From: HCSB, J. David Williams, Chairman

Proposal: 1442 (RIN 7100-AD 87) Regs H, Q, & Y Regulatory Capital Rules

Subject: Regs H & Y Regulatory Capital Proposals

Comments:

Basel III Issues - HCSB, a state banking association's Comment Letter on Basel III proposals

October 22, 2012

Hon. Ben Bernake, Chairman, Federal Reserve System:

HCSB protests the additional regulatory burden of the Basel III proposals as they are entirely too complex We believe that many smaller community banking institutions will be forced out of existence and be replaced by the big banks as their interest is not served in smaller markets and rural America. As a member of the Independent Community Bankers Assoc.'s "Regulatory Review" committee, I have met with senior Federal Banking Regulators and discussed the Basel III related issues in depth. The OCC's analyst insisted that they had done everything possible to keep the rules simple. This comment in itself speaks to the naivety of the regulatory process for our company (HCSB) has undertaken significant resources and expense just to understand the complexity of the proposal to determine how HCSB's capital will be affected. "In terms of Basel III, of course, it's not one-size-fits-all. Many of the most difficult, complex regulations apply only to the largest and most complex institutions," Fed Chairman Bernanke said following a recent Federal Open Market Committee meeting. "For the smaller banks, what our proposed rule does is try to strengthen their capital, and many small banks will already meet those capital requirements."

Yes, because of our risk management processes and procedures we meet current Basel I and Basel III requirements. But going forward Basel III, if applied to HCSB will have three significant adverse effects:

1. Capital will only be available through retained earnings, unless our shareholders want to sell additional stock and dilute their current pro rata ownership. Other capital resources, such as Trust Preferred will no longer exist. We will of course restrict growth and change our business model to adapt to international standards that are written for large, international complex financial institutions; many of which are too big to fail.

2. Our declining net interest margins will significantly decrease for interest rate management purposes due to HCSB's change in its business plan to shorten the duration of its investment portfolio (including the sale of longer tax-free municipal securities) so as to decrease the volatility in its investment portfolio; therefore to minimize the AOCI requirements in Basel III that will effect our quarterly earnings.

3. Our SFR customers (that obtain financing from HCSB) will no longer be able to obtain such financing for their rural and non-conforming residential owner-occupied property.

My Board agrees with FDIC Director, Thomas Hoenig when he said in the American Banker on Oct. 4th: "Basel III is nearly incomprehensible to most readers, including bank directors, managers, and analysts. Of what use is a measure that no one can understand? Tangible equity capital is understood by all. Therefore, on its face, it is more useful."

HCSB and all community banks should be allowed to continue using the current Basel I framework for computing our capital requirements. Basel III was designed to apply to the largest, internationally active, banks and not community banks. Our bank did not engage in the highly leveraged activities that severely depleted capital levels of the largest banks (many of which we know are "too big to fail" and created panic in the financial markets). HCSB operates a relationship• based business model that is specifically designed to serve customers in their respective communities for a lifetime. As I said above, we will have to re-invent our business model, a successful business model, to exist in a post Basel III world. An environment we did not create. We have been successful in managing our risk. Why should you require us to adapt to standards of the large banks that have proven their inability to manage risk; time and time again?

The largest banks operate purely on transaction volume and pay little attention to the customer relationship. Our model is based on customer service and furthering our long-term relationships. This difference in banking models demonstrates the need to place tougher capital standards exclusively on the largest banks to better manage the ability to absorb losses. We have proven our ability to manage risk. This is proven by our continued long-term success in the markets we serve.

UNINTENDED CONSEQUENCES ON HOUSING: Even the big banks acknowledge the negative effects on community banking. In an article published by POLITICO, Bank CEOs warn Bernanke, Fed officials of new rules housing impact, BY Jon Prior, published on Oct. 9th, the Big Bank CEOs stated to members of the Board of Governors of the Federal Reserve System, " Along with worries about how the rule will impact the housing market because of how it treats mortgages when determining capital requirements, the CEOs complained that it should not apply to community banks and that the method used for determining the risk of assets is flawed." The Big banks (in attendance at this meeting) openly acknowledged the upcoming detriment to the mortgage lending models of community bankings customers should these provisions of Basel III be enacted.

The proposed risk weight framework under Basel III is too complicated and will be an onerous regulatory burden that will penalize community banks and jeopardize the housing recovery. Increasing the risk weights for residential balloon loans, interest• only loans, and second liens will penalize HCSB as we offer these loan products. Our customers should not be deprived of many financing options for residential property. Additionally, higher risk weights for balloon loans will further penalize community banks for mitigating interest rate risk in their asset• liability management. HCSB will likely not originate only 15 or 30-year amortizing mortgages, as it will make our balance sheet more sensitive to changes in long• term interest rates. We fear that many community banks will either exit the residential loan market entirely or only originate those loans that can be sold to a GSE. Second liens will either become more expensive for borrowers or disappear altogether as banks will choose not to allocate additional capital to these balance sheet exposures. HCSB and the Community banking industry should be allowed to stay with the current Basel I risk weight framework for residential loans. Moreover, the Community banking industry will be forced to make significant software upgrades and incur other operational costs to track mortgage loan• to• value ratios in order to determine the proper risk weight categories for mortgages.

Specifically, HCSB's core-processing system will have to be redesigned for proper reporting under Basel III. Current core-processing systems do not provide input fields for the following information (that will be required under the proposal.)

1. L to V's is not input into community banking core-processing systems.

2. Appraisal values are not input in our core systems.

3. Updated appraisals will be difficult to accurately input into core-processing systems, not to mention the cost and regulatory burden of putting such processes in effect.

HCSB proudly serves both rural and urban markets in the Texas Panhandle, South Plains and Hill Country. We make portfolio held SFR loans in all of these markets. 15% of our loans are in this type of credit. HCSB escrows tax and insurance when underwriting requires escrow. We also make secondary market loans. Our portfolio loans are generally made on "non-conforming" properties; many of which are difficult to support under FNMA & Freddie guidelines and lack comparable property sales (for appraisal purposes). Many of HCSB's portfolio loans are 3, 5 & 7 yr. balloon loans on longer amortizations - some out to 30 years. The bullet or balloon nature of these loans is for HCSB's interest rate risk management.

UNINTENDED CONSEQUENCES: Incorporating AOCI as Part of Regulatory Capital

Inclusion of accumulated other comprehensive income (AOCI) in capital for HCSB will result in increased volatility in regulatory capital balances and could rapidly deplete capital levels under certain economic conditions, i.e. when interest rates rise. HCSB's AOCI represents unrealized gains and losses on investment securities held available• for• sale. HCSB has elected to be taxed as a Sub S Corp., along with 2400 other banking institutions in the United States. This is roughly 1/3 of the remaining bank charters in the United States. This business model is not the same in other Basel countries. Because these securities are held at fair value, any gains or losses are reflected in regulatory capital and not run through quarterly earnings. Many Sub S banks have significant tax-free municipal investments, due to their attractiveness to Sub S business models. These positions are well underwritten and our bank has experienced $00 loss from these types of investments.

We all know, as interest rates rise, investment portfolio fair values will fall causing the balance of AOCI to decline and become negative. This decline will have a direct, immediate impact on common equity, tier 1, and total capital, as the unrealized losses will reduce capital balances. At my bank, for instance, if interest rates increased by 300 basis points, HCSB's bond portfolio would show a paper loss of $5.1million. This would mean that my bank's tier one ratio would drop from 9.41% to 7.57%. HCSB's portfolio duration is 2.5 yrs; we consider this fairly short. By reducing our duration and most likely liquidating a significant portion of our tax-free portfolio the bank's net interest margin will be further reduced. This will impact our core earnings significantly. Local Government Municipalities will receive the "unintended consequences" of Basel III when the community banking industry no longer buys their longer-term securities, specifically due to this illogical provision of Basel III. This will drive up the cost of their financing activities. Small communities rely on their community banking organizations to buy there smaller debt issues.

Large, complex financial institutions have the ability to mitigate the risks of capital volatility by entering into qualifying hedge accounting relationships for financial accounting purposes with the use of interest rate derivatives like interest rate swaps, option, and futures contracts. HCSB does not have the knowledge or expertise to engage in these transactions and manage their associated risks, costs, and barriers to entry.

Unintended Consequences - Ability of Community Banking Industry to Access Capital:

Basel III removes many options of the Community Banking Industry to raise capital.

There must be provisions to allows Sub S banks to raise capital such as a 2nd class of Sub S stock (cumulative preferred) that will allow Sub S banks to augment capital. Both the ICBA and IBAT (Independent Banker's Assn of Texas) are currently pursuing such legislation. Trust Preferred issues should be Grandfathered on banks and BHCs]$500M to [$15Billion consistent with current guidelines.

HCSB operates a relationship• based business model that is specifically designed to serve customers in their respective communities on a long• term basis. This model contributes to the success of community banks all over the United States through practical, common sense approaches to managing risk. The largest banks operate purely on transaction volume and pay little attention to the customer relationship. This difference in banking models demonstrates the need to place tougher capital standards exclusively on the largest banks to better manage the ability to absorb losses.

1. Capital Conservation Buffers:

Implementation of the capital conservation buffers for community banks will be difficult to achieve under the proposal and therefore should not be implemented. Many community banks will need to build additional capital balances to meet the minimum capital requirements with the buffers in place.

Community banks do not have ready access to capital that the larger banks have through the capital markets. The only way for community banks to increase capital is through the accumulation of retained earnings over time. Due to the current low interest rate environment, community bank profitability has diminished further hampering our ability to grow capital. If the regulators are unwilling to exempt community banks from the capital conservation buffers, additional time should be allotted (at least five years beyond 2019) in order for those banks that need the additional capital to retain and accumulate earnings accordingly.

2. HCSB is a Subchapter S Bank:

Imposing distribution prohibitions on community banks with a Subchapter S corporate structure conflicts with the requirement that shareholders pay income taxes on earned income. HCSB, as well as all Sub S banks' capital 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.

Our board recommends that the capital conservation buffers be suspended during those periods where the bank generates taxable income for our shareholders. For Sub S banks Basel III will have an even more pronounced impact and result in more volatility, as AOCI gains or losses are not "tax effected" for Sub banks as they are for C corp. banks. In effect a $1million AOCI (loss in value) would be recorded as a $650thousand loss by a C Corp but a Sub S bank would have to reduce its quarterly earnings (i.e. capital) by $1million. This disparity must be recognized and understood by the Regulators.

3. Excess capital:

Allow movement of excess RFBD (]1.25%) into Tier 2 Capital.

4. Proposed Phase• out of Trust Preferred Securities:

HCSB objects to the proposed ten-year phase• out of the tier one treatment of instruments like trust preferred securities (TRUPS) because it is a reliable source of capital for community banks that would be very difficult to replace. We believe it was the intent of the Collins amendment of the Dodd• Frank Act to permanently grandfather tier one treatment of TRUPS issued by bank holding companies between $500 million and $15 billion. Phasing out this important source of capital would be a particular burden for many privately• held banks and bank holding companies that are facing greatly reduced alternatives in raising capital. While we acknowledge the fact that TRUPS issued by bank holding companies under $500 million would not be impacted by the proposal, consistent with the Collins Amendment, we urge the banking regulators to continue the current tier one treatment of TRUPS issued by those bank holding companies with consolidated assets between $500 million and $15 billion in assets.

In conclusion, Basel III will be extremely detrimental to safe and soundly run community banking institutions like HCSB; my Board of Directors and I agree that it serves little merit to include our institution in requirements that are intended for complex internationally active banks. This proposal will require HCSB to change its business model. A Business model that has been successful in providing financial services to the communities we serve in the Texas Panhandle, South Plains and Texas Hill Country since 1934.

Sincerely,

HCSB

J. David Williams

Chairman

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