October 18, 2012

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

Officer of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, D.C. 21219

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:

Thank you for the opportunity to provide comment on the Basel III proposals[1] 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").

Headquartered in Richmond, Virginia, Union First Market Bankshares Corporation is the holding company for Union First Market Bank (the "Bank"), which is a $4.0 billion asset community bank with 94 full service branches throughout Virginia. Although the holding company was formed in 1993, certain of the community banks that were acquired and ultimately merged to form what is now Union First Market Bank date back to 1902. In addition to the bank, non-bank affiliates of the holding company include the following: Union Investment Services, Inc., which provides full brokerage services; Union Insurance Group, LLC, which offers various lines of insurance products; and Union Mortgage Group, Inc., which provides a full line of mortgage products and generally sells originations in the secondary market.

After reviewing the proposals and their implications on both our bank and the industry, we felt it necessary to comment on the following components of the proposals:

1. Unrealized Gains and Losses "Flow Through" to Regulatory Capital
2. Treatment of Cash Flow Hedges
3. Proposed Rules Regarding Residential Mortgages
4. Credit Enhancing Representations (removal of 120 day safe harbor)
5. Phase Out of Trust Preferred Securities as Capital Instruments
6. Highly Volatility Commercial Real Estate Loans

---

[1] The proposals are titled: *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions*; *Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements; and Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rules; Market Risk Capital Rule.*

7. Delinquent Loans and Workouts
8. Scope and Granularity of Proposed Rules

Unrealized Gains and Losses "Flow Through" to Regulatory Capital

The Basel III Notice of Proposed Rulemaking ("NPR") proposes that unrealized gains and losses on Available-For-Sale (AFS) securities "flow through" to common equity Tier 1 ("CET1"), whereas under current risk-based capital rules, unrealized gains and losses in accumulated other comprehensive income ("AOCI") are not included in regulatory capital.

Union First Market Bank's investment portfolio consists primarily of agency mortgage backed securities and highly rated municipal securities (general obligation or essential service revenue bonds). Based on our internal analysis, under the proposed rule, a 300 basis point immediate increase in interest rates would result in significant decrease in our CET1 ratio. In general terms, our optimal portfolio has a lower weight as a percent of assets than our peer community banks and has only a modestly higher duration. This suggests that the impact may be even greater for community banks with a larger allocation of assets to the investment portfolio.

Because of the volatility this proposal introduces into Tier 1, likely consequences would be:

1) *Reclassification of investments into the Held-to-Maturity account to remove volatility from Tier 1.* This action would negatively impact liquidity positions by reducing marketable liquid assets and encumber interest rate risk management strategies (i.e. cannot manage portfolio duration with the flexibility provided through AFS).
2) *Shortening of the duration of the investment portfolio to minimize the impact of volatility on Tier 1.* This action would compress portfolio yields because longer duration securities naturally carry a higher yield in a steep yield curve environment. In addition to reducing bank profitability, it could lessen demand for longer duration bonds and consequently potentially negatively impact longer duration issuers such as smaller municipalities.
3) *Maintaining capital ratios well above the levels that would otherwise apply in order to avoid the sanctions applicable to banks that fall into the capital conservation buffer.* As described above, in our case, this may amount to a significant decrease in our CET1 ratio.
4) *Restricting use of the investment portfolio as a tool for asset liability management.* The investment portfolio is one of our most efficient tools to offset interest rate risk on the balance sheet. For example, there are times where our interest rate risk profile would suggest adding duration to the investment portfolio to minimize asset sensitivity. The resulting impact to capital under the proposed rules from adding duration may discourage us from employing this type of asset liability management strategy.

We ask that the proposed rule be revised so that unrealized gains and losses on AFS securities that reside in accumulated other comprehensive income do not flow through regulatory capital. Credit impairment is already required to be reflected in capital under GAAP through other than temporary impairment (OTTI) recognition.

Treatment of Cash Flow Hedges

Under the Basel III proposal, banks would be required to deduct any unrealized gain and add any unrealized loss on cash flow hedges included in AOCI to CET1, net of tax effects, which relate to the hedging of items that are not recognized at fair value on the balance sheet.

The Bank uses cash flow hedges to hedge short duration liabilities. In addition to hedging interest rate risk on margin, these hedges are executed to offset the AFS investment portfolio risk to the capital position. If cash flow hedges are not deducted, the Bank's internal analysis suggests that current cash flow hedges may offset a meaningful amount of the decrease in CET1 resulting from the proposed impact of the AFS rule change discussed above.

We would argue that the cash flow hedges subject to the proposed deduction present little or no economic risk to the bank and actually reduces interest rate risk, increasing its safety and soundness. We believe this proposal must to be considered together with the AFS proposal discussed above; including one and not the other is inconsistent with interest rate risk management strategies employed by banks. We ask the banking agencies to eliminate this proposed deduction.

Proposed Rules Regarding Residential Mortgages

The proposed Basel III rules assign residential mortgages to one of two Categories and then risk weights the exposure based on loan-to-value (LTV) ratios. In order for a loan to be a Category 1 loan (and therefore receive the most preferential risk weights) it must meet several requirements. We would like to draw specific attention to two of those requirements for Category 1:

1) *Payments do not result in a balloon payment*. A large percentage of the Bank's residential mortgages have a balloon payment. These loans are structured to manage interest rate risk by shortening the duration of the loan. Because of our allocation to balloon mortgages, this proposal could significantly impact capital ratios. Based on our internal analysis, including these as Category 2 loans instead of Category 1 loans may result in a significant decrease in our CET1 ratio. If balloon mortgages remain in Category 2, we see several consequences:
    a. Pricing on balloon mortgages will increase to compensate for the additional capital, which will have a negative impact on consumers. We have already discussed internally our likely diminished appetite for balloon mortgages if the final rules include the proposed increase in risk weighting for balloon mortgages.
    b. Interest rate risk will potentially increase if balloons are substituted with longer duration amortizing products because of their impact on the capital position. Alternatively, mortgage production will be slowed if we decide not to substitute balloons with fully amortizing products. This will have a negative impact on consumers.
2) *The terms allow the annual rate of interest to increase no more than 2 percent in any twelve month period and no more than 6% over the life*. It is unclear as to whether this provision applies to Home Equity Lines of Credit (HELOCs). Because most

> HELOCs are not structured in this manner, this proposal, if applicable, would classify a majority of HELOCs as Category 2. The result, as discussed above, could have negative consequences for consumers because pricing would need to be adjusted to compensate for the additional capital requirements.

We ask that the banking agencies consider removing balloon payments as a disqualifier for Category 1 treatment and exclude HELOCs from the periodic and lifetime cap requirements for Category 1. At minimum, we ask that the agencies consider grandfathering existing loans of these types.

The proposed rules contain other risk weighting measures that concern us as well. First, the proposed rules do not recognize private mortgage insurance (PMI). Mortgages are therefore subject to high risk weights even if PMI reduces the risk of loss on such loans. We ask that at minimum, the banking agencies recognize the reduced risk of PMI and allow for its inclusion in the LTV calculation.

Second, the proposed rules classify all junior liens, such as home equity loans and lines of credit, as Category 2 exposures with risk weights ranging from 100 to 200 percent. In addition, a bank that holds two or more mortgages on the same property would be required to treat all the mortgages on the property, even the first lien mortgage, as category 2 exposures. This provision could significantly impact home equity pricing and we ask that the banking agencies consider less punitive capital treatment of junior liens.

<u>Credit Enhancing Representations (removal of 120 day safe harbor)</u>

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 risk-based capital framework, this does not apply.

Through its subsidiary Union Mortgage Group, the Bank originates mortgages and sells them into the secondary market. Based on our average production volume and representation and warranty periods, we estimate this could substantially reduce our CET1 ratio. Given the possibility of a significant impact on the Bank's capital ratios, we ask that this element be eliminated from the final rules. If not, the consequences could be increased pricing to customers to compensate for higher capital allocations or reduced availability and credit as we and other banks reevaluate the economics of the more capital intensive mortgage banking structure.

<u>Phase Out of Trust Preferred Securities as Capital Instruments</u>

Despite the Collins Amendment exemption in the Dodd Frank Act, the proposed Basel III capital rule does not grandfather Trust Preferred Securities (TRUPs) for institutions with assets between $500 million and $15 billion, but rather phases them out of Tier 1 capital at 10 percent annually beginning in 2013.

Union First Market Bankshares Corporation has $60 million in TRUPs which accounts for roughly 15 percent of current Tier 1 capital. These TRUPs were entered into by the Bank only after gaining clarity on the regulatory treatment just prior to issuance. The impact of this provision on Tier 1 ratios is significant when fully phased in.

Phasing out this source of capital burdens community banks in their capital planning processes. Rather than accessing capital for growth opportunities, community banks will need to fill capital holes caused by this change in regulation. This could have a negative impact on loan growth as community banks look to avoid replacing TRUPs with higher cost capital. We ask that the banking agencies change the proposed rule to conform to the treatment of TRUPs in the Collins Amendment of the Dodd Frank Act and permanently grandfather outstanding TRUPs for institutions with assets between $500 million and $15 billion.

Highly Volatile Commercial Real Estate Loans

Under the banking agency's proposal, Highly Volatile Commercial Real Estate loans (HVCRE) will be assigned a 150 percent risk weight versus the 100 percent risk weight today. Assuming certain exceptions described in the proposal are not met, HVCRE could include all Acquisition, Development and Construction (ADC) loans including owner-occupied properties, borrowers with debt service coverage well above 100 percent, and income-earning loans. We ask that at minimum the banking agencies reconsider the exceptions to include performing loans with higher credit quality characteristics such as collateral characteristics and debt service coverage ratios.

Delinquent Loans and Workouts

Basel III assigns 150 percent risk weights to nonresidential loans over 90 days past due, and requires banks to re-assess a mortgage's risk weight after a modification. This is an incentive to be more aggressive with delinquent borrowers and less willing to consider modifying a loan. As a community bank, we feel this contradicts the spirit of working with our borrowers and communities when loan repayment difficulties arise, and consequently ask the banking agencies to remove this element from the final rules.

Scope and Granularity of Proposed Rules

The proposal requires collecting and reporting new information at a very granular level in order to calculate the risk-weighted assets, specifically as it relates to residential mortgages and highly volatile commercial real estate loans. Since existing loans are not grandfathered, we must be able to collect this information on the existing portfolio. The Bank has determined at minimum it will need to allocate significant time and resources to updating its internal reporting systems and provide additional employee training to capture required information. Further, this adds another layer of periodic reporting and controls. The total one time and ongoing resource requirements is yet to be quantified in terms of hours or staffing. We ask that the banking agencies at minimum consider grandfathering existing loans to lessen the reporting burden on community banks.

Thank you for the opportunity to comment on the Basel III proposals and hope our comments assist the agencies and industry to find a reasonable solution. If there are questions or more information is needed, please contact us.

Sincerely,

G. William Beale
Chief Executive Officer

Robert Gorman
Executive Vice President & Chief Financial Officer

D. Anthony Peay
Executive Vice President & Chief Banking Officer

John Neal
Executive Vice President & Chief Banking Officer

Toler Cross
Senior Vice President, Director of Finance & Treasurer