South Carolina
Bankers Association

October 18, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Ave., N.W.
Washington, D.C. 20551

Thomas J. Curry
Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, D.C. 20219

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: Regulatory Capital, Implementation of BASEL III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (R-1442, Docket ID OCC-2012-0008, RIN 1557-AD46, RIN 3064-AD95)

Proposed Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements (R-1442, Docket ID OCC-2012-0009, RIN 1557-AD46, RIN 3064-AD96)

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

On behalf its 81 member banks and thrifts, the South Carolina Bankers Association (SCBA) thanks the agencies for the opportunity to submit this comment regarding the referenced proposed capital rules. SCBA agrees that clear, consistent capital standards are necessary for the safety and soundness of the American banking system; yet any rules adopted must take into account not only their impact on banks and thrifts but also on businesses and consumers.

The majority of South Carolina's banks are community banks. All of the 71 banks and thrifts headquartered in the state have less than $10 billion in assets; of those only five have more than $1 billion in assets and more than 50 have less than $500 million in assets. Community banking



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is at the heart of South Carolina banking and it is these community banks that serve many of our businesses and consumers. With this in mind, SCBA's below comment focuses on the overall impact of these proposals on the state's economy, commenting particularly on provisions that our bankers and others have identified as most concerning.

## I. Overall Comment

Since the June 2012 publication of the proposals, SCBA studied the proposals closely, held an instructional Basel III seminar for members, spoke to many of our CEOs, reviewed input from various partners and attended the agencies' informative programs. Across the board, there is extreme concern from our bankers and partners that, if adopted as written, not only would the banking system be negatively affected but so would lending to our businesses and consumers.

South Carolina's community banks, like many others across the states, play an integral part in financing economic development and growth. Statistics show that even though these banks hold a lower percentage of overall banking assets, they still make 40% of small business loans. Small businesses and our communities' health depend heavily on our community banks. Yet these proposed standards will only harm this relationship. As written, the standards will require banks to hold significantly more capital than they presently do – even though the vast majority of these banks are already sufficiently capitalized. If this occurs then there will simply be less lending – particularly to small businesses.

Raising this capital is difficult for these community banks as many do not have the meaningful access to capital markets that larger, international banks do. Because of this, these banks will not have the capacity to address their community's needs in residential and small business lending. After studying the proposals, reviewing feedback and our banks' comments, SCBA has come to the following conclusions:

- **The higher capital requirements will reduce available credit to businesses and consumers in our communities;**
- **International banking standards cannot – and should not – apply to the community banking system in this country.**
- **Residential lending and the housing industry (homebuilders, contractors, realtors, etc.) will be deeply impacted as there will be reduced residential lending; and**
- **There will be fewer banks to serve our communities as consolidation will become a reality. Many well-run community banks will not be able to maintain these capital standards, leading to consolidation, fewer banks competing for business, and an overall poorer lending environment.**

Below are our comments on some of the key issues our bankers raised in their comment letters and in our discussions with them.

## II. Risk-Based and Leveraged Capital Rules

### *A. Flow-Through of AFS Securities' Unrealized Gains and Losses*

The Basel III NPR proposes that unrealized gains and losses on a banking organization's Available-For-Sale (AFS) securities to "flow through" to common equity Tier 1(CET1). Under the current risk-based capital rules, unrealized gains and losses that exist in accumulated other comprehensive income on AFS debt securities are not included in regulatory capital.

Bankers manage risk but allowing the flow-through to Tier 1 Capital of unrealized gains and losses on AFS securities will greatly impair many banks' ability to appropriately measure and monitor their interest and liquidity risk. In a future rising interest rate environment, not an unreasonable assumption given the present historic low rates, then if this proposal is adopted there will be significant downward pressure on the capital levels in a bank, introducing great volatility to the bank's capital ratios. One of our banks has pointed out that it presently has a $2 million unrealized gain in investment securities. With just a 200 basis point increase in rates, this will result in a $2.8 million unrealized loss for the bank.

In order to avoid such volatility, banks will need to take other measures. One will be to move these securities to the Held to Maturity (HTM) account but this will then take away the banks' ability to use these long-term securities to manage other risks, as they normally do. Another alternative will be to invest in shorter term investments but in this case the bank is then deprived of its ability to produce income and generate capital with longer term investments. Ultimately, under this proposal, a bank may need to decrease assets in order to raise their capital ratios.

There is no other conclusion but that this proposal will introduce great volatility into all banks' capital ratios, affecting capital levels, investments and community lending. SCBA recommends that the proposed rule should be revised so that unrealized gains and losses on AFS securities that reside in Accumulated Other Comprehensive Income do not flow through to capital. This would allow unrealized losses due to credit impairment to be reflected in capital, but would exclude the interest rate impact.

### *B. Phase out of Trust Preferred Securities as Tier 1 Capital*

SCBA asks that this proposal be eliminated, recognizing Congress' legislative intent on this issue, via the Dodd-Frank Act, and also preserving a vital source of capital for community banks.

Trust Preferreds are a capital option that community banks rely heavily on in their capital planning strategy. Many of these community banks are privately held and do not have access to capital markets that larger banks do. As such, phasing out Trust Preferreds as Tier 1 Capital will leave many community banks few options to retain the capital necessary under these proposals.

It is important to appreciate that this issue was handled by Congress. During the Dodd-Frank debate, an amendment was offered that would have eliminated Trust Preferreds from Tier 1 Capital. The effect of the amendment would have been tremendous – **more than $129 billion in capital supporting more than $1.3 trillion in assets would have been removed from the**

**banking system.** Upon further study when Congress saw the impact of this disastrous amendment, it quickly amended it to allow banks with less than $500 million in assets to continue to hold Trust Preferreds as Tier 1 capital and also grandfathered in those banks with assets from $500 million to $15 billion. To adopt the this proposal would be to negate Congress' intent and to deeply affect community banks throughout the states.

Trust Preferreds do not add an element of risk to the banking system, especially to well-run banks. SCBA asks that this proposal be eliminated thus recognizing Congress' legislative intent and preserving a vital capital resource for community banks.

### *C. Capital Conservation Buffer*

Allowance for Loan and Lease Losses (ALLL) already provide a sufficient buffer for possible future losses. Applying this proposed arbitrary buffer that has no basis would unfairly restrict well-managed banks from properly managing capital, as they already do, and thus keeping them from meeting the needs of their communities. SCBA recommends that this proposal be removed.

## III. Standardized Approach

### *A. Risk-Weighting of Residential Mortgages*

The proposals establish new risk-weightings of residential real estate loans, including existing loans, from 35% to 200% based on the category of the loan and the loan's original LTV. Lower risk-weightings are applied to Category 1 loans and loans defined as Category 2 loans have higher risk-weightings - at a minimum a 100% risk-weighting. Yet, the definition of a Category 1 loan is so narrow that few loans will be able to meet that standard. For instance, loans with balloon payments are a typical, best-practice for many smaller banks in mortgage lending. Balloon payment loans allow these banks to better manage their credit and interest rate risk. Classifying these loans as Category 2 loans with the higher risk-weightings punishes banks that have long practiced prudent, responsible residential lending and will lead to reduced homeownership.

Further, the risk-weightings of Category 2 loans are so punitive that many banks also may not offer loans on home equity anymore. Category 2 exposures can range from 100% to 200% and the proposals classify junior liens such as home equity lines in this category. These risk-weightings will simply de-incentivize banks from offering home equity loans, taking away not only building opportunities but also depriving many small businesses access to a credit source that many use to fund their businesses. The proposals go even further and treat a first lien as a Category 2 loan if the bank has a junior lien also with the borrower. This is wholly unreasonable and not based on any substantial evidence. In fact, it is often the bank that has the entire relationship with a borrower that is in the position to work with the borrower to ensure timely payment.

SCBA recommends that if the standardized approach is adopted that this provision but significantly rewritten taking into account these risk-weightings are punitive and will do nothing but reduce residential lending and a small businesses' credit sources.

### *B. Existing Mortgages*

The standardized approach includes new mortgage risk-weighting methodologies that heavily depend on data and increase risk weights up to 200%. However, these methodologies apply not only to new mortgages, but also to existing mortgages currently on banks' balance sheets that were underwritten, and priced, with existing capital standards in mind. There are many problems with this:

- The proposed mortgage categories did not exist at the time these mortgages were originated, and as such, the originator might not have recorded data or other information that would allow the current holders of such mortgages to assign the appropriate risk weight. Underwriting criteria will be particularly difficult—if not impossible—to obtain. For example, the proposal defines a category 1 mortgage to mean one in which the *"standards used to underwrite the residential mortgage exposure . . . [t]ook into account all of the borrower's obligations, including for mortgage obligations, principal, interest, taxes, insurance (including mortgage guarantee insurance), and assessments."*
- 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 do so with respect to mortgages already made.

Any final rule should grandfather all existing mortgage exposures by assigning them risk weights as required under the current general risk-based capital requirements (*i.e.* 50% risk weight). Given the substantial increase in capital that would be required for such existing category 2 mortgages, which may constitute a substantial amount of assets on a bank's balance sheet, the retroactive impact of the proposed treatment would be especially harsh. Since the Basel III NPR is already substantially increasing required minimum capital, the need for retroactive application of the new standards is unnecessary.

### *C. Past Due Loans*

Risk-weighting of up to 150% of 90 day past due unsecured loans is wholly unnecessary. Again, if a bank properly calculates its ALLL, then there is no need for adding a capital charge and significantly risk-weighting these assets. If this proposal is adopted then the bank loses incentive to keep heavily risk-weighted past-due loans on its books. The consequence is that the bank is less willing to work with the borrower that is behind in payments. Is it better for a community that a bank would now be incentivized to pursue collection activities or to foreclose? SCBA asks that this proposal be removed.

## IV. Conclusion

The effect of adopting the capital standard proposals will be dramatic. It is estimated that South Carolina banks will have to increase their risk-based capital reserves by at least 3% to 4%. Since one dollar of capital supports $10 in lending, then these increased reserves will lead to billions of dollars in decreased lending capacity. At such a crucial time when South Carolina's businesses and residents need financing to grow and to create jobs, we do not need to be unreasonably tightening capital standards thus restricting these businesses' access to credit.

Further, the standardized approach should be removed and redrawn. Not only is it exceedingly complex and burdensome to banks but its treatment of residential mortgage lending is detrimental to consumers seeking home loans and will have a negative effect on the housing industry. Small businesses will also have reduced access to credit as banks tighten home equity and junior lien lending. One thing is agreed by all, whatever the cause of the downward turn in the housing market is determined to be, it will not be due to community banks' residential lending and funding of small businesses.

Finally, the agencies should not push down on well-run community banks international banking standards that never took into account this country's banking system. The agencies' capital standards rules should appreciate how successful community banking has been for many decades.

After review of the proposals and gathering feedback from our members and partners, we strongly request that the regulators withdraw the proposals; taking the time to review input and then to create a system that allows for reasonable and prudent capital standards while preserving our banks' ability to serve their communities. The United States' banking system has long proved itself the key linchpin to our country's economic growth and prosperity; regulatory capital standards should be a support for a vital banking system – not a detriment.

With kind regards,

Fred L. Green, III
President and CEO

Cc: Sen. Lindsey Graham
Sen. Jim DeMint
Rep. Tim Scott
Rep. Joe Wilson
Rep. Jeff Duncan
Rep. Trey Gowdy
Rep. Mick Mulvaney
Rep. Jim Clyburn