South Atlantic Bank

September 27, 2012

The Honorable Thomas J. Curry, Comptroller
Office of the Comptroller of the Currency
Regs.comments@occ.treas.gov
Docket ID: OCC-2012-008

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 3054-AD95

Re: Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Correction Action

Gentleman:

On behalf of the Board of Directors of South Atlantic Bank (SAB), we are commenting on the proposed notices of rulemaking (NPR) dealing with Basel III. The NPRs were released for comment on June 12, 2012 by the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC), (together, "the Agencies") and are designed to incorporate the latest revisions to the BASEL III capital framework and to implement relevant provisions of the Dodd Frank Wall Street Reform and Recovery Act. The Agencies have stated their belief that the proposals will result in capital requirements that "better reflect banking organizations' risk profiles and enhance their ability to continue functioning as financial intermediaries, including during periods of financial stress, thereby improving the overall resiliency of the banking system."

SAB supports the Agencies' efforts to address perceived weaknesses in the banking industry's capital framework; however, these perceived weaknesses should be evaluated and determined to be actual weaknesses, especially for community banks. The significant impact this will have on community banks makes it imperative that all recommendations are fully vetted based on real world environments and not just academic. The expansion of the comment period hopefully will allow more real world comments to assist you in decisions; however, it will diminish the amount of time to review comments due to the impending start date of January 1, 2013.

For this reason, SAB is providing a simplified response on the key components of the NPRs that we believe could, in practice, run counter to the Agencies objectives of providing a better mechanism for reflecting capital risk within the banking system. The comments provided below reflect specific aspects of the proposals that, in our view, will have the most significant impact on our community bank. We

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recognize, however, that other aspects of the NPRs that are not addressed herein could have a material impact on the operations of individual organizations.

General Observation on Proposed Rules: All of my life the United States of America set the standard on how businesses, especially banks operated. Now, it seems that we do not set policy any more, but rely on other countries to provide input on how we as a country should operate. Our understanding with BASEL III is that no foreign country operates a community banking system similar to our system. They all are large money center institutions. There is a very large difference in the operation of a community bank and the operation of multi-billion dollar institutions. There always needs to be a separation in standards for these two dramatically different businesses. We encourage the committee to once again set the rules for how an American bank should operate and not listen to foreign input that at this time is not going to implement these same rules in their countries.

- 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).
- SAB Comments: SAB has a number of concerns about the inclusion of AOCI as a component of Tier 1 Capital. By definition, unrealized gains and losses are just that gains and losses that have not be REALIZED, thus creating requiring adjustments to Tier 1 capital based on something that may not even happen. 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." While we recognize the appropriateness of AOCI inclusion in a tangible capital ratio from a market valuation perspective, the introduction for a similar structure to the regulatory capital metric has the potential to create confusion over the adequacy of recorded ratios and could lead to flawed, uneconomic and even unsound decisions regarding an institutions asset-liability management and investment options. Some of the more troubling aspects of this proposal include the following:

    1. Inclusion of AOCI in the standardized regulatory capital ratios would force regulators and our bank to calculate alternative ratios to determine an effective capital position, exclusive of AOCI. Capital ratios bolstered by market appreciation would most certainly be discounted to reflect the potential volatility that might exist in a rates-up environment. At the same time, market depreciation would be counted against capital, even though a rates-down scenaireo might significantly improve our institution's capital position. In the latter case, institutions would need to hold greater levels of common equity capital to comply with a ratio requirement that reflects a potentially temporary adjustment.
    2. To avoid recognition of AOCI, we may be incentivized to hold securities in the held-to-maturity (HTM) account. While the move to the HTM account would no longer require gains and losses on those securities to be recorded in Tier I capital, the operational restrictions imporsed on the HTM account would greatly reduce our ability to properly adjust our portfolio for liquidity and funds management purposes. Additionally, when different banks place identical securities in AFS or HTM, it creates differing capital treatments even though the relative risks involving the securities are the SAME.
    3. To avoid capital ratio volatility, we may also be inclined to make shorter-term investment decisions that reduce the 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 and generate capital appreciation. We would be forced to pursue other options to generate yield, which will undoubtedly contain more risk. One of the main purposes of the portfolio is to provide liquidity in a mostly risk free environment.
    4. The AOCI inclusion for AFS securities applies mark-to-market treatment to only one set of assets on our bank's balance sheet. Other balance sheet components that are economically very similar

do not receive the same treatment, such as loans and HTM securities. There are two very real difficulties of this treatment. First, this violates the basic accounting principal of consistency. Second, it would in effect weaken our bank's asset-liability management; specifically, it adds potential capital penalty on using the securities portfolio, the most flexible tool at our ALCOs disposal, to reduce overall asset sensitivity while leaving no such penalty on any other balance sheet component.

5. The negative impact of these requirements would fall disproportionately upon our bank and all community banks due to our limited ability or access to capital markets for funding and temporary equity enhancements or options as would the large money center or Wall Street banks.

We have included an illustration of the impact of this proposal on our bank.

SAB Recommendation: Our Board 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 liquidity and funds management function. While the impact on capital should be considered, our bank's capital ratios cannot be effective measurements of risk when only one class of assets (the ones with less risk) among many is considered to recognized ongoing market value adjustments.

It has been suggested that 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 and other political subdivisions. SAB supports these exclusions and agrees that they would help to minimize the impact of the proposed AOCI treatment. However, our Board should have full power to diversify the investment portfolio and total balance sheet, make informed investments in securities that contain some level of risk without an inequitable capital volatility penalty!

- **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 leveraged capital framework. The Agencies are also proposing limits on capital distributions and certain discretionary bonus payments of 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 the 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.

SAB Comments: We understand the requirement for having minimum capital requirements; however, we strongly oppose adding an additional buffer to the minimum requirements. Basically, you are using bait and switch on exactly what levels constitute "Well Capitalized."
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 actually 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 to absorb cyclical risks at the "well-capitalized' level.

SAB Recommendations: To avoid confusion and to better link the proposed capital guidelines to the existing PCA framework, SAB recommends that the Agencies determine the actual minimum capital ratios and do away with any type of "buffer" or smoke and mirror approach to regulation. The current laws and regulations address troubled institutions and the Agencies abilities to limit or restrict certain activities. Stop adding additional overhead to an industry that is already burdened to the choking point. In addition, we feel this is an attempted over-stepping of authority to add additional requirements and limiting the ability of the Board of Directors to act on behalf of the shareholders in approving dividends and or incentive payments based on an arbitrary ratio. Who has a better grasp of the financial condition of a bank than the Board of Directors? Most recently during a conversation with our Regulator, she had no knowledge of our bank and when the last exam was conducted and if we responded to the numerous inaccuracies cited in the report.

- **Proposed Rule: Residential Mortgage Exposures** – 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 treatment would be maintained for residential mortgage exposures that are guaranteed by the U. S. government or a U. S. government agency.

SAB Comments: We do not agree with the Agencies assumption that Community Banks were the culprit of the mortgage products and the high default that resulted during this recession. The sister Agencies, Fannie Mae and Freddie Mac set the standards on what types of mortgages they would purchase, thus creating the mortgage debacle. To punish community banks for these actions is way off base.
There are some key questions concerning this NPR that must be answered in order to fully comment.

1. Does the standardized approach treatment fairly align with the approach guidelines for similar assets? Specifically, do non-community banks have the ability to offer similar or more innovative mortgage products with a lower capital charge than what our community bank may offer?

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 quality as Category 1 exposure, even if the loan meets the specified criteria. What will be the basis for that determination? Individual examiners should never have authority to act outside of prescribed limits. This is currently common practice.

SAB Recommendation: SAB would like the criteria for Category 1 loans be more clearly defined so that prudently underwritten loan products are not unfairly targeted. 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.
The Agencies must adhere to established criteria in determining whether the 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 or examiner.

- **Proposed Rule: Past Due Exposures –** The Agencies have proposed that banking organizations assign a risk weight to 150 percent to any exposure that is not guaranteed or not secured 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.

  SAB Comments: In determining the level of our allowance for loan losses (ALLL), increases in past-due and non-accrual loans is a primary factor in increasing this allowance. If we are calculating the ALLL properly and reflective of the risk of loss in the loan portfolio, there is no need to create an additional capital charge to reflect temporary and expected fluctuations in the economic cycles of different markets. 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 bank's capital ratios at a time when a bank would most need to sustain those ratios. This approach would discourage our ability or willingness to work with borrowers and from taking appropriate lending risk during time of economic stress. In addition, please justify the 150 percent risk weighting. In all of our years in banking, we have never lost more than 100 percent of the debt.

  SAB Recommendation: Loan loss exposures are already handled in the ALLL, which is currently 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. The Agencies should consider one approach over the other. We do not need two systems for handling reserves on past due loans. This appears to be another approach to dilute the capital of well-capitalized community banks.

Conclusion

SAB supports the Agencies effort to improve the quality and quantity of regulatory capital and to build additional capacity in to the banking system to absorb losses in times of economic stress. SAB has attempted to provide feedback that will help improve and enhance the quality of the overall proposals. We have concentrated our comments on areas that have the greatest impact to our community bank. In our view, there are several provisions that could create significant volatility and inconsistency in their reported capital ratios. We believe these provisions could impact the effectiveness of the proposal and have negative consequences to our community bank.

In summary, as it relates to the BASEL III NPR, the AOCI provision is a matter of GREAT concern, both in terms of creating significant volatility and inconsistency in reported ratios and in potentially introducing economically unsound decision-making constraints. As a result, we do not believe that AOCI should be included as a part of regulatory capital. We also believe that the Capital Conservation Buffer should be removed from the proposal. A single framework for establishing minimum capital ratios similar to current practice should be considered. The NPR should not contain smoke and mirror proposals. Further, there are several provisions of the second proposal, the Standardized Approach NPR that, if left unadjusted, could create inaccuracies and inconsistencies in the reported ratios, particularly the risk-based adjustments for mortgage exposures and past dues.

SAB appreciates the opportunity to comment on this proposal. If you have any questions or would like additional information, please do not hesitate to contact any of the undersigned at 843.839.0100.

Sincerely,

Richard N. Burch
Executive Vice President
Chief Financial Officer

K. Wayne Wicker
Chief Executive Officer
Chairman of the Board

R. Scott Plyler
President

Appendix to South Atlantic Bank Letter of September 27, 2012

The below is a simulation of our community bank's financial balance sheet and the consequent capital effects of applying the proposed AOCI provision under rate shocks ranging from down 300 bps through up 300 bps.

We have modeled our community bank with average total assets of $500 million, a securities portfolio of $100 million (20% of assets), leverage capital of $40 million (and therefore a leverage ratio of 8.00%), and a securities portfolio of about 3.50 years.

To remove any asymmetrical peculiarities due to current rates being less than 300 bps from zero, the case is modeled in an environment in which the 3.75-year Treasury rate is 4.00%. This maturity was selected because at a 4.00% yield, this Treasury would have a 3.49-year duration.

To simplify the illustration and to remove any potential additional capital volatility due to security credit, structure, optionality or basis risk, the portfolio is modeled to consist entirely of this 3.75-year Treasury with a 4.00% coupon and currently priced at par.

Initial Condition (,000s)

Assets		**Liabilities and Equity**	
AFS Securities	$100,000	Liabilities	$460,000
Loans and Other Assets	$400,000	Equity	$ 40,000
Total	**$500,000**		**$500,000**

Rate Shock Impact on Capital

Rate Shock in bps	**-300**	**-200**	**-100**	**0**	**100**	**200**	**300**
Yield (1)	1.00%	2.00%	3.00%	4.00%	5.00%	6.00%	7.00%
Price (2)	111.01	107.18	103.52	100.00	96.61	93.37	90.25
AOCI (,000)	$11,005	$7,183	$3,516	-	($3,385)	($6,631)	($9,749)
Capital (,000)	$51,005	$47,183	$43,516	$40,000	$36,615	$33,369	$30,251
Assets (,000)	$511,005	$507,183	$503,516	$500,000	$496,615	$493,369	$490,251
Leverage Ratio (3)	**9.98%**	**9.30%**	**8.64%**	**8.00%**	**7.37%**	**6.76%**	**6.17%**

1 Market yield on a 3.75-year Treasury given the rate shock, assuming initial yield is 4.00%
2 Price of a 4.00% coupon, 3.75-year Treasury, given the shocked market yield
3 (After-shock capital/After shock assets); assume go-forward average assets = after-shock assets