merchants BANK

October 21, 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 Proposals

Ladies and Gentlemen:

Thank you for the opportunity to provide you with my comments 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.

Established in 1849, Merchants Bank is the last remaining state wide independent bank in the state of Vermont with $1.7 billion in assets and 33 community banking offices throughout Vermont. Together with our holding company, Merchants Bancshares, Inc., we employ approximately 300 full-time employees and 40 part-time employees. We are a well capitalized financial institution, and exceed all minimum ratios to be considered well capitalized at both the bank and the holding company level under the current regulatory framework. Based on our preliminary estimates we would also exceed all minimums to be considered well capitalized, including the capital buffer, if the proposed regulations were implemented in their entirety today.

Strong asset quality is a core strength of our institution, our non-performing assets as a percentage of total assets are consistently below 0.25%, loans past due 90 days are consistently at or near zero, as are loans past due 30-89 days. Throughout the recession and the subsequent tepid recovery we have continued to grow our business profitably and have experienced strong growth in both our loans and deposits.

Although we are in favor of strengthening the quality and loss absorption safeguards in the financial institutions sector we have concerns about certain aspects of the proposed capital regulations.

Inclusion of securities mark to market (MTM) in CET1

We have a $515 million investment portfolio with an unrealized pre-tax gain of approximately $12 million. 99% of our portfolio is in Agency backed product, there is almost no credit risk in our investment portfolio. As rates rise the unrealized gain quickly goes away, and eventually becomes a large unrealized loss. This is no surprise given the current interest rate environment. This fluctuation in value based solely on changes in interest rates has no place in regulatory capital; in my opinion the mark to market on the investment portfolio has no business in capital in any form. The idea that we should pick one segment of our balance sheet and mark it to market through capital is fundamentally flawed. As Sandler O'Neill pointed out in their comment letter, the genesis of this particular accounting standard was flawed from the outset. Be that as it may, we have learned to live with it after two decades.

The inclusion of the securities MTM in regulatory capital will force a shift in how banks like ours manage their investment portfolio, and their entire balance sheet. Like many banks, our investment portfolio is used as a tool to help manage our liquidity and overall interest rate risk. The inclusion of the securities MTM in regulatory capital will disrupt the sound risk management practices that we have developed with the encouragement of the agencies. We may have to consider putting more securities into the held to maturity designation, thereby hindering our ability to react to changes in interest rate movements by strategically re-positioning the investment portfolio. We may also have to consider shorter duration positions in order to mute the effect the market value of the portfolio has on our capital. The proposed rule will place material pressure on regulatory capital in a rising rate environment.

The capital position should reflect investments in which the initial investment is not expected to be recovered because of an other than temporary impairment, as is currently required by GAAP. Gains or losses solely related to movements in interest rate risk are transitory in nature, with the passage of time and the intent and ability to hold the securities, these instruments will return their par value.

We are concerned about how this proposal might impact our asset/liability function and our liquidity, our contingency funding plans, and ultimately our appetite for loans, and our earnings. If implemented as proposed we will need to hold regulatory capital against potential securities price volatility, leaving less capital to support lending. We ask that the proposed rule be revised so that unrealized gains and losses on AFS securities do not flow through regulatory capital. This would allow unrealized losses due to credit impairment to be reflected in capital but would exclude the interest rate impact. At the very least we ask that unrealized gains and losses that arise predominantly from fluctuations in interest rates be carved out of the proposal.

Trust Preferred Capital Treatment

Despite the clear exemption within the Collins amendment for institutions under $15 billion in total assets, the proposal requires all institutions to deduct trust preferred instruments from Tier 1 capital based on the phase out schedule provided in the proposed regulation. Our holding company currently has $20 million in outstanding trust preferred securities. Our trust preferred issuance is, like many others, floating rate, and is a cost-effective source of capital in the current low interest rate environment. These securities have served as an important source of capital for a wide range of small-cap institutions. We encourage the agencies to remain consistent with the intent of the Collins amendment and allow for grandfathering of existing trust preferred instruments for institutions under $15 billion in assets, or consider a phase-out over a ten year period prior to contractual maturity instead of an arbitrary date that does not consider the term of the issuance.

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 would be excluded from regulatory capital. The proposed deduction would have a particularly negative impact in light of the proposal that the MTM on the AFS portfolio flow through to regulatory capital. As we look at ways to protect our capital when interest rates ultimately move up, a cash flow hedge is an instrument we would consider. We ask that the proposed rule be revised to eliminate this proposed deduction.

Conclusion

As mentioned above, we are in favor of strengthening the quality and loss absorption safeguards in the financial institutions sector. However, this proposal as currently written has the potential to negatively impact the community banking sector. The potential level of volatility in regulatory capital and the regulatory complexity being proposed is unprecedented. The amount of work and the cost required to fully understand the rules, train our staff, make needed system adjustments, create new reports to analyze the data and potentially hire outside experts to assist us is unknowable at this point.

We appreciate the opportunity to comment on this proposal, thank you for considering our views.

Sincerely,

Janet P. Spitler

Janet P. Spitler
Executive VP/Chief Financial Officer
Merchants Bank