PALMETTO BANCSHARES, INC.
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October 5, 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, SW
Mail Stop 2-3
Washington, DC 20219

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation,
550 17th Street, N.W.
Washington, D.C. 20429

Re: Basel III Capital Proposals

Ladies and Gentlemen:

Palmetto Bancshares, Inc. and its wholly-owned subsidiary, The Palmetto Bank (the "Bank"), appreciates the opportunity to provide comment on the Basel III proposals[1] (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.

The Bank is a 106-year old independent state-chartered commercial bank with assets of $1.2 billion serving a nine county region of South Carolina (commonly referred to as the "Upstate") through 25 branch locations. Our primary federal regulator is the Federal Deposit Insurance Corporation ("FDIC"). The Bank specializes in providing personalized community banking services to individuals and small to mid-size businesses. The services provided to the Upstate of South Carolina include, among other things, residential mortgage and commercial loan origination and servicing as well as Small Business Administration lending. We are providing this letter to you to convey our comments on the Proposals.

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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.*

Like many banks, we analyzed the pro forma impact of the Proposals on our regulatory capital ratios in order to assess the potential impact on the Bank. Not surprisingly, application of the Proposals is expected to have a substantial impact on our capital ratios, both in terms of the level of capital and our risk-weighted assets. While our analysis indicates that we would likely continue to meet the proposed "well-capitalized" thresholds, including the phased-in capital buffers, our capital levels would nonetheless be significantly affected by the Proposals. To fully offset the estimated capital impact and maintain our capital ratios at today's levels, we would have to raise additional Tier 1 capital, reduce outstanding loans (primarily through reduced lending) or some combination thereof. Irrespective of the potential impact of the Proposals on the Bank's regulatory capital ratios, we present our thoughts and comments on certain provisions outlined in the Proposals as discussed further below.

Capital Ratios

The Proposals establish a Common Equity Tier 1 risk-based capital ratio, increase the minimum "adequately capitalized" threshold for the Tier 1 risk-based capital ratio and introduce the concept of a capital conservation buffer. The additional capital needed as a result of the conservation buffer is in addition to the capital requirements stemming from an overall increase in risk-weighted assets resulting from other changes outlined in the Proposals. The conservation buffer and changes to risk-weighted asset factors both serve to provide additional capital to cover perceived risk within an organization. We believe that these combined provisions create the need for a level of capital well in excess of what is required to maintain a sound banking system. We request that the Agencies reconsider the combined effect on capital of both of the Proposals. Capital levels that are too high reduce shareholder returns, provide incentives to reduce lending and credit availability and may drive capital from the banking system to more efficient industries that provide better returns.

Servicing Assets

The Bank participates in the Small Business Administration ("SBA") 7(a) program which provides government guarantees of a portion of each qualifying loan. The Bank generally sells the guaranteed portion of these loans, which provides funds to make additional loans. The Bank retains the rights and obligations to service the loans and therefore records a servicing asset when the loan is sold. The servicing asset is amortized as a reduction of servicing income over the life of the underlying loan. Since the sale of the guaranteed portion of the SBA loan represents only a portion of the originated loan, the Bank reallocates the recorded investment in the loan between the portion sold and the portion retained, which results in a discount being recorded on the retained portion.

The Bank also services residential mortgage loans for its own account and for the account of others. The process of selling mortgage loans and retaining the servicing obligation creates a servicing asset in much the same way that one is created for selling SBA loans.

While these servicing assets are considered an intangible asset, unlike other intangible assets such as goodwill, there is a future cash flow that is payable to the Bank. The Proposals, however, significantly restrict the inclusion of these assets in regulatory capital and impose an increase in the risk-weighting for servicing assets that are able to be included in regulatory capital.

While the Bank's servicing rights do not exceed the proposed threshold deductions, we nonetheless recommend that 100% of servicing assets be included in Common Equity Tier 1 capital since these intangible assets are supported by future cash flows and are already reflected at the lower of cost or fair market value under US GAAP. An additional compensating measure supporting more lenient capital treatment of servicing assets in the case of SBA loans results from the discount recorded on the unguaranteed (retained) portion of the loan. While the servicing asset is considered the capitalization of future servicing income, the discount can be considered the deferral of a portion of the gain on sale. The servicing asset and discount are generally recognized in like amounts and amortize and accrete in like amounts over the same period. The effect of loan prepayments tends to accelerate the respective amortization and accretion equally. All of this tends to cancel out to a capital neutral position and therefore an additional reduction in capital is considered punitive.

In addition, for the reasons noted above, the Bank also recommends that the current risk-weighting of 100% for servicing assets be retained as opposed to increasing to 250% as outlined in the Proposals. A punitive risk-weighting on servicing assets provides a disincentive for community banks such as the Bank from providing valuable mortgage servicing benefits to homeowners in the communities served and from generating lendable funds through the sale of SBA loans.

Accumulated Other Comprehensive Income ("AOCI")
As drafted, the Proposals would end the practice of excluding items included in AOCI from regulatory capital. AOCI for the Bank includes unrealized gains and losses on debt securities classified as available for sale ("AFS securities) and defined benefit pension plan adjustments.

Regarding the component of AOCI related to unrealized gains and losses on AFS securities, we request that the Agencies maintain the current practice of excluding these amounts from the calculation of regulatory capital. The inclusion of unrealized gains and losses in the calculation of regulatory capital would introduce a degree of volatility in capital levels that is inconsistent with the risks faced by the Bank and with its risk management objectives. A bank maintains flexibility over when such gains and losses are ultimately realized in earnings, if ever, through its decisions to sell or retain such securities as desired. Changes in regulatory capital from temporary increases and decreases in unrealized gains and losses do not properly capture the actual loss absorbing capacity of a bank's capital base. Further, requiring banks to include these unrealized gains and losses in the calculation of regulatory capital would likely have the unintended result of decreasing participation and liquidity in markets for securities other than the safest of instruments (e.g. US Treasury securities). Markets for US Agency debt, municipal bonds and mortgage-backed securities could suffer from a lack of liquidity as banks avoided these markets in an effort to reduce potential volatility in regulatory capital levels. As a result, municipalities and consumers may see a reduction in available credit and banks would experience reduced earnings as more funds are retained in low yielding cash accounts.

In addition, to limit potential volatility in unrealized gains and losses, banks will likely avoid taking duration risk on investment securities. While lower duration risk may appear to be a desirable outcome, there is a cost to bank earnings and the ability to generate capital internally as these instruments result in lower overall yields and may actually increase a bank's interest rate risk profile.

Regarding the proposed inclusion of underfunded pension plan liabilities in regulatory capital, we also request that the Agencies consider retaining the current guidance which excludes this component of AOCI from the determination of regulatory capital. In a receivership situation, claims of the FDIC would be senior to those of the beneficiaries of underfunded defined benefit plans, who would be considered unsecured general creditors of a sponsoring bank. Including these amounts in regulatory capital introduces a counterproductive measure of volatility that does not further protect the deposit insurance fund or taxpayers.

Deferred Tax Assets ("DTAs")

Current regulatory rules allow the inclusion in Tier 1 capital of DTAs expected to be realized in the ensuing 12 months. While we ultimately would like to see the inclusion in regulatory capital of all DTAs recognized under U.S. GAAP, we recognize the Agencies' desire to provide limits on the amount of DTAs included in regulatory capital. However, given the already stringent recognition criteria under U.S. GAAP, it appears that more restrictive recognition criteria for regulatory capital purposes reduces an institution's capital unnecessarily since the presence of a DTA indicates that the institution has already performed an assessment and concluded that the DTA is "more likely than not" to ultimately be realized. Given that the Agencies appear to desire including a provision for excluding a portion of DTAs, we recommend that the Agencies retain the current provision which allows for the inclusion of DTAs in regulatory capital that are expected to be realized over the next 12 months.

Categorization and Risk-Weighting of Residential Mortgage Exposures

Under the Proposals, risk-weightings for residential real estate loans range from 35% to 200% depending on the "Category" to which a loan belongs and the loan's original loan-to-value ("LTV") ratio. Under the Proposals, a residential real estate exposure must satisfy a set of criteria to be treated as a "Category 1" exposure (a lower risk-weighting is applied to these loans as compared to "Category 2" loans). All residential real estate loans that do not satisfy these criteria will be treated as "Category 2" loans and subject to a minimum risk weight of 100%. One of the conditions for satisfying the "Category 1" criteria is that the underwriting standards on these loans took into account all of the borrower's obligations and resulted in a conclusion that the borrower is able to repay the loan using (1) the maximum interest rate that may apply during the first five years after the closing date and (2) the amount of the exposure is the maximum possible contractual exposure over the life of the loan as of the date of the closing of the loan.

We request that the Agencies consider modifying the Proposals to allow a "grandfathering" of loans originated prior to the issuance of the final rules and retain the current risk-weighting guidance for these loans or, at a minimum, allow them to be included in "Category 1" without regard to the underwriting criteria noted above. In certain cases, due to the passage of time and inability to locate documentation from many years ago it may be extremely difficult or impossible to conclude that such underwriting criteria were applied at the time the loan was originated. In instances where such documentation exists, significant time and effort will need to be invested collecting the required evidence and documenting conclusions. By allowing an exception for existing loans, the Agencies will allow a practical exception that will diminish in exposure as time passes and the loans in question are repaid and will allow critical bank resources to be used elsewhere. This is particularly important as banks will already be expending significant effort gathering LTV information for residential real estate loans originated over a period of many years; in some cases hiring additional resources to do so.

Risk-Weighting of High Volatility Commercial Real Estate Loans
We are concerned that the increased risk-weighting to be applied to High Volatility Commercial Real Estate ("HVCRE") loans as outlined in the Proposals will result in an overall reduction in affordable lending for property developers and community banks alike. Increased buffers to absorb losses from this form of lending are already captured through an appropriate allowance for loan losses. Higher capital requirements implemented through an elevated risk-weighting factor will require institutions, community banks in particular, to increase pricing in order to appropriately compensate them for the added capital. We are concerned that this will drive commercial real estate development financing into non-traditional areas such as private equity or other alternative channels that do not necessarily support local community investment to the degree seen in the community banking industry. We recommend that the Agencies consider retaining the risk-weighting factor for HVCRE loans at the current level.

Credit Equivalent Amounts of Off-Balance Sheet Commitments
We recommend that the Agencies retain the current practice of applying a 0% credit conversion factor to unfunded lines of credit with an original maturity of one year or less regardless of the ability of the lender to unconditionally cancel the commitment. Banks generally have built-in safeguards that allow for cancelation of commitments in the event the borrower does not maintain compliance with pre-established covenants incorporated into the borrowing agreement. These covenants are designed to be triggered when the borrower's financial condition weakens and therefore provides a way for the bank to limit its exposure to further credit extensions to this borrower. Requiring a bank to have the unconditional ability to cancel the commitment in order to maintain a 0% credit conversion factor will likely result in the imposition of even more prohibitive credit terms to small businesses and other commercial entities seeking seasonal lines of credit for expansion an working capital needs as banks begin to add unconditional cancellation provisions to borrowing agreements.

Summary

As discussed in our comments above, while we are in agreement with the overall objective of ensuring a strong banking system in the United States, we take issue with certain provisions outlined in the Proposals. Our comments are based on what we think will be unintended consequences of more restrictive and onerous capital requirements such as increased costs of compliance, decreased ability of banks to internally generate capital, reduced lending to consumers and small businesses and less than optimal interest rate and liquidity risk management strategies. In addition, given the proposed increases in minimum capital levels, the higher risk-weighting implications discussed in our comments above exacerbate the detrimental impact such changes are likely to have on the banking industry and in the availability of credit for consumers and small businesses. Finally, the higher capital requirements may actually serve to reduce the amount of new capital attracted to the banking system as a result of a reduced ability to leverage capital leading to an expectation of diminished shareholder returns, at which point capital investment is redirected to other industries with more favorable prospects for appropriate returns.

In closing, we thank the Agencies for allowing the banking industry and other interested parties an opportunity to comment on the Proposals. The Bank recognizes the need for a safe, efficient and well-capitalized banking industry and is supportive of efforts to improve the current system. We welcome the opportunity to answer question or discuss our comments as the Agencies finalize the rules outlined in the Proposals.

Sincerely,

Samuel L. Erwin
President and Chief Executive Officer

Roy D. Jones
Chief Financial Officer