Coastal Community Bank

October 15, 2012

Federal Reserve Bank
Subject: Basel III docket No. 1442

I am the CEO of Coastal Community Bank, a $339 million, 8 branch commercial bank headquartered in Everett, WA. I am writing to comment on the proposed regulation under Basel III. While I understand the purpose of the regulation is to require more capital for banks that take on more risk, I believe there are some unintended impacts to Community Banks based on certain elements in the proposal. These impacts will result in our bank, and likely many others, changing the way we do business and the type of loans we will make resulting in negative consequences to the economy. In addition, the impact of the proposed regulation may actually have a negative impact to a community bank's safety and soundness.

Inclusion of unrealized gains or losses in Common Equity Tier I

The Basel III proposal requires unrealized gains or losses on the banks available for sale bond portfolio to be included in the calculation of Common Equity Tier I capital (CET1). The current regulatory capital calculations exclude these unrealized gains or losses. While the impact to Coastal Community Bank on our 6/30/12 balance sheet would be relatively small (it actually would be a $39,000 addition to capital), it could have a very large negative impact on the CET1 calculation in the future when rates increase. Community Banks like Coastal often invest excess funds in our available for sale securities portfolio or to have collateral available for borrowings or public funds deposits. With the inclusion of the unrealized gains and losses in the capital calculation, Coastal may change the way we do business in several ways.

First, to reduce unrealized losses in a rising rate environment, we will invest our available for sale securities in a shorter term maturity. This will reduce the yield achieved on our investment portfolio and therefore impact our ability to produce organic capital through earnings. Second, if we invest in longer term maturity securities, we would be inclined to classify them as Held to Maturity (HTM). This would reduce our available liquidity, but also reduce the risk of large swings in our unrealized gains or losses on investments. Finally, we may avoid investing our excess liquidity in anything other than overnight deposits, which would reduce our earnings capacity even further.

Finally, if Basel III requires us to mark our available for sale investment portfolio to market and include it in our calculation of capital, it should also include the mark to

market of our liabilities to offset that impact. Basel III only looks at one side of the interest rate risk equation.
The Basel III proposed rules on available for sale securities should be dropped or amended, otherwise it will cause community banks like us to react as described above which will reduce liquidity or will reduce earnings.

Phase out of non-qualifying tier I capital instruments

The holding company of Coastal Community Bank has issued Trust Preferred Securities (TRUPS) and Senior Subordinated Securities from which the proceeds were down-streamed to the Bank as Tier I capital. Based on our interpretation of this complicated NPR, those securities will be considered non-qualifying tier I capital under Basel III and subject to phase out over 10 years. The TRUPS total $3.6 million and mature in December 2034. The Senior Subordinated Securities total $474 thousand and are due in June 2019. While the elimination of these capital instruments is phased in 10% a year over ten years, the final impact is Coastal will either need to raise an additional $4.08 million of additional capital during the phase-in period or reduce loans by approximately $41 million to maintain our capital ratios.

Existing capital instruments should be grandfathered into the capital calculations under Basel III, and not phased out as proposed.

Risk weighting of 1-4 family 1st lien loans

Current regulatory capital calculations require loans secured a 1st lien on 1 - 4 family real estate to be risk weighted at 50%. We believe the objective of the Basel III proposal is to properly risk weight traditional 1-4 family mortgages which may carry more risk, such as high Loan to Values or structures that reprice frequently or have other unusual options. Coastal Community Bank does not originate, nor hold, traditional 1-4 family mortgages. However, we do make loans to individuals, investors and business owners which are secured by a 1st lien on 1-4 family real estate. These are typically loans for consumer purposes (approximately 30% of our 1st lien 1-4 family loans) or for business/investment purposes (approximately 70% of our 1st lien 1-4 family loans). We cannot take on the interest rate risk of those loans having a fixed rate for more that 5 years, so we typically have a balloon payment after 3 or 5 years. As a result of our "balloon" payment, 88% of our 1st lien 1-4 family loans will fall into the category 2 of the proposed rules, which have risk weightings between 100% and 200%.

At 6/30/12, Coastal had approximately $33.8 million of loans secured by 1st lien on 1 - 4 family real estate, which received a risk weighting of 50%, or $16.9 million. Under the proposed Basel III guidelines, those same loans secured by 1-4 family 1st liens will receive a risk weighting that ranges from 35% to 200%. We estimate, under Basel III, Coastal's 1-4 family 1st lien loans at 6/30/12 would result in $37.5 million of risk weighted assets, or an additional $20.6 million. That means under Basel III, Coastal would require $2.06 million more in capital to maintain approximately the same capital ratios, or we would need to eliminate $20.6 million or 61% of our loans secured by 1st lien on 1-4 family real estate.

As a result, Coastal would be making a lot fewer loans secured by 1-4 family real estate in the future. The primary issue under the Basel III proposal is any loan with this collateral is required to be fully amortizing with no balloon payments. I believe the authors of the proposed regulations were trying to increase the risk weighting for those loans that did not look like a traditional mortgage. The problem for most community banks is often times we will use equity in a residence as collateral on a small business loan when the business does not have adequate collateral. While we may amortize those loans over a 10 to 30 year period, we typically have a balloon payment due in 5 years or less. We do not want to take on additional interest rate risk by making 10 year term or longer loans and perhaps be in the same position the Thrift industry found itself in the early 1980's. To avoid the additional capital requirements, we likely would make fewer loans to small businesses or investors of rental properties, or avoid taking 1 - 4 family residential real estate as collateral. Ironically, we would have lower risk weighted assets if we replaced those 1st lien, 1-4 family real estate loans with unsecured loans with no collateral, but the bank would not be safer or sounder as a result.

These are the primary changes under the proposed Basel III regulation that would have a negative impact on Coastal Community Bank's capital ratios. If enacted, Coastal will be discouraged in making future loans on residential real estate, or in investing in bonds. In fact, just with these three elements of the proposal, Coastal Community Bank would need to reduce future loan totals by $61.6 million to maintain our current capital ratios. When applying this impact to the thousands of community banks across the country, this could severely reduce the availability of these loans and have a devastating impact on the economy.

I urge you modify the proposed Basel III regulation to eliminate the unrealized gains/losses on AFS securities inclusion in the capital calculation, to eliminate the exclusion of existing TRUPS and subordinated debt from the capital calculation and to eliminate the balloon payment clause from classifying 1st lien 1-4 family real estate loans from category 1 for risk weighting purposes.

Sincerely,

Eric Sprink
President & CEO