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To: Comments
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Subject: August 30, 2012 - FDIC (RIN 3064-AD95)

Pacific Continental Bank appreciates the opportunity to submit comments on the above-referenced notice of proposed rulemaking ("NPR"). The NPR was released by the Federal Reserve, Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation on June 12, 2012 and are designed to incorporate revisions to the Basel III capital framework and to implement relevant provisions of the Dodd Frank Wall Street Reform and Recovery Act. Pacific Continental fully supports the regulatory agencies efforts to address perceived weaknesses in the banking industry's capital framework and recognize the challenges the agencies face in developing a system that accurately reflects risk across the diverse nature of financial institutions that make up the United States banking system. Because of the scope of the exercise and the significant impact on the banking industry, particularly community and regional banking institutions, we appreciate the agencies willingness to extend the comment period until October 22, 2012. We hope this additional time will allow the institutions to properly evaluate the impact of these changes and provide meaningful responses to their ongoing effort to refine these rule changes.

Proposed Regulatory Capital Rules: Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (Basel III NPR)

Proposed Rule: Accumulated Other Comprehensive income (AOCI) as a component of Tier 1 capital – The Agencies are proposing that AOCI, which includes all unrealized gains and losses on AFS securities, would flow through to common equity Tier 1 capital. This would include unrealized gains or losses related to debt securities whose valuations primarily change as a result of fluctuations in a benchmark interest rate, as opposed to changes in credit risk (for example U.S. Treasuries and U.S. government agency debt obligations).

Pacfic Continental Comments: Pacific Continental has a number of concerns about the inclusion of AOCI as a component of Tier 1 capital. The Agencies themselves have recognized that the inclusion of unrealized gains and losses on securities could "introduce substantial volatility in a banking organization's regulatory capital ratios." While we recognize the appropriateness for AOCI inclusion in a tangible capital ratio from a market valuation perspective, the introduction of a similar structure to the regulatory capital metric has the potential to create confusion over the adequacy of recorded ratios and could lead to flawed, uneconomic, and even unsound decisions regarding an institution's asset-liability management and investment options. Some of the more troubling aspects of this proposal include the following:

1. Inclusion of AOCI in the standardized regulatory capital ratios would force regulators and financial institution managers to calculate alternative ratios to determine an effective capital position, exclusive of AOCI. Capital ratios bolstered by market appreciation would most certainly be discounted to reflect the potential volatility that might exist in a rates-up environment. At the same time, market depreciation would be counted against capital, even though a rates-down scenario might significantly improve the institution's capital position. In the latter case, institutions would need to hold greater levels of common equity capital to comply with a ratio requirement that reflects a potentially temporary adjustment.
2. To avoid recognition of AOCI, institutions may be incentivized to hold more securities in the held-to-maturity (HTM) account. While the move to the HTM account would no longer require gains and losses on those securities to be recorded in Tier 1 capital, the operational restrictions imposed on the HTM account would greatly reduce management's ability to properly adjust its portfolio for liquidity and funds management purposes. Additionally, when different institutions place identical securities in AFS or HTM, it creates differing capital treatments even though the relative risks involving the securities are the same.

3. To avoid capital ratio volatility, institutions may also be inclined to make shorter-term investment decisions that reduce volatility and increase liquidity. This may help to reduce market risk, but it also could reduce the ability of the investment portfolio to produce income and generate capital appreciation. As a result, banks would be forced to pursue other options to generate yield, which could include diverting investment to other asset classes, with higher levels of credit risk and/or greater levels of unrecorded market volatility. In addition, a secondary undesirable economic effect may occur as the desire to avoid balance sheet volatility may lead to disruption in municipal securities market as the banking industry historically has be a major purchaser of long-term municipal securities. In order to avoid market volatility, supply of municipals would likely exceed demand by the banking industry thus potentially creating higher interest rates for already strapped municipalities across the country.

4. The AOCI inclusion for AFS securities applies mark-to-market treatment to only one set of assets on an institution's balance sheet. Other balance sheet components that are economically very similar do not receive the same treatment, such as loans, structured liabilities, and HTM securities. We find two difficulties in this inequivalent treatment. First, this appears to violate the basic accounting principle of consistency. Second, it would in effect weaken an institution's asset-liability management; specifically, it adds a potential capital penalty on using the securities portfolio, the most flexible tool at ALCO's disposal, to reduce overall asset sensitivity while leveling no such penalty on any other balance sheet component.

5. The negative impacts of these effects would fall disproportionately upon community banks, due to their limited access to capital markets for funding and temporary equity enhancements.

To illustrate the potential impact of this proposal, examine the impact of rate changes on the capital of a $500 million dollar institution, with a typical AFS securities portfolio of $100 million, and a leverage ratio of 8.00 percent. In order to model the institution's investments in a simple fashion, and to remove basis, credit and optionality variables, assume the bond portfolio consists entirely of a 3.5-year duration Treasury. Such a portfolio would presumably be less volatile and risky than that of the average real financial institution with that typical portfolio duration and the aforementioned additional risk components. Further, to remove the asymmetrical effects of the current near-zero level of interest rates, we will consider this institution in a different rate environment, specifically the environment in which the 3.75-year Treasury (3.50 year duration) with a 4.00 percent coupon is priced at par. Based on an instantaneous rate shock of plus or minus 300 basis points, application of AOIC causes the institution's leverage ratio to fluctuate between 9.98 percent and 6.17 percent. This is a difference of 381 basis points due solely to AFS market value changes caused by interest rate movements on a risk-free asset. While real institutions will certainly have the ability to make some adjustments to the AFS portfolio to reduce the size of this capital fluctuation, considerable questions persist as to how such institutions would be treated from a regulatory perspective when an instantaneous shock scenario shows such a dramatic impact.

Pacific Continental Recommendation: Pacific Continental recommends that the Agencies exclude any AOCI adjustments from the regulatory capital calculations and continue to include an addendum in the Call Report to reflect ongoing gains/losses in the AFS portfolio. In our view, the concerns addressed about market value appreciation/depreciation are best managed through a strong liquidity and funds management function. While the impact on capital should be considered, financial institution capital ratios cannot be effective measurements of risk when only one class of assets among many is required to recognize ongoing market value adjustments.
The Agencies have suggested a potential exclusion of the capital charges for debt obligations to U.S. government, U.S. agency, and U.S. Government Sponsored Entities. The Agencies have also suggested a similar exclusion on general obligations issued by states or other political subdivisions. PTCP supports these exclusions and agrees that they would help to minimize the impact of the proposed AOCI treatment. However, to minimize risk and properly diversify the investment portfolio and total balance sheet, institutions should also be able to make informed investments in securities that contain some level of credit risk without an inequitable capital volatility penalty. If there is a need to hold higher levels of capital against these investments, that need should be addressed through an appropriate adjustment to the standardized risk weight measurement, not through an ongoing fluctuation in the Tier 1 capital ratio.

Proposed Rule: Minimum Capital Ratios, Capital Conservation Buffer, and Prompt Corrective Action Requirements – Under the Basel III NPR, the Agencies have introduced a new common equity Tier 1 capital ratio and have modified the capital components and ratios for the existing risk-based and leverage capital framework. The Agencies are also proposing limits on capital distributions and certain discretionary bonus payments if the banking organizations do not hold a specified "Capital Conservation Buffer" in addition to the established minimum risk-based capital requirements. The minimum risk-based capital requirements correspond to the minimum thresholds for "adequately capitalized" status under the Prompt Corrective Action (PCA) framework, and the Capital

Conservation Buffer is proposed to be 2.5 percent above these minimum requirements. The Agencies are proposing to continue the PCA framework, with existing requirements still in force for organizations that fall below the statutory definition of “well-capitalized”, which is 2.0 percent above the minimum requirement.

Pacific Continental Comments: Pacific Continental does not object to the proposed minimum capital requirements, or to the addition of the new common equity Tier 1 capital ratio. However, it is unclear why the Agencies would create a capital conservation buffer that would exceed the minimum thresholds for “well-capitalized” under the PCA framework. In essence, the proposal suggests that an institution needs a 2.0 percent buffer to be “well-capitalized’, but it would need a 2.5 percent buffer be “resilient” throughout different financial cycles. By establishing this framework, an institution could be “well-capitalized” and free from any restrictive covenants under the PCA framework, e.g., limitations on brokered deposits, but at the same time still have restrictions on capital distributions and discretionary bonuses if it did not exceed the requirements for the Capital Conservation Buffer. This staggered and somewhat parallel layer of restrictive covenants above the PCA “well-capitalized” framework will create a confusing and contradictory set of standards.
In reviewing the Agencies’ justification for Capital Conservation Buffer, it was not clear how the Agencies empirically developed the specific 2.5 percent ratio or how that level, over and above a “well-capitalized” level, would help to “bolster the resilience of banking organizations throughout financial cycles.” It was also unclear if the Agencies considered the impact of the proposed changes to risk-weighting requirements in their determination of the 2.5 percent buffer. If the proposed changes to the Standardized Approach NPR create a risk-weighting mechanism to better reflect balance-sheet risk, it would seem that the revised capital ratios would automatically be more resilient and better able to absorb cyclical risks at the “well-capitalized” level.

The proposal also did not appear to address the authority that currently exists within the Agencies’ enforcement powers to restrict capital distributions when appropriate. If, through the examination process, an Agency determines that capital distributions need to be restricted because of the specific financial condition of the institution, the Agency has the power to restrict those distributions through existing enforcement authority. Codifying this type of restriction in a regulation over-simplifies this issue and could impact the ability to exercise appropriate regulatory flexibility.

PTCP Recommendation: To avoid confusion and to better link the proposed capital guidelines to the existing PCA framework, PTCP recommends that the Capital Conservation Buffer be adjusted to 2.0 percent. This would align the Capital Conservation Buffer with the buffers that already exist between “adequately-capitalized” status and “well-capitalized” status under the PCA framework. Banks that fall below “well- capitalized” could be subject to a variety of restrictions, including the proposed restrictions under the Capital Conservation Buffer. However, in the interests of clarity, flexibility and simplicity, we believe the Agencies may even wish to consider eliminating the Capital Conservation Buffer altogether in favor of instead applying existing enforcement authority to restrict capital distributions as circumstances warrant.

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