

BANK OF STOCKTON

- Divisions -

MODESTO COMMERCE BANK - TURLOCK COMMERCE BANK - ELK GROVE COMMERCE BANK

Office of the President

May 15, 2013

Technical Director Financial Accounting Standards Board 401 Merritt 7 PO Box 5116 Norwalk, CT 06856-5116

> RE: Proposed Accounting Standards Update Financial Instruments – File Reference No. 2013-220

Dear Technical Director:

Thank you for allowing us to formally comment on the proposed Accounting Standards Update – Financial Instruments. Of particular concern is the proposed treatment of equity securities and the requirement to measure of an equity investment at fair value with all changes in fair value recognized in earnings unless the investment qualifies for the equity method of accounting or results in consolidation (825-10-35-13). The following demonstrates the potential harmful impact to the Bank's business model pertaining to investment in equity securities. Our recommendation is either scope out equities from this proposed accounting treatment and continue to allow unrealized gains or losses to continue to be adjusted through other comprehensive income or allow equity securities to use the Business Model parameters of 825-10-25-25 and illustrated at 825-10-55-28 without first passing the Contractual Cash Flow Characteristics test in 825-10-25-17 through 24-28.

Bank of Stockton was formed in 1867 and operates 16 branches in the San Joaquin Valley region of California. We are the oldest, locally owned, state-chartered bank in California operating under our original charter and have grown to over \$2 billion in asset size. We are a substantial corporate citizen to the communities we serve and have donated tens of millions to local charities over our 146 year history. We have been able to achieve this success through conservative management and demonstrating our strength and stability through our financial performance. Much of our success is through prudent

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investment strategies developed under a specific business model we refer to as "The Municipal Bond Substitute Program."

Investment in equity securities was being conducted for years under specific state powers and was further augmented when the FDIC allowed the Bank to continue its strategy set forth in 12 C.F.R § 362.3(b)(4). Over time we were granted the approval to invest 100 percent of our tier 1 capital (at cost) in equity securities. The equity security portfolio represents more than 50 percent of our investment portfolio and has become a substantial asset in generating income, representing approximately 47 percent of pretax income. Even though our equity portfolio is relatively small in comparison to our total assets, the potential volatility on earnings would be significant if we were required to report unrealized gains or losses through the income statement.

BUSINESS MODEL: The Municipal Bond Substitute Program

The philosophy behind our Model is derived from years of understanding the potential revenue a well managed investment portfolio can generate. Historically, banks utilized revenues from municipal bonds to enjoy the higher tax free income. However, we determined that a well diversified equity portfolio of dividend producing stocks would produce a much better return on investment than municipal bonds especially given changes in the tax regulations pertaining to municipal bonds that evolved over time. As such the total return profile for municipal bonds was no longer as attractive to us as the tax benefit received through dividend income from equity securities.

The objective behind our investment philosophy is to employ high-yielding equities with the attribute of consistent dividend growth in lieu of fixed-income securities. The strategic attraction is a consistently rising income stream from dividend increases, which substantially adds to the compounding process. The same dividend growth enhances the upside performance of these equities and serves to cushion downside movement when interest rates rise. Furthermore, because of the Dividend Received Deduction qualification of such income the tax effective yield of the cash flow from dividends is accentuated.

As of March 31, 2013, our equity portfolio had a market value of \$281.7 million with a cost basis of \$196.3 million, for an unrealized gain of \$85.4 million. Our concern is accounting for the fluctuations in market value through the Bank's earnings. Because we do not actively trade these securities and primarily hold them for dividend return, it is misleading to users to present the changes in fair value through earnings. We agree with carrying these equity securities at fair value but believe management's business model should be the guiding principle, as is the case under U.S. GAAP. We also observe with the FASB's changes to comprehensive income presentation, comprehensive income (which does include changes in fair value for equity securities currently classified as available for sale) is more prominently displayed such that users are not misled.

Table 1: Bank of Stockton – Equity Portfolio Analysis below demonstrates the volatility in the market value of our equity portfolio over time. The table depicts one point in time (December 31st) annually.

Table 1
Bank of Stockton
Equity Security Analysis
(in thousands of dollars, 000's)

As of December 31,	Cost Basis		Market Value		Unrealized Gain or (Loss)		Percentage Change in Gain or (Loss)	
2012	\$	185,382	\$	243,905	\$	58,523	-2.21%	
2011	\$	186,349	\$	246,197	\$	59,848	112.25%	
2010	\$	158,684	\$	186,881	\$	28,197	54.11%	
2009	\$	134,054	\$	152,351	\$	18,297	1543.94%	
2008	\$	96,289	\$	97,402	\$	1,113	- 98.91%	
2007	\$	143,621	\$	245,543	\$	101,922	1.46%	
2006	\$	142,664	\$	243,117	\$	100,453	14.64%	
2005	\$	136,272	\$	223,899	\$	87,627	6.90%	
2004	\$	128,299	\$	210,270	\$	81,971	16.38%	
2003	\$	124,466	\$	194,897	\$	70,431	190.11%	
2002	\$	101,048	\$	125,325	\$	24,277	-56.07%	
2001	\$	101,304	\$	156,573	\$	55,269	-13.56%	
2000	\$	99,498	\$	163,439	\$	63,941	47.85%	
1999	\$	95,284	\$	138,532	\$	43,248	-14.87%	
1998	\$	83,900	\$	134,700	\$	50,800	83.92%	
1997	\$	80,927	\$	108,547	\$	27,620	160.42%	
1996	\$	75,484	\$	86,090	\$	10,606	-61.77%	
1995	\$	42,267	\$	70,009	\$	27,742	119.97%	
1994	\$	39,026	\$	51,638	\$	12,612		

Referring to the Table above, the volatility of unrealized gains are substantial and would only be exacerbated by more frequent reporting which at a minimum must be performed quarterly through call reporting. The difficulty in explaining to various constituencies the large fluctuations in earnings would be extremely challenging especially to our depositors. The main focus of financial reporting for our industry is net income or earnings per share and return on assets. Many of the peers we are compared to do not have equity portfolios that would cause fluctuations in earnings resulting from the proposed fair value reporting changes. The potential negative impact to report such fluctuations in earnings would be devastating to our customer base as the potential for misinterpretation is high. The stability of earnings is critical to our financials success and has been extremely valuable to us over the last five years.

Our success has been our ability to provide consistent earnings over time, 146 years. Strength and stability is very much derived from our ability to manage during economically challenging times. Of grave concern would be a public announcement of

losses, even more than fluctuations in capital. The proposal would negatively impact our reputation given the 100 percent certainty that the market value of our equity portfolio will be extremely volatile over the next few years and into the future which will cause extreme fluctuations in earnings.

Table 2: Bank of Stockton – Equity Portfolio Potential Earnings Impact details the historical impact from market fluctuations if we had accounted for changes in fair value through the earnings.

Table 2
Bank of Stockton
Equity Portfolio - Potential Earnings Impact
(in thousands of dollars, 000's)

As of December 31,	Unrealized Gain or (Loss)		Change (Impact to Earnings)	Net Income (Actual)	Net Income (Adjusted for Proposed Change)	Percent Change to Net Income
"						
2012	\$	58,523	-1,325	16,801	15,476	-7.9%
2011	\$	59,848	31,651	13,670	45,321	231.5%
2010	\$	28,197	9,900	13,054	22,954	75.8%
2009	\$	18,297	17,184	7,860	25,044	218.6%
2008	\$	I,113	-100,809	12,350	-88,459	-816.3%
2007	\$	101,922	1,469	28,785	30,254	5.1%
2006	\$	100,453	12,826	28,373	41,199	45.2%
2005	\$	87,627	5,656	24,122	29,778	23.4%
2004	\$	81,971	11,540	21,056	32,596	54.8%
2003	\$	70,431	46,154	11,809	57,963	390.8%
2002	\$	24,277	-30,992	14,835	-16,157	-208.9%
2001	\$	55,269	-8,672	14,415	5,743	-60.2%
2000	\$	63,941	20,693	16,344	37,037	126.6%
1999	\$	43,248	-7,552	12,903	5,351	-58.5%
1998	\$	50,800	23,180	8,454	31,634	274.2%
1997	\$	27,620	17,014	8,140	25,154	209.0%
1996	\$	10,606	-17,136	22,142	5,006	-77.4%
1995	\$	27,742	15,130	6,699	21,829	225.9%
1994	\$	12,612	,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,,	3,832	3,832	

What is particularly disturbing and potentially devastating to us or any financial institution holding equity securities would be its inability to manage its investment portfolio utilizing a strategic and effective business model approach. We would inevitably have to make investment decisions that are not congruent with sound investment strategies and will have to diverge from our business model which has proven highly successful over a great many years.

Furthermore, banks unlike other businesses are highly regulated. As such, a bank's financial performance is critical to the success and longevity of its operation. Fluctuations in a bank's earnings have the potential to cause a run on its deposits. This was the experience of many financial institutions during the last five years, particularly in 2008 and 2009. Such potential runs can cause bank regulators to take unprecedented

action, one of which is the closure of a bank. The proposed changes will absolutely produce extreme financial results which would not be representative of true banking operations.

The business model that we have created is an integral part of the financial success of the Bank. Over the last five years the dividends generated from the equity portfolio has allowed the Bank to maintain a respectable return while other financial institutions have been struggling to maintain their profitability. Table 3: Bank of Stockton Income Analysis details the continued importance the Municipal Bond Substitute Program model has on the financial success of the Bank. The tax benefit garnered due to the dividends received deduction increases the importance of dividend income. The current tax effective yield on the equity portfolio is 6.12 percent, a substantial yield in today's investment environment. Compare this to the 25 basis points received on overnight funds and approximately two (2) percent on the ten (10) year treasury. The importance of this source of earnings is critical to the success of the Bank.

Table 3
Bank of Stockton
Income Analysis
(in thousands of dollars, \$000)

	2007	2008	2009	2010	2011	2012	2013 (1)
Pre-Tax Income	\$ 44,946	\$ 18,810	\$ 9,484	\$ 25,217	\$ 21,423	\$ 23,295	\$ 24,000
Dividends	\$ 8,395	\$ 5,852	\$ 6,532	\$ 8,190	\$ 10,046	\$ 10,861	\$ 11,314
Dividends as a % of Pre-Tax							
Income	18.68%	31.11%	68.88%	32.48%	46.89%	46.62%	47.14%

Notes: (1) Projected

REGULATORY CONCERNS

It was previously mentioned that there are a number of regulatory concerns that could be devastating to the success of our Municipal Bond Substitute Program. First, regulators tend to frown upon extreme changes in the financial performance of a bank, as evidenced in Table 1 and Table 2 history would show substantial swings in the Bank's earnings especially if negative earnings were reported caused by unrealized losses from our equity securities portfolio. We do no believe that such fluctuations flowing through capital as other comprehensive income are as concerning to regulators as long as regulatory "well-capitalized" ratios are maintained. Despite the fluctuations through capital, we have always maintained such capital ratios. Second, past data demonstrates that financial

markets fluctuate, and sometimes with great severity. In such times it is almost certain that the regulators would begin to put an inordinate amount of pressure to have us dispose of our equity portfolio as they would determine that such financial performance would not be acceptable. Managing our investment portfolio in such a manner would be ineffective as the buying and selling would be dictated by other than prudent investment strategy. The success of our model is based on a long-term investment strategy and the proposed changes that contemplate accounting for unrealized gains and losses through the income statement could have the potential to operate more with a short-term perspective as regulatory pressures would supersede. Third and most devastating of all, regulators could eliminate our powers to operate this business model which has taken years to build. The elimination of the dividend income produced by the Municipal Bond Substitute Program would be devastating to our financial success.

CONCLUSION

We believe that the proposed changes pertaining to equity securities would be detrimental to our financial success. Not only would it be misleading to the true financial operations of the Bank but it would also produce very inconsistent results as is evidenced in the tables presented above. Rather, we recommend the classification of equity securities be based on the Business Model as described in 825-10-25-25. Doing so would eliminate the various issues presented in this letter. And if a corporation, bank included, operates and holds equities pertaining to a specific business model it should be allowed to report such equity investments utilizing the fair value - other comprehensive income approach. However, if no specific business model is being followed then it might be appropriate to utilize the fair value - net income reporting approach.

Our Business Model has proven successful for many years and our desire to maintain that success is being challenged by the proposed changes. We urge you to strongly consider these comments when finalizing the proposed changes. Again, we appreciate the opportunity to comment on this proposal. Should you have any questions, please contact 209-929-1258.

Very Truly Yours,

Douglass M. Eberhardt
CEO and President