through to common equity Tier 1 capital. This would include unrealized gains or losses related to debt securities whose valuations primarily change as a result of fluctuations in a benchmark interest rate, as opposed to changes in credit risk (for example U.S. Treasuries and U.S. government agency debt obligations).

Southside Comments: Southside has a number of concerns about the inclusion of AOCI as a component of Tier 1 capital. The Agencies themselves have recognized that the inclusion of unrealized gains and losses on securities could introduce substantial volatility in a banking organization's regulatory capital ratios.

We understand that the proposed treatment of AFS securities reflects an attempt to accelerate the recognition of potential credit-related losses in regulatory capital. The development of an expected loss approach to the recognition of other than-temporary impairment ("OTTI") of securities and loans by the Financial Accounting Standards Board ("FASB") we believe substantively addresses this perceived problem for U.S. banks.

For our bank in particular the proposed capital recognition would largely reflect temporary impairments caused by the fluctuation of market interest rates rather than credit impairments because on average some 70% of securities portfolio consists of instruments issued by the U.S. government and its agencies and government sponsored enterprises ("GSEs"), whose market value reflects market interest rate levels rather than credit spreads.

On the other hand, if the supervisory purpose were to capture interest rate risk in capital, the proposed inclusion of unrealized AFS gains and losses is ill suited because it is so incomplete. Southside has on average, 60% of its assets in the securities portfolio, which means that the interest rate risk attributable to 40% of our assets and all of our liabilities would not be reflected in capital. We along with most U.S. banks manage interest rate risk on an enterprise basis, and requiring us to reflect in capital the interest rate risk inherent in one component of our assets would disrupt sound risk management practices that we and other banks have developed over decades with the encouragement of the Agencies.

Some of the more troubling aspects of this proposal include the following:

1. The AOCI inclusion for AFS securities applies mark-to-market treatment to only one component of an institution's balance sheet. Other balance sheet components that are economically very similar do not receive the same treatment, such as loans, structured liabilities, and HTM securities. We find two difficulties in this inequivalent treatment. First, this appears to violate the basic accounting principle of consistency. Second, it would in effect weaken an institution's asset-liability management; specifically, it adds a potential capital penalty on using the securities portfolio, the most flexible tool at ALCO's disposal, to reduce overall asset sensitivity while leveling no such penalty on any other balance sheet component. Our institution borrows long-term funds to manage our interest rate risk. As the market value of our AFS securities decreases, due to an increase in interest rates, the value of our long-term borrowings increases. Inclusion of AOCI for AFS securities impose a capital penalty during a period of increasing interest rates while providing no capital appreciation for other balance sheet components.

2. To avoid recognition of AOCI, institutions will be incentivized to hold more securities in the held-to-maturity (HTM) account. While under the current proposal rules the move to the HTM account would no longer require gains and losses on those securities to be recorded in Tier 1 capital, the operational restrictions imposed on the HTM account would greatly reduce management's flexibility to properly adjust its portfolio for liquidity and funds management purposes. Additionally, when different institutions place identical securities in AFS or HTM, it creates significantly differing capital treatments even though the relative risks involving the securities are the same.
3. To avoid capital ratio volatility, institutions may also be inclined to make shorter-term investment decisions that reduce volatility and increase liquidity. This may help to reduce market risk, but it also could reduce the ability of the investment portfolio to produce income which could generate additional organic capital appreciation. To affect this potential reduction in income a bank would be forced to pursue other options to generate income which would likely lead to investment in other higher credit risk asset classes that might have greater levels of unrecorded market volatility.
4. The negative impacts of these effects would fall disproportionately upon community banks, due to their limited access to capital markets for funding and temporary equity enhancements.

Southside's Recommendation: Southside recommends that the Agencies exclude any AOCI adjustments from the regulatory capital calculations and continue to include an addendum in the Call Report to reflect ongoing gains/losses in the AFS portfolio. In our view, the concerns addressed about market value appreciation/depreciation are best managed through a strong ALCO function that controls interest rate risk inherent in the total balance sheet component. While the impact on capital should be considered, financial institution capital ratios cannot be effective measurements of risk when only one component of the balance sheet is required to recognize ongoing market value adjustments.

The Agencies have suggested a potential exclusion of the capital charges for debt obligations to U.S. government, U.S. agency, and U.S. Government Sponsored Entities. The Agencies have also suggested a similar exclusion on general obligations issued by states or other political subdivisions. Southside supports these exclusions and agrees that they would help to minimize the impact of the proposed AOCI treatment.

Proposed Rule: Minimum Capital Ratios, Capital Conservation Buffer, and Prompt Corrective Action Requirements – Under the Basel III NPR, the Agencies have introduced a new common equity Tier 1 capital ratio and have modified the capital components and ratios for the existing risk-based and leverage capital framework. The Agencies are also proposing limits on capital distributions and certain discretionary bonus payments if the banking organizations do not hold a specified "Capital Conservation Buffer" in addition to the established minimum risk-based capital requirements. The minimum risk-based capital requirements correspond to minimum thresholds for "adequately capitalized" status under the Prompt Corrective Action (PCA) framework, and the Capital Conservation Buffer is proposed to be 2.5 percent above these minimum requirements. The Agencies are proposing to continue the PCA framework, with existing requirements still in force for organizations that fall below the statutory definition of "well-capitalized", which is 2.0 percent above the minimum requirement.

Southside Comments: Southside does not object to the proposed minimum capital requirements, or to the addition of the new common equity Tier 1 capital ratio. However, it is unclear why the Agencies would create a capital conservation buffer that would exceed the minimum thresholds for "well-capitalized" under the PCA framework. In essence, the proposal suggests that an institution needs a 2.0 percent buffer to be "well-capitalized", but it would need a 2.5 percent buffer to be "resilient" throughout different financial cycles. By establishing this framework, an institution could be "well-capitalized" and free from any restrictive covenants under the PCA framework, e.g., limitations on brokered deposits, but at the same time still have restrictions on capital distributions and discretionary bonuses if it did not exceed the requirements for the Capital Conservation Buffer. The restrictive covenants above the PCA "well-capitalized" framework will create a confusing and contradictory set of standards.

In reviewing the Agencies' justification for Capital Conservation Buffer, it was not clear how the Agencies empirically developed the specific 2.5 percent ratio or how that level, over and above a "well-capitalized" level, would help to "bolster the resilience of banking organizations throughout financial cycles." It was also unclear if the Agencies considered the impact of the proposed changes to risk-weighting requirements in their determination of the 2.5 percent buffer. If the proposed changes to the Standardized Approach NPR create a risk-weighting mechanism to better reflect balance-sheet risk, it would seem that the revised capital ratios would automatically be more resilient and better able to absorb cyclical risks at the "well-capitalized" level.

Southside's Recommendation: To avoid confusion and to better link the proposed capital guidelines to the existing PCA framework, Southside recommends that the Capital Conservation Buffer be adjusted to 2.0 percent. This would align the Capital Conservation Buffer with the buffers that already exist between "adequately-capitalized" status and "well-capitalized" status under the PCA framework. Banks that fall below "well-capitalized" could be subject to a variety of restrictions, including the proposed restrictions under the Capital Conservation Buffer. However, in the interests of clarity, flexibility and simplicity, we believe the Agencies may even wish to consider eliminating the Capital Conservation Buffer altogether in favor of instead applying existing enforcement authority to restrict capital distributions as circumstances warrant.

Proposed Rule: Residential Mortgage Exposures – In light of the recent experiences of the U.S. residential mortgage market, the Agencies are proposing a wider range of risk weightings (between 35 percent and 200 percent) for residential mortgages. Mortgage loans would be subdivided into two risk categories based on underwriting criteria (traditional vs. nontraditional) and lien position. Within each category, risk-weights would then be assigned based on standard Loan-to-Value ratios. The current risk-based capital treatment would be maintained for residential mortgage exposures that are guaranteed by the U.S. government or a U.S. government agency.

Southside Comments: Southside agrees with the Agencies' assertion that inadequate loan underwriting and high-risk mortgage products have contributed to an increase in mortgage loan defaults and home foreclosures. In the NPR, the Agencies have tried to create a set of standardized criteria that segregate higher risk loan products from more traditional loan products. We concur with the intent however the Agencies are penalizing a mortgage lending source that was not responsible for the mortgage crisis. The mortgage crisis that unfolded in 2008 was not born out of poor mortgage loan underwriting originating from community banks. Penalizing community banks by placing onerous restrictions and additional capital requirements on one of community banks more credit stable loan products will cause community banks to make less mortgage loans and will hurt consumers and the eventual housing recovery. It seems counterproductive that one of the Agencies is busy buying most of the current mortgage production in an attempt to stimulate additional mortgage borrowing by consumers, that the

Agencies' would at the same time issue capital standards that will likely reduce the number of banks able to make those loans to those same consumers. Our primary questions about the Agencies' segmentation include the following:

1. Does the standardized approach treatment fairly align with the advance approach guidelines for similar assets? Specifically, do larger banks have an ability to offer similar or more innovative mortgage products with a lower capital charge than what would be allowed under the standardized approach used by community banks?
2. With regard to the specific criteria, questions remain about what constitutes a "balloon payment" and what are the specific regulatory requirements to demonstrate that the borrower's income has been sufficiently "documented and verified".
3. Will the inability to recognize private mortgage insurance for risk mitigation impact the cost and availability of mortgage products to credit-worthy borrowers, particularly first-time home buyers?
4. The NPR allows the primary federal regulator to make an independent determination that any particular loan may not qualify as Category 1 exposure, even if the loan meets the specified criteria. What will be the basis for that determination?

Southside's Recommendation: Southside believes that the criteria for Category 1 loans need to be more clearly defined so that prudently underwritten loan products similar to those underwritten by most community banks are not unfairly targeted. Specifically, we would redefine the Category 1 exclusion for loans that "result in a balloon payment" and only include loans that are not amortizing. A five-year amortizing adjustable rate mortgage does not have the same risk characteristics as a payment-option or negative amortization loan.

We would also recommend requiring the Agencies to adhere to established criteria in determining whether a loan is qualified as Category 1. In order to lend to credit-worthy borrowers, institutions need to have confidence that if they follow defined criteria, their actions will not be overturned by an arbitrary regulatory ruling.

Proposed Rule: Past Due Exposures – The Agencies have proposed that banking organizations assign a risk weight of 150 percent to any exposure that is not guaranteed or not secured (and that is not a sovereign exposure or a residential mortgage exposure) if it is 90 days or more past due or on nonaccrual. A banking organization may assign a lower risk weight to the collateralized or guaranteed portion of the past due exposure if the collateral, guarantee, or credit derivative meets the proposed requirements for recognition.

Southside Comments: Southside currently follows very well defined procedures related to past-due and nonaccrual loans. To account for the potential loss exposure of these problem loans, institutions will make periodic provisions to their respective allowances for loan and lease losses (ALLL). In our institution, as I assume is the case in all institutions, once a credit reaches 90 days past due or is included in nonaccrual it is evaluated for impairment as required under FAS 114. If the ALLL is calculated properly and reflective of the risk of loss in the loan portfolio, there should be no need to create an additional capital charge.

Assigning a higher risk weight to past due loans does not appear to be a proactive measurement of risk. Instead, it is a retroactive penalty that has the potential to lower institution capital ratios at

a time when a bank would most need to sustain those ratios. In fact, this provision could discourage institutions from working with borrowers and from taking appropriate lending risk during times of economic stress, thereby potentially increasing the overall economic stress.

Bank Recommendation: Since loan loss exposures are already reflected in the ALLL, which is limited as a Tier 2 capital component to 1.25 percent of risk weighted assets, we do not believe there is a basis for an additional capital charge based solely on past-due status.

Proposed Rule: Phase out of Trust Preferred Securities – The Agencies are proposing to phase out trust preferred securities from capital regardless of the asset size of the issuer. The only distinction between issuers with \$15 billion or more in assets and those with less than \$15 billion is a more aggressive phaseout for the former than for the latter.

Southside Comments: While the phaseout for larger issuers is consistent with section 171 of the Dodd-Frank Act, the phaseout for smaller issuers is much more aggressive. More specifically, whereas under Dodd-Frank and the current capital rules, a smaller issuer would enjoy full inclusion in consolidated tier 1 capital for the first 25 years of the 30-year term of a trust preferred security, under the Basel III NPR the security would be phased out over 10 years beginning in 2013.

As a \$3.4 billion bank holding company with \$60 million of Trust Preferred securities we would argue that because the provisions of Dodd-Frank are statutory expressions of congressional intent specific to banking organizations in the United States, they should trump conflicting Basel III provisions, and that the accelerated phaseout schedule for smaller issuers impermissibly contravenes section 171 of the Dodd-Frank Act. The counter-argument would be that Dodd-Frank does not limit the Federal Reserve Board's inherent authority to revise its capital rules consistent with safety and soundness.

Rather than join this legal debate, we urge the Agencies for numerous reasons to approach with extreme circumspection the accelerated deprivation for smaller issuers of capital recognition for trust preferred securities. Those reasons are as follows:

- Because Basel III is addressed to much larger banks than the smaller issuers of trust preferred securities, Dodd-Frank grandfathering of smaller issuers of trust preferred securities should have more weight with the Agencies.
- The capital levels of holding companies are less critical than those of their subsidiary depository institutions because bank deposits are federally insured and because banks generally are more important to the financial system than their parents.
- Because smaller issuers of trust preferred securities have less access to capital markets for purposes of refinancing trust preferred securities, their past reliance on the current capital regulations should weigh more heavily with the Agencies than the reliance of larger issuers.
- Our trust preferred securities are floating rate and thus represent an extremely cost effective source of capital in the current historically low rate environment, and they could be refinanced only at significantly higher cost – if they could be refinanced at all.

- The protracted low rate environment is depressing asset yields and compressing net interest margins for all banks with no end in sight, increasing the importance of existing sources of low-cost capital for smaller banks without economies of scale.

Southside's Recommendation: We believe there are more than sufficient reasons for the Agencies to lay a lighter hand on smaller issuers of trust preferred securities than they propose, and they should apply Dodd-Frank grandfathering to smaller issuers absent compelling safety and soundness considerations to the contrary that the Agencies have not advanced.

Conclusion:

All community banks are struggling to address and implement the large volume of regulatory changes that have been promulgated over the last few years. Our institution has experienced significant increases in cost in terms of personnel, systems and processes needed to incorporate new rules and regulations (e.g. Dodd Frank requirements).

Given this environment, we are concerned with the proposed timeline for implementing the Basel III proposals. We believe that the currently proposed timeline is too aggressive for community banks. Implementing the proposed changes will result in an increase in personnel costs due to additional staffing and training needs. These costs will have an adverse effect on our earnings as well as our ability to organically increase capital.

We are also concerned about the ability of our vendors to accommodate the modification and/or creation of new systems which may be required to monitor and track many of the new requirements (e.g. changes in LTV requirements and risk weighting). If the systems modifications are not available on time, we will be required to handle the new regulations on a costly manual basis.

The incorporation of these new regulations do not take into consideration the current stagnant economic environment. Any new interest rate, financial or systemic shocks that might occur during the phase in period of Basel III could have major unintended consequences for community banks, their market areas and the larger national economy.

Finally, we believe that the increase in regulatory capital ratios will severely limit the growth of many community institutions.

We respectfully request that the timelines be reviewed and modified so as to allow ample time for community banks to implement the Basel III proposals.

Again, we thank you for the opportunity to express our views on the Basel III proposals. We trust that the agencies will give our comments and suggestions the consideration they deserve. Please call or email if you have any questions or if you need additional information.

Sincerely,



Lee R. Gibson
Sr. Executive Vice President and
Chief Financial Officer