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July 22, 2011

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

RE: Docket No. R- 1417; RIN No. AD 7100 AD 75
Regulation Z proposed amendments - Qualified Mortgage under the Reform Act

Dear Ms. Johnson:

The Canandaigua National Bank and Trust Company appreciates the opportunity to comment on the Federal Reserve Board's proposed amendments to Regulation Z. The Canandaigua National Bank and Trust Company (CNBT) is a community bank chartered in 1887 with branches in Ontario and Monroe counties in the Finger Lakes Region of Western New York. One of the ways in which we serve our customers and communities is by offering mortgage loans that are funded by core deposits gathered from the communities we serve.

We are distressed by the proposed "ability to repay" provisions that will make illegal the 3-Year Callable Mortgage product that CNB has offered to its customers for thirty years. Quite apart from the steps necessary to verify and document the appropriate underwriting of residential mortgages to be held in portfolio which support a determination of the customer's ability to repay the mortgage, is the new notion that the CNBT 3-Year Callable Mortgages which our customers have happily used to finance the purchase of their homes for the last 3 decades is somehow pernicious and should now be outlawed.

In the proposal, the Federal Reserve staff asserts that a 5 year balloon mortgage is acceptable, but a 3 year balloon is not because the former allows customers to build equity before the 5 year call and the 3 year may not. We heartily disagree. Here are the numbers:

Assume a mortgage of \$100,000 at 6% with a 30 amortization requires a \$599.55 monthly payment. At the end of three years the unpaid principal balance is \$96,554 or a 3.4 % reduction; at 5 years the balance is \$93,584 or another 3.1% reduction or a 6.5% reduction for a total \$6,416. Now, if we were to adjust the loan at the end of three years by plus 1% or 7% on the then balance of \$96,554 then at the fifth year, the balance would be \$94,880 or \$1,296 more than the above figure and at sixth year \$93,778. Now we adjust the fifth year \$93,554 to the same 7% and at ten years the balance is \$88,520. The three year callable has seven years at 7% and the balance is \$88,515 or actually \$5.00 less than the 5 year.

The Fed's contention fails and their conjecture is that "if the pattern is repeated the consumer may never make significant progress toward owning his home unencumbered". Here the pattern of 3 year calls

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at the 6th and 9th year at the prevailing rate of 7% applied to the 5 year call loan beginning in the 6th year actually gives a slightly better position at the 10th year. The doom and gloom prediction was dramatic, but not true. Moreover, the value of the property (\$125,000) is likely no more reliable than +/- 5% (\$12,500) or maybe +/- 10% (\$25,000). If not the amortization then the range of values of the error analysis would render any difference statistically irrelevant, especially if that is the rationale to prohibit a perfectly safe and sound approach to the community bank's funding of home mortgages which may be little used but nonetheless has proven its worth during the last Crisis.

The CNBT cost of funds drawn from the communities it serves over the last 25 years tracks the 3 yr Treasury almost exactly. Indeed, the dilemma of the mortgage banking problem is the funding a 30 year asset with a liability that has a propensity of a 3 year cycle. This is due to the bias of the consumer against lengthening longer than 3 years in our market. So, the three year is an exact match for our 3 year callable. A callable at five years exposes the Bank to the interest rate risk mismatch of three-year funding of a five-year asset without corresponding compensation paid by the borrower who benefits from a longer term, but does not pay for the benefit due to market forces, and which becomes particularly acute in periods of a compressed, and low short-term yield curve. One might query, "Why not offer a three-year ARM, instead?" An ARM product provides the borrower the normal embedded put option, i.e. they can refinance or repay the loan at any time prior to maturity without penalty. However, the ARM, does not give the bank a call option. In the community banking model, lower and balanced risk has proven to be a benefit to the banking system by reducing the volatility of earnings, and more importantly the volatility of capital. The elimination of the three-year callable, but allowability of the five-year callable increases interest rate risk, earnings volatility, and value-at-risk without corresponding compensation paid by the borrower for the bank taking that risk. It would seem counter to prudential regulation to support such a model.

We have 25% of our loans in this callable product or \$300,000,000. Today the cost of funds, all in, is 1.5% and the average yield on a 30 year amortizing 3 year callable is 5.5% or a NIM of 4.0%, representing a core part of our revenues. This is compared to the fixed rate version over 30 years which we would be foolish to retain because of the rate risk which and is therefore sold to FHLMC or FNMA Fannie with servicing retained providing revenue of 1/16th of the NIM above at just .25%

This is the epitome of CRA: community deposits recycled into residential mortgages in our area from which the deposits were drawn. This source of funding is stable unlike wholesale funding of Freddie and Fannie which failed to hold up during the Crisis when the market for wholesale money seized. By contrast, CNB's consumer deposits for the 2 year period ending in 2009 grew 38% in the depth of the Recession! And it did not have anything to do with the 10 basis points we were paying. These deposits primary value is to serve a utility function for their owner to tie the payables and receivables of the home or business together just as water serves the indoor plumbing and electricity the lighting and gas the heat. This is in contrast to the 30 year fixed rate mortgages sold to Freddie and Fannie which requires wholesale funding and is subject to market forces which are far more fragile and unreliable than our stable community source.

The sustainability and strength for all seasons of our Bank is derived by this community bank mortgage strategy. We were open for business throughout the Crisis when most non-regulated mortgage brokers closed or failed. The key point here is the **availability** of mortgage financing, not the price; in the face of financial upset it is critical to enable the continuation of home construction to stimulate recovery. Only then is the price a concern and at that a distant second. Why should a consumer not pay the real cost of capital raised from the community? To the extent he does the deposits will be there and we will be there. To the extent he gets a fixed rate in a rising market he receives a subsidy from someone else; inherently destabilizing the health of the banking industry-very short sighted policy. Our approach for the last 30 years (through four recessions) has allowed us to serve our community in times of crisis, fairly and reliably

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by use of the 3 year opportunity to adjust asset rates in line with the general level of cost of our funds. ARM indexes have little correlation with the three year cycle of our cost of funds-tracking roughly the 3 yr treasury.

To cast the 3 year callable mortgage aside is a poor idea that undermines the essence of community banking, removes a valid and stable source of revenue for community banks and a reliable funding source for individual mortgages and construction lending on a reliable and sustainable basis. Our intention with a three year maturity was not to call the mortgage in but rather to re-price the loan at a sustainable and fair rate which we could book in our own portfolio. We have specifically avoided the legal restraints of the ARM rules which required any "variable" rate loan to be tied to an index NOT within the control of the Bank. It is foolish to tie ones rate to an index which does not correlate to ones cost of funds and this has been well demonstrated over many years, especially since just such a mismatch destroyed the Thrift Industry in the 1980's leaving community banks like ours to absorb the systemic losses in the wake of 3,000 failed thrifts.

Rates are generally lower than for longer term mortgages, which is attractive to the borrower and the interest is generally deductible. Where most focus on the rate, it is the amortization which gives the payment relief that is the object of the consumer's intent. Over the term of the long mortgages the rate cycles tend to even out the cost of the interest. This allows for customized underwriting and flexibility not available in the national securitized markets and not to mention a simple and quick closing. The customers in a down rate environment in our experience are more likely than not to select to keep the monthly payment the same and with a lower interest rate seek to seize the advantage of accelerating the payment of their obligation instead of what most believe would be the urge to seek a lower payment to ease cash flow burdens. The consumer is smarter and more conservative than most would imagine.

Most suppose that the consumer in a callable mortgage transaction runs the risk of the loan actually being called. In thirty years we have NEVER called a mortgage loan that was being paid as agreed; at the call date, we ask our customer to negotiate a rate adjustment aligned with our cost of funds. Why would we go through that expense of seeking a new loan with all of the attendant costs when the existing loan needs only its rate to be adjusted to market. Rather we merely reset the rate at a fair market rate for the time generally around a rate on the yield curve at 2/3rd of the term remaining on the original contract, amortized over the remaining term of the original mortgage or as the parties might prudently agree. Therefore the adjusted rate is generally lower than a comparable fixed rate 30 year mortgage.

I note that the proposed revised regulation would permit 3 year callable mortgages in predominantly rural or underserved areas which are very narrowly defined. If the product itself is so pernicious that it should be outlawed, why do you propose to permit it to be inflicted upon consumers in rural or underserved areas? As I have set forth above, we believe that the 3 year callable mortgage is a useful product to permit consumers to finance their home purchases and also permit community banks the essential ability to manage interest rate risk by pricing assets relative to cost of funds.

We then urge that 3yr callable be permitted so we may continue our solution to the funding of a long term mortgage with consumer deposits which seldom extend more than 3 years based on this analysis and our 25-30 track record and experience and so as not to destabilize this significant piece of business we have conducted successfully for three decades with nothing but satisfied customers with mortgages paid in full and generally at a lower overall cost.

Sincerely,



George W. Hamlin, IV
Chairman and CEO