October 26, 2012

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

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

Dear Ms. Johnson and Mr. Feldman:

Thank you for the opportunity to provide comment on the Basel III proposals[1] that have been issued for public comment by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

We are submitting this letter to you on behalf of Union Bank, a community bank founded in 1891. It is a $580 million subsidiary of a one bank holding company, Union Bankshares, Inc. It is located in Vermont with 13 branches across north central Vermont and 4 branches in northwestern New Hampshire. The communities that we serve are mainly rural in nature and are all under 10,000 in population with a number of them having a population less than 1,000. The commercial customers that we serve are primarily small businesses. The Basel III proposals would apply to both organizations increasing our regulatory burden, potentially changing our business model and making our stock less attractive to investors.

Applicability of Basel III to Community Banks

It appears that Basel III was designed to apply to the largest, internationally active, banks and not community banks. Community banks did not engage in the highly leveraged activities that severely depleted capital levels of the largest banks and created panic in the financial markets. Community banks operate on a relationship-based business model that is specifically designed to serve customers in our respective communities on a long-term basis. This model contributes to the success of community banks all over the United States through practical, common sense approaches to managing risk. The largest banks seem to operate purely on transaction volume and pay little attention to consumer relationships. This difference in banking models demonstrates the need to place tougher capital standards exclusively on the largest banks to better manage the ability to absorb losses. Community banks should be allowed to continue using the current Basel I framework for computing their capital requirements. Also, community banks compete directly with credit unions in our various communities who are exempt from the Basel III proposal. Community banks are financial intermediaries that pursue lower-risk lines of business in exchange for federal deposit insurance and relatively modest, reliable returns on investment. The implementation of Basel III proposals for community banks may result in the unintended consequence of additional consolidation in the banking industry with the elimination of many small community banks that are the main source of consumer and business financing in many small to medium size towns and cities around the country.

---

[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.*

Incorporating Accumulated Other Comprehensive Income (AOCI) as Part of Regulatory Capital
Inclusion of 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 that are totally outside the control of the community bank. This segment of the BASEL III proposal results in the application of fair value accounting to regulatory bank capital. AOCI for most community banks represents unrealized gains and losses on investment securities held available-for-sale which is normally not a large percentage of its interest earning assets. Because these securities are held at fair value, any gains or losses due to changes in interest rates are captured in the valuation while any gains or losses due to changes in credit factors underlying the investment are recognized through current income which flows through capital. Over the past four years, interest rates have fallen to historic lows generating unprecedented unrealized gains for most investment securities. Additionally, demand for many implicitly and explicitly government guaranteed securities has risen due to a flight to safety, recommendations from regulators and government intervention in the capital markets. This increased demand has caused credit spreads to tighten further increasing bond valuations. Interest rates have fallen to levels that are unsustainable long-term once an economic recovery accelerates. As interest rates rise, fair values will fall causing the balance of AOCI to decline and become negative, introducing substantial volatility to regulatory capital ratios arising from all investments, even those with little or minimal credit risk. This decline will have a direct, immediate impact on common equity, tier 1, and total capital as the unrealized losses will reduce capital balances. This treatment of AOCI results in looking at a Bank's capital from a liquidation point of view as opposed to an ongoing concern point of view. Generally accepted accounting principles already delineate that should a loss on an impaired security be other than temporary, that loss should be recognized through the income statement, not as a component of AOCI, and therefore that loss would be recognized through a reduction of primary capital. At our bank, for instance, if interest rates increased by 300 basis points, our bank's bond portfolio would show a <u>paper</u> loss of $4 million from its current $1.6 million <u>paper</u> gain. This would mean that our bank's tier one ratio would drop by 8%.

The other component of AOCI that many community banks have is related to the company's offering of a defined benefit pension plan for the benefit of their employees. Currently most defined benefit plan sponsors have an accumulated other comprehensive loss in their capital category which is not taken into account for regulatory capital calculations but under the proposed Basel III rules will be deducted to arrive at Common Equity Tier 1 Capital. For our bank, this change would cause a $5 million, or 11.2%, drop in Common Equity Tier 1 Capital once the phase-in period is complete. This proposed regulatory change may encourage the bank to terminate the current plan much more expeditiously which would probably not be the correct business decision given the current low interest rate environment.

Large financial institutions have the ability to mitigate the risks of capital volatility by entering into qualifying hedge accounting relationships for financial accounting purposes with the use of interest rate derivatives like interest rate swap, option, and futures contracts. Most 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. Capital volatility would raise the cost of capital for community banks and harm investors by increasing the risks of investing in community banks. It is our feeling that investors in community banks typically focus on expected future dividends generated by expected future earnings instead of net book value in the knowledge that banks manage to the spread relationships between all interest earning assets and all interest bearing liabilities not to total return.

Capital Conservation Buffers
Implementation of the capital conservation buffers for community banks will be difficult to achieve under the proposal in the six year time frame allowed and therefore should not be implemented as presented in the proposal. Many community banks will need to build additional capital balances to meet the minimum capital requirements with the buffers in place. The need for this additional capital will put community banks at a disadvantage in terms of additional asset growth including but not limited to the availability of credit to local consumers and businesses, the ability to attract and retain quality personnel and the ability to attract investors

that have traditionally purchased community bank stock for the dividend income stream. Community banks do not have ready access to capital that the larger banks have through the capital markets and the proposed phase-out of trust preferred securities as a capital supplement will only exacerbate this difficulty. The primary way a community bank can increase its capital is through the accumulation of retained earnings over time. Therefore, a six year window for full implementation of these buffers, in a period of historic low interest rates where bank's interest margins are nearing an all time low and interest rates are not expected to rise for another three years, is unrealistic. In part, due to the low interest rate environment, community bank profitability has diminished further hampering their ability to grow capital. If the regulators are unwilling to exempt community banks from the capital conservation buffers, sufficient additional time should be allotted for those banks that need the additional capital to retain and accumulate earnings accordingly.

New Risk Weights

The proposed risk weight framework under Basel III is too complicated and will be an onerous regulatory burden that will penalize community banks and further jeopardize the housing recovery especially in rural areas of the country where properties that qualify for a secondary market mortgage are less common. 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. Additionally, higher risk weights for balloon loans will further penalize community banks for mitigating interest rate risk in their asset-liability management. Community banks may be forced to originate only 15 or 30 year fixed-rate mortgages with durations that will make their balance sheets more sensitive to changes in long-term interest rates. It is possible that some community banks will either exit the residential loan market entirely or only originate those loans that can be sold to a Government Sponsored Entity therefore removing the opportunity for home ownership from many consumers. 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. Home equity loans are an important source of credit for consumers and small businesses at reasonable interest rates and current favorable tax treatment. Community banks should be allowed to stay with the current Basel I risk weight framework for residential loans. Furthermore, community banks will be forced to make significant software upgrades and incur other operational costs to track the lower of mortgage loan-to-value or loan-to-purchase price ratios in order to determine the proper risk weight categories for mortgages. There is also an unintended disincentive for community banks to work with borrowers experiencing short-term financial difficulties as the risk weighting for these loans may encourage banks to call the loan versus assisting the borrower to work through their financial difficulty.

In addition, the new designation of "high volatility commercial real estate exposures" with a highly punitive risk weighting fails to adequately account for an institution's experience and expertise in this type of lending, the adequacy of its policies and procedures, and the level of concentration. This blanket approach may serve to dampen community banks' willingness to finance acquisition, land development and construction projects which are an integral part of our communities' and local businesses' ability to grow and prosper. These projects also promote job creation not only during the acquisition, development and construction stages but for many future years.

Proposed Phase-out of Trust Preferred Securities

Even though this would not have an immediate impact on our bank, we object to the proposed ten year phase-out of the tier one treatment of instruments like trust preferred securities (TRUPS) because these are a reliable source of capital for community banks that will be very difficult to replace especially when TARP and SBLF funds continue to be considered "clear capital". We believe it was the intent of the Collins amendment of the Dodd-Frank Act to permanently grandfather tier one treatment of TRUPS issued by bank holding companies between $500 million and $15 billion. Phasing out this important source of capital would be a particular burden for many privately-held banks and bank holding companies that are facing greatly reduced alternatives in raising capital. While we applaud the fact that TRUPS issued by bank holding companies under $500 million would not be impacted by the proposal, consistent with the Collins Amendment, we urge the banking regulators to continue the current tier one treatment of TRUPS issued by those bank holding companies with consolidated assets between $500 million and $15 billion in assets.

Mortgage Servicing Rights
Penalizing the existing mortgage servicing rights assets under the proposal is unreasonable for those banks that have large portfolios of mortgage servicing rights. Many community banks have elected to retain the mortgage servicing rights for the majority of mortgage loans originated over the years as a way of providing ongoing customer service to local consumers over the life of the mortgage to augment the customer relationship on which community banking is based. Any mortgage servicing rights existing on community bank balance sheets should be allowed to continue to follow the current risk weight and
deduction methodologies.

In summary, we believe that the Basel III Capital proposal attempts to remedy various issues that occurred during the financial crisis largely brought about by large, complex financial organizations and that these proposed regulations are building a capital framework that is more complex, more prone to volatility and that do not give due weight to the differences in the business models of community banks versus large financial institutions.

We appreciate the opportunity to respond to the Basel III Capital proposal and hope that you will consider our concerns in your final decision making.

Respectfully yours,

David S. Silverman
President & CEO

Marsha A. Mongeon
Senior Vice President & Treasurer

Cc: Congressman Peter Welch
Senator Patrick Leahy
Senator Bernie Sanders