SOUTH COAST
Bank & Trust

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

Re: Basel III Capital Proposals

Dear Secretary Johnson:

Thank you for the opportunity to provide comment on the Basel III proposals[i] that were recently issued for public comment by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation. We have been thoroughly reviewing the developments regarding Basel III as they pertain to our bank. We are a $220 million bank in south Georgia. Our lending is conservative and widespread throughout the community. We have never been under a regulatory order since our establishment in 2001. We have an extremely favorable loss history, much better than that of our national and state peer groups.

We have historically carried strong capital ratios. We understand the importance of a strong capital base in running a sound institution. We hold $9.7 million (58.6%) more in risk based capital than required by mandated guidelines to be considered "Well Capitalized" by our primary regulators.

Should Basel III be implemented in its current form, it will have a substantial negative impact. Our risk-based capital drops by $2.9 million. Risk-weighted assets increase by $67.5 million, or 41%. We would be below the Capital Conservation Buffer and unable to pay adequate distributions to fund our Sub-S investors' tax obligations. Further, to get capital ratios back in line, we would have to invest in the shortest (and lowest return) bonds available to preserve capital. We would have to end our home mortgage program, so our customers who do not qualify for traditional mortgages would have to find other options. We will have to speed up our treatment of past due customers, which will not allow them to work through a temporary problem because of the capital implications. Our regulatory oversight costs would rise, resulting in higher costs for the customer. Lastly, we would most likely curtail taking risks on small, prudently underwritten development loans because of their severe risk weightings.

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Below are areas of the Basel III proposal that will have a substantial impact.

Accumulated other Comprehensive Income ("ACOI") in Common Equity Ratios
For many community banks, ACOI takes the form of unrealized gains or losses on the investment portfolio. The inclusion of ACOI as Tier 1 capital essentially marks a portion of the capital to market value. Since banks do not mark their entire balance sheet to market value and this has no impact on common equity until the investment is sold, it should not be included in Tier 1. Additionally, this could overstate\understate real capital depending on the interest rates. Should rates rise, community banks generally would not sell these investments due to the devaluation in their holdings, yet they would be penalized with lower capital for a transaction that most likely will not occur. Likewise, the opposite would be true as well; capital would be over stated in a decreasing rate environment.

We tested our Basel III capital numbers under an adverse rate shock of 300 basis points. The result is a decrease in capital of almost $3 million, or 12.6%, before any loss is actually realized by the Bank. This aspect erodes capital for any bank in good standing, and it could artificially improve the capital stance of a bank in trouble.

1-4 Family Residential Mortgages
Traditional 30 year mortgages are rare in community banks. Most use 3 and 5 year term loans with a 30 year amortization. These loans are not predatory in general, as they must follow current APOR guidelines and other regulatory compliance rules. These loans service two primary forms of customer. The first are customers that do not qualify under the strict rules of the large mortgage companies, yet have the capacity to make the payments. This group is underserved by the general mortgage market, and community banks provide this service more than any regional, super-regional, or systemically important banking institution. The second group is homebuyers who intend to be in the house for a short period. While this admittedly does apply to "house flippers," it also applies to those in military service, government employees routinely transferred, and first-time homebuyers.

If you leave these types of mortgages in Category 2, the risk-weighting will require additional capital be held if a bank engages in this business. Therefore, costs will rise. These loans have become increasingly burdensome for banks to offer. I think many banks will elect not to do them, thereby cutting off credit to the customer segments mentioned above.

Balloon notes are generally renewed at the end of the term; some move on to the traditional mortgage product. They have an amortization schedule to decrease principal. At the end of the term, the loan is renegotiated at the current market rates. These should be considered for Category 1.

Category 2 risk weightings above 100% appear excessive. I understand there are some disposition costs involved, but I don't know if community banks are losing 150% on 1-4 family loans. Could we get that percentage quantified, or at least see discussion as to how this percentage came to be?

Loan to Value Components

The loan to value components need more definition. Community banks in general cross-collateralize many of their loans. For example, a business may borrow money and use commercial assets plus their personal home as collateral. Would this commercial loan carry the general 100% risk weighting, or is this considered as a Category 2 loan under the 1-4 family LTV rules?

High Volatility Commercial Real Estate ("HVCRE")

I do not agree with a 150% risk weighting. These loans are, by the FDIC's admission, a small subset of the community bank portfolio. Examination procedures, supervisory guidelines, and prompt corrective action protocols discourage this type of lending. Increasing the risk-weighting from 100% to 150% puts more capital burdens on struggling banks without giving them much of an outlet to retain capital ratios as they work through problem loans in this category. For is, it is seen as an encouragement to not take the small risks on HVCRE we have in the past, most of which resulted in little loss to the bank and the establishment of a good small business for the community.

Past Due Assets Risk Weights

The 150% risk weighting for nonaccrual loans and assets past due 90+ days may place undue capital burdens on community banks. These assets generally carry specific loan loss reserves due to required impairment testing. Banks are mandated to partially charged off when an impairment is estimated on certain loans. The charge offs decrease the loan loss reserve, which impacts capital reserves. The new guidelines will add an additional burden on capital due to the excessive risk-weighting above 100%.

Additionally, a risk rating this high could increase the amount of foreclosures, as other real estate owned is risk weighted at 100% as opposed to the 150% past due risk weight. For community banks, small business lending is their strong suit. It is community bank lending that drives economic development by providing capital to small businesses. Many of these small businesses use their primary residences as collateral for business loans. While the past due thresholds exclude 1-4 family exposure, the collateral on a commercial loan may be a 1-4 family dwelling.

Loan Loss Reserve Inclusion

If we are to give a risk weighting higher than 100% on past due 90+ and non-accruals, then we should be able to use the entire loan loss reserve as a part of the capital base. Currently we see a portion of it as Tier 2 capital. I'd like to see all of it used as Tier 1 capital, as the loan loss reserve is the first line of defense for troubled loans before capital reserves are depleted.

Threshold of Applicability
The $500 million threshold for holding company compliance should be raised to at least $1 billion. Banking companies of this size do not pose systemic risk to the system. The size and type of risks tolerated by super-regional and systemic banks are vastly different from that of the smaller community banks. Most of the failures of community banks have been handled through acquisition by other banks and have resulted in manageable losses to the FDIC insurance reserve, which is fully funded by member banks.

Burden of Compliance
The set-up costs will be over-burdensome to community banks. Most core systems used by community banks do not adequately capture loan to value information necessary for the new regulations. Many banks would like to begin inputting the data, but the core systems most likely will not change their systems until closer to the deadline. Therefore, data entry, data review, and report preparation will be condensed into a short period, which will ultimately cost the banks in productivity as well as excess personnel costs.

Implementation Period
Basel III begins phase-in of certain items in 2013, with full implementation by 2019. With the recent pronouncements of a flat economic environment most likely through 2015, banks are limited in their options to shift their balance sheet to meet the new requirements. That essentially shrinks the phase-in window. Phase in should begin in 2015 at the earliest.

We understand the reasons why Basel III has been adopted as a potential replacement for the current capital requirements. Those reasons apply to larger institutions with more optionality risk and international risks than the standard community banks. When it comes to capital, one size does not fit all. If you review the capital ratio history for most of the failed community banks, you will see the original capital reporting framework provided a clear record of that bank's decline. Modifications may be needed to the existing structure for local banks. However, the dramatic changes proposed in Basel III will result in a contraction of the banking industry via failures and forced mergers, higher costs and fewer products for the general public, and a continuation of our recessionary economy due to less credit availability.

Sincerely,

South Coast Bank & Trust

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[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.*