COASTALSOUTH BANCSHARES, INC.

October 22, 2012

Via e-mail

regs.comments@federalreserve.gov
Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N. W.
Washington, D.C. 20551

regs.comments@occ.treas.gov
Thomas J. Curry
Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, D.C. 20219

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

Re: **Proposed Regulatory Capital Rules - Basel III**

Dear Ms. Johnson, Mr. Feldman, and Mr. Curry:

CoastalSouth Bancshares, Inc. and its wholly-owned subsidiary, CoastalStates Bank appreciates the opportunity to comment on the proposed Basel III Regulatory Capital Rules. We are supportive of the agencies objective of further strengthening the safety and soundness of our banking system, but believe there are components in the proposed rules that would negatively impact the communities that are served by our banking system.

CoastalStates Bank was chartered in 2004 as a community bank serving the greater Hilton Head Island, South Carolina community. Today, CoastalStates Bank is the largest privately-held financial institution and maintains the number two deposit market share in Beaufort County. By our focused approach, we have provided banking and credit products to consumers and small business in our community. Further, we own and operate a mortgage subsidiary, Homeowners Mortgage Enterprises, Inc., headquartered in Columbia, South Carolina that provides both retail and correspondent mortgage business serving South Carolina, North Carolina, and Georgia. Through our mortgage subsidiary, we have originated over $2 Billion and assisted over 15,000 homeowners either acquire a home or lower their rate.

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

Capital Ratios

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

Servicing Assets

The Bank services residential mortgage loans for its own account and for the account of others. The process of selling mortgage loans and retaining the servicing obligation creates a servicing asset.

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

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

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

Accumulated Other Comprehensive Income ("AOCI")

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

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

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

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

Deferred Tax Assets ("DTAs")

Current regulatory rules allow the inclusion in Tier 1 capital of DTAs expected to be realized in the ensuing 12 months. While we ultimately would like to see the inclusion in regulatory capital of all DTAs recognized under U.S. GAAP, we recognize the Agencies' desire to provide limits on the amount of DTAs included in regulatory capital. However, given the already stringent recognition criteria under U.S. GAAP, it appears that more restrictive recognition criteria for regulatory capital purposes reduces an institution's capital unnecessarily since the presence of a DTA indicates that the institution has already performed an assessment and concluded that the DTA is "more likely than not" to ultimately be realized. Therefore, if a DTA exists on a bank's balance sheet, it has been deemed a true asset and should not be disallowed in the Tier 1 calculation.

Categorization and Risk-Weighting of Residential Mortgage Exposures

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

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

Risk-Weighting of High Volatility Commercial Real Estate Loans

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

Credit Equivalent Amounts of Off-Balance Sheet Commitments

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

Phase out of Trust Preferred Securities as Capital Instruments

Inconsistent with the intent of the Collins amendment, the proposed Basel III capital rule does not grandfather Trust Preferred Securities for institutions between $500 million and $15 billion. Instead, Basel III requires the phase-out of these instruments 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. Access to capital is already extremely hard for community banks. Eliminating the ability to utilize or obtain multiple types of "equity-like" instruments for community banks will ultimately weaken their holding companies and in turn, may not be a future source of strength to banks. It is very important for bank holding companies to have multiple sources of cash in order to be that source of strength to its bank during all economic cycles.

Summary

As discussed in our comments above, while we are in agreement with the overall objective of ensuring a strong banking system in the United States, we take issue with certain provisions outlined in the Proposals. Our comments are based on what we think will be unintended consequences of more restrictive and onerous capital requirements such as;

- increased costs of compliance;
- decreased ability of banks to internally generate capital;
- decreased access to multiple types of capital;
- reduced lending to consumers and small businesses;
- less than optimal interest rate and liquidity risk management strategies; and
- shrinkage of the banking industry assets, leading to a shrinkage of banking industry jobs.

Additionally, given the proposed increases in minimum capital levels, the higher risk-weighting implications exacerbate the detrimental impact such changes are likely to have on the banking industry and in the availability of credit for consumers and small businesses. Further, the higher capital requirements will reduce the amount of new capital to the banking system as a result of a reduced ability to leverage capital leading to an expectation of diminished shareholder returns, at which point capital investment is redirected to other industries with more favorable prospects for appropriate returns.

Thank you for allowing the banking industry and other interested parties an opportunity to comment on the Proposals. CoastalSouth Bancshares, Inc. and its subsidiaries recognize the need for a safe, efficient and well-capitalized banking industry and are supportive of efforts to improve the current system.

Sincerely,

Randy K. Dolyniuk
Vice Chairman and President
CoastalSouth Bancshares, Inc.

Charles D. Christy
Chief Financial Officer
CoastalSouth Bancshares, Inc.