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October 22, 2012

The Honorable Thomas J. Curry, Comptroller
Office of the Comptroller of the Currency
regs.comments@occ.treas.gov
Docket ID OCC-2012-0008 and OCC-2012-0009
RIN 1557-AD46

The Honorable Ben S. Bernanke, Chairman
Board of Governors of the Federal Reserve System
regs.comments@federalreserve.gov
Docket R-1430 and R-1442
RIN No. 7100-AD 87

The Honorable Martin J. Gruenberg, Acting Chairman
Federal Deposit Insurance Corporation
comments@fdic.gov
RIN 3064-AD95 and RIN 3064-AD96

Re: Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (the "Basel III Proposal") and Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements (the "Standardized Approach Proposal")

Gentlemen:

First Reliance Bancshares, Inc. (the "Company") and its wholly-owned subsidiary, First Reliance Bank (the "Bank"), appreciate the opportunity to provide you with our comments on the Basel III Proposal and the Standardized Approach Proposal (together, the "Proposals"). By way of background, the Bank is a state-chartered commercial bank with assets of approximately $470 million in assets as of June 30, 2012. Founded in 1999, the Bank currently serves three counties in central South Carolina through its six branches, and is headquartered in Florence, South Carolina. Our primary federal regulators are the Federal Reserve Bank of Richmond and the Federal Deposit Insurance Corporation ("FDIC"). The Bank provides traditional banking services to small and medium sized businesses within our market area, including residential mortgage and commercial loan origination, as well as a wide array of deposit products focused on specific segments of our market area.

We have modeled the pro forma impacts of the Proposals on our balance sheet to judge the impact of the Proposals on the Bank. While the Bank is projected to continue to be well-capitalized for regulatory purposes on a pro forma basis following the implementation of the Proposals, the Proposals will have a substantial impact on not only our capital levels, but also our risk-weighted assets. In total, should the Proposals be fully implemented as planned, we will likely be forced to raise capital in the future in order to sustain our current lending activities within the communities we serve. To this end, our comments will focus on certain provisions described in turn in each of the Basel III Proposal and the Standardized Approach Proposal that we project will have a significant impact on our Bank and our customers.

THE BASEL III PROPOSAL

Increases in Required Capital: We recognize that the expectations for minimum levels of capital for financial institutions have changed in the wake of the recent financial crisis. However, we are concerned that the long-term consequences of raising minimum capital levels in the industry, particularly among smaller community banks, are not yet truly understood and that changes in minimum capital levels should not be implemented until the regulatory authorities have an opportunity to study the impact of the proposed risk-weighting rules on the industry. As will be more fully described below, we believe that several aspects of the proposed risk-weighting rules, if adopted as proposed, could have a material impact on our balance sheet. In particular, we anticipate that the combination of the increased minimum capital levels and the increased risk-weights would likely detrimentally affect the Bank's profitability without any correlative improvement in our risk profile.

In addition, we note that the proposed changes to minimum capital levels are being proposed at a time when sources of capital are still scarce for many financial institutions. In light of the negative impacts of the Basel III proposal on our future profitability, it could become increasingly difficult for us to provide a suitable return to our investors. In the end, we could face a vicious circle in which additional capital is needed to sustain profitability and meet regulatory requirements, but such capital is unavailable because of the limits placed on our ability to grow earning assets. The uncertainty of the impact of the Proposals only exacerbates this already difficult situation. As a result, we submit that delaying the implementation of new minimum capital levels would be appropriate in order to more fully understand the significant impacts of the higher minimum capital ratios.

Capital Conservation Buffer: We also believe that the restrictions proposed for financial institutions that do not maintain the full capital conservation buffer required by the Basel III Proposal should be reconsidered. As proposed, financial institutions that do not maintain the full capital conservation buffer will be subject to restrictions on capital distributions and on the payment of executive compensation. The existing regulatory framework contains appropriate restrictions on the payment of dividends. The regulatory agencies have existing rules or policies in place that require financial institutions to consult with, or obtain the approval of, the appropriate regulatory agency prior to paying a dividend that is in excess of an established percentage of recent earnings of the institution.

For smaller financial institutions that do not necessarily intend to pursue growth through significant mergers or acquisitions, the payment of dividends is crucial to our ability to attract and retain shareholders, as stable distributions of earnings can be a significant inducement to prospective investors. As proposed, the capital conservation buffer could require the Company to raise additional tier 1 common equity, diluting our current shareholders, while also further restricting our ability to pay dividends. As with the increased minimum capital requirements, the proposed capital conservation buffer could have a circular effect that would impact our ability to raise capital without effecting any significant improvement to our risk profile.

Inclusion of Accumulated Other Comprehensive Income in the Calculation of Common Equity Tier 1 Capital: We are concerned about the volatility that would be introduced to bank balance sheets through the inclusion of Accumulated Other Comprehensive Income ("AOCI") in the calculation of Common Equity Tier 1 Capital ("CET1"). The primary driver of AOCI (or loss) for most institutions is unrealized gains and losses in the available-for-sale securities portfolio and such securities are generally designated as available for sale to provide the bank with a beneficial source of liquidity. While Generally Accepted Accounting Principles require a financial institution to record changes in the fair value of the bank's AFS securities portfolio in the equity section of its balance sheet, regulatory precedent currently excludes unrealized gains and losses on the AFS portfolio from the calculation of Tier 1 regulatory capital, instead including that amount in the calculation of the institution's Tier 2 capital.

We believe this regulatory capital treatment to be justified, as interest rate swings create increases and decreases in the market value of our securities that often do not reflect changes to the portfolio's value that the Bank will ever realize. Instead, we often continue to hold the securities as a hedge against contrary interest rate risk elsewhere on the balance sheet. Should these unrealized securities gains and losses be counted in our regulatory capital calculations, our regulatory capital levels would become more sensitive to interest rate fluctuations without providing a significant improvement in our risk profile. For example, in the current long-term low rate environment, including AOCI as a component of CET1 would likely require us to maintain increased capital levels in relation to our available-for-sale securities portfolio, knowing that a future increase in interest rates would reduce our CET1. Even more perversely, in a falling rate environment, such as what we experienced in 2008, a time in which the Bank also experienced loan losses, the unrealized gains associated with an AFS securities portfolio would have worked counter-cyclically to increase the regulatory capital levels of the Bank.

In managing the increased volatility of our capital ratios, we would have two alternatives – convert our AFS securities portfolio to a held-to-maturity portfolio, which would reduce the liquidity options available to us, or hold much more capital in reserve (rather than deploying it through making loans) in order to offset downward pressure on our CET1 caused by an increase in interest rates. We do not believe that including AOCI in CET1 will promote any desired supervisory objective. Instead, it will increase the volatility of bank balance sheets, which is contrary to our understanding of the objectives of the Basel III Proposal. As a result, we suggest that this provision of the Basel III Proposal be removed.

Phase Out of Restricted Core Capital Elements: The Basel III Proposal phases out from Tier 1 capital eligibility the proceeds received from the issuance of certain securities that are considered "restricted core capital elements" under the current rules. Most notably, proceeds from issuances of trust preferred securities are phased out from Tier 1 capital eligibility. At present, the Company has approximately $10.3 million in outstanding trust preferred securities, all of which are included as Tier 1 capital at the Company. While we appreciate the length of the phase-out period for those institutions like us with less than $15 billion in assets, we believe that the legislative intent expressed in the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") to exclude those institutions with less than $15 billion in assets should be respected. Institutions such as the Company and the Bank below $15 billion in total assets have far less access to capital markets than those above that size threshold. By phasing out trust preferred securities from Tier 1 capital eligibility, the Basel III Proposal would further tax our ability to meet minimum regulatory capital thresholds, and could create a need for us to raise additional capital in the future.

REGULATORY CAPITAL RULES: STANDARDIZED APPROACH FOR RISK-WEIGHTED ASSETS

<u>Revised Risk-Weighting - Residential Mortgage Exposures</u>: Perhaps the most problematic component of the Proposals for the Bank, the new risk-weighting for residential mortgage exposures could cause a significant disruption to our balance sheet, and significantly limit our ability to develop flexible loan products that meet the needs of our customers.

Under the Proposals, in order for a residential mortgage to receive "category 1" treatment, and thus a lower risk-weighting, it may not result in a balloon payment. For smaller community banks like us, originating residential mortgage loans with a relatively short duration is not only key to our ability to compete with larger institutions in the mortgage market, but also critical to our credit and risk management strategies. The Bank typically structures its residential mortgage loans on the basis of a 15-, 20-, or 30-year amortization of principal with a balloon payment at the end of two, three, or five years. By doing this, the principal amount of the loan amortizes, but we retain the ability to review the credit and change its terms at the time of maturity. Most importantly, the balloon payment structure allows us to shorten the duration of the asset, which allows us to better match the durations of our liabilities. For us, matching the durations of our assets and liabilities is a critical component of our interest rate risk management strategy, and one of the few tools available to smaller community banks to manage interest rate risk.

Should we be unable to have some control over the duration and credit terms of these "bread and butter" assets for the Bank, our balance sheet would become more susceptible to interest rate risk. Further, we could be forced to increase the pricing of these loans to accommodate the higher risk-weights, or narrow our product options. For us, personal service not only means a helpful face at the teller window, but also flexible loan products that meet the individual needs of the communities we serve. Many of our borrowers may not qualify for traditional mortgages, including consumers who are self-employed and therefore do not have consistent documented income, even though they clearly have the financial means to repay the loan. We believe the economic impact of the proposed change to the risk-weighting of residential mortgage exposures would be real and would most directly impact the consumers who need these loans that would otherwise not be available in their market.

<u>Risk-Weighting of "High Volatility Commercial Real Estate" Loans</u>: We also believe that the increased risk-weighting for loans deemed to be "High Volatility Commercial Real Estate" ("HVCRE") loans is fundamentally flawed, in part because it relies too heavily on the equity injected into the project as a sole determinant of risk. For the Bank, the minimum equity requirements of the Standardized Approach Proposal could sharply curtail our ability to make construction loans to many of our customers.

The Standardized Approach Proposal contemplates that acquisition, development and construction ("ADC") loans that do not meet certain requirements, including that the borrower inject cash or unencumbered readily marketable collateral of at least 15% of the appraised "as completed" value of the project, will be assigned a risk weight of 150%. We suggest that the regulatory agencies study additional factors beyond minimum equity ratios, particularly those based upon appraised "as completed" values, that can mitigate the risk of these loans and thereby remove the loan from the definition of an HVCRE loan. Finally, we submit that there are other appropriate forms of collateral beyond cash and readily marketable assets that can serve as appropriate equity for ADC projects. For example, we believe it could be appropriate to inject real estate as equity into a project, perhaps at a ratio higher than 15%, to remove a loan from the definition of an HVCRE loan.

Further, this component of the Standardized Approach Proposal continues to place a heavy reliance on appraisals to determine the present market value of the collateral securing the loan. As we learned through the recent economic downturn, appraisals often provide only rough estimates of the present value of the real property, and in a relatively rural market such as ours, there may be no relevant comparable sales by which to present a meaningful comparison. In a time of slow real estate activity, risk-weighting that relies on loan-to-value calculations based on appraisals would likely bring most development activity in our market area to a halt through prohibitive loan pricing and borrower equity contributions. We believe that the HVCRE definition should be much more limited so as to take into account of other risk mitigation approaches adopted by community banks to limit the risk of certain development loans. If the definition is not further limited, we could be driven out of financing development activity, which will act to restrain the expansion of the economy.

Risk-Weighting of Past Due Exposures: We are also have concerns with respect to provisions of the Standardized Approach Proposal requires banking organizations to apply a 150% risk-weighting to assets that are 90 days or more past due or on nonaccrual status to the extent that those assets are not secured or guaranteed in accordance with the requirements of the Standardized Approach Proposal. Specifically, we are believe that the risk-weighting of past due exposures in the Standardized Approach Proposal largely ignores the existing processes by which financial institutions account for past due exposures and could result in the double-counting of many past due assets in the calculation of our regulatory capital ratios.

At the Bank, when a loan or a security is 90 days or more past due or on nonaccrual status, it is tested for impairment. If the asset is deemed to be impaired, we make a judgment as to the amount collectible with respect to the asset. To the extent that the full carrying amount of the asset is not anticipated to be collected, which, in the case of a loan, is based upon the value of the collateral or anticipated cash flows, the financial institution makes the appropriate accounting entries: for an impaired loan, an increase in the provision for loan losses is charged directly to earnings and a specific reserve is added to our Allowance for Loan and Lease Losses and for an impaired security, the amount is included in AOCI or charged directly our earnings. In any of those instances, our CET1 would be reduced under the Basel III Proposal.

Given that accounting framework, we believe that adding to the risk-weighting of past due assets constitutes unnecessary double-counting of the risk of the assets. Decreasing the numerator of risk-based capital calculations while simultaneously increasing the denominator of the calculation would have a pro-cyclical impact and would unnecessarily strain the capital ratios of financial institutions encountering asset quality problems.

CONCLUSION

As we have discussed more fully above, we believe that the Proposals are fundamentally flawed such that they should be withdrawn completely. As we have described above, several aspects of the Proposals would directly impact our ability to serve our customers and our community, and provide a sustainable return to our investors. Beyond the immediate impacts on the Bank, we believe that there is a great deal of risk in simultaneously finalizing such broad-based and sweeping changes to the way that financial institutions calculate their capital and risk-weighted assets and the capital ratios they are required to maintain. Notwithstanding the various phase-in periods set forth in the Proposals, the rule changes set forth in the Proposals are currently planned to be finalized simultaneously, leaving little ability to adjust the rules after understanding the impact on the industry of isolated facets of the rule changes.

Finally, we submit that the best regulation is often implemented through experienced and principled regulators, rather than complex rules. We have always valued our discussions with our regulators – while we are proud of our bank, the open relationship we have built with our regulators through the routine examination process has made us better bankers. While we believe that some bright line rules are helpful in governing bank risk, nothing is more valuable than having the opportunity to discuss the Bank's challenges with a knowledgeable bank regulator to find a mutually agreeable and common-sense solution. In many ways, the Proposals substitute a complex regulatory framework for the sound judgment of experienced professionals, with our customers and local economy left to pay the price.

We very much appreciate the opportunity to comment on the Proposals. We ask that you consider our comments in developing and prior to adopting the final rules. We believe that through appropriate regulation, we can help meet the needs of businesses and consumers in our communities as we look forward to full economic recovery and beyond.

Respectfully submitted,

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President and Chief Executive Officer

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