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October 22, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the 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

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

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.

The Canandaigua National Bank and Trust Company is a community bank chartered in 1887, it is the lead bank of Canandaigua National Corporation, a multi-bank Financial Holding Company and an SEC registrant. Now in our 125th year of providing financial services to the communities, businesses, and individuals in the Finger Lakes Region of Western New York, we are dismayed and extremely concerned by the poorly considered and misguided proposal issued by your agencies to impose an international capital standard on community banks in the United States. Community banks should be allowed to continue using the current Basel I framework for computing their capital requirements. If enacted as proposed, the rules will cause a significant reduction in the number of community banks in the United States resulting in damage to the economy of the United States and a permanent loss of community support in the communities served by these financial institutions.

[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.*

Wall Street Risk vs. Main Street Risk

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 of packaging and selling mortgage backed securities containing tainted sub-prime loans and the proprietary trading of these and other securities for their own accounts. The losses from these reckless activities severely depleted capital levels of the largest banks and created panic in the financial markets resulting in the Great Recession and the traumatic economic damage done to the economy of the United States. During the five years leading up to the collapse, the dozen largest banks garnered substantial revenues from the proceeds of the sales of these poisonous securities and proprietary trading, in some cases more than 75% of total revenue, a practice which is totally dependent on functioning markets and "caveat emptor." In stark contrast, community banks operate on a relationship based business model that is specifically designed to serve customers in their respective communities on a long term basis measured by the term of the amortization from three to thirty years. These loans are on our books for their duration, sustained by a faithful payment each month which depends only upon the activities of the borrowers each day, not the success of some electronic market far removed from human activity or on governmental interference and support. It is this process which in the aggregate is the principal cash flow of the community bank's revenue and thus the profits which are a far more reliable source of sustained retained earnings after the payment of taxes and dividends that is the source of reliable common equity of the community banks which sustains them through adversity even in periods of extreme economic decline such as the Great Recession which we have just experienced.

Quite simply, we gather core (thus reliable) deposits from the community (not wholesale from wherever) and lend them back into the same community which literally underwrites the growth of businesses and jobs in our community. Our customers, employees, and stockholder all live, work and play in this community and have a vested interest in its success which informs our risk decisions regarding lending and the management and investment of capital. This same community bank model contributes to the success of communities all over the United States through practical, common sense, approaches to managing risk through the specific design and composition of the balance sheet of the community bank. The enormous Wall Street and Money Center banks operate purely on transaction volume and trading for their own account and are driven by quarter-to-quarter earnings and their overwhelming need to "maximize earnings" for nameless faceless stockholders who trade stocks moment to moment without any interest in the underlying business. These behemoths pay little attention to the customer relationship and none to the health of individual communities. Unquestionably, there is a need to implement significantly tougher capital standards on the largest Walls Street and Money Center banks who have demonstrated inappropriate risk taking and an inability to absorb losses resulting in taxpayer bail outs. A valid case has yet to be made that the same rules need shackle a well-managed and constructed balance sheet of our Community bank which has been successful for 125 years at the current levels of Basel I.

The Canandaigua National Bank and Trust Company was well capitalized before the Great Recession, remained well capitalized during the Great Recession, and continues to be well capitalized. We had record earnings and loan growth during this period of time resulting from our common sense and reasonable approaches to underwriting and risk management as reflected in the choices we have intentionally made in the construction and management of our balance sheet. Although qualified to receive TARP funds, we declined to participate in that program which, although correctly designed to provide much needed capital for the over-leveraged and under-capitalized very large banks, was not designed with appropriate risk and return features for community banks and outrageously contained a contractual provision permitting the Treasury to unilaterally change any provision of the agreement – on its face an unsafe and unsound business practice! Although the additional capital could have been put to use for additional lending in the communities we serve, the cost of the capital and terms as offered by the former investment bankers who designed the program was not appropriate for our company or the communities we serve, nor were such provisions contained in the agreements back in 1934 where the government purchased 5% preferred to provide capital during the Great Depression which was then redeemed by the banks five years later in 1939 in the normal course of business.

None of the agencies who proposed this new capital standard have demonstrated by analysis that the community banks in the United States as a group (and in particular The Canandaigua National Bank and Trust Company) are over-leveraged and in need of additional capital rules to manage the risks of community banking.

Proposed New Risk Weights

The proposed risk weight framework under Basel III does not accurately reflect data regarding the probability of default and risk of loss given default of residential mortgages originated by community banks and held in their portfolios. In addition, it is much too complicated and will be an onerous regulatory burden that will penalize community banks and jeopardize the housing recovery.

The proposal assigns risk weights for residential mortgages based on classification of the mortgage as "traditional" labeled category 1 or "riskier" labeled category 2, and loan-to-value ratio of the mortgages. Under the proposal, "traditional" is defined as fixed rate, fully amortized for 30 years (or under) which is a very rigid structure that spelled ruin for the Savings and Loan industry in the late 1980s where thousands of S&Ls were overcome by the dynamics of liability rates driven up by worldwide inflation run rampant with long term fixed rate mortgages as the matching asset. This represents very poor asset liability management of interest rate risk which proved disastrous in the 1980s and would be equally disastrous for Community banks funded by community deposits. For the last thirty years, The Canandaigua National Bank and Trust Company has been successfully originating two, three, and ten-year callable mortgages with varying amortization periods ranging out to 30 years. For these mortgages "callable" is no more nor less an option in the bank's hands than the bank has in the case of a mortgage being 32 days delinquent. In either case, our practical common sense incentive is not to call upon the customer for payment in full. In fact the data shows that we in 35 years and over 15,000 mortgages have NEVER exercised the call to pay in full in EITHER case: rate adjustment or 32 days past due, even though we have the right to, any more than one who has "tactical atom bomb" would be stupid enough to actually use it- thank God! The "call" provision is not intended to cause the payment in full of the loan but rather to avoid the strictures of the adjustable rate mortgage ("ARM") imposed upon our effective and popular product to fix a problem which did not exist.

The requirement of the ARM is to adopted and index for cost of funds NOT WITHIN THE CONTROL OF THE BANK. What retailer in his right mind would set the price of his product on a margin based on someone else's costs? Foolishness in the extreme. Our intent, of course, is just the reverse, that is to preserve and continue the loan on our books at a margin of at least 2.50% over our current cost of funds (not sold and service at .25%). Generally we find agreement with the customer with a rate matching the yield curve appropriate for the remaining term to maturity.

In this way we as a bank can provide to our market a stable availability of mortgage money at a fair price (net after tax deduction, a bargain) while securing that reliable source of funds by delivering a fair return to the depositor, the source of our stable core community deposits. This Recession demonstrated that we were flooded with consumer deposits +38% for 2 years ending 2009 since we were regarded as the safest repose of our depositors' funds even with the lowest rates of interest in living memory because of the "utility value" to the depositors to cover the payable-receivable cycle of the business or household. In the desert what is more valuable to the man on foot, the water in the bottle or its price? Our data gathered over 40 years show our cost of funds tracks the 3 year Treasury. Thus, a negative spread can be expected 10 times in 30 years for the traditional product (fixed rate). Sustainability is based upon a mutual benefit among the parties along the way not one group subsidizing another. The mortgage customer is a practical person who values his relationship with his community bank he regards as his "asset" not liability because if he needs consideration and flexibility he will be accorded that opportunity; moreover as rates fall more likely than not they will decline the opportunity to take the new lower payment resulting from the recalculation of the amortization over the remaining term since they have grown used to the old payment and value more the accelerated pay-down of the balance. Yes, the consumer IS smarter than Congress and the Regulators which under the ARM structure would insist on the lower payment.

The callable portfolio mortgage loans we offer permit appropriate management of interest rate risk for our bank using only the resources and market loan demand for building and buying homes located within the TWO COUNTY community where the core deposits exist to fund lending within the same community in which they are located. Importantly, these funds cycle and re-cycle here regardless of what Wall Street is infected with at any particular moment. Forcing Community banks to do what only the mega Wall Street banks can do – (securitize and service) DESTROYS OUR COMPETITIVE ADVANTAGE in the name of symmetry and robs us of our highest risk adjusted yielding business (available locally) that has provided the most assured supply of retained earnings after the payment of taxes and dividends and as a result the most reliable source of new capital to absorb financial shocks and also to continuously underwrite the growth and service to our community. These loans are very popular with our customers and thus valuable to us and have a very low probability of default and loss given default, in fact the lowest charge off risk of any of the loans on our balance sheet and therefore the best risk adjusted yield of any loan category and a secure source of retained earnings to restore and grow the capital base. This has been demonstrated over the last thirty years and continues to be the case. Under the proposal, these mortgage loans since they are not "traditional" by default are relegated to be Category 2 (reserved for risky commercial real estate loans) a shift from 50% risk capital to 200% risk capital – four times the risk according to your agencies but there is no data to support your position. We have innovated and our performance over thirty years is proof positive of how it is possible to borrow short (deposits) and lend long (30 year amortization) by collaborating with each customer in a way that has succeeded for both the customer and the bank where Freddie and Fannie using the securitization model for funding have failed. By agreement the customer accedes to a practice to pay the <u>real</u> cost of funding his house with core available local deposits secured at a fair rate on a three year cycle. The traditional structure of the 30 year fixed rate mortgage is doomed by structure to be ultimately funded not by core deposits but the funds drawn from markets where confidence and rate are the only variables which inevitability fails in every down financial cycle. We are not crippled by these market elements and thus have the best plan. The merits do matter; they do not go away because they are overlooked, it is better to recognize them.

We participated in the July 19, 2012 national conference call hosted by the Comptroller of the Currency regarding the Basel III proposal and we were surprised and disappointed by the admission of representatives of the Comptroller of the Currency that the agency did not have the data to be able to analyze risk of loss for callable first lien residential mortgages originated by community banks and held on their books, and apparently failed to consider this data prior to issuing the Basel III proposal. Each of your agencies has access to Call Report data and you examine the community banks you supervise on a routine basis. In our case, we are examined annually by the Comptroller of the Currency. Our examiners are highly trained competent professionals who provide appropriate independent review of the risk management of our loans and mortgages and capital adequacy of the bank given the choices made in developing the array of loan products and their risk/return features and we have not been advised of concerns that the first lien residential mortgages or home equity loans which we have been making for the last thirty years using common sense underwriting standards present a significant risk of loss and indicate a need for additional capital. There is no data that has been presented by your agencies that demonstrates that these types of loans pose significant additional risk or that community banks that make these loans are, as a result, overleveraged and therefore in need additional capital. Increasing the risk weights for residential balloon loans, interest only loans, and second liens will penalize community banks who have demonstrated their ability to safely and soundly offer these loan products to their customers because their access to vital additional underwriting elements not covered by "credit scoring." Consumer lending has been overly limited to such metrics which ignore the intangibles that are far more telling as to behavior in down times, namely character and capacity to manage challenges, which are commonly known by the loan officer in a community bank setting. Just because this advantage is not accorded or considered by the large high volume suppliers is no reason to deny community banks the competitive advantages they have over their larger competitors who recently had a poor showing of effective management. There is no reason to limit our wise discretion which will deprive customers of many financing options we can provide for residential property in our home town. It was General Pershing instructing his young attaché Dwight Eisenhower that "all generalizations are wrong" in the application to a specific human situation which by definition is as unique and it is human!

The proposed higher risk weights for balloon loans will penalize community banks for appropriately and successfully mitigating interest rate risk in their asset liability management. Your proposals appear to be designed to force community banks 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 which interference was at the root of the Thrift Crisis that is still within the memory of most of our officers and directors. Furthermore, community banks will be forced to make significant software upgrades and incur other operational costs to track mortgage loan to value ratios quarter to quarter in order to determine the proper risk weight categories for mortgages and this constant re-evaluation will lead to increased volatility in capital calculations. The proposed rule does not grandfather the existing risk-weighting of the mortgages that community banks have originated prior to the Notice of Proposed Rule Making which will create a significant and potentially impossible task as the data required for the calculation may be difficult or impossible to obtain. Many community banks will be forced to either exit the residential loan market entirely or only originate those loans that can be sold to a GSE because they cannot prudently take interest rate risk that is detached from the funding source which for community banks is core deposits. Think of the violence this proposal does to the concepts of Community Reinvestment (CRA). Second liens will either become more expensive for borrowers or disappear altogether from the regulated banking industry as banks will choose not to allocate additional capital to these balance sheet exposures. The advent of the Home Equity Line was a wonderful tool in the hands of the community bank providing flexibility to the customer and safety to the banks by permitting the use of the largest source of available collateral for most Americans, the equity in the own home. To go back to the "old" days is as foolish as it is unnecessary.

We question the proposed limitation of 1.25% of risk-based assets in the loan loss reserve. It makes no sense to limit an allocation of capital that serves the purpose of being a buffer against loss. Financial Institutions should be encouraged to build reserves during good times and an artificial and arbitrary restriction should not be imposed upon the judgment of management who has intimate knowledge of the loan portfolio and the need for appropriate reserves at the local level. Moreover, such prudential and necessary provisioning should be tax deductible in the current year as an ordinary and necessary business expense of lending money as was the case in 1979 when provisioning up to 2.0% of loans as reserve for loss was deductible. Under the accusations that banks were "smoothing" earnings from one year to another, the provision limit was reduced to up to 1.2% of loans and then to .6% which was its practical repeal. Think of it, the cost to the IRS of "smoothing" compared to the cost of many times that of assisting trouble banks who likely would have had better reserves had the practice continued. In addition, increasing the risk weighting on delinquent loans is redundant. Delinquent loans are currently addressed in the analysis for calculation of the Allowance for Loan and Lease Losses. Community banks and in particular Canandaigua National have demonstrated over decades that they are able to manage the risks involved in loans made within the communities they serve through good times and bad times. The proposed rules will place arbitrary punitive restrictions on our ability to work with challenged borrowers to overcome whatever short term issues have impacted them and hopefully for commercial loans permit the continuation of the business and for mortgages, allow the customers to stay in their homes. The error here "of one size must fit all" burdens 7,000 community banks for the errors of the largest 15 mega banks who were both greedy and derelict. We urge you not to implement these rules which were designed to curtail the excesses of the world's mega banks proprietary trading activities versus the intermediation of deposit/loan dynamic of communities which demonstratively "kept on ticking" when Wall Street seized up.

Proposed Phase out of Trust Preferred Securities

We object to the proposed ten year phase out (or the provision of any phase out in any revised Proposed Rule) of the tier one treatment of instruments like trust preferred securities (TruPS) because it has been and continues to be a reliable source of long-term capital for community banks that would be very difficult, and costly to replace. In 2006 and 2007 Canandaigua National Corporation took advantage of the rules regarding TruPS and issued two series of 30 year TruPS. To protect against the variability of cash flows for these securities resulting from changes in interest rates over time we have entered into interest rate swaps with respect to both issuances, which expire in the years 2021 and

2023. Each swap agreement qualifies as a cash flow hedge accounting, thus changes in the fair value of the swaps are accounted for in Accumulated Other Comprehensive Income. . In accordance with sound banking principles (holding company acting as a source of capital strength), a substantial portion of the initial TruPS was down-streamed to Canandaigua National Bank. The additional capital provided by the TruPS has enabled Canandaigua National to provide significant additional lending in excess of $250 million in the communities it serves on a safe and sound basis thereby benefitting the communities and also Canandaigua National as a company. Over the life of the TruPS, Canandaigua National will repay the principal and interest from earnings resulting from the lending enabled by the additional capital. This capital is expected to be repaid well beyond the expiration of the swap agreements, but within the TruPS maturity of 2036 and 2037. The proposed precipitous elimination of the availability of this capital will cause Canandaigua National to either seek additional capital from new sources or direct more of its retained earnings to repayment thereby reducing the availability for lending in the communities we serve. This requirement is specifically contrary to the Collins Amendment to the Dodd-Frank Act which was designed to permanently grandfather the capital treatment of TruPS for bank holding companies with less than $15 billion in assets. Phasing out this important source of capital would be a particular burden for many privately held banks and bank holding companies that do not have readily available alternatives for raising capital. The Collins Amendment was designed to allow smaller financial institutions the opportunity to replace TruPS as they matured, in an orderly fashion, in accordance with the capital planning strategies used to support the original decision to obtain this form of capital. The negative impact on Canandaigua National if TruPS are phased out will result in Canandaigua National becoming less than well capitalized using June 30, 2012 Call Report data. Clearly this was not the intent of Congress, and raises serious questions as to whether the agencies considered this potential impact. Furthermore, the additional potential capital damage caused by the early termination of our interest swaps cannot be exclusive to Canandaigua National. Did the agencies consider this economic impact in drafting the proposal? We urge you to engage in additional research.

While we are pleased that TruPS issued by bank holding companies under $500 million would not be impacted by the proposal, consistent with the Collins Amendment, we urge you 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.

Accumulated Other Comprehensive Income ("AOCI") as Part of Regulatory Capital

The Canandaigua National Bank and Trust Company uses its investment portfolio for liquidity and to support the municipal governments in the communities we serve. Unlike the Wall Street banks whose primary source of income is proprietary trading of their investment portfolios, we have never viewed the investment portfolio as a means of deriving increased revenue for the sake of revenue alone. Prior to the Great Recession, we held no preferred securities of the GSEs and were not impacted when they were taken into receivership. Most of the leaders of community banks view the investment portfolio the same way. 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 most community banks represents unrealized gains and losses on investment securities held as available for sale ("AFS"). Because these securities are held at fair value, any gains or losses due to changes in interest rates are captured in the valuation. Recently, both short term and long term 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 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 without continuing intervention by the Federal Reserve once an economic recovery accelerates. 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. These changes are not indicative of a change in credit risk or the equity of the bank but reflect only fluctuation of interest rates in the market. Using June 30, 2012 Call Report data, Canandaigua National has a $98 million AFS portfolio. Consider a 200 basis point upward shock test for this investment portfolio which would show a paper loss of $10 million. This would mean that our bank's tier one ratio would drop by 70 basis points with no increased credit risk and it would effectively wipe out a year of earnings – with no change to the core business transactions having occurred. Community banks generally do not have the knowledge, expertise, access to appropriate markets, or desire to engage in the type of hedging and derivative transactions that would be required to address the volatility introduced by this proposal nor to manage their associated risks. Other potential reactions of community banks to this proposal may be to hold all investment securities to maturity but this would severely and unnecessarily limit the ability of the community banks to manage their liquidity needs and meet the lending needs of the communities they serve or to shorten the duration of investments which would be potentially detrimental to the municipal securities markets at the local level, in particular nonrated, bank-qualified local municipal bonds. In addition, it does not appear that the agencies have given adequate consideration to the potential that one or more ratings agencies might downgrade the debt of the United States which would have potentially disastrous impact on the capital calculations under the proposed rule but would likely not result in a change in either the market for these securities or the cash flows generated by these securities. Community banks should continue to exclude AOCI from capital measures as they are currently required to do today.

Additionally, the inclusion of gains and losses on cash flow hedges will significantly impact the capital of financial institutions and introduce a level of increased volatility not only not contemplated by their managements, but also contrary to the intention and purpose of hedging instruments. Since hedges for non-traded instruments are intended to mitigate periodic changes in the instruments' fair value or their related cash flows, introducing that volatility into the consideration of adequate capital levels is contrary to safe and sound banking practices. Please explain how management is expected to minimize interest rate risk and the related risk to earnings and capital, when hedging instruments, vital products to effectuate risk management, will result in greater volatility than under the Basel I capital rules. This could not be what you intended.

Capital Conservation Buffers

The ACOI proposal and proposed changes to risk weights have the significant potential to create a rapid reduction in the capital of community banks as measured under the proposed rules without any change in the actual economic substance of the transactions. Community banks do not have ready access to additional sources of capital that the larger banks have through the capital markets. Community banks increase capital through the accumulation of retained earnings over time. This has proven to be an appropriate growth strategy for well run community based financial institutions that are focused upon growing the communities they serve rather than daily trading of their shares on some exchange. This method of capital growth is and will be challenged as a result of the historic ultra low interest rate environment where net interest margin has been compressed and community bank profitability has been reduced. Layering on a restriction in the ability to pay dividends and discretionary bonuses that are paid in respect of high performance by management will cause community banks to have even less opportunity to raise additional capital and to retain management sufficiently skilled to address the challenges faced by the community bank.

Mortgage Servicing Rights

Under the proposal, banks will not be able to count mortgage servicing assets that exceed 10% of their common equity tier 1 capital as a part of common equity tier 1 capital and beginning in 2018, the amount of mortgage servicing rights in excess of 10% will receive a 250% risk weight. Community banks use the servicing relationship as a means of broadening our customer relationships. Penalizing the existing mortgage servicing assets under the proposal is unreasonable for those banks that have under the current regulatory capital treatment developed portfolios of mortgage servicing rights over time as a means of customer retention and development. Any mortgage servicing rights existing on community bank balance sheets should be allowed to continue to follow the current risk weight and deduction methodologies.

Common Sense and Unintended Consequences

Whether by design, or following the rule of unintended consequences, the Basel III proposals will, if forced upon community banks, dramatically reduce the number of community banks which, although they hold only a small percentage of the assets in the banking system, are currently responsible for a significant portion of the small business lending that generates jobs and thereby economic activity and financial well being of communities. It is common sense that concentration of assets and resources generally increases risk and volatility; we have all witnessed the disastrous results of this concentration and failure to understand and manage risks by both those on Wall Street and in Congress. Failure to heed the wisdom of our grandparents "never put all of your eggs in one basket" will result in potentially disastrous results for our national economy and specifically for the many small communities served by the community banks. We urge you to exempt community banks and holding companies, those having less than $10 Billion in assets, from the application of the Basel III proposals.

Very truly yours,

George W. Hamlin IV

Frank H. Hamlin III

George W. Hamlin, IV
Chairman and CEO

Frank H. Hamlin, III
President

CC: Board of Directors
The Canandaigua National Bank and Trust Company