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Via Email to arrc@ny.frb.org

February 5, 2018

Alternative Reference Rates Committee (ARRC)
Board of Governors, Federal Reserve System
New York Federal Reserve

Re: Consultation Response – New Originations of LIBOR Bilateral Business Loans

To the Members of the ARRC:

Please accept this letter as the internally coordinated response from Umpqua Bank (the "Bank"). The Bank's commentary on the "ARRC Consultation Regarding More Robust LIBOR Fallback Contract Language for New Originations of LIBOR Bilateral Business Loans" follows.

Background

As a community financial institution with $26.9 billion in assets, we have approximately $8 billion or 40% of our loan portfolio referencing LIBOR. The composition of this exposure includes Multi-family loans, Residential mortgages, Commercial real estate mortgages, and Commercial & Industrial (C&I) lending. Our C&I lending includes both bilateral loans and syndicated credits. In addition to the on-balance sheet exposure, we also facilitate derivative transactions on behalf of our commercial clients.

Approach to Fallback Proposals

(Question 1) The Bank has reviewed the ARRC's proposed adoption of business loan fallback language and, of the options presented – amended or hardwired – we generally prefer the hardwired approach. However, we have concerns about this approach as presented; and would look to obtain a clearer understanding of the proposed SOFR Term Option, Compounded SOFR, the Replacement Benchmark Spread mechanics, as well as the impact of ISDA and ARRC deviating from each other (should that occur) and the influence that may have on lenders' approaches. We wish to highlight that we view the inclusion of negative consent by Required Lenders in the hardwired approach as a positive. The Bank currently uses the negative consent amendment approach. Until a replacement reference rate is selected an amendment will need to be used to update existing loan documentation.

(Question 2) We're mostly concerned about Bilateral loans with a related swap product.

Triggers

Pre-Cessation Triggers

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(Question 3(a)) The Bank supports the use of the three opt-in triggers (3, 4, and 5) to reduce risk by promoting a reduction in LIBOR-based loans prior to a LIBOR discontinuance, as this would allow lenders to better manage their document/note conversion workloads. Given our size and complexity, this is less of an issue for syndicated credits, but is an extremely important consideration for the thousands of bilateral loans in our portfolio that will be affected.

(Question 3(b)) Our primary concern with the triggers is the undetermined consistency between the loan and the swap trigger language. ISDA and ARRC need to provide a clear path forward. Clients are currently worried about any potential mismatches.

(Question 3(c)) If pre-cessation triggers are not included, we would need to have the loan amended or face the regulatory and legal risk (and possibly underwrite the additional risk). We would worry that lenders or the borrower may disagree about timing, risk, or other elements which would make it difficult to push through an amendment.

Credit agreements do currently contain provisions to allow us to pick a new rate to replace LIBOR; however, smaller clients could consider the language initially unreasonable for the borrower or have us creating a synthetic LIBOR, which is not ideal. Client education about the industry changes is important to mitigate client concerns. Governing body and regulator communication to the public could be another opportunity to inform borrowers and potential borrowers.

Lenders may want to consider having another index (such as fed funds, or base) as a hardwired backup in the likelihood of triggers 3, 4, & 5 and lenders/borrower cannot agree to amend.

Early "Opt-in" Triggers

(Question 4(a)) The Opt-In approach is appropriate to include. It allows us to work through the number of loans that need to be transitioned to the updated documentation over time. It would be an operational struggle to notify and update everyone in a compressed period.

(Question 4(b)) The Opt-In approach should be included in both the hardwired and amendment proposals.

Other Triggers

(Question 5) Another possible event that could require a trigger is a disconnect between the ARRC and ISDA recommended approaches which could create a mismatch between the loan and the swap.

Replacement Benchmark

Step 1. Forward-Looking Term SOFR

(Question 6) The Bank has concerns about the use of a forward-looking term SOFR as the primary fallback for bilateral loans referencing LIBOR when derivatives reference overnight versions of SOFR. Ideally, term point availability between credit and traded products should be aligned. Banks may lose revenue and customers/borrowers might be exposed to **more** interest rate risk if a disconnect makes it less attractive to

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obtain a derivative hedge. The Bank prefers a forward-looking term rate with the same or similar (but aligned with swaps) term-points as currently available with LIBOR, if possible.

(Question 7) Yes, if options are not available then the lender must be allowed and able to clean up unavailable options, and we prefer option "i" as suggested. We have concerns about Term SOFR and our operational ability to reasonably interpolate rates. An interpolation process would increase the operational risk to interest rate setting. To be successful in interpolating interest, loan/accounting systems would need to be updated to allow for efficient and continuous operation. In such a case, it is recommended that ARRC and the regulators perform outreach to industry technology vendors in advance of LIBOR retirement so that stable platforms exist for banks to leverage. As the discussion around Term SOFR progresses we may be willing to accept an interpolated rate as well as issue them.

Step 2. Compounded SOFR

(Question 8) The Bank agrees that Compounded SOFR should be included as the second step in the Replacement Benchmark Waterfall but, as described in the September 24, 2018 ARRC Consultation, a new calculation methodology would increase the operational risk to interest rate setting due to the extra process needed in performing a calculation. To be successful in calculating interest in arears, loan/accounting systems would need to be updated to allow for efficient and continuous operation. In such a case, it is recommended that ARRC and the regulators perform outreach to industry technology vendors in advance of LIBOR retirement so that stable platforms exist for banks to leverage. Compounded SOFR raises several large considerations for us:

- It is largely driven by what ISDA does;
- Impacts to a bank are a function of its level of volume/activity in its swap program; and
- Particularly for bilateral loans, we want the agreements between credit and traded products to be aligned.

(Question 9) A Compounded SOFR in advance is preferred. A lack of interest rate clarity could cause borrowers to start looking toward daily floating options, which would increase operational work volumes. In addition, our accounting system would likely need a significant – and very costly – upgrade to handle calculations in arrears. Lastly, many banks accrue interest income daily. A daily reference rate recalculation could make the accounting process more difficult.

Other Fallback Rates

(Question 10) In considering the appropriateness of Overnight SOFR as a fallback reference rate for bilateral loans, the Bank would look for consistency with ISDA-implemented fallbacks; and prefers the use of a Compounded SOFR to a more volatile Overnight SOFR reference rate. Overnight SOFR for longer-term loans seems disconnected and could increase interest rate volatility and risk for both bank and borrower.

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The Bank would be reluctant to enter into an agreement with the described Overnight SOFR due to concerns about large interest rate swings, and timing disconnects between interest income resets and our funding strategy/cost-of-funds resulting in reduced net interest margin.

The Bank recognizes that there are fundamental differences between the SOFR "risk-free" rate and LIBOR, which captures credit risk. Day-to-day drivers such as fiscal policy and geo-politics in the news will bring new variables into the daily output. The possibility exists that borrowers may show increased demand for fixed-rate loans to control for volatility. Using a comparison of the daily data for SOFR versus 3-month LIBOR in September/October 2018 as an example, we can see that SOFR increased by more (in bps) than 3-month LIBOR over that time horizon and had a more volatile up/down daily percentage change. SOFR also has issues with large volatility on certain days, which also opens a large risk to banks selecting a poor representation of even a 3-month term.

(Question 11) In contemplating another potential replacement rate for the hardwired approach waterfall, the Bank notes that FHLB interest rates are published across the different FHLB districts for numerous term-points and structures. We posit that a replacement rate based on an aggregated, calculated and statistically "sanitized" (to account for possible variances between rates for the same term-point across FHLB banks) FHLB set of rates might be created and considered as a replacement rate to be used before Step # 3 of the waterfall.

Spread Adjustments

Step 1: ARRC Spread Adjustment

(Question 12) The Bank favors the use of an ARRC-recommended spread adjustment for cash products, including both syndicated and bilateral loans. There will be concerns by borrowers that any spread adjustment will be unequitable or disadvantageous to them. A recommended and publicized ARRC spread adjustment, as well as industry-wide borrower education and outreach, will be key to applying any spread adjustment; and the use of a consistent spread across the industry may alleviate borrower concerns.

Although a spread adjustment is needed, the volatility of SOFR versus today's (as an example) more stable 3-month LIBOR term point would make it a challenge to pick the "right" spread. Ultimately, the goal is to identify a spread adjustment that factors in the difference between the "risk-free" SOFR and the credit risk capturing LIBOR. However, determining this spread adjustment could include qualitative components. While a purely quantitative approach would be ideal, and the easiest to explain to borrowers; there would likely be "noise" in a historical/statistical analysis. For example, the spread between 3-month LIBOR and SOFR has decreased since 6/1/18 from 51bps to 26bps as of 10/16/18. Was this driven by SOFR process/calculation refinements, the Treasury market, or a change in relationship between financial institution credit risk and Treasuries? More data will be needed to ensure the credit spread selected doesn't punish the borrower or the bank.

Step 2: ISDA Spread Adjustment

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(Question 13) The Bank does not consider a spread adjustment applicable to fallbacks for derivatives under anticipated ISDA definitions appropriate. We do not favor using a spread adjustment that is fixed, or one that fixes based on a trigger event, as that event could occur on a date such as a quarter end, which may not be a reasonable adjustment.

Other Spread Adjustments

(Question 14) In consideration of other potential spread adjustments, the Bank concludes that the spread adjustment will need to be published on a trading screen or public and frequently updated platform. Interest rates set offline and independently by lenders, the agent, etc. may not work, particularly on derivatives and syndicated loans.

The Role of the Lender

The Bank agrees with the proposals to require affirmative consent of the Required Lenders to be by class in selecting a replacement rate through the amendment or "opt-in" amendment processes under the amendment approach; but notes that negative consent may be preferable in the "opt-in" process.

(Question 15(a)) Yes, we will work with borrowers to identify the best solution for them, while allowing the Bank a to control interest rate risk and operational stability. We would prefer the adjustment spread to be mechanical in nature and something universally applied (launch point adjustment to LIBOR). Otherwise, the LIBOR retirement will become a widespread renegotiation of both reference rate and spread that could create disruption in the credit market.

(Question 15(b)) No, generally we would prefer that the trigger decisioning is standardized and centrally communicated. However, in regard to the Opt-in trigger, we would work with the client to determine if it's their best solution.

(Question 15(c)) Yes, we would be willing to select screen rates where reference rates are found. However, the cost to access the screen rates is a consideration.

(Question 15(d)) Yes, we are willing to interpolate loan rates; however, as previously stated, there are significant operational and technological considerations to make it a repeatable and well-controlled new process.

(Question 15(e)) Yes, we are willing to execute technical or operational amendments in order to administer the replacement benchmark. However, frequent amendments could be operationally disruptive and costly to either/both the Bank and the client.

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(Question 16) Yes, we would prefer that the lender can conduct equitable changes supported by the borrower's negative consent.

(Question 17) Yes. Operationally we need reference rates to be efficiently published so that we can easily integrate rate changes into our loan and accounting systems. While we could leverage access to online sources, it would be easier to use rate screens and publish change logs and alerts for our operations staff. Rate screens are generally more predictable then other non-vetted sources. We can also attempt to save on costs when rates are published by a single provider instead of having multiple providers to pay. We also firmly believe the "modifier" or spread adjustment needs to be published so that all lenders are on the same page and it would possibly allow for it to be included in the ISDA which would make it possible to hedge the entire rate. In addition, published rates would seem more transparent to borrowers.

(Question 18) We believe it may be more appropriate to give a small window for "corrective" updates to be made under similar rules as the initial change; market standards do change over time generally, and we tend to just need to catch those via the nearest amendment point that comes up, rather than trying to force a change. A possible option would be for a one-year window for updates and corrections.

Operational Considerations

(Question 19) The Bank has major operational concerns about converting a large volume of loans in a limited timeframe. First, it is a system and manpower challenge to update 100% of legal documents in a timely manner with minimal interruption to the loan payment process. Specific challenges include:

- The coordination of changes and signatures on amendments.
- Archiving old versus new documentation.
- Personnel and IT system costs to support SOFR conversion.
- Staff could be stretched thin to support SOFR conversion of existing loans versus originating new loans; or servicing existing loans for non-SOFR related reasons.
- We also are concerned that clients will see this as an opportunity to negotiate more favorable terms (credit, collateral, payment) after funds have been extended. Ideally, the LIBOR to other rate conversion is equitable to both sides at the point of transition, and impacts are minimal. Thereafter, the new reference rate will adjust in due course of market changes to that reference rate.

(Question 20) Proactive and advanced notices, education, and open communications are important during this process.

Hedged Loans

(Question 21) A disconnect between the loan and the swap could lead to additional interest rate risk and net interest income volatility. Hedged borrowers could find themselves needing to pay to terminate hedges if the costs begin to outweigh the initial planned benefit.

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(Question 22) ISDA Definitions would likely be preferable for the ongoing operations of interest rate swaps, given potential lack of pricing, liquidity and valuation support for non-ISDA supported swap contracts.

(Question 23) It would not be operationally practical for us to align only the hedged portion of a loan. Swaps are transferable and not necessarily linked to one specific loan in which a borrower has multiple loans and swaps. Loan agreements themselves typically do not reflect which portion is hedged or unhedged.

General Feedback

(Question 24) The Bank would appreciate the ARRC's consideration of additional provisions in the fallback language proposals to better facilitate bilateral loan originations. Stronger codification of the consequences of lenders and/or /borrower refusal of the new index, i.e., the syndication falls back to a rate that lenders accept today. This "emergency" fallback could also be an opportunity to take out any dissenting lender(s) as if they were a non-consenting lender generally.

(Question 25) The Bank offers the following additional feedback regarding the SOFR process for consideration:

Given the LIBOR dislocations and operational risk with the current LIBOR process, it is understandable that SOFR has been identified as a solution to remove/mitigate the risk to future financial/credit market disruptions. However, it is the Bank's opinion that, as presented, the SOFR process is missing several key components to make it operationally equivalent, transparent, and efficiently executable to banks and borrowers as LIBOR is today.

The limited historical data for SOFR indicates changing relationships with LIBOR; and illustrates some volatility that LIBOR does not have currently. SOFR is a new, somewhat volatile or less understood rate in comparison to the existing LIBOR rate, which was volatile in the past; but has somewhat more market understanding and a comprehensive forward-term framework.

Unknown variables such as U.S. fiscal policy, U.S. dollar demand, and Fed actions along the Treasury curve (now and in the future) create more uncertainty for the use of SOFR. While it is clear LIBOR has flaws and could benefit from more automation and controls, SOFR does not definitively appear to be a less volatile option at this point.

Lastly, if Term SOFR (with generally equitable term-points to LIBOR) is not available and the suggested SOFR calculations/interpolations would need to occur, ARRC and the regulators need to engage information technology vendors to update systems and functionality so the transition is seamless. While banks will work with vendors on these changes, another powerful voice through the governing bodies could push change faster than the voice of smaller banks alone. Otherwise, there could be a disruptive period of early-on manual processes to adopt the change until technology vendors evolve their systems. Manual or less-than-ideal temporary automation would increase operational risks and could be disruptive to client needs and the credit markets.

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We appreciate this opportunity to share our comments; and invite the ARRC to contact us for discussion or additional information.

Sincerely,

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