Seacoast Commerce Bank ®

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September 25, 2012

The Honorable Ben S. Bernanke
Chairman
Federal Reserve System
20th Street and Constitution Ave, NW
Washington, DC 20429

The Honorable Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

The Honorable Thomas J. Curry
Comptroller of the Currency
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

Re: Implementation of Basel III – Regulatory Capital Rules
Basel III FDIC RIN 3064-AD95, RIN 3064-AD96, and RIN 3064-D97

Dear Chairman Bernanke, Acting Chairman Gruenberg, and Comptroller Curry:

Thank you for the opportunity to provide a comment letter on the Basel III proposals. Seacoast Commerce Bank is a small community/business bank headquartered in San Diego, California which has been operating for approximately the past 10 years and has approximately $160 million in assets. The primary focus of the bank is to accept business deposits and lend those deposits out primarily through the U.S. Government's Small Business Administration ("SBA") program, providing financing for small business owners to acquire real estate for use by their business. Seacoast's lending operations provide credit to small businesses in California, Arizona, Nevada, Texas, Utah, and Washington.

First and foremost, I firmly believe that community bankers understand the need to review the capital standards for banks and holding companies, in light of the recent financial downturn, and to develop a framework which provides for larger, systemically important and more complex banks to become safer. However, if enacted in its current form, the notice of proposed rulemaking ("NPR") will have certain unintended consequences on smaller community banks which I would like to address in this letter.

While exemptions exist for smaller institutions with respects to many parts of the NPR, several are applicable to <u>all</u> banks, regardless of size, and can have significant, and sometimes volatile, impacts on their capital. One particular provision of the NPR which relates to the deduction of mortgage servicing assets is particularly troublesome.

In a very generalized example, after funding an SBA loan for a small business client, typically the guaranteed portion of that loan is sold in the secondary market (guarantees from the SBA range from 75%-85% of the loan amount). All sales of SBA guaranteed loans are done on a "servicing retained basis" requiring that Seacoast retain the rights and obligations to service the loan. It is particularly important for Seacoast to continue to service the loan, after it has been sold, as the bank continues to maintain an on-going relationship with the client and continues to hold the unguaranteed portion of the loan on the bank's books.

SBA regulations require lenders to retain a minimum of 100 basis points of the cash-flow (from the interest portion of the client's payment) from the loan for any guaranteed loan sold as compensation for servicing that loan. That monthly servicing income has to be capitalized into a "mortgage servicing asset" based on the discounted present value of the future payments as required under Accounting Standards Codification ("ASC") 860, "Transfers and Servicing".

As also required under ASC 860 is the need to reallocate the recorded investment in the loan between the sold and retained portion relative to fair value, with the fair value of the retained, unguaranteed portion, also being based on a discounted cash flow method. The discounted cash flow calculation on the unguaranteed portion of the loan retained creates a "book discount" which is recorded against the unguaranteed portion retained.

Simply put, there is economic value to the 100 basis point servicing income received, which is offset by the discount which has been taken on the retained portion of the loan held. Existing accounting treatment creates a book discount that is recognized as an increase to capital over the similar time period, and using similar methods as the servicing asset, which is recognized as a decrease to capital…they offset. If this loan pre-pays early, or defaults, there would be no adverse hit to capital as the servicing asset and discount on retained appropriately offset each other.

This is very different than the mortgage servicing asset created by larger consumer mortgage originators/servicers as they do not retain any portion of the loans they sell. Upon pre-payment or default, there is no offsetting "discount" so there is a significant hit to capital.

The treatment of mortgage servicing assets in the calculation of capital under the proposed Basel III framework, if implemented, will result in the reduction of Seacoast's Common Tier 1 capital by 15.3%, as depicted below:

(as of July 31, 2012)	Common Tier 1 Capital Pre-Basel III	Common Tier 1 Capital Post-Basel III
Common, Surplus, & Retained Earnings	$14,014,567	$14,014,567
Unrealized Gain/(Loss) on AFS Securities	-0-	60,427
	14,014,567	14,074,993
Excess Servicing Asset Adjustment	-0-	(2,206,134)
Common Equity Tier 1 Capital	14,014,567	11,868,859
Capital Lost as a result of Basel III		15.3%

It should also be noted that Seacoast's Tier 1 Capital to Risk-Weighted Assets ratio will be reduced by 15.5%, and the Total Risk-Based Capital to Risk-Weighted Assets ratio will be reduced by 14.4% under the Basel III framework.

While for regulatory purposes Seacoast would still be considered "well capitalized", given current regulatory expectations on banks in this environment, a 15% reduction in capital could prompt (require) the bank to limit lending until such time as the capital levels have returned to pre-Basel III levels. This would require a reduction of the Seacoast's lending by a corresponding 15%.

As a small bank, Seacoast's business model is heavily focused on lending to small businesses through the SBA program. For the SBA's fiscal year ending September 30, 2011, Seacoast had SBA loan approvals in excess of $150 million. A 15% reduction in capital, and a corresponding 15% reduction in lending, would translate into approximately $30 million less in small business lending to small business.

According to SBA data, every $1 million that is lent out under the SBA's lending program creates or saves 33 jobs. A $30 million reduction in lending would result in roughly 990 fewer jobs being created or saved by small businesses, which are the backbone of our economic recovery.

While the intent of Basel III may be to make large, systemically important banks stronger, it is apparent that there are unintended consequences to smaller banks. Given the ASC 860 Accounting standards controlling SBA guaranteed loan sales and servicing assets, the Basel III change in the capital treatment for these servicing assets is unjustified and unnecessary. The reduced capital levels for smaller banks will result in weaker bank balance sheets and less credit available to small businesses.

I strongly urge you to consider the adverse impact which Basel III will have on community banks in this country, and their ability to lend to small business, and to consider an exemption for all banks under a certain size and complexity which were not responsible for the financial crisis. Thank you for your time and consideration.

Respectfully submitted,

Richard M. Sanborn

Richard M. Sanborn
President & CEO

cc: Senators Johnson and Shelby, Senate Committee on Banking
Senators Landrieu and Snow, Senate Committee on Small Business
Representatives Bachus and Frank, House Committee on Financial Services
Representatives Graves and Velazquez, House Committee on Small Business
American Bankers Association
Independent Community Bankers of America