FARMERS & MERCHANTS BANK

◆ *THE "COMMUNITY" BANK THAT PUTS PEOPLE FIRST* ◆

Member FDIC

October 17, 2012

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

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219

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 issued for public comment by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

Farmers and Merchants Bank was established in 1919 and is headquartered in Upperco, MD. Our bank has over $270 million in assets with six locations. We are a classic, traditional community bank. Farmers and Merchants has been an active lender before, during, and after the financial crisis, doubling our loan portfolio over the last four and one-half years. The bank has been well-capitalized since the criterion was first established. Our earnings have been at historic highs over the last several years. An independent consulting firm has ranked Farmers and Merchants as the second best performing Maryland state chartered bank for the last two and one-half years.

We believe that community banks should be allowed to continue using the current Basel I framework for computing capital requirements. Basel III was designed for the "To Big To Fail" banks, not community banks like Farmers and Merchants. Community banks did not engage in activities that caused the financial crisis. We operate on a relationship-based model that is

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[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.*

designed to serve the customers in our community on a long-term basis. Placing tighter capital standards on the largest banks makes sense because they operate primarily on transaction volume and are not focused on the customer relationship. Basel III does not make sense for community banks.

The capital conservation buffer concept will be difficult for community banks to achieve under the proposal and therefore should not be implemented. Many community banks will need to increase capital to meet the buffer requirements. Community banks, unlike large banks, do not have ready access to capital and therefore need to grow it through earnings. If this provision is not removed, than additional time to comply needs to be allotted.

The following are some specific areas that will impact Farmers and Merchants Bank and which we believe should not apply to community banks:

The inclusion of accumulated other comprehensive income (AOCI) in capital for community banks will result in increased volatility in regulatory capital balances and could rapidly deplete capital levels under certain economic conditions. AOCI for Farmers and Merchants and most community banks represents unrealized gains and losses on investment securities held available-for-sale. Because these securities are held at fair value, any gains or losses due to changes in interest rates are captured in the valuation. Declining interest rates over the last several years have generated unprecedented unrealized gains for most investment securities. As interest rates rise, fair values will fall causing the balance of AOCI to decline and become negative. This decline will have a direct, immediate impact on common equity, tier 1, and total capital as the unrealized losses will reduce capital balances. At Farmers and Merchants, for instance, if interest rates increased by 300 basis points, our bond portfolio would have a net loss of $1,117,000. This would mean that our tier one ratio would drop by .44%. Large financial institutions have the ability to mitigate the risks of capital volatility by using various hedging tools. Community banks do not have the knowledge or expertise to engage in these transactions and manage their associated risks, costs, and barriers to entry. Community banks should continue to exclude AOCI from capital measures as they are currently required to do today.

The proposed risk weight framework under Basel III is too complicated and will be an onerous regulatory burden that will penalize community banks and jeopardize the housing recovery.

Increasing the risk weights for residential balloon loans, interest-only loans, and second liens will penalize community banks who offer these loan products to their customers and deprive customers of many financing options for residential property. Farmers and Merchants has utilized five year balloon loans for over 90% of its portfolio loans including approximately $29 million of residential loans. Short duration loans are a big part of our interest rate risk strategy. Higher risk weights for balloon loans will penalize Farmers and Merchants and all community banks for mitigating interest rate risk in their asset-liability management. Community banks will be forced to originate only 15 or 30 year mortgages with durations that will make their balance sheets more sensitive to changes in long-term interest rates. This was the downfall of many savings and loans in the early 1980s. Many community banks will either exit the residential loan market entirely or only originate those loans that can be sold to a GSE. FNMA and FHLMC requirements are now so stringent that many quality loans are considered non-conforming.

Balloon products allow community banks to originate these loans and keep them in portfolio while not taking on significant interest rate risk. Second liens will either become more expensive for borrowers or disappear altogether as banks will choose not to allocate additional capital to these balance sheet exposures. This change will cause Farmers and Merchants risk-weighted capital ratios to fall by approximately .70%. Community banks should be allowed to stay with the current Basel I risk weight framework for residential loans.

Another area of concern is the increased risk-weighting for past due loans to 150% from 100%. Currently, the loan loss reserve takes into account past due loans and the provision for loan losses reduces capital. Increasing the risk-weighting would result in past due loans reducing capital two times. Double counting should not occur. This will reduce Farmers and Merchants risk-weighted capital ratio by approximately .05%.

Unused commitments with a maturity of greater than one year currently have a risk-weighting of 50%. Unused commitments with a maturity of less than one year currently have a 0% risk-weighting. Under Basel III, the risk-weighting will increase to 20% from 0%. This will reduce Farmers and Merchants risk-weighted capital ratio by approximately .20%.

Finally, Farmers and Merchants, like many community banks, enters into overnight and term borrowing arrangements with depositors that are collateralized by investment securities. The borrowings are structured as a sale of securities with an agreement to repurchase. However, the securities are never delivered to the counter party, so there is no risk that the counter party will not return the collateral. The Off Balance Sheet Exposure section of the proposed risk-weighting changes states that the market value of the securities pledged will receive a 100% risk-weighting because of the counter party risk. For large banks, the control of the collateral does change hands in repurchase arrangements, so counter party risk is a concern. However, for a typical community bank repurchase arrangement, there is no change of control and therefore, no risk. This proposal would reduce Farmers and Merchants risk-weighted capital ratios by approximately.75%. At a minimum, the language of this section needs to be clarified to specify which types of repurchase arrangements would be impacted.

In summary, we believe that community banks should be exempted from compliance with Basel III. It was written for the large international banks and not with community banks in mind. Basel III will force fundamental changes to the successful ways that community banks have operated for many years. The proposed changes will reduce the availability of credit in our community and communities across the country at a time when it is needed the most. Basel III makes no sense for community banks.

Thank you for your consideration.

Sincerely,

James R. Bosley, Jr.
President

Mark C. Krebs
Chief Financial Officer