CORNERSTONE
NATIONAL BANK

October 10, 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:

Thank you for the opportunity to provide comment on the Basel III 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 "banking agencies").

Cornerstone National Bank was established in 1999 in Easley, South Carolina. Our mission as a community bank is to provide exceptional banking services to our personal and commercial banking customers through exemplary service and prompt, local decision making. We conduct our business almost exclusively in the Upstate counties of South Carolina, and we are an active corporate citizen. We employ thirty-six full-time banking professionals and we support many local charities. As of June 30, 2012 our Bank had total assets of $161 million. Our shareholders are primarily customers of our Bank.

As a result of the Great Recession and the decreases in sales of real estate and the resulting decreases in real estate prices in our area, we have been managing significant issues over the past several years. However, we have managed through the crisis and can now see economic improvements in our area, lower unemployment, and a more active real estate market. We have remained well capitalized, even with higher capital minimums required by our primary regulator, and we expect to emerge from the crisis as a stronger institution. However, we are concerned that the Basel III capital structure changes will heavily impact our Bank at precisely the wrong time and with unintended consequences. Many community banks will be emerging from the Great Recession with lower capital levels and fewer potential investors, and rates will be climbing from unprecedented (low) levels, potentially at a very swift pace. Regulation has increased considerably in the past few years, and community banks have not yet been able to absorb the cost of the changes efficiently. Many banks are under individual capital maintenance requirements that are higher than regulatory "well capitalized" ratios, and no information has been forthcoming regarding any potential changes to those individual capital maintenance requirements. That uncertainty alone is causing banks to resist any changes in the regulatory capital calculations.

One of our primary concerns is the proposal to require that all unrealized gains and losses on available for sale securities (AFS) must "flow through" to common equity tier 1 (CET1). We believe that this proposal will add an unprecedented amount of volatility to our capital ratios at a time when banks are at the low point of capital following the recession. We believe that institutions our size will need to carry more capital to absorb swings in market prices of our securities and that the increased requirement will be difficult for us to meet because smaller institutions do not have access to capital markets at this time. We also believe that transferring our AFS securities to a held-to-maturity (HTM) status in order to avoid the associated volatility is detrimental to our ability to use our securities portfolio for liquidity and to control risk in other areas of our balance sheet.

The business of banking is substantially one of balancing risks. Bankers use many tools to reduce risk to an acceptable level while earning a reasonable return for accepting that risk. We believe that the proposal will eliminate or damage a tool that we have for managing various types of risk that are inherent in banking. We believe that the proposal will limit our ability to manage risk in the following ways:

- We feel that we will be forced to move securities to the HTM category until we can organically grow earnings to a high enough level to compensate for swings in market values. Having all of our securities in HTM status means that we cannot sell securities to meet funding needs or take advantage of opportunities in the market to restructure our portfolio to offset emerging risk in other areas.
- We believe that the proposal will force us to invest in shorter-term assets. Limiting our ability to use the investment portfolio across various terms will inhibit our ability to manage interest-rate risk in our balance sheets over time and increase interest-rate risk. It will also cause a decrease in demand for longer-duration assets and will affect funding for entities which actively support the housing markets in the United States.
- We believe that the proposal will cause detrimental changes to our contingency funding planning and decrease our ability to react in times of local stress (i.e., following natural disasters, etc.)
- We believe that we will be forced to shrink total assets in order to increase capital levels. Lending will be reduced in an effort to reduce total assets.

We also believe that rates will be increasing at the same time that the proposals will be going into effect. As of June 30, 2010 our securities portfolio was approximately 32.8% of total assets. By our estimates, a 300 basis point increase in market rates would create a decrease in market values of 11.86%. This change is equal to approximately $2.5 million. This is a very significant amount to our bank (amounting to a capital swing of 1.55% on average assets.) With rates at historic lows, an increase of 300 basis points over a short period of time is not unreasonable.

We believe that many community banks have had difficulty lately investing their liquidity in quality loans. Loan underwriting requirements have certainly tightened and many companies and consumers do not have healthy enough balance sheets to support additional borrowing or are very risk-averse at this time. The result of low loan demand is that investment portfolios at many banks are larger than ever. The resulting capital volatility related to the AFS portfolio will be dramatic. We do not believe that the volatility will serve our industry or our customers well. Ours is a confidence industry, and introducing more volatility into our capital calculations at this time will be disastrous. Investors who are the potential source of capital will not appreciate the volatility and will not invest if higher capital reduces returns to very low levels. If we are unable to raise capital, we will be forced to reduce the size of our bank in order to boost capital ratios, and that will lower our ability to lend in our communities even further. **Therefore, we do not support the inclusion of unrealized gains and losses on AFS securities in CET1 as proposed.**

The vast majority of community banks do not hold risky or exotic investments in our portfolios. We manage our portfolios for liquidity and earnings and to off-set interest rate risk in our loan portfolios. We own agency debt, agency mortgage-backed securities, and municipal bonds for the most part. We believe that risk-weights are already employed for various types of instruments and that inclusion in CET1 is not necessary or desirable. If risk-weights are deemed insufficient, as an alternative, we believe that agency debt, agency mortgage-backed securities, and general obligation municipal GO bonds could be exempted from the proposal so that community banks could continue to use these instruments to manage risk. Other instruments that have greater volatility, more optionality, and other volatile features could be required to be included in CET1. In that manner, purchasers of these types of investments could weigh the benefits of those types of instruments against the risk of having to hold more capital, but their entire AFS portfolio would not be included, and the amount of volatility in most community bank capital calculations would be reduced to a more reasonable and manageable amount. We believe that current systems in place for measuring market values and calculating required capital levels could be updated to reflect capital considerations for certain types of investments since most portfolio accounting systems already reflect different risk-weightings for various types of investments.

The next area of concern for our bank is the complexity of the proposed residential mortgage risk weights and difficulties involved in capturing the required data, maintaining the data, and reporting it accurately. The proposal assigns risk weights to residential mortgages based on (1) whether the mortgage is a "traditional" category 1 mortgage or a "riskier" category 2 mortgage; and (2) the loan-to-value (LTV) ratio of the mortgage.

The proposal requires not only an increase in the amount of information included in bank information systems, but also constant maintenance of that data. The proposal does not address residential mortgages that are made for <u>business purposes</u> such as the loans in our portfolio, our systems are not designed to capture some of the information needed to meet the proposed requirement, and we do not have the manpower or access to the necessary information to keep the data updated on a quarterly basis when we file Call Reports. We do not portfolio conventional 15- or 30-year mortgages, but we have loans in our portfolio that appear to fall under the new requirements. Loan-to-value ratios change over time on every loan, and we would need significant additional information and manpower to keep the information in our systems current and accurate. The proposed rules do not include any type of grandfather provision, so all mortgage loans currently on bank books will be subject to the new capital requirements. As a result, banks would be required to examine old mortgage underwriting files to determine the appropriate category and LTV ratio for each mortgage. We anticipate a substantial investment on the part of our core-information system provider and we anticipate that the costs of providing the programming resources to change our system, test it, implement it, and train our personnel on the changes will be significant and will be passed on to all user institutions, even if we do not have a significant amount of the types of loans that the proposal targets.

In addition, even though we do not hold the types of mortgages that this proposal appears to target, we will be impacted and required to hold higher risk-based capital as a result. For the reasons noted above, we believe this will make it more difficult to attract investors and capital to the industry.

The next issue is that the proposal classifies all junior liens, such as home equity loans and lines of credit, as category 2 exposures with risk weights ranging from 100 to 200 percent. In addition, a bank that holds two or more mortgages on the same property would be required to treat *all* the mortgages on the property even the first lien mortgage as category 2 exposures. Thus, if the bank that made the first lien also makes the junior lien, then the junior lien may "taint" the first lien into a category 2 mortgage, which results in a higher risk weight for the first lien mortgage. By contrast, if one bank makes the first lien and a separate bank makes the junior lien, then the junior lien does *not* change the risk weight of the first lien.

The proposal provides one exception to these general rules: the first and junior lien may be combined into one category 1 mortgage exposure only if the bank holds both the first and junior lien on the same property, no party holds an intervening lien, and the combined exposure meets all the requirements of a category 1 mortgage. This exception is very narrow, and most junior lien mortgages likely will be deemed category 2 mortgages.

These items will require additional information to be gathered and maintained in our core-information system. There will be a cost associated with it for us, regardless of our portfolio size, which is small. If the changes require a significant amount of additional capital, we may be forced to limit home equity lending. Many of our customers are small business owners who use their home equity lines for cash flow that they indirectly use in their business. This will likely put stress on many of our customers if lending of this kind is curtailed. A further reduction in the types of loans we are able to offer will increase risk in our portfolio as diversification of loan types is further reduced.

Under the proposed rules, "High Volatility Commercial Real Estate" (HVCRE) is defined as acquisition, development and construction (ADC) commercial real estate loans, with certain exceptions. HVCRE would include, assuming the exceptions are not applicable, all ADC loans including owner-occupied properties, borrowers with debt service coverage well above 1.0 and income-earning loans. Under the proposed standardized approach, each HVCRE loan in a bank's portfolio will be assigned a 150 percent risk weight. This represents a significant increase as these loans are currently risk-weighted at 100 percent.

Community banks in our region are often lenders on this type of collateral. It will cause a significant increase in required capital levels upon adoption of the proposed requirements. As in previous items, community banks could have a significant increase in capital requirements until this type of lending can be curtailed. Financing for this type of collateral will become limited and pricing will increase, limiting economic growth and activity.

Next, the proposal would change the current capital calculation to require a change in the risk-weight when a nonresidential loan becomes over 90 days past due to a risk-weight of 150%. This will create additional monitoring and additional software programming changes to implement, similar to other changes in the proposed rules. Our core-information processor will incur significant costs to program this change, which will be passed on to community banks regardless of portfolio size and personnel costs will increase due to increased workload and training. It is possible that the banks will be more likely to foreclose on delinquent borrowers than to work with them and hold more capital to do so.

In all the proposed capital rules will have a significant impact on community banks, and will likely bring consolidation to the industry due to costs, increased capital requirements, and lack of available capital. Community banks will likely be just recovering from the Great Recession when the compliance with the proposed rules is required. Interest rates will likely be higher at that time, and unrealized losses on available-for-sale securities portfolios will likely have increased, creating an immediate negative impact on capital levels in the industry. While we understand that additional capital would strengthen the industry, we urge you to reconsider many of these rules and their current costs of implementation and unintended consequences. Community banking is an important part of our financial system and community banks provide financial services to many individuals and small businesses. Community banks are also significant employers in many towns and are good corporate citizens that support various not-for-profit agencies in our communities. As written, the Basel III proposal will not be a change for the better for community banks.

Sincerely,

Jennifer M. Champagne, CPA
Chief Financial Officer and Director

Cc: US Senator Lindsey Graham
US Senator Jim Demint