

October 17, 2012

919 658-7000

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:

I truly appreciate 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”).

Southern BancShares (N.C.), Inc. (“BancShares”) is a \$2 billion bank holding company headquartered in Mount Olive, North Carolina, a town with a population of approximately 4,600 residences. The banking subsidiary of BancShares, Southern Bank and Trust Company (the “Bank” or “Southern”), was founded in 1901 in Mount Olive, and currently through its sixty seven branch locations, serves the residences and small to mid-sized businesses of eastern North Carolina and southeastern Virginia.

Southern is a premier community bank in the communities we serve, as we have maintained sound asset quality and solid earnings and capital levels throughout the financial crisis, while continuing to meet the needs of the citizens within our foot print. Until our FDIC assisted acquisition of the failed Bank of the Commonwealth in Norfolk, Virginia on September 23, 2011, the largest metropolitan center served by Southern was Greenville, North Carolina, with a population of approximately 85,000. However, in several communities in rural eastern North Carolina, Southern is the only bank within a several mile radius. The small business loans, agricultural loans, consumer loans, and over \$100 million in mortgage loans provided by our Bank each year to these communities is imperative to their economic success. While our commitment to the communities we serve is vital to our business, our sustained asset quality and

earnings are a testament to our recognition of sound lending and fundamental banking practices, which are inherent in our culture.

While I fully believe that a certain level of legislation and regulatory reform is needed to ensure a sound financial system, the new Basel III proposals will hinder our ability to continue to grow our organization and serve the communities we have been a part of for the past 111 years. More specifically, the following items are areas of the proposal that cause grave concern:

- **Requirement that unrealized gains and losses on available for sale securities flow through regulatory capital**

Under the current proposals, unrealized gains and losses on available for sale securities would be included in regulatory capital, which based on the current value of Southern's portfolio, would be beneficial to our organization. However, this could create a tremendous amount of volatility in our regulatory capital causing us to fundamentally change our investment strategies and composition of the investment portfolio. Our investment portfolio is a significant part of the interest rate risk management of the Bank. Subjecting the Bank to investment portfolio restrictions due to potential capital volatility could jeopardize our ability to effectively manage that risk.

- **Phase out of Trust Preferred Securities**

The current proposals approved by the banking agencies phase-out Trust Preferred Securities as tier 1 capital for bank holding companies having between \$500 million and \$15 billion in total consolidated assets as of December 31, 2009, permitting the inclusion of 90% of the carrying value of such instruments in 2013, with annual 10% decreases in the includible amount through 2021, until the instruments are fully phased-out on January 1, 2022. For BancShares and the Bank, this means that we will eventually lose \$23.7 million in stable regulatory capital. This would have a detrimental impact on our organization as our trust preferred securities represent approximately 12% of our total tier 1 equity capital.

- **Requirement to hold additional capital for credit enhancing representations and warranties on 1-4 family loans which have been sold into the secondary market**

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).

As I mentioned earlier, we provide over \$100 million annually in mortgage loans to communities in North Carolina and Virginia. Many of these communities fall within counties that have a tier 1 economic designation, including thirteen counties in eastern North Carolina in which we have branches. Given the size of our organization and structure, it is necessary that we sell the majority of these mortgage loans into the secondary market. Based on our current servicing portfolio of loans we have sold with servicing retained, combined with the loans that we have originated and sold servicing released in the secondary market in the past five years, there are over \$600 million in mortgage loans that will significantly impact our capital ratios and potentially cause us to fall below the newly proposed regulatory minimum ratios. We understand that there are risks involved in this line of business, especially when a bank has provided credit enhancing representations and warranties. However, it is my belief that banks that have loss experience or expected loss experience should have proper loss reserves recorded on the face of their balance sheet to provide for such contingent liabilities, if deemed material. Due to our prudent underwriting standards, our organization has experienced very little loss related to such warranties and representations on mortgages we have sold in the secondary market. However, as a result of the proposed rules and capital constraints that could result, we would be forced to consider closing our mortgage line of business, thereby placing the jobs of our 29 mortgage department employees at risk. Also, this could result in the unintended consequences of reducing available credit to potential home buyers in our market.

- **Increased risk weighting for residential mortgage loans**

As I mentioned earlier, our Bank provides over \$100 million annually in mortgage loans to the citizens of North Carolina and Virginia. While we sell the majority of the traditional 1-4 family residential mortgages into the secondary market, this practice will be hindered by the capital requirements I mentioned previously around credit enhancing representations and warranties. However, Southern has over the years built a mortgage portfolio that we have retained on our balance sheet. Under the current proposal, the banking agencies are proposing new methodologies for risk weighting mortgages that are heavily dependent on data and can increase risk weights up to 200%. Under the current proposals, capital would be impacted by 1) loans falling into either a "Category 1" or "Category 2" classification and 2) loan to value of the loans. My interpretation of the proposed rules lead me to believe that the only way a 1-4 family mortgage can qualify as a "Category 1" mortgage is by the loan being a fully amortizing traditional mortgage. Further, a loan that once met the characteristics of a "Category 1" mortgage could be reclassified to "Category 2" if the loan is modified and the new terms do not meet the characteristics required for a "Category 1" mortgage. This could require a loan with less than 60% loan to value to be re-risk weighted from 35% to 100% if the loan is modified for any number of reasons and the new terms are not those of basically a traditional 1-4 family mortgage.

Further, these new methodologies apply not only to new mortgages, but existing mortgages currently on our balance sheet that were underwritten, and priced, with existing capital standards in mind. As a result, Bank staff would be required to go through decades-old loan files to determine appraisal values and borrower characteristics to determine the appropriate risk weight. While institutions can adjust their lending practices on a going forward basis to avoid some of the more punitive risk weights, they cannot effectively and efficiently do so with respect to mortgages already made. In light of these facts, I ask that you at least consider grandfathering existing mortgages.

- **Proposed changes in capital requirements related to mortgage servicing assets**

Banks would be required to deduct all mortgage servicing assets (net of deferred tax liabilities) that exceed 10% of its common equity tier 1 under the proposal. Currently, our organization's mortgage servicing asset is well below 10% of our common equity tier 1. However, the proposal requires that the amount that is below the 10% threshold receive a 100% risk weight and eventually 250% beginning 2018. The current proposal will cause us to consider scaling back or totally eliminating our mortgage servicing business. While I believe that this item should be completely revisited, one solution is the grandfathering in of existing mortgage servicing assets. We have long standing servicing relationships that were entered into on the basis of previous and current regulations and requiring that new capital regulations be placed on these existing relationships, would cause many community banks to consider selling these assets, at what would probably be less than favorable terms.

- **New rules related to increase risk weights on delinquent loans**

The proposals as they stand today require increased risk weighting for delinquent loans. We have an organization that has a long standing conservative credit culture, which allowed us to maintain strong earnings and capital levels throughout the recent financial crisis. This conservative credit culture has resulted in a relatively low delinquency volume on originated loans as compared to our peers and as a result this particular item may not have the same impact on our organization that it has on other organizations. However, this item does essentially have a double effect on our organization's capital ratios. Southern has always prided itself on identifying potential problem loans early and properly accounting for these loans through our Allowance for Loan Losses, which I believe is the most prudent way of accounting for risk in the portfolio. The increased risk weighting of these loans, for which we have already increased our loss reserves, will now cause even more strain on our capital ratios and may lessen many banks' willingness to work with potentially troubled borrowers. This may force banks to aggressively push delinquent loans off of their balance sheets.

In summary, the complex proposals approved by the banking agencies and the tremendous burden that the proposals would place on community banks to comply with the proposals, are in my mind, detrimental to our nation's current banking system and overall economy. In a time when the economy needs to be revitalized and the federal government has instituted the Small Business Lending Fund to ensure adequate lending levels to small businesses, the banking agencies are proposing capital reform that could result in lower legal lending limits. As legal lending limits are based on capital levels, the proposals as they stand today could hinder community banks' ability to lend to small and mid-sized businesses, which drive the local economies of many communities. Further, it is inevitable that many smaller community banks will not be able to meet the new capital requirements and will be forced to merge with larger banks. For those community banks that are able to meet the proposed capital requirements, I fear that the capital constraints placed on them will inevitably tie their hands and limit their ability to serve the communities in which they are located. This is extremely troubling to me, as I understand firsthand the role of the community bank in our communities. As a result, I ask that the banking agencies begin with a clean slate and craft a more suitable set of capital proposals.

Thank you for your consideration of the above mentioned points.

Sincerely,

A handwritten signature in cursive script that reads "David L. Sauls, Jr.".

David L. Sauls, Jr.
Staff Accountant