SALISBURY BANK

October 22, 2012

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

Robert E. Feldman **via email: comments@FDIC.gov**
Executive Secretary
ATTN: Comments/Legal ESS
Federal Deposit Insurance Corporation,
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Office of the Comptroller of the Currency **via email: regs.comments@occ.treas.gov**
250 E. Street, SW
Mail Stop 2-3
Washington, DC 20219

RE: Basel III Capital Proposals

Ladies and Gentlemen:

Thank you for the opportunity to provide comment on the Basel III proposal that was recently approved by the Federal Reserve Board, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation.

While we generally support an increase in the capital requirements, the rules as proposed in Basel III should not, and do not, apply to community banks. The Basel III rules were designed to apply to the largest international banks and **not** community banks. Community banks should be allowed to continue using the current Basel I framework for determining our capital requirements.

Salisbury Bank and Trust was formed as a result of the merger of Salisbury Savings Society (founded in 1848) and the Robbins Burrall Trust Company (founded in 1868), in 1874. Our bank has $600 million in assets, eight branches, four in Northwestern CT, two in Southwestern MA, and two in Eastern NY State. We employ 130 people and provide retail and business banking services, residential mortgages, and Trust and Wealth Advisory services to about 10,000 individuals and businesses in our rural market areas.

Our employees and their families are actively involved in promoting and enhancing the quality of life in the markets we serve. In 2011, more than 90% of our employees volunteered a total of 10,629 hours of their time supporting everything from fire and emergency services to fund raising activities for the many non-profit agencies serving our areas. Salisbury Bank made 543 contributions to various eleemosynary organizations and made $75 million in home mortgages and more than $37 million in loans to local businesses in 2011.

Salisbury Bank and the thousands of other community banks around our country are dedicated to the communities we serve. Community banks are often the financial lifeblood of rural and small town America. The unintended consequences of much of the recent regulatory burden will force many small community banks out of business and will forever change what has been a way of life for small town, rural America. Basel III is just another example of regulation gone too far, and if implemented as proposed, will serve to hasten the demise of small community banks.

We have the greatest concern with the following specific components of the Basel III Capital Proposals:

- Regulatory Capital Proposed Rule – Inclusion of AOCI in Calculating Tier 1 Capital Increases Capital Volatility and Distorts Capital Ratios

    - The proposed capital rule includes Accumulated Other Comprehensive Income (AOCI) in calculating Tier 1 capital. The inclusion of unrealized gains and losses on securities held as "available for sale" in determining Tier 1 capital has the potential to substantially increase the volatility of Tier 1 capital and distort the bank's regulatory capital ratios.
    - Community banks holding interest rate sensitive securities for liquidity asset diversification purposes could see changes to their capital ratios based solely on interest rate changes rather than changes from credit quality. While larger banks can hedge the impact of interest rate changes on AOCI, community banks generally cannot.
    - In a rising interest rate environment, declining unrealized gains and losses in determining capital would negatively impact the ability of banks to contribute to economic recovery.
    - A market driven liquidity crisis, reflected in a precipitous sell-off in the bond market and significant decline in fair values could reduce Salisbury's regulatory capital to a level that triggers prompt corrective action enforcement and adversely impact Salisbury's CAMELS rating.
    - Other things remaining equal, this proposal would incent Salisbury to reduce its exposure to fair value fluctuations by reducing the size of its AFS securities portfolio, altering its portfolio composition and reducing its duration target, each of which will diminish Salisbury's portfolio yield.
    - Stakeholders (capital markets, regulators, shareholders) may expect Salisbury to maintain an additional capital conservation buffer to hedge against the expected decline in fair values of AFS securities resulting from both a 300 basis point rate shock and a widening of spreads associated with the corresponding decrease in market liquidity. This will further dilute Salisbury's ROE.
    - Further diminish limited access to capital markets. Small community banks such as Salisbury have very limited access to the capital markets during periods of prosperity. The capital markets are generally unavailable during economic downturns. This proposal will further exacerbate the challenge of attracting capital.

    - Recommendation: Exclude unrealized gains and losses on AFS securities from capital for community banks under $5 billion in total assets.

- Structured Securities: Salisbury holds $12 million of non-Agency CMO securities that it purchased before the recent economic downturn.

    - Salisbury has incurred $1 million in OTTI losses from these securities and is a victim of the private-label securitization and lack of government regulation in this part of the market that resulted in the oversupply of underpriced housing finance.
    - The secondary market for Salisbury's non-Agency CMO securities is either non-existent or severely distressed to the degree of making it uneconomic to deplete capital to sell these positions. The proposed capital measurement requirements for structured securities will unreasonably exacerbate the harm to Salisbury caused by these pre-financial crisis legacy securities. We believe it is unfair to punish community banks for the structural deficiencies in such securities at a time when they are deprived of the opportunity to dispose of their holdings.
    - Prior to the financial crisis, Salisbury, like many community banks, invested $3 million in Federal Home Loan Mortgage Corporation (FHLMC) preferred stock, relying on the low risk weighting assigned by the FDIC and the attractive dividend. The Federal Housing Finance Agency's takeover of FHLMC in 2008 created a $3 million loss for Salisbury, while the bond holders were protected. We feel it was unfair and unjust for the community banks to absorb these losses. New capital regulations should give consideration to the losses that community banks have already had to bear.

    - Recommendation: Grandfather the present treatment of non-Agency CMO securities purchased before the financial crisis by community banks under $5 billion in total assets to allow these banks to continue to pursue an orderly exit from these markets.

- Risk-Weight Proposed Rule – The Proposal is Overly Complicated and Onerous for Community Banks

    - The consequences of this proposal will be devastating not only for community banks, but for consumers and communities alike. The costs will increase for borrowers as banks search for methods to pay for the increased capital requirements for "non-traditional" mortgages.
    - Salisbury has made over $19 million in loans to first-time homebuyers in its community over the last 3 years. These loans require a 5% down payment and delinquency rates are negligible on this portfolio. These are people that otherwise would be unable to afford to buy a home as they do not have the 20% down payment required to qualify as a traditional mortgage.
    - The proposed risk-weighting for loans will make it very difficult for community banks like Salisbury to meet the requirements of the Community Reinvestment Act and will set back advances made in affordable lending over the past decade.
    - The proposed risk-weighted framework is overly complicated and will impose an onerous regulatory burden on and penalize community banks, and jeopardize their ability to contribute to our nation's economic recovery.

- Under the Basel III risk-weighted asset proposed rule, mortgage insurance will no longer be considered when determining loan-to-value ratio. This will increase the cost of mortgages for first time homebuyers and other consumers who cannot afford to put 20 percent or more down in cash.
- For well underwritten, fully documented first mortgages, with no balloon payments, no negative amortization, and with prescribed interest rate caps if the loan is an ARM, the capital risk weight will increase from 50% to 75% if the LTV ratio is above 80% and the risk weight will increase to 100% if the LTV is above 90%.
- Thus, the current capital charge will double on a loan made to a first time home buyer who puts 5% down in cash and has mortgage insurance to cover the rest of the loan.
- For second liens, home equity lines of credit, and first mortgages that do not meet the requirements noted above (for example because the loan has a balloon feature), the risk weight for the loan will increase even more dramatically. For example, the risk weight for a home equity line would be 200% if the combined LTV (based on the amount of the first loan plus the total amount of the line, whether drawn or not) exceeds 90%.
- This proposal significantly increases capital costs for portfolio lenders, and disadvantages insured banks compared to unregulated mortgage lenders and foreign banks not subject to these requirements.
- The proposal makes it more expensive for first time home buyers who have fewer funds for a down payment. It will adversely affect minorities and other disadvantaged consumers who have difficulty making large down payments.
- Community banks that plan on selling loans into the secondary market will also be impacted by the proposal. The regulation requires a bank that recognizes a non-cash gain under GAAP when it sells loans into a securitization to deduct that gain from its capital account. If that non-cash gain on sale is required to be deducted from capital, the securitization option will be much less desirable for many banks.
- The proposal would also require banks to deduct any retained or purchased mortgage servicing rights in excess of 10 percent of tier 1 common equity. As a result, most banking organizations will be forced to sell their mortgage servicing rights to non-regulated companies, probably at fire sale prices.
- Restricting the ability of a bank to retain mortgage servicing rights makes securitization more expensive for the selling bank, and in addition, makes it harder for a community bank to sell customer loans into a securitization while maintaining the close customer relationship that many community banks value.
- The proposed rule makes it virtually impossible for a community bank to purchase private label mortgage backed securities. In order to hold non-GSE mortgage backed securities, a community bank would have to conduct extensive due diligence including an analysis of the cash waterfall, credit enhancements, the performance of the underlying loans, market data, price, volatility, trading volume, and other details. Most community banks cannot devote or do not have the resources to conduct this extensive due diligence.
- The market for private label mortgage backed securities would also diminish because the capital charge for these securities would also increase since the risk weight of the underlying loans will now be higher.

- The market for non-conforming loans would be impaired, hurting the ability of community banks to make these mortgages.
- The proposed regulation would also increase the capital charge for so-called "highly volatile commercial real estate," defined as loans for the acquisition, development and construction of projects (other than 1-4 family residential property). The risk weight for these loans would increase from 100 percent to 150 percent. This will make "highly volatile" commercial real estate lending more expensive.

- Recommendation: Community banks should be allowed to comply with the existing Basel I risk-weight framework for residential loans.

- The standardized approach for risk weighting assets and non-reliance on credit ratings will be unduly and disproportionally burdensome for Salisbury and other small community banks that lack the technical expertise and financial resources to comply with this rule. For example, Salisbury might be expected to subscribe to Bloomberg for bond analytics at a cost of $30,000 per year. As noted above, rules that force Salisbury to liquidate its remaining positions in non-Agency CMO securities to avoid the cost and complexity of complying with this proposal will be disproportionately punitive to any perceived improvement in the measurement of risk weighted assets.

    - Recommendation: Grandfather the present reliance on credit ratings for community banks under $5 billion in total assets.

- Non-traditional mortgages: Salisbury's market area includes an affluent residential housing segment, whose borrowers are wealthy, financially sophisticated and highly credit worthy. Salisbury has been able to capture a piece of this market by offering non-traditional mortgage products, specifically fixed and adjustable rate mortgage loans with interest only terms. Salisbury presently has $23 million of such loans. These products are specifically designed to meet the financing needs of this unique and valuable market segment. The "one-size-fits-all" proposal that assigns the same risk weight as commercial loans is illogical and irrational and gives no consideration to the differences in credit risk. The higher risk weight will make Salisbury's pricing less competitive and reduce Salisbury's ability to serve this market at a time when loan demand is scarce, which will negatively impact Salisbury's profitability and may restrict its ability to serve its less affluent market segments.

    - Recommendation: Include certain non-traditional mortgage products that are conservatively underwritten (e.g. minimum standards for LTV, credit score, debt/income) in Category 1 for community banks under $5 billion in total assets.

Salisbury's loan portfolio totals $375,000,000; of these balances, $320 million, or 85%, consists of residential and commercial real estate mortgages. If approved as proposed, the Basel III requirement would impose significant limitations on funds available for mortgage lending, increase costs for borrowers, and potentially cause our bank to layoff mortgage staff as we re-consider the viability of this part of our business.

Additionally, the risk-weight proposals ignore the massive amount of new regulation coming from Washington under the Dodd-Frank Act, and it assumes that community banks have and continue to participate in the lax underwriting standards that led to the bursting of the housing bubble. That is plainly and blatantly incorrect. Community banks are victims of the previously unregulated markets and are being unfairly punished. This will undoubtedly fuel bank consolidation and the disappearance of community banks across the country will have negative consequences for the availability of finance to small business at a precarious time in our nation's economic recovery.

The proposed Basel III capital rules are illustrative of regulatory overreaction that will hamper our country's economic recovery, fail to contribute to the safety and soundness of community banking and drive another nail in the coffin of community banking, ironically while penalizing consumers and rewarding our nation's largest banks who are well positioned to adjust to these requirements.

Thank you for the opportunity to comment on this important issue.

Sincerely,

Richard J. Cantele, Jr.
President and Chief Executive Officer

B. Ian McMahon
Chief Financial Officer

cc: Senator Richard Blumenthal
Congressman Chris Murphy
Lindsay Pinkham, CBA President