TOWNEBANK

Via Email

October 19, 2012

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N. W.
Washington, D. C. 20429
FDIC RIN 3064-AD96
FDIC RIN 3064-AD95

Re: *Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements*

and

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

Mr. Feldman,

TowneBank appreciates the opportunity to submit comments on the above-referenced notices of proposed rulemaking (NPRs). The NPRs were released 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 Consumer Protection 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."

TowneBank is a $4.3 billion community bank in Virginia and North Carolina that operates 26 banking offices serving Chesapeake, Hampton, Newport News, Norfolk, Portsmouth, Suffolk, Virginia Beach, Williamsburg, James City County and York County in Virginia along with Moyock, Grandy, Camden, Southern Shores, Corolla and Kill Devil Hills in North Carolina. Towne also offers a full range of financial services through its controlled divisions and subsidiaries that include Towne Investment Group, Towne Insurance Agency, TFA Benefits, TowneBank Mortgage, TowneBank Commercial Mortgage, Prudential Towne Realty, Towne 1031 Exchange, LLC, and Corolla Classic Vacations. Through its strategic partnership with William E. Wood and Associates, the bank also offers mortgage services in all of their offices in Hampton Roads and Northeastern North Carolina. Local decision-making is a hallmark of its hometown banking strategy that is delivered through the leadership of each group's President and Board of Directors. We are publicly traded on NASDAQ under the symbol TOWN with a market capitalization of approximately $497 million on October 16, 2012. Our bank is extremely community focused with local management and substantial community involvement. Our capital is strong with a 10.76% leverage ratio, a Tier 1 risk based capital of 12.29% and a 13.44% total risk based capital ratio as of June 30, 2012 under today's regulations.

We began operation April 8, 1999 and have since then expanded our operations to include banking, real estate, mortgage, title, insurance, employee benefit services and investments. We have three reportable segments: Banking, Realty and Insurance. Our Banking segment provides loan and deposit services to retail and commercial customers. The realty segment offers residential real estate services, mortgage loans, and residential and commercial title insurance. We are a significant provider of residential mortgage loans in our communities, with expected 2012 mortgage brokerage production of $1 billion. Commercial and retail insurance and employee benefit services are provided through our Insurance segment.

In summary, while we believe strong capital is paramount in banking and is the foundation every community bank is built upon, we also believe that Basel III will add complexity and volatility to an already complicated calculation.

Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III

I. Capital Conservation Buffers

Description of Issue:

Basel III introduces a new regulatory capital component, common equity tier 1 capital, and it also establishes higher capital ratios along with a capital conservation buffer of 2.5%. Failure to maintain the buffer would result in restrictions on dividends and certain bonus payments. The limits apply if the buffer is less than 2.5% for <u>any</u> of the risk-weighted capital ratios.

Why it is an issue:

The new rules introduce new levels of uncertainty and levels of volatility to regulatory capital that community banks have not seen before. We will face the administrative burden of tracking information to comply with the NPR and the related deductions and adjustments to capital and risk weighted assets on a daily basis to ensure compliance with the capital conservation buffer to avoid restrictions on capital distributions and discretionary payouts. The higher capital requirements, increased complexity and volatility associated with the computations of regulatory capital may raise investor requirements for returns given the uncertainty over dividend payments under the capital conservation buffer. Although the new rules are being phased in 2013-2019, investors will look upon passage as being fully phased in during the first quarter of 2013. Related community bank valuations will be based off of that, giving no time to assess impact and raise additional capital, as the larger banks did in anticipation of Basel III. The proposed changes will require us to increase compliance, reporting and modeling with additional training and product design. This will reduce, through increased cost, returns to our shareholders rather than helping the communities we serve with loans.

Additional issues include:

1) The ability of a bank to accurately budget capital growth and to accurately reflect these market movements in the calculation of the ratios;

2) The ability to maintain a legal lending limit from quarter to quarter which is based off Tier 1 capital;

3) The ability to increase shareholder dividends and shareholder value due to the volatility of the market.

4) With the capital conservation buffer you could have a temporary AFS unrealized loss and not be able to pay reliable dividends or bonuses.

In theory a bank may allow its equity to dip below the capital conservation requirement, however if it does it will be subject to restrictions on dividend payments and bonuses, which continue for as long as equity remains below the level. As a result, banks will regard this requirement as mandatory.

Recommendation:

Our recommendation would be to set higher capital ratios and to eliminate the capital conservation buffer leaving the current buffer between well capitalized and adequately capitalized at 2%.

This would align the Capital Conservation Buffer with the buffers that already exist between adequately capitalized and well capitalized status. Banks that fall below well capitalized could be subject to a variety of restrictions, including those under the NPR guidelines, or make such restrictions on an individual bank by bank case as circumstances warrant. This would create flexibility, simplicity and clarity, as opposed to the proposed capital conservation buffer.

II. Accumulated Other Comprehensive Income:

Description of the Issue:

The proposed rules require that all unrealized gains and losses on available for sale securities (AFS) must "flow through" to common equity tier 1 (CET1) (a new measure under the proposal). In other words, if there is a change in the value of an AFS security (which can occur daily in some cases), that change must immediately be accounted for in regulatory capital. Unrealized gains and losses occur in AFS portfolios primarily as a result of movements in interest rates as opposed to changes resulting from credit risk. Interest rates, particularly on debt securities, can fluctuate frequently, and therefore the proposed rules will introduce significant volatility into capital calculations. The Basel III NPR's propose to include all elements of Accumulated Other Comprehensive Income (AOCI) in the definition of Regulatory Capital, with only a few isolated exceptions that are not common to most community banks.

Why it is an Issue:

Gains/losses on available-for-sale ("AFS") debt securities, which have been excluded from regulatory capital ever since the concept of AFS securities and unrealized gains/losses being recorded through capital accounts, was first introduced by FASB Statement Number 115 in May 1993. Although the impact of this rule change will be phased-in at 20% per year over a 5 year period beginning in 2014, the impact on community banks in the relatively near term could still be significant due to the concentration of AFS securities currently held by U.S. banks.

Largely as a result of the long running exclusion and the lack of any impact on regulatory capital ratios, banks have gravitated debt security investments towards the AFS category, with over 90% of all bank securities now residing in that category as of March 31, 2012. Additionally, the AFS category has allowed banks the flexibility to sell securities to help satisfy their liquidity needs, to manage interest rate risk and to better manage overall profitability relative to securities holdings. Bottom line, the AFS classification makes sense for most community banks and has for a number of years.

The high level of concentration in AFS securities combined with the current low interest rate environment and the expectation of an increasing rate environment has the banking industry very worried about the impact of AFS unrealized gain/loss inclusion in regulatory capital.

Concern is justified based on the stress test that the investment banking firm of Sandler O'Neill recently published. Sandler's study assumes a 300 basis point increase in interest rates as applied to March 31, 2012 bank data and the results are dramatic. The study finds that Common Equity Tier 1 ("CET1") capital decreases from 11.5% to 9.3% for all U.S. banks, which represents a 28% drop in CET1. This is a very large decrease in regulatory capital considering the fact that it relates entirely to <u>unrealized</u> losses on securities, which in most cases will never be realized. This unrealized loss would consist solely of interest rate related market fluctuation as any credit loss component to the unrealized loss would be considered other-than-temporary impairment and already be reflected as a reduction of income, not AOCI.

The potential for debt security based capital volatility that is illustrated in the Sandler study will result in banks adopting various strategies to manage the associated risk, including:

- Reallocation of assets away from investment in debt securities;
- Shortening durations on new purchases of debt securities, and/or;
- Transferring or assigning new purchases of debt securities into the Held To Maturity (HTM) category

Unfortunately, all of these strategies come at an underlying cost compared to the current rules. Any industry downsizing of investment security holdings as a percentage of total assets (currently at about 21%) would seem contrary to the Agencies' overarching safety and soundness goals, as banks might be incentivized by the new rule to seek out other, possibly higher-risk investment alternatives, such as loans where changes in interest rates would not directly impact regulatory capital.

Banks may also elect to shorten the duration of their securities holdings to lessen the risk of unrealized losses as shorter-term holdings have less potential to generate unrealized losses. The cost of this strategy would come in the form of reduced income as shorter durations are usually accompanied by lower yields. The reduced income would negatively impact the Banks ability to increase capital through earnings.

Transferring or assigning new purchases into the HTM category could be an effective strategy at reducing investment security volatility, but it would also reduce or totally eliminate the flexibility of banks to include securities for liquidity purposes, interest rate risk mangement and for maximizing total income on securities via sales when market conditions allow.

Concurrently, the Financial Accounting Standards Board ("FASB") is re-writing the financial instrument measurement rules and a "Held-to-Maturity ("HTM")-like" category <u>may or may not</u> be available to shield unrealized gains and losses from AOCI/regulatory capital treatment.

We have a very stable deposit base with 27.7% in noninterest bearing deposits, which has given us flexibility in our investment strategies over the past, with realized investment gains of over $26.8 million during the period 2008-2012 contributing directly to building our Tier 1 capital. We are not sure if this could have happened if subject to the NPR rules. For example, we may not have selected longer term investments with the potential of capital appreciation.

The attached chart illustrates the interest rate volatility of community bank AFS securities. In the extreme cases, this could hinder without actual losses the banks' ability to pay dividends which could send the wrong signal to investors. At our bank a good majority of our investors are also customers and in the extreme case could cause a run on deposits if dividends were curtailed due to unrealized losses in high quality treasury and agency investments.

Banks also purchase longer duration tax exempt municipal bonds due to the tax savings and impact on profitability; we may be forced to eliminate or reduce these holdings, in turn impacting net income and our support for local municipal projects.

Banks also purchase longer duration mortgage securities for diversity in investments and profitability. We may be forced to eliminate or reduce these holdings. Combined with proposed changes in the risk weighting of assets, this may reduce funding available to housing at a time when the U.S. Housing market is still in recovery.

The adjustments to regulatory capital, such as inclusion of unrealized losses on AFS securities, together with the changes in risk weighting of loans has the potential to introduce substantial volatility to the capital accounts during periods of rising interest rates or deteriorating credit quality. Over the last twenty years there have been eight four quarter periods of high interest rate volatility despite rates ending roughly where they began with rate fluctuations during that period as high as nearly 150 basis points from low to high. Such volatility would make it difficult for banks to manage their regulatory capital ratios.

While we understand the inclusion of AOCI in a tangible capital ratio from a market valuation perspective, the introduction of it as a regulatory metric will lead to substantial volatility, incorrect conclusions regarding an institutions asset-liability management, liquidity and investment options. This could require institutions to carry higher levels of capital for temporary market fluctuations through this adjustment.

Temporary impairments are caused by the fluctuation of market interest rates rather than credit impairments; on average 2/3 of the investments held by banks are instruments issued by U.S. government and its agencies and government sponsored enterprises (GSE) whose market value reflects market rates of interest rather than credit spreads.

Banks will hold increased regulatory capital against potential fluctuations in market values of investments, leaving less capital to support lending. Additionally if banks go shorter with their investments, that would impact MBS and agency debt and municipals. The inclusion of AOCI in CET1 will place pressure on Banks in a rising rate environment, will reduce rather than improve the safety and soundness of the banking system, and has the potential to increase systemic risk to the US economy and several capital markets

Impact on TowneBank:

The proposed capital rules would create tremendous volatility and uncertainty on capital levels. For example, if we were fully invested at 18% of total assets, that would be $774 million in investments. Assuming that there's no held to maturity portfolio and the whole portfolio gets marked to market, it would do the following:

- At a duration of 3 years and rates up 3%, it would take away $70 million of capital. That would drop our Total Risk Based ratio from 13.44% to 11.45% (reduction of -1.99%).

- At a duration of 5 years and rates up 3%, it would take $116 million of capital. That would drop our Total Risk Based ratio from 13.44% to 10.14% (reduction of -3.30%). Under the NPR we would be subject to the capital conservation buffer restrictions in this scenario.

Recommendation:

We would recommend that you do not include AOCI in the calculation of common equity tier 1 capital. The volatility that it would create in all banks would be a huge detriment to the industry and would serve no useful purpose. Credit risk is already associated with the risk weightings of investments and disclosed in all of our financials.

We recommend that the agencies exclude any AOCI adjustments from the regulatory capital calculations and continue to include an addendum in the call report that reflects ongoing unrealized gains and losses in the AFS portfolio. If there is a need to hold higher capital against the AFS investments, that need should be addressed through an appropriate adjustment to the standardized risk with measurement, not through an ongoing fluctuation in the Tier I capital ratio.

III. Deferred Tax Assets:

Description of Issue:

The Basel III proposal adds complexity and restrictions on how much DTA's can be included in capital. DTA's that result from carryovers of net operating losses and tax credits are required to be deducted from capital. In addition, limitations are placed on certain assets as a group (DTA's, MSR's, goodwill and pension accounts). Thus, banks will need to carefully monitor the combination of the entire group of assets, including DTA's, to insure that capital levels are appropriate.

Why it is an Issue:

Includable DTA's are currently limited to those that can be realized from taxes paid in prior carryback years plus the lesser of the tax on 12 months of projected future taxable income, or 10% of Tier 1 capital. Note that the 10% limitation is only applied to the tax on future taxable income component, not the entire DTA balance. Under the new rules, DTA's are first reduced by the amount attributable to NOL and tax credit carryovers and then subject to an overall 10% limitation of CET1 and then the 15% overall limitation of CET1 when combined with includable MSR's. Banks with large on-balance sheet DTA's (common with institutions which have acquired other institutions) will likely see a reduction in their regulatory capital as a result of this charge.

To illustrate the complexity of the NPR rules, KPMG LLP, in a recent presentation noted the following needing clarification or confirmation:

1) Whether DTAs realizable through loss carrybacks continue to be measured by assuming temporary differences reverse at report date as under the current rules? If not, is some other convention derived from GAAP intended?

2) Whether banks can elect, as facts and circumstance warrant, either to (i) net Deferred Tax Liabilities (DTL's) against assets subject to deduction or adjustment against regulatory capital under NPR, or (ii) include these DTLs in the general allocation of DTLs against DTAs?

3) Whether banks can treat DTAs arising from temporary differences in the same fashion that they treat DTLs under the DTA NPR?

4) Whether banks can gross-up the DTLs embedded in the asset value of a leverage lease accounted for pursuant to the purchase accounting provisions in ASC paragraphs 840-3-25 through 35 (former FIN 21)?

5) Whether during the transition period for DTAs relating to temporary differences, can banks elect annually to treat adjustments relating to AOCI items either net or gross of associated deferred taxes?

6) Whether banks can evaluate DTAs solely under the DTA NPR beginning in 2012 (i.e., ignoring the current rules altogether)?

Impact on TowneBank:

There is no current impact to TowneBank, but could limit our ability to expand through acquisitions in the future.

Recommendation:

We support the recommendations of the Clearing House contained in their September 19, 2012 letter as follows:

1) *Recommends* that U.S. generally accepted accounting principles ("U.S. GAAP") with respect to the treatment of DTAs be used as the initial source of guidance for U.S implementation of the DTA Proposals;

2) *Recommends* that the rules for the treatment of DTAs previously adopted by the Federal Reserve Bank (the "FRB"), the Federal Deposit Insurance Corporation (the "FDIC") and the Office of the Comptroller of Currency (the "OCC") (collectively hereinafter, the "Current Rules") be retained, except to the extent they have been specifically overridden by the DTA Proposals;

3) *Recommends* that DTAs realizable via loss carrybacks be treated as assets that do not rely on the future profitability of the bank (referred to as "valid" assets for convenience hereafter) pursuant to provisions similar to those in Current Rules;

4) *Recommends* that banks be permitted to elect to net deferred tax liabilities ("DTLs") associated with mortgage servicing rights ("MSRs") against their MSRs before the MSRs are subjected to Basel III "threshold calculations" as defined;

5) *Recommends* that in making the required threshold calculations, 1) the 10% calculation should be made separately for each of the Specified Items (as defined below) without reduction for any of them and 2) during the transition period, the 15% calculation should be made without reduction for each of the Specified Items; and

6) *Requests* that the transition framework be easily administrable and ensures consistent treatment across jurisdictions.

IV. Exclusion of Goodwill and Intangibles from Tier 1:

Description of Issue:

The exclusion of goodwill and all other intangible assets (other than MSRs) from the newly created CET1 and Tier 1 capital in essence creates a merger and acquisition growth penalty to our capital ratios. Since our inception acquisitions have been a significant source of growth for us, particularly in the Insurance and Realty segments. We have had a strategic initiative since we began business to grow a diversified source of fee income, with both annuitive and counter cyclical economic benefits to our revenue. We believe we are operating under outdated and punitive capital rules in this area. At June 30, 2012 our total goodwill and intangibles were $113.7 million.

Why it is an Issue:

Subsequent to the inception of the existing Risk-Based Capital Accord in 1988, the accounting principles (GAAP) that affect the treatment of the Goodwill asset on the balance sheet have changed. Under GAAP today, goodwill must be reviewed for impairment on a quarterly basis. As such, we believe that goodwill now represents an asset with an accepted value equal to its recorded balance sheet amount, and should no longer be a required deduction from Tier 1 Capital in the regulatory capital calculations. In contrast to other banking assets that, by GAAP standards, are subjected to similar impairment analyses on an ongoing basis, the capital treatment of goodwill and intangibles is disproportionately harsh.

This is less of an issue when acquiring a public company compared to a closely held businesse. All of our non-bank acquisitions have been with closely held companies. Public companies are more likely to accept stock than a closely held business, the owners normally want all cash or at minimum 50/50 stock and cash. Under the current rules cash acquisitions and resultant goodwill directly reduces the Tier I capital accounts and resulting capital ratios.

Impact on TowneBank:

The following illustrations show how punitive the deduction of goodwill is from Tier I capital where cash is either a percentage or the entire amount of the purchase price:

1) Capital changes due to a $36,000,000, 50% cash/50% stock acquisition

	(in thousands) Debit	Credit
Goodwill/Intangibles	$36,000	
Cash		$18,000
Stock		$18,000

Tier 1 capital before acquisition	$431,999
Plus stock issued	18,000

Less goodwill/intangibles created	(36,000)		
Tier 1 capital after acquisition	$413,999		

Risk weighted assets-unchanged	$3,350,441
Tier 1 Capital – before acquisition	12.89%
Tier 1 Capital – after acquisition	12.36%
Total risk based capital – before acquisition	14.10%
Total risk based capital – after acquisition	13.56%

2) Capital changes due to a $36,000,000 all cash acquisition

	(in thousands)	
	Debit	Credit
Goodwill/Intangibles	$36,000	
Cash		$36,000

Tier 1 capital before acquisition	$431,999
Less goodwill/intangibles created	(36,000)
Tier 1 capital after acquisition	$395,999

Risk weighted assets-unchanged	$3,350,441
Tier 1 Capital – before acquisition	12.89%
Tier 1 Capital – after acquisition	11.82%
Total risk based capital – before acquisition	14.10%
Total risk based capital – after acquisition	13.02%

3) Capital changes due to a $36,000,000 all stock acquisition

	(in thousands)	
	Debit	Credit
Goodwill/Intangibles	$36,000	
Stock		$36,000

Tier 1 Capital before acquisition	$431,999
Plus stock issued	36,000
Less goodwill/intangibles created	(36,000)
Tier 1 capital after acquisition	$431,999

Risk weighted assets-unchanged	$3,350,441
Tier 1 Capital – before acquisition	12.89%
Tier 1 Capital – after acquisition	12.89%

Total risk based capital – before acquisition	14.10%
Total risk based capital – after acquisition	14.10%

In example 1, you can see that our capital is reduced for the $36,000,000 in goodwill/intangibles created by the acquisition but with 50% stock issued the penalty is only an $18,000,000 reduction to Tier 1 capital or a .53% decrease in our Tier 1 capital ratio. In example 2, which is an all cash acquisition where no stock is issued, our Tier 1 capital decreases 100% of the goodwill/intangibles created or a 1.07% decrease in our Tier 1 capital ratio. This is a significant penalty. Finally, in example 3, which is an all stock acquisition, you will note that the new issuance stock offsets the goodwill/intangibles and there is no penalty to capital and no change in the Tier 1 capital ratio.

Recommendation:

It is our recommendation that goodwill and intangibles not be deducted from Tier 1 capital, and included in the 100% risk weighted asset category.

Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements

V. Residential Mortgages Risk Weights:

Description of Issue:

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 mortgages; and (2) the loan-to-value (LTV) ratio of the mortgage.

The table below highlights the changes in the risk weights for Category 1 and Category 2 mortgages.

Loan-to-Value ratio (in percent)	Category 1 residential mortgage exposure (in percent)	Category 2 residential mortgage exposure (in percent)
Less than or equal to 60	35	100
Greater than 60 and less than or equal to 80	50	100
Greater than 80 and less than or equal to 90	75	150
Greater than 90	100	200

As set forth in the table above, the proposed category 2 risk weights are high relative to category 1 risk weights (35 to 100 percent), delinquent loans (150 percent), and general unsecured credit (100 percent).

The proposed residential mortgage rules raise several additional issues. Under the proposed rule, a bank is required to re-assess a mortgage after a loan restructuring or modification, unless the modification is made under the federal Home Affordable Mortgage Program (HAMP). Thus, a category 1 mortgage might become a category 2 mortgage after modification if the bank does not modify the loan under HAMP. In addition, the proposed rules do not recognize private mortgage insurance (PMI) at all. Mortgages are therefore subject to high risk weights even if PMI reduces the risk of such loans. Finally, 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.

With regard to the risk weightings on residential mortgage based on LTV ratios, a risk weighting framework that is single-factor focused without regard to the overall profile of a borrower will contribute to delay in the recovery of our residential mortgage market. The retroactive inclusion of higher risk weighting of residential mortgage loans could cause the devaluation of existing mortgage portfolios and a substantial increase in risk based capital requirements for banks involved in mortgage lending. If existing loans are not grandfathered banks would have to decide to hold additional capital or sell the newly depreciated loans.

The Standardized Approach Proposal also imposes a continuing requirement. If at any time after the loan has closed, the loan is 90 days or more past due or is on non-accrual status, it is re-assigned to category 2. The existing capital rules do not change the risk weighting of a mortgage loan that becomes past due.

Why it is an Issue:

A. The increased risk weightings will lead to an increase in interest rates charged on these loans in order for us to justify the higher capital requirements;

B. These factors could materially impair the business model for creating residential mortgage credit in in increased cost to the consumer or limit access to funding;

C. Greater levels of capital will be required for banks with positions in the riskier asset categories noted above:

D. Substantial declines in regulatory capital ratios could arise due to deteriorating credit quality when evidenced by past due loan status over 90 days and increasing loan-to-value on 1-4 family residential loans;

E. The increased capital requirements and complexity associated with the related risk-weighted calculations will likely discourage ownership of private-label MBS and further depress the market for such securities, in addition to devaluation of outstanding loans;

F. These provisions relating to the risk-weights on certain assets are effective earlier (January 2015) than most of the other provisions of significance and therefore warrant management's immediate attention;

G. The increases in risk weightings over current rules without grandfathering, will have an immediate negative impact on capital ratios;

H The new risk weightings for loans do not give consideration for portfolio diversification, which would serve to prevent over concentration or growth. Diversification impacts credit risk and related losses or impact on capital, so it seems this warrants consideration;

I. All of the rules will affect capital planning. Efforts to maximize capital efficiency for a particular asset class will depend on the nature of the change. For example, the higher risk weights for mortgage loans that are either nontraditional or have LTV ratios above 50% may cause a bank to consider whether to offer such loans;

J. Balloon mortgages are an effective tool for interest rate risk without increased credit risk if properly underwritten and some customers prefer the balloon mortgage if they expect to move within a certain timeframe (i.e. military personnel);

K. The changes to residential mortgages risk weight will definitely impact the availability of mortgages in the areas community banks serve in the form of reduced availability due to the higher capital requirements of category II loans;

L. If the ALLL is calculated properly and reflective of the risk of loss in the portfolio, there should be no need to create an additional capital charge to reflect temporary and expected fluctuations of different markets. A higher risk weight to loans does not appear to be a proactive risk management tool but rather a retroactive penalty to lower institution capital ratios at a time when a bank would most need to sustain those ratios. This provision could actually discourage banks from working with borrowers and from taking appropriate lending risk during economic times of distress;

M. With a junior lien on a home to a borrower there is the psychological notion of a commitment. The reality is under the NPR, unsecured debt is only a 100% risk weighted compared to the higher rates above for category 2 mortgages. This could lead to more capital efficient lending but with less of a collateral position and psychological commitment from the borrower.

Impact on TowneBank

This proposal would increase our risk-weighted assets in this category which would decrease our Tier 1 Capital. Many companies will do a reallocation of capital and risk between different lines of business and products to reflect that reality, in addition to increased pricing to retain profitability.

Recommendation:

We would recommend not risk weighting anything above 100%, as credit risk of our loans is addressed through the allowance for loan losses and we would suggest that all residential loans maintain their 50% risk weighting as they are collateralized loans. If there are questions as to types of collateral, that should be addressed through underwriting standards and not risk weightings.

The credit profile of borrowers should be incorporated rather than relying on collateral values with LTV, and PMI should be considered and not eliminated in consideration of risk weighting.

The requirements that combine 1^{st} and 2^{nd} lien loans should be clarified and the measurement and determination of income verification used in category 1 loans should be clarified.

We recommend that at a minimum all outstanding mortgages be grandfathered with prospective adoption. We believe the NPR could change the mortgage market and has the potential to impede the residential junior lien market.

VI. 150% Risk Weight for Past Due Loans:

Description of Issue:

Under existing rules, the risk-weight of a loan does not change when the loan becomes delinquent. Instead, the additional risk is addressed through the Allowance for Loan and Lease Losses. The proposal would change this approach significantly assigning nonresidential loans over 90 days past due a risk-weight of 150%.

Why it is an Issue:

Volatility due to Credit Quality Deterioration

Whereas the volatility relating to changes in interest rates is very much an unsettled matter as per the discussion above, the volatility relating to credit quality deterioration is more certain, though perhaps more manageable in terms of effect. This volatility relates to the proposed new risk-weighted asset percentages that will begin to apply to certain categories of loans beginning on January 1, 2015, with no phase-in period provided. The changes that will cause the most capital volatility due to deteriorating credit quality are:

1. Generally all nonaccrual loans and loans over 90 days past due will be risk-weighted at 150% instead of the typical 50% (1-4 family and multi-family meeting certain criteria) or 100% (all others). Exceptions to this general rule are:
    - 1-4 family residential loans, whose risk-weights depend on whether Category 1 or 2 and LTV. See additional explanation below.
    - A lower risk-weight may be assigned to loans that are:
        - Guaranteed by certain high level guarantors as defined in the NPR.

- Collateralized by financial collateral such as cash on deposit at the bank or a 3rd party custodian, investment securities, money market fund shares, etc.
- Such guarantees and collateral are rare for nonaccrual and past due loans so the relief offered is not expected to be common.

2. For 1-4 family residential mortgages, a move from category 1 to Category 2 would occur when the loan is placed on nonaccrual or becomes past due more than 90 days, thereby increasing the risk-weight as per the table below:

   - Category 1 loans meet certain characteristics, including:
     - Term does not exceed 30 years.
     - Repayment terms fully amortize the loan (e.g. no balloon payment).
     - Meets certain underwriting standards.
     - Is not more than 90 days past due or on nonaccrual
     - Is not a junior lien.
   - Category 2 loans would be all other loans.
   - LTV would be determined using the lesser of the acquisition cost or the estimate of the property's value at the origination of the loan or at the time of restructuring. Based on this definition, changes in LTV over the life of the loan (other than in a restructuring) would not cause capital volatility.

	RISK-WEIGHT	RISK-WEIGHT
LTV Ratio	**Category 1 Residential Mortgage Exposures**	**Category 2 Residential Mortgage Exposures**
(percent)	(percent)	(percent)
Less than or equal to 60	35	100
Greater than 60 and less than or equal to 80	50	100
Greater than 80 and less than or equal to 90	75	150
Greater than 90	100	200

Based on the above, capital volatility due to credit quality deterioration would mainly occur with loans either being placed on nonaccrual status or becoming past due more than 90 days but still accruing, with the magnitude of the effect depending on whether the loans are secured by 1-4 family residential mortgages or not.

Loans in the 90 days past due, but still accruing category are becoming increasingly rare in this regulatory environment so the risk-weight increase that occurs when loans are placed on nonaccrual status is the single most significant source of increased capital volatility that community banks will have to deal with relative to credit quality. This will likely be the focus of banks as they attempt to project and stress test their capital ratios under the Basel III-based rules relating to deteriorating credit quality.

On past due loans there are already internal controls, internal audits and supervisory processes that determine that non-accrual and charge off policies are applied correctly. To apply a 150% risk weighting factor to loans past due 90 days calls into question the ALLL and credit risk management.

If the ALLL is calculated properly and reflective of the risk of loss in the portfolio, there should be no need to create an additional capital charge to reflect temporary and expected fluctuations of different markets. A higher risk weight to loans does not appear to be a proactive risk management tool but rather a retroactive penalty to lower institution capital ratios at a time when a bank would most need to sustain those ratios. This provision could actually discourage banks from working with borrowers and from taking appropriate lending risk during economic times of distress.

Since loan loss exposures are already reflected in the ALLL, which is limited as a Tier 1 component to 1.25% of risk weighted assets, we do not believe there is a logical basis for an additional capital charge based solely on past due status.

Impact on TowneBank:

The impact to TowneBank will be an increase in risk weighted assets.

Recommendation:

For these reasons we make the following recommendations:

- Let the ALLL continue to account for the risk and related capital allocation for past due and non-accrual loans without double counting through higher risk weightings for these loans;
- At a minimum final changes to risk weightings should be applied on a prospective basis

VII. High Volatility Commercial Real Estate:

Description of Issue:

Under the proposed rules, "High Volatility Commercial Real Estate" (HVCRE) is defined as acquisition, development and construction (ADC) commercial real estate loans except:

1) One-to-four family residential ADC loans or;
2) Commercial real estate ADC loans that:
   a. meet applicable regulatory LTV requirements;
   b. the borrower has contributed cash to the project of at least 15 percent of the real estate's "appraised as completed" value prior to the advancement of funds by the bank; and
   c. the borrower contributed capital is contractually required to remain in the project until the credit facility is converted to permanent financing, sold or paid in full.

HVCRE would include, assuming the exceptions described above are not applicable, to all ADC loans including owner-occupied properties, borrowers with debt service coverage well above 1.0 and income-earnings loans.

Under the proposed standardized approach, each HVCRE loan in a bank's portfolio will be assigned a 150% risk weight. Today, under existing rules, these loans are risk-weighted at 100%.

Why it is an Issue:

The higher risk in these types of assets is also addressed in our allowance model and generally a higher rate is charged to compensate the bank for making these types of riskier loans.

Impact on TowneBank:

This designation is estimated to increase our risk-weighted assets.

Recommendation:

While we agree that a concentration of these types of loans is not beneficial to our community banking, we would rather see it addressed through loan portfolio concentration limits or credit policy and not a higher risk weighting.

VIII. Credit Enhancing Representations (removal of 120 day safe harbor)

Description of Issue:

Under the Basel III Standardized proposal, if a banking organization provides a credit enhancing representation or warranty on assets it sold or otherwise transferred to third parties, including in cases of early default clauses or premium-refund clauses, the banking organization would treat such an arrangement as an off-balance sheet guarantee and apply a 100 percent credit conversion factor to the transferred loans while credit-enhancing representations and warranties are in place. Under the current general risk-based capital framework, risk based capital charges do not apply to mortgages once they are sold to third parties, even where the seller provides representations and warranties to take back mortgages that experience very early payment defaults (i.e., within 120 days of sale of the mortgages).

Why it is an Issue:

The proposed change would result in substantial additional capital charges for a significant volume of sold mortgages. There is little evidence that the temporary representations and warranties associated with "sold mortgages" have resulted in significant losses for regulated banking organizations, even during the financial crisis. As a result, we urge the banking agencies to retain the 120 day safe harbor in the current rule.

The NPR wording is silent on whether the credit conversion factor would be removed at the time of expiration of a representation or warranty, or only is for the period of the early payment default and premium refund clauses. It is silent on how long the return of assets for fraud, misrepresentation, or incomplete documentation would be considered off balance sheet guarantees.

Impact on TowneBank:

We are unsure of the exact impact on TowneBank that this rule would have due to the unclarity and disparity of the current rules and how they are being interpreted and reported.

Recommendation:

We would leave the 120 day safe harbor clause in the final rule. We recommend that the standard reps and warranties required by government agencies be excluded from the definition of credit enhancing. If not excluded we seek clarity on the exposure amounts and time to maintain the recourse capital

We recommend that clarity be given to the representation periods versus the time to hold capital for these off balance sheet assets. Upon a review of banks call reports and the amount of reported off balance sheet recourse exposures and related capital allocations we noted extreme diversity within companies with similar mortgage production companies.

IX. Pending Lease Accounting Changes:

Description of Issue:

There is a pending accounting rule that would require all leases greater than a year to appear on the balance sheet. Since the original exposure draft, there has been difficulty between the Financial Accounting Services Board (FASB) and the International Accounting Services Board (IASB) in determining what constitutes a lease and how to account for the lease on the income statement side.

In the most recent FASB meeting in July 2012, the boards determined that a "Right of Use" asset would be recognized on the balance sheet and, depending on the consumption of the asset over the lease term, would determine how to account for the lease on the income statement. If a lessee does not consume more than an insignificant portion of the asset life over the lease term, the asset would be amortized using a straight-line method with total lease payments being allocated evenly over the lease term. An example of this would be a real estate lease.

If the lessee consumes more than an insignificant portion of the lease, then there would be a combination of amortization and interest expense charged to the income statement. An example of this would be an equipment lease whereas the majority of the asset life is consumed over the lease term.

Based on the lease proposal, by recording a "Right of Use" asset on the balance sheet, the asset would be included in risk-weighted assets for regulatory purposes. Currently, depreciable assets are included in the 100% risk weight category, so any "Right of Use" asset could potentially increase risk-weighted assets significantly for banks. It should be noted that short term leases do not apply to the proposed standard. The updated exposure draft is scheduled to be released by the end of 2012.

Why it is an Issue:

Banks are heavy users of real estate through leases; when the accounting proposal is passed banks will be required to hold capital against the leases at a time of significant other risk-weighted assets increases.

Impact on TowneBank:

We are currently determining the additional assets that would be created on our balance sheet as a result of the new rules.

Recommendation:

We would like consideration of this asset group that will result from the new accounting standard be excluded from risk weightings or at a minimum allow a phase in period for banks to handle the increased assets from leases along with those from the NPR if not amended.

X. Mortgage Servicing Rights:

Description of Issue:

Under the proposed rule, banks may not count as part of their CET1 capital measure any mortgage servicing assets (net of deferred tax liabilities) that exceed 10% of their CET1. Moreover, when aggregated with deferred tax assets and investments in common stock of unconsolidated financial entity, all of that together may not exceed 15%. The amount of mortgage servicing assets that is below the 10% threshold will receive a 100% risk weight (and eventually a 250% risk weight beginning in 2018).

Why it is an issue:

Under existing treatment of MSR's under Basel 1, Tier 1 capital is reduced by 10 percent of the value of an institution's MSRs and the asset is risk weighted at 100%. Under Basel III, MSRs up to 10% of Tier 1 common equity are risk weighted at 250% with the remainder of the MSR value deducted from Tier 1 Common. This capital intensive requirement is similar to intangible asset treatment, however, MSRs are tangible and in fact are contractually based, marketable and valued accordingly. The risk associated with this asset is inherent within interest rate movements as rates increase, the value of the asset increases. In a declining rate environment, the value of the MSR declines. This is not that different from other rate sensitive assets like fixed rate loans or investments. We actively manage interest rate risk of all assets on the balance sheet. Further, under Basel III, the aggregated of MSRs, certain deferred tax assets, and equity in unconsolidated subsidiaries would be subject to a limit of 15 percent of Tier 1 common equity. Any excess above that limit would have to be deducted from Tier 1 common equity. This treatment could have devastating impacts, particularly on community banks that recognize this asset, if properly managed, as safe and profitable asset. These new rules will lead to pressure on profitability, return on equity and therefore, access to capital to community banks.

Consumers will be negatively impacted by the changes in relationships that the proposal will no doubt necessitate. Most mortgage business models allow customers to have a long term relationship with a traditional bank. In an environment where mortgage servicing becomes a commodity for non-bank servicers, consumers will most likely see their mortgage servicing traded more frequently to their detriment.

Impact on TowneBank:

There is currently no impact to TowneBank.

Recommendation:

As an alternative, we would ask the regulators to consider either 1) grandfathering existing servicing assets, or 2) allowing a greater percentage (for instance (30%) to be included in capital.

Summary and Conclusion

The significance, volatility and complexity of the proposed capital rules cannot be understated. The proposed capital volatility would raise the cost of capital for community banks and harm investors by increasing the risk of investing in our company if the AOCI rules are adopted. The retroactive inclusion of higher risk weighting of residential mortgage loans could cause the devaluation of existing mortgage portfolios and a substantial increase in risk based capital requirements for banks involved in mortgage lending. If existing loans are not grandfathered banks would have to decide to hold additional capital or sell the newly depreciated loans.

With regard to the risk weightings on residential mortgage based on LTV ratios, a risk weighting framework that is single-factor focused without regard to the overall profile of a borrower will contribute to delay in the recovery of our residential mortgage market.

Items impacting mortgage businesses which could have a significant impact on economic growth and transformation of the residential mortgage industry:

- GSE reform
- Consumer Protection Act
- Consumer Financial Protection Bureau
- Dodd Frank Wall Street Reform
- Incentive restrictions on Mortgage personnel
- Mortgage Servicing Rights Increased Capital Requirement
- Category 1&2 capital requirements of increased risk weighting
- Change in recourse provisions and 120 day safe harbor rule

The above items run the risk of having a significant impact on economic growth, mortgage availability and related pricing.

The change in risk weighting of loans will impact the amount of leverage and pricing of loans. For example, for every dollar of Tier 1 capital it maintains, and with a Tier 1 capital ratio of 8%, a bank can lend $12.50 for a typical CRE loan with a 100% risk-weighting or $8.33 in a HVCRE loan with a 150% risk-weighting. In order to achieve an equivalent return, banks may have to raise rates as much as 50% or turn away deposit customers to de-leverage their balance sheet or reduce staff levels.

Finally, Basel III seems to leave unanswered questions about non-bank financial institutions which will not be governed by it. Shadow banking, which contributed greatly to the financial crisis, through insurance firms, hedge and pension funds, and investment banks are an important sector of financial services, and the NPR's avoid the very firms that largely lead to the financial crisis while allowing them a competitive advantage and no impediment to risk taking.

TowneBank appreciates the opportunity to comment on this proposal. We strongly encourage the banking regulators to exempt community banks from the proposed implementation of Capital NPRs and allow community banks to continue to operate under Basel I capital requirements. If you have any questions or would like additional information, please do not hesitate to contact me at 757-638-6801.

Sincerely,

Clyde E. McFarland, Jr

Clyde E. McFarland, Jr
Senior Executive Vice President and Chief Financial Officer

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Chairman and CEO
TowneBank

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Commissioner of Financial Institutions
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Senator Jim Webb

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Representative Randy Forbes

Representative Scott Rigell

Representative Bobby Scott

Representative Rob Wittman

Representative G.K. Butterfield

Representative Walter Jones, Jr.

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Secretary
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The Honorable Ben S. Bernanke
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Assistant Director and Chief Accountant of Banking Supervision and Regulation
Federal Reserve Board

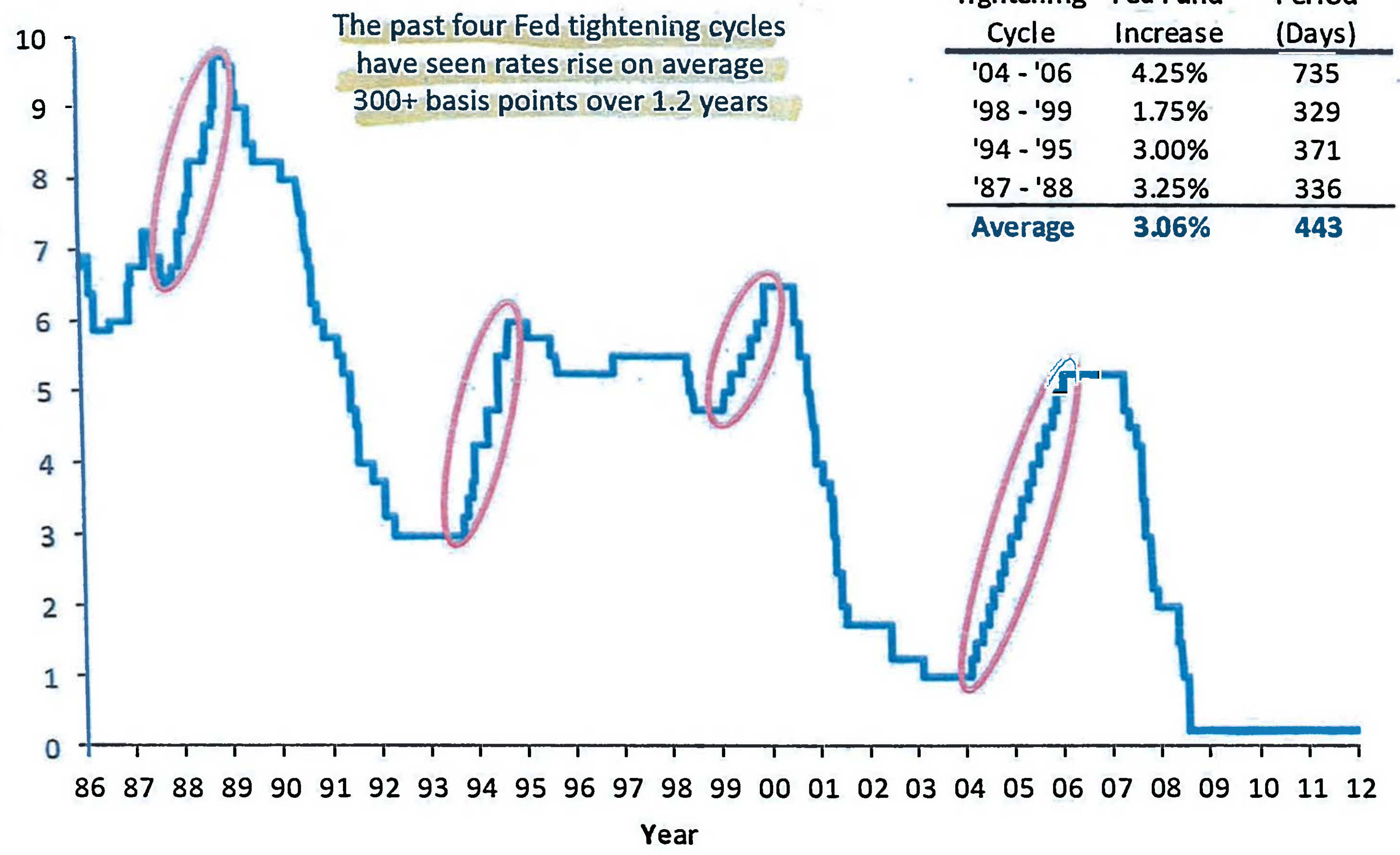
Juan Climent
Division of Banking Supervision and Regulation
Federal Reserve Board

The Honorable Elizabeth Duke
Governor
Board of Governors of the Federal Reserve System

EXHIBIT ..

Fed Funds Target Rate: 1986 - 2012

Tightening Cycle	Fed Fund Increase	Period (Days)
'04 - '06	4.25%	735
'98 - '99	1.75%	329
'94 - '95	3.00%	371
'87 - '88	3.25%	336
Average	**3.06%**	**443**



Source: Bloomberg