



October 16, 2012

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Jennifer J. Johnson, Secretary  
Board of Governors of the Federal Reserve System  
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Re: FRB Docket Nos. R-1430; RIN No. 7100-AD87; and R-1442; RIN No. 7100-AD87

We at Community Bancorp., and our subsidiary, Community National Bank, appreciate the opportunity to comment on the Basel III proposals<sup>1</sup> published in June.

Like many other community banks, we are very concerned that the Proposals, if implemented in their present form, will adversely affect our bank, as well as the retail, commercial and municipal customers we serve. We also fear that the new requirements will, more broadly, damage the community banking industry and lead to ever greater consolidation and reduced choices for the banking public. Our concerns are summarized below.

### General Observations

- **The Basel III Net Is Cast Too Wide.** The Basel III capital framework was designed for large, complex financial institutions with international operations, not community banks engaged in traditional, relationship-based banking in their local communities. The typical community bank's balance sheet and associated risk exposures bear no resemblance to those of a large, internationally active, money center banking organization. It was the activities and risk exposures of those large institutions, not community banks, that helped to precipitate the financial market disruptions of 2008-09. Community banks, which have provided important islands of stability throughout this period, should not be penalized and made less competitive by having to comply with rules designed for much larger, complex organizations with vastly different risk profiles.

- **The Concept of Scaled Regulatory Requirements Should Not Be Abandoned.** One of the most sensible--and welcome--regulatory developments in the last 10-15 years has been the increasing recognition by the federal banking agencies of the appropriateness of adopting scaled regulatory requirements in a variety of contexts, based on the size and complexity of the

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<sup>1</sup> 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.*

regulated institution. The Basel III proposal in many respects represents a return to the "bad old days" of one-size-fits-all regulation.

- **The Law of Unintended Consequences Has Not Been Repealed.** A proposal as far-reaching and complex as Basel III is guaranteed to have significant unintended consequences, to the serious detriment of community banks and our customers. We urge you to reconsider applying the Basel III framework to a segment of the banking industry---community banks---for which it was neither designed nor intended. As discussed below, we believe the Proposals are likely to damage community bank profitability, reduce available resources for lending and raise borrowing costs for bank customers.

- **The Timing of the Proposals Will Add to the Implementation Burden.** The significant change made by the Proposals in regulatory capital requirements, including the complexity of the revised risk based capital provisions, would pose a significant compliance challenge to community banks at any time, but particularly so during this time of prolonged economic weakness, when bank profitability and resources are already strained.

#### **Including Accumulated Other Comprehensive Income (AOCI) in Regulatory Capital**

- **Volatility in Regulatory Capital Calculations Will Increase.** Requiring AOCI to be included in the calculation of regulatory capital will cause unnecessary and confusing volatility in our regulatory capital ratios. Given the nature of community bank investment portfolios, changes in unrealized gains and losses result primarily from changes in interest rates rather than fundamental changes in credit risk. In order to provide meaningful information to regulators, investors and the banking public, capital ratios should properly reflect the long-term relative strength (or weakness) of a financial institution. That important informational function will be seriously undermined if banks are forced to reflect in their quarterly capital ratios unrealized gains and losses that are temporary in nature and that are unlikely to be realized. This volatility will also needlessly make capital planning by bank management more difficult.

- **The Coming Interest Rate Capital Charge.** In recent years, both short-term and long-term interest rates have fallen to historically low levels, resulting in unrealized gains from increases in the fair values of many Available-for-Sale (AFS) investment securities. However, when interest rates rise, as they must eventually when the economic recovery takes hold, fair values of AFS securities will fall, resulting in a reduction to regulatory capital. This will predictably result in a capital squeeze for banks, particularly community banks which do not have ready access to the capital markets to replenish "lost" capital resulting from volatile AOCI accounting calculations.

- **Volatility Requires an Implied Additional Capital Cushion.** Because of the volatility introduced by requiring AOCI to be included in the calculation of regulatory capital, banks will in effect be forced to maintain a capital cushion above the regulatory capital levels otherwise required under the Proposals in order to absorb the impact of temporary unrealized losses. This will unnecessarily tie up additional capital and further impair our earnings potential and lending capacity.

- **Contractual Mitigation Methods Not Readily Available to Community Banks.** Large financial institutions are able to mitigate the effect of the AOCI volatility through the use of various forms of derivative contracts. Community banks, however, do not have the expertise or administrative resources to acquire and monitor sophisticated hedging instruments in order to smooth out temporary swings in regulatory capital.

### Higher Capital Ratios/Capital Conservation Buffers

- **Community Banks' Access to Capital Markets is Limited.** The higher capital ratio requirements, including the 2.5% capital conservation buffer, will disproportionately impact community banks. Unlike large financial institutions, community banks do not have ready access to the capital markets. Rather, community banks must generally rely on accumulated earnings to build capital, a process that takes considerable time. Moreover, the combined effect of the Proposals will place a drag on bank earnings by pushing banks to reallocate assets to lower yielding assets, in turn making it harder to attract investment capital. That is particularly true at this time, when the prolonged low interest rate environment has adversely affected bank profitability. The need to accumulate capital through retained earnings will also depress investor interest in bank stock, as banks are forced to cut (or refrain from increasing) their dividends to satisfy the new capital requirements. This drag on community bank profitability will ultimately lead to greater consolidation and concentration of risk in the banking industry as community banks find it ever more difficult to produce acceptable shareholder returns.

- **The Proposed Phase Out of TRUPs Will Harm Community Banks and Exceeds the Agencies' Authority.** Because community banks do not generally have access to the credit markets, many, like our bank, have relied in the past on the issuance of trust preferred securities (TRUPs) through pooled facilities in order to raise additional Tier 1 capital. The so-called "Collins Amendment", codified in section 171 of the Dodd-Frank Act, recognizes the importance of TRUPs to community banks by expressly preserving the existing capital treatment (i.e., Tier 1) for TRUPs issued prior to May 19, 2010 by bank holding companies with consolidated assets of between \$500 million and \$15 billion. There is no ambiguity in the statutory grandfather provision, no grant of authority to the banking agencies to vary the provision indirectly by rulemaking. Had Congress intended to phase out Tier 1 treatment for TRUPs for smaller institutions it would have done so, as it did for larger institutions. Instead, Congress pointedly adopted language preserving the existing TRUPs capital treatment, without any phase out or other qualification.<sup>2</sup> The TRUPs grandfather provision was included in section 171 precisely because Congress recognized the difficulty smaller institutions would have in replacing Tier 1 capital due to their inability to access the capital markets. The Proposals ignore this express grandfather provision, and improperly purport to overturn a federal statute by regulation. Such action would exceed the agencies' regulatory authority.

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<sup>2</sup> Section 171(b)(4)(c) reads in pertinent part: "...[T]he capital deductions that would be required for other institutions [those with consolidated assets of \$15 billion or more] under this section are not required as a result of this section." This statutory language is simply not consistent with the agencies proposed change in the capital treatment of TRUPs from Tier 1 to Tier 2, whether done immediately or over a period of years.

- **The Calculation Adjustments to Capital are Needlessly Complex and Burdensome.**

The capital framework in the Proposals introduces significant complexity in the calculation of regulatory capital, with thirteen deductions and adjustments to common equity, in addition to the changes to risk weights discussed below. Community banks engaged in traditional banking activities do not warrant this level of complexity in assessing their regulatory capital position.

Among the deductions from capital required under the Proposals is one relating to goodwill. Beginning in 2013, 100% of goodwill must be deducted from Tier 1 capital. This timetable is much more aggressive than under Basel III itself, which provides for a five year phase in of the goodwill deduction requirement. At the very least, the agencies should adopt a multi-year phase in of this requirement, similar to that under Basel III.

### Changes to Risk Weights

- **The Proposed Changes in Risk Weightings are too Complex and Burdensome.** The existing system of risk weightings, with its four categories, is easily understood and applied. The Proposals would replace this straightforward framework with one that is much more complex, with many more risk weight categories and variables to consider in assigning risk weights. These changes will put a strain on the administrative resources of community banks. Moreover, risk weightings would need to be adjusted during the life of the assets upon the occurrence of various events, thus placing a further burden on administrative resources.

- **The Proposed Risk Weights Will Adversely Affect Mortgage and Commercial Lending.** The Proposals significantly increase the complexity in the risk weighting of residential mortgage loans. This complexity and the increased capital charge for all but standard first lien residential mortgage loans will ultimately reduce mortgage lending options for consumers. Those banks that don't exit mortgage lending entirely will in effect be pushed to originating only standard 15 or 30 year mortgages that can be sold FannieMae or FreddieMac. Consumer choice will suffer.

In addition, the new 150% risk weight for so-called "High Volatility Real Estate Exposures" (HVCREs) will, predictably, result in higher borrowing costs to commercial real estate borrowers, as banks attempt to recoup the higher capital charge through higher loan fees and/or interest rates. Similarly, the addition of a 20% "credit conversion factor" (CCF) to unfunded off balance sheet commitments of one year or less (unless unconditionally cancellable) and a 100% CCF for financial standby letters of credit, guarantees and similar obligations, will likely translate into higher costs to our commercial customers.

Thank you again for this opportunity to comment on the Proposals. We trust that you will re-evaluate them carefully in light of the many comments you have received from concerned

community bankers and others. I sincerely believe that, in this instance, you would do well to adopt the mantra of the medical profession: First, do no harm.

Sincerely,

COMMUNITY BANCORP.

A handwritten signature in black ink, appearing to read "Stephen P. Marsh". The signature is fluid and cursive, with the first name being the most prominent.

Stephen P. Marsh  
President and CEO

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