FirstBank

October 18, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve Systems
20th Street and Constitution Avenue, NW
Washington, D.C. 20551
Delivered via email regs.comments@federalreserve.gov

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

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, D.C 20219
Delivered via email regs.comments@occ.treas.gov

Re: Basel III & Standardized Approach NPRs

Ladies and Gentlemen:

This letter is in response to the comment period for the Basel III and Standardized Approach proposals approved by the Federal Deposit Insurance Corporation, Federal Reserve Board and the Office of the Comptroller of the Currency (the agencies). Thank you for the opportunity to express our concerns regarding the effect the referenced proposals will have on our institution and the communities we serve.

First, I understand the agencies have the obligation to promote a safe and sound financial system. Further, I agree that the industry must thoroughly study the balance sheet composition, policies and procedures and risk management processes of the failed or severely stressed institutions during the recent economic events and use that data to strengthen our industry. However, I strongly believe this study and resulting regulatory changes have to be extremely thoughtful and probing, not reactionary, to ensure the appropriate remedies and precautionary actions are adopted. The effect the proposed capital changes will have on the nation's community banking system and its ability to provide the lending activity needed to spur our current economy convince me they are not the appropriate solution.

First Bank is Tennessee's 3rd largest bank with assets of approximately $2.1 billion and employs 656 associates. The bank, headquartered in Lexington, Tennessee, has 45 offices in 26 counties across the state, serving rural, urban and suburban markets. The First Bank footprint also includes mortgage offices in Alabama, Florida, Georgia and South Carolina. Community banking is the cornerstone of First Bank's operations and has been its philosophy since the bank was founded in 1906. First Bank is a subsidiary of First South Bancorp, Inc. (First South), a single bank holding company. As of September 30, 2012 First Bank had Tier 1 Leverage Capital of 9.02%, Tier 1 Risk Based Capital of 14.18% and Total Risk Based Capital of 15.90%. First South's ratios are 9.02%, 14.15% and 16.17% respectively. Under the proposed rulings, the change in the current levels and future volatility of each ratio will be at risk.

First, the proposed categorization and risk weighting of residential mortgages will be extremely punitive, negatively impacting community lending. The proposal currently divides mortgage loans between category 1 and category 2, with category 2 risk-weighted at levels as high as 200%. The definition of a category 1 mortgage loan includes very specific underwriting guidelines which can't currently be verified in many operating systems, so today it is impossible to determine how the total portfolio will be risk-weighted. The bank's total first lien mortgage portfolio is approximately $300 million and currently would generally be 50% risk-weighted. Under the proposals in a mid to worse-case scenario the portfolio could be risk-weighted in a range between 100% and 200%, requiring an additional $15 - $45 million to capitalize the portfolio at a well-capitalized level. Such increases in capital are extremely difficult in today's environment and will definitely inhibit lending activity in our communities, preventing future growth. This negative effect will come at a crucial time when our nation is trying to spur the economy, not further slow it down.

The Overview of Addendum 1 of proposal 2 states the agencies are issuing the notice "to harmonize and address shortcomings in the measurement of risk-weighted assets that became apparent during the recent financial crisis, in part by implementing in the United States changes made by the Basel Committee on Banking Supervision to international regulatory standards and by implementing aspects of the Dodd-Frank Act". Thus, the proposals were written to increase the capital in financial institutions for the assets that during the financial crisis revealed significant stress and resulted in losses, which would have decreased capital in greater amounts than what current regulations require. The new strict risk-weightings applied to mortgage loans in the proposal would infer that banks experienced losses on these loans at significantly greater amounts than the capital current regulations require. The data in the Statistics on Depository Institutions (SDI) section of the FDIC web site includes information on standard peer groups. A review of the standard peer group of U.S. commercial banks with assets $1 billion to $10 billion reveals that for the 4 years ended 12/31/2008 – 12/31/2011 the average balance (based on a simple average of year end balances) of first lien mortgage loans for the entire group was approximately $113 billion. At the current 50% risk-weighting for a well-capitalized level, that balance would require the group to hold approximately $5.7 billion in capital. The peer group's net charge-offs for the first lien loan category for the same time period was $3.5 billion, $2.2 billion less than the required capital. The total 1-4 family mortgage portfolio for the group reveals similar statistics, with average balances of $162 billion, $8.1 billion in required capital and $5.9 billion in net charge-offs for the 4 year period. Admittedly, during the recent financial crisis there was misuse of non-conventional mortgage products. However, the SDI data statistics on losses strongly support the fact that this abuse was not prevalent in community banks. Further, banks in the $1 - $10 billion peer group had more than enough capital to cover their losses under the current standards for these loan types.

A study of First Bank's mortgage loss experience during 2008 – June 30, 2012 reveals similar results. Our average balance of first lien mortgages was approximately $274 million which would require $13.7 million in capital under current risk-weighting at a well-capitalized level. Our net losses for that same time period were $6.5 million, 47% of the capital required. Our total 1-4 residential average loan balance for the same period was $460 million which would require $23 million capital at the current 50% risk-weighting and our net losses for the 4.5 year period was $14.5 million, well below the capital held for the assets. Not only was the current capital requirement sufficient, it was significantly higher during a severe economic environment when losses were at their peak. Therefore, the proposal's significant increase in risk-weightings for mortgage loans appears to be excessive. This required level of capital will force us to review our loan product strategy and pricing which would affect the availability of credit in the communities we serve. I encourage you to reconsider their application as proposed.

Furthermore, the required balance for the Allowance for Loan & Lease Losses (ALLL) is calculated considering portfolio risk factors such as loan to value, delinquencies, credit scores and economic conditions. Therefore, bank portfolios with higher risk of loss must have a higher ALLL. The adequacy of the ALLL is reviewed independently during annual external audits and regulatory examinations to insure it is appropriate for the specific portfolio. Increasing capital requirements to cover the same risk elements has a double impact on bank capital. This issue is compounded by the limitation of the ALLL in tier 2 capital to 1.25% of risk-weighted assets. Currently First Bank has an ALLL of $38.7 million, 3.05% of gross loan balances, however, only approximately $17 million of that balance can be included in regulatory capital. The redundancy of higher capital requirements in addition to this limitation intensifies the negative effect on capital and is extremely punitive based on our experience.

In addition, as referenced above many data fields required to assess the appropriate risk-weighting under the proposals are not available in operating systems currently. Therefore, not only will systems have to be updated by vendors or even new ones purchased but also significant time and money will be required to collect the data from files and document for loans already in the portfolio. The complexity, retroactive application and transactional focus on the calculations will also require more human capital to comply, monitor and report the necessary data. This increased expense comes at a time when banks are prudently trying to increase capital through earnings.

My second area of concern is the inclusion of the unrealized gains and losses on available for sale (AFS) designated securities in tier one common equity. With this requirement, interest rate fluctuations, not credit risk, will significantly impact tier one equity, resulting in volatile capital ratios. Currently First Bank has a $20 million unrealized gain on its $663 million bond portfolio, of which 89% is invested in U.S. Agency MBS and CMOs. The portfolio has an average life of 4.1 years and duration of 3.7. Due to low loan demand First Bank's bond portfolio is more than 32% of total assets, much higher than historically. The portfolio has strong credit quality due to the composition. Our nation is currently experiencing historic low interest rates and most institutions have gains in their investment portfolios, however when interest rates do increase, these gains will be eliminated and unrealized losses will occur. If First Bank's current unrealized gain was included in tier one equity our Leverage Ratio would increase from 9.02% to 9.92%. However, this benefit will be short lived in an increasing rate environment. Based on a 300 basis point interest rate increase the gain reverses to a significant unrealized loss, resulting in a Leverage Ratio of 5.62%. The decline in capital is simply due to the effect the interest rate environment has on a bond portfolio with an average duration, not a decline in credit quality.

This type of fluctuation will create significant volatility in our capital ratios that will have negative consequences on investment practices. In order to avoid the capital volatility caused by this change, bank's will have to consider reclassification of assets to the held to maturity designation, which would negatively affect liquidity. Further, for the portion of the investment portfolio in AFS we will have to consider much shorter durations to lower the unrealized gain (loss) fluctuation in changing rate environments. This action will significantly lower the yield of the portfolio at a time when institutions are already experiencing significant pressure on the net interest margin. As a result, earnings will decline, lowering capital, opposite of the proposal's goal.

Another related issue is the variance in the effect on capital depending on an institution's tax status. The portion of the AFS adjustment that decreases capital is net of the relative deferred taxes, which will be much lower for institutions that file as C Corporations. First Bank is a Sub-chapter S (Sub S) for tax filing purposes. In a 300 basis point interest rate increase the estimated loss in our portfolio would be approximately $76 million, of which $71 million would decrease equity on the balance sheet through other comprehensive income. If we filed as a C Corporation the amount that would decrease equity would be approximately $46 million, 35% lower due to the federal income tax affect. Therefore, the capital of Sub S banks will be significantly more volatile simply due to their tax status. Surely this is not the intent of the agencies.

Furthermore, GAAP currently requires recognition of an investment loss that is other than temporary impairment through earnings. Therefore, capital already reflects true losses in the asset that are not expected to be recovered. Any unrealized gains and losses are temporary by nature and should not be included in the regulatory capital definition.

The third area of the proposals that significantly impacts our institution is the phase-out of trust preferred securities as capital instruments. First South has $30 million in trust preferred securities that were issued in 2003 to capitalize a bank merger. These have served as a stable source of capital both prior to and during the economic crisis. The elimination of this capital would lower the First South Leverage ratio from 9.02% to 7.58%, a significant decline. Although the Collins amendment grandfathered Trust Preferred issues for institutions under $15 billion, the proposal does not; we believe Dodd-Frank never intended the phase-out of this capital instrument for community banks. Due to disturbing government predictions for additional economic pressure on financial institutions at the time, First South also participated in the Department of Treasury's Capital Purchase Program (CPP). In July 2009, First South received $50 million in CPP with $2.5 million in warrants, which were immediately exercised. In October, 2011 we repaid $13.125 million and have a current outstanding CPP balance of $39.375 million. The CPP instruments are grandfathered as capital in the proposal. However, in July 2014 the CPP interest rate increases from 7.70% to 13.80%, which will decrease our earnings by approximately $2.3 million annually. Due to this negative affect on earnings have a current outstanding CPP balance of $39.375 million. The CPP instruments are grandfathered as capital in the proposal. However, in July 2014 the CPP interest rate increases from 7.70% to 13.80%, which will decrease our earnings by approximately $2.3 million annually. Due to this negative affect on earnings our plans are to repay this debt before the rate increases, which will also assist in meeting the government's goal to end their investment in community banks. However, if the proposal is adopted we will have difficulty meeting this goal due to decline in capital for the trust preferred instruments. Therefore, I encourage you to be consistent with the Collins amendment and grandfather existing trust preferred instruments for institutions and holding companies less than $15 billion in assets.

The fourth element of the proposal that will significantly affect our bank is the requirement to apply a 100% credit conversion factor to loans sold with credit enhancing representations and warranties in place that contain an early default clause and/or certain premium refund clauses. FirstBank Mortgage Partners, a division of First Bank, employs 145 associates and currently sells approximately $63 million per month of mortgages in the secondary market. Our projected pretax direct contribution from the division for 2012 is approximately $3 million. Most investor contracts include enhancements and warranties related to fraud, deficiencies in underwriting, and early default with premium refund. If First Bank has to capitalize a monthly volume for 90 – 120 days it could require $9.5 – $12.6 million in capital in addition to the $4 million we already have for the pipeline mortgage loans closed but not yet sold. In the 15 years First Bank has been active in the secondary market mortgage business we have only had to repurchase 2 loans for approximately $460,000; therefore this capital increase is extremely high. Furthermore, if a loan prepays early we are only obligated to return the premium earned with a small fee, not the entire amount of the loan. If implemented, this proposal will force us to re-evaluate our secondary mortgage strategy which could lower our earnings when it is not warranted. This loss of earnings would force us to restructure staffing at a time when unemployment is already at historical peaks in our communities. Due to the evidence that these credit enhancements do not pose a threat of significant losses for community bank operations I ask that you reconsider the proposed risk weight calculation.

In summary, while I support the agencies' intent to strengthen our industry I strongly believe the implementation of the proposals as currently written will have unintended results and be detrimental to community banks due to the excessive required capital, complexity and punitive effects. This will no doubt affect the ability of community banks to serve their customers and communities through lending, asset expansion and associate employment at a time when it is crucial to spur growth in the United States economy. Thank you for your consideration.

Respectfully,

Douglas Cruickshanks, Jr.
Vice Chairman