From: Sarah Salo <sarah.salo@ledyardbank.com>
Sent: Thursday, October 18, 2012 4:54 PM
To: Comments
Cc: Kathy Underwood
Subject: Basel III FDIC RIN 3064-AD95, RIN 3064-AD96, and RIN 3064-D97

Re: Basel III Capital Proposals

Ladies and Gentlemen:

Thank you for 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 (the "banking agencies").

Ledyard National Bank is a full service community bank providing lending, deposit, wealth advisory and brokerage services to the businesses and individuals that are in the New Hampshire and Vermont communities we serve. We were founded in 1991 by a group of individuals that believed that community banks are a vital part of most communities in our country.
We have assessed the impact of the proposals to Ledyard National Bank and feel compelled to comment on those aspects that have the potential to impact our institution. Below is a summary of the items which we have provided comment on:

1. Available for Sale Inclusion in Tier 1 Common Equity (T1CE)
2. Cash Flow Hedge Adjustment
3. Residential Mortgage Loans

Available for Sale Inclusion in T1CE
According to the proposal, unrealized gains and losses on all AFS securities would flow through to T1CE. This would include those unrealized gains and losses related to debt securities whose valuations primarily change as a result of fluctuations in a benchmark interest rate, as opposed to changes in credit risk. This requirement will add a significant amount of volatility to our capital ratios.

Several consequences will be realized as a result of attempting to strategically manage the capital position assuming this rule is adopted. The asymmetric sensitivity of the capital account to rising rates could prove troublesome in the current environment. Ledyard will likely trend towards greater use of the held to maturity (HTM) designation. However, this action will limit Ledyard's ability to hold a cushion of marketable liquid assets, thereby hindering our liquidity position. Ledyard's investment portfolio is used heavily as a mechanism to manage our overall interest rate risk sensitivity, shortening or lengthening duration/cash flows when necessary to affect the balance sheet's global sensitivity. A reclassification into the HTM account will constrain Ledyard's ability to influence its interest rate risk position efficiently. To the extent that Ledyard maintains an allocation within the AFS portfolio, it will most likely target much shorter durations in order to mute any ancillary effects the portfolio may have on its capital position. This will not only compress the yield naturally achievable by longer duration products (in a steep yield curve environment) but also exacerbate our balance sheet rate risk sensitivity (e.g., Ledyard is an asset sensitive institution). One could argue that each of these results is counter to the ultimate goal of creating and preserving capital (through retained earnings and balanced risk profiles). Finally, the ancillary effects of this declining demand from financial institutions for longer duration products, such as municipal bonds, could prove detrimental to smaller municipalities' ability to efficiently fund themselves.

Ledyard would argue that inclusion of the AFS adjustment within capital is unnecessary. Given the GAAP requirements relating to other than temporary impairment, the capital position should reflect investments in which the initial investment is not expected to be recovered by way of the permanent impairment recognition process. Apart from that, any residual unrealized gains and losses are transitory by nature. With the passage of time, these instruments will return par given the intent and ability to hold to recovery. However, if the agencies conclude that some recognition of the AFS adjustment is required, we would agree with the suggested alternative as the lesser of two evils, classifying the portfolio into two categories: instruments whose value solely changes due to changes in the benchmark interest rate, and all others. The agencies should note however the diversification disincentive this creates relating to credit risk allocation within the investment portfolio. In the current environment, we are struggling in our attempt to prudently achieve loan growth in our market. As a result of this and the flattened yield curve, longer duration GSE (debentures and MBS) have been utilized to combat compressing margins despite its resulting increased interest rate risk. However, in situations like this, one can make a strong argument for diversification into "credit" products (corporate debentures, CMBS, ABS and CLO's) instead of duration extension as a form of risk balancing (especially in light of reduced credit exposure within the loan portfolio – reduced loan portfolio size relative to total assets). This balancing of risks (credit, interest rate, liquidity, etc.) is essential to prudent balance sheet management. The requirement of the alternative to include unrealized gains/losses of "credit" products would clearly dilute Ledyard's ability to accomplish this goal efficiently.

Finally, in the event this route is taken, we would also ask for a much more explicit definition of what instruments are considered "debt securities whose valuations primarily change as a result of fluctuations in a benchmark interest rate." The current definition given by the proposal provides a few examples:

1. U.S. government and agency debt obligations
2. U.S. GSE debt obligations
3. Other sovereign debt obligations that would qualify for a zero percent risk weight under the proposed standardized approach

Ledyard would argue that the definition (especially 2 above) is too limited in scope. The term "U.S. GSE debt obligations" appears to focus solely on debentures and does not extend to GSE mortgage guaranty obligations. Ledyard would ask for the agencies to extend the definition to include Agency MBS pass-through and CMO's, and SBA guaranteed pools. Ledyard would also argue that General Obligation Municipals and Essential Service (Water and Sewer) Revenue Obligations should fall under the scope of this alternative as well.

Cash Flow Hedge Adjustment

The proposal states that unrealized gains and losses on cash flow hedges that relate to the hedging items that are not recognized at fair value on the balance sheet (including projected cash flows) should be excluded from regulatory capital. We would argue that this issue must be evaluated in light of the conclusion the agencies reach on the AFS inclusion item.

The exclusion of cash flow hedges associated with hedged items that are not carried at fair value appears to have some logic given the following rationale. One could create a cash flow hedge relationship with an instrument not carried at fair value and a subsequent market move occurs in such a way that there is an unrealized gain on the swap (recognized in AOCI) and an unrealized loss on the hedged item (not reflected anywhere on the balance sheet). The inflated capital position due to the gain on the swap is not entirely accurate as the underlying hedged items unrealized loss would have to be recognized as an offset assuming liquidation. This becomes increasingly important upon the conclusion the agencies reach on the AFS portfolio inclusion issue.

Residential Mortgage Loans

The proposals currently create a set of criteria differentiating between Category 1 and 2 loans (with their respective LTV risk weight buckets). There are two impactful and perhaps unintended consequences of the definition as written. The first item relates to the follow requisite characteristic of a category 1 loan:

"The terms of the mortgage loan provide for regular periodic payments that do not:

a. Result in an increase of the principal balance

b. Allow the borrower to defer repayment of principal of the residential mortgage exposure
c. Result in a balloon payment"

It seems clear that the intent of this paragraph was to apply a more capital intensive charge to loans commonly referred to as option loans (e.g., Option ARMs). Ledyard requests a more explicit ruling that requires satisfaction of all three of the criteria (or at least two of the three) listed simultaneously to be disqualified as a Category 1 loan.

The second item within the mortgage loan proposals relates to periodic and lifetime caps. According to the NPR, a residential mortgage loan would be disqualified as a Category 1 loan if:

"The terms of the residential mortgage loan allow the annual rate of interest to increase no more than two percentage points in any twelve month period and no more than six percentage points over the life of the loan"

Applying this definition with the HELOC market results in an overwhelmingly immediate classification into the category 2 bucket.

In summary, we feel that Basel III is too complex and has unintended consequences. It is likely to impact lending by community banks. It is also likely to impact community bank interest in mortgage servicing. As you are aware, servicing provided by community banks has not been an issue and in fact has kept more borrowers in their homes during these troubling times as we work with them. Our ability to work with troubled borrowers will also be impacted by the proposal.
Because of the complexity of the proposal and the unintended consequences, I would request that community banks be exempt from Basel III.

Sincerely,
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