

UMPQUA HOLDINGS

C O R P O R A T I O N

Parent company for Umpqua Bank and Umpqua Investments, Inc

October 22, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
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Delivered via email
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Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
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**Re: Basel III Capital Proposals:
Basel III Federal Reserve Board Docket No. R-1442
Basel III FDIC Docket RIN 3064-AD95, AD96**

Ms. Johnson and Mr. Feldman:

Thank you for the opportunity to provide comment on the Basel III proposals that were recently proposed by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively the "banking agencies").

Umpqua Bank, headquartered in Roseburg, Ore., is a subsidiary of Umpqua Holdings Corporation (NASDAQ: UMPQ). Umpqua is a state chartered bank with 193 locations in Northern California, Oregon, Washington and Nevada and assets of approximately \$11.5 billion. Umpqua Bank has been nationally recognized by *The Economist*, *The Wall Street Journal*, *The New York Times*, *BusinessWeek*, *Fast Company* and CNBC for its innovative customer experience and industry-leading banking strategy. For the past consecutive six years, the company has been included in *FORTUNE* magazine's list of the country's "100 Best Companies to Work For."

Before commenting on the proposed rules and their impact on Umpqua Bank, its customers and communities, some background about the bank's commercial and residential lending is in order.

Umpqua Bank's Commercial Lending

Umpqua Bank is an important leader in the effort to accelerate economic recovery through increased lending to small and mid-sized business customers throughout our four-state

footprint. As a regional community bank, Umpqua Bank has dramatically increased commercial lending:

- In 2011 Umpqua Bank generated a 78% increase in loan production over 2010 in the \$250,000 to \$1 million category.
- In 2011 Umpqua Bank increased loan production 85% over 2010 in the > \$1 million category.
- Umpqua originated more new business loans in 2011 than any year in the company's 58-year history.

However, this record is tempered by several important economic realities:

- Utilization of business lines of credit is currently around 45% -- compared to 55-60% before The Great Recession. The problem is not the availability of credit, but the reluctance of businesses to borrow given great economic, tax and regulatory uncertainty.
- Slow overall commercial lending growth mirrors slow growth in the GDP – *the commercial lending pie is not growing because economic output is not growing*. Financial institutions are fiercely competing for pieces of a stagnant economy.
- Major economic headwinds and uncertainties are holding back recovery, including U.S. fiscal and regulatory policies, and the European sovereign debt crisis.
- Banks are challenged by interest rate compression due to current monetary policy and market conditions. Deposit and loan interest rates are low, creating increasing financial pressure on investors, and small and mid-sized community banks.

Umpqua Bank Home Lending

Building on a foundation of responsible lending focused on our customers and community, Umpqua Bank's Home Lending division has achieved consistent growth, strength, and stability despite the ongoing economic and regulatory challenges faced in the market.

- With a servicing portfolio approaching \$3 billion, Umpqua's Home Lending division ended 2011 with delinquencies of just 1.24% versus a national rate of 8.15%¹. Only 0.3% of our servicing portfolio went to foreclosure, less than a tenth of the rate nationally (3.3%²). Through the end of July 2012, our delinquencies have declined to only 1.09% of our residential loan portfolio.
- Since the start of 2011, we've grown our mortgage lending staff by more than 40%. We've responded to a rigorous regulatory environment by tripling our staff assigned to

¹ Mortgage Bankers Association National Delinquency Survey

² CoreLogic National Foreclosure Report for January 2012

monitoring loan quality and regulatory compliance and leveraged this risk into a competitive advantage.

- With record low rates, 2011 was a record year for loan production. Home Lending increased residential lending volume by 26% over 2010. Eight months into 2012, Umpqua is on track to double our 2011 mortgage lending production. In 2011, home purchase activity increased almost 50% over 2010 and is maintaining that trend into 2012. In addition, we've continued our commitment to new construction lending.

With that background in mind, let me turn to specific facets of the proposals and their impacts on Umpqua Bank, its customers and communities.

Phase out of Trust Preferred Securities (TruPS) as Capital Instruments

Inconsistent with the clear intent of the Collins Amendment to the Dodd-Frank Act, the proposed Basel III capital rule *does not* grandfather Trust Preferred Securities for institutions between \$500 million and \$15 billion. Instead, Basel III requires the phase-out from Tier 1 capital of these instruments for bank holding companies having between \$500 million and \$15 billion in total consolidated assets as of December 31, 2009, permitting the inclusion of 90% of the carrying value of such instruments in 2013, with annual 10% decreases in the includible amount through 2021, until the instruments are fully phased-out on January 1, 2022.

Phase Out Issues:

- In passing the Collins Amendment to the DFA, Congress clearly expressed its intent to grandfather TruPS for institutions between \$500 million and \$15 billion in assets. The banking agencies' proposal essentially ignores this legislative intent, without providing any clear benefit to the safety and soundness of the banking system, while placing a significant capital burden on the community bank sector.
- The TruPS market is dead. These securities are not being issued and the perceived problem associated with TruPS, that they are not common equity, is getting smaller every day, as they amortize over their contract life or are refinanced.

Currently, investors providing capital to a community bank want that capital deployed to support investments in earning assets, primarily loans, and to finance other growth opportunities. Requiring community banks to raise capital to fill a capital hole caused by a change in regulation defeats that purpose and slows the availability of credit in the market.

Recommendation: The proposed rule should be revised to reflect Congressional intent by permanently grandfathering outstanding TruPS for institutions between \$500 million and \$15 billion in assets.

Requiring Unrealized Gains and Losses to Flow through Capital

Basel III proposes unrealized gains and losses on a bank's Available for Sale (AFS) securities to flow through the new Common Equity Tier 1 (CET1). Under current rules, unrealized gains and losses that exist in Accumulated Other Comprehensive Income (AOCI) on AFS debt securities are not included in regulatory capital.

Issues pertaining to unrealized gains and losses flowing through capital:

- The proposed rule is pro-cyclical because it will negatively impact the ability of banks to contribute to economic recovery through commercial and residential lending in a rising interest rate environment. Rising interest rates would put downward pressure on capital levels, potentially causing banks to reduce lending growth or shrink its securities portfolios significantly to maintain capital levels at the new required levels.
- Because of the interest rate volatility of CET1 and Tier 1 capital, it could force banks to maintain ratios of both risk weighted assets substantially above the levels needed in order to avoid the capital conservation buffer.
- This provision could limit a bank's use of routine asset-liability management tools, and could force banks into much shorter term government backed assets to limit the price risk to regulatory capital from market interest rate changes.

Recommendation: The banking agencies should revise the rule so that unrealized gains and losses, at least on government-backed AFS securities that reside in AOCI, do not flow through regulatory capital. This would allow unrealized losses due to credit impairment to be reflected in capital, but would exclude the interest rate volatility and pro-cyclical impact. As an alternative, riskier non-government backed AFS securities could be allowed to flow through to AOCI.

Deduction of Mortgage Servicing Assets (MSAs) that Exceed 10% of an Institution's CET1

Under the proposed rules, banks are required to deduct all Mortgage Servicing Assets (net of deferred tax liabilities) that exceed 10% of its CET1 (15%, when aggregated with deferred tax assets and investments in common stock of an unconsolidated financial entity). In addition, the amount below the 10% threshold will receive a 100% risk weight (and eventually 250% beginning 2018).

A mortgage servicing asset is the right of a bank to service mortgage loans owned by others. Institutions of all sizes sell mortgage loans they originate to third parties like Freddie Mac and Fannie Mae and retain the right to service those loans. Umpqua Bank is no exception. Of the approximately 17,000 outstanding mortgages originated by the bank, approximately 14,000 are owned by investors and serviced by Umpqua. (The other 3,000 are retained in portfolio and also serviced by Umpqua.)

We retain servicing so our customers have a relationship with us -- as the bank that originated the loan rather than the distant third party that owns the mortgage. This has allowed Umpqua to be the "single point of contact" and helped keep foreclosures to three-tenths of a percent, and defaults to around one percent, well below regional and national averages, as noted above.

Issues Related to Deduction of MSA:

- Servicing loans is a specialty of many community banks, including Umpqua. Mortgage servicing assets could exceed 10% of CET1.
- The deduction of MSAs that exceed 10% of a bank's CET1 capital combined with the high (and in 2018 punitive) risk weight could severely impact some community banks, perhaps even lowering their capital levels below well-capitalized status.
- Based on the capital treatment, some banks may choose to exit the mortgage servicing business, negatively impacting long standing customer relationships, reducing fee income, and further consolidating the servicing industry. We don't need rules that further the concentration of mortgage origination and servicing in the large money-center banks.
- Current rules already impose a 10% haircut on the fair market value of readily marketable MSA's that are included in regulatory capital. Imposing this new requirement will further impact U.S. banks beyond the 10% requirement of Basel III.

The unintended result of this proposal is that Umpqua Bank and other community banks will be limited in their ability to service their customers' mortgages, provide the single point of contact, and build the relationships which have allowed us to avoid foreclosures to an impressive degree. This is an unfortunate case of government regulation acting at cross purposes.

Recommendation: There should be no deduction from capital of MSAs. The deduction would undermine not just the bank's capital, but sound housing policy.

Treatment of High Volatility Commercial Real Estate (HVCRE)

The proposed capital rules would assign a high risk weight of 150 percent to exposures defined as HVCRE. Any bank that has or will finance the acquisition, development, or construction of a commercial real estate project will be defined as HVCRE unless the borrower has contributed capital *in the form of cash*, or unencumbered *readily marketable assets*, or has paid development expenses out of pocket of at least fifteen percent of the real estate's *appraised as completed value*.

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Using "as completed" instead of "project cost" or "stabilized value" adds unnecessary uncertainty to this definition. "As completed" fails to address tenant improvements; leasing commissions; and interest expense after completion. As a result, this provision would require a higher percentage of cash to total cost than the required fifteen percent. Further, there is no definition of the term *readily marketable assets*.

HVCRE Issues:

The proposed rule punishes long term holders of land whose cost basis is very low relative to current market value and it also punishes those who have obtained entitlements or generated leases that greatly increase the value of their property. The risks associated with this type of loan should be supervised through the regulatory examination process. One size cannot possibly fit all.

Recommendation: We believe the proposed rule should use "project cost" to define the borrower's equity requirement. In addition, the borrower should be able to include appraised equity, not just the cost of land, in the 15 percent equity requirement.

In conclusion, we appreciate and support the agencies' goal of ensuring adequate capital for all banks. However, an international agreement, designed for large international institutions, is not the correct approach for the regulation of community bank capital. The unintended consequences will damage or prove fatal for many safe and sound community banks that are often the sole source of commercial and residential lending and other bank services to customers and communities throughout the United States.

We have touched on only a few of the major issues presented in the proposed Basel III that negatively impact Umpqua Bank and many others. The answer is not a bright asset line defining community banks, but an appreciation for the differences in practices, not size, of community banks from larger and internationally significant institutions. If I can provide further information, please contact me at stevenphilpott@umpquabank.com or at 541-434-2997.

Sincerely,



Steven L. Philpott
Executive Vice President/General Counsel