From: Stephen Lange Ranzini

Proposal: 1442 (RIN 7100-AD 87) Regs H, Q, & Y Regulatory Capital Rules

Subject: Regs H & Y Regulatory Capital Proposals

Comments:

Summary

University Bank would be negatively impacted by the Basel 3 capital proposal and would have to greatly reduce the amount of lending it does to ensure it complies with the new regulation. The new regulation is unsound public policy, flawed intellectually and should not even be applied to community banks like ours which are not active in international business.

Background

University Bank is the 8th highest rated bank headquartered in Michigan according to the IDC Rating agency, with a rating of 289 out of 300. Our Tier 1 capital exceeds 10%, our earnings as a percent of assets put us in the top 20 banks nationwide, and our asset qualify far exceeds our peer group. University Bank has 309 employees, making us the 9th largest bank headquartered in Michigan. Our largest division, Midwest Loan Services, is a business process outsourcer of mortgage services to 4.0% of the 7,535 credit unions in the U.S. Midwest Loan Services grew 29% per year on average for the past thirteen years in the value of mortgage loans subserviced to over $11.6 billion. Our retail mortgage origination operation originates on average $70 million per month in mortgages on single family homes, of which about $15 million a month is from Muslims across the United States and $20 million a month is for credit unions for which we are back office loan originators.

Problems with Modeling

We were unable to devote the resources required to model our loan portfolio using all the valuations required. We don't have the staff to do it and the data is not available on our current systems. We have no idea how to estimate the time required to do the loan modeling the proposed regulation requires. It would be a significant problem for us on top of all the other tens of thousands of new pages of regulations that we will have to deal with in early 2013 that impact the residential mortgage business.

In addition, the new rule that requires loans sold to secondary market investors to be carried on our books if there is a buyback clause of up to 120 days in during would have a catastrophic impact on University Bank, perhaps doubling, tripling or quadrupling the amount of risk based assets of the bank, and is not modeled in the ratio analysis below because we couldn't figure out how to do it in the worksheets provided.

Your worksheet is relatively useless to us since the loan portfolio data required to be input is not available from current call reports or our computer systems and we could not determine how the loan origination rule impact could be modeled.

Capital Ratio Impacts on University Bank nts without retaining substantial amounts of earnings in future years. If, as we expect, our country suffers a relapse of the business depression during this timeframe, we may not have sufficient earnings that we can retain to be able to meet the new capital thresholds. Because all banks with assets less than $1 billion do not have access to the capital markets because of the onerous rules imposed on securities sales by the SEC and the onerous rules that have been imposed on the banking industry by the regulatory community, which has destroyed the value of the community banking model from the point of view of Wall Street and the investment community, we would not likely be able to raise any capital to fill the hole (nor would any community bank with assets under $1 billion).

In addition, the new rule that requires loans sold to secondary market investors to be carried on our books if there is a buyback clause of up to 120 days in during would have a catastrophic impact on University Bank, because we originate on average about $70 million a month in mortgages most of which are subject to a maximum 120 day early default buy-back provision in the loan purchase contracts. This could double, triple or quadruple the amount of risk based assets of the bank, and is not modeled in the ratio analysis below. If implemented in the final rule, and we were unable to renegotiate these provisions, we would have to radically scale back or exit our mortgage origination business. Access to loan capital in the communities we serve (SE Michigan, Indiana, the Florida Panhandle and Muslims in 15 states nationwide) would be diminished. We have material market shares in each community we serve, with market shares ranging from #1 or #2 to #10. Using the regulator provided worksheets, we would have the following ratios (please note additionally that we were unable to fill in all fields and could NOT model all impacts of the proposed regulation because of limitations of the worksheet described above, and the fact that some of the data required to be input was not available to us from our current systems, so we estimate the numbers would be materially worse than listed below):

2013

2017

2018

2019

PCA Category

Well

Adequately

Adequately

Adequately

Conservation Buffer Maximum Payout

n/a

No Limit

20%

40%

Leverage Ratio

6.84%

5.56%

5.27%

5.27%

Common Equity Tier 1 Capital Ratio

10.67%

8.74%

8.11%

8.11%

Tier 1 Capital Ratio

10.67%

8.74%

8.11%

8.11%

Total Capital Ratio

11.53%

9.62%

8.98%

8.98%

Capital Conservation Buffer

1.62%

0.98%

0.98%

Major impacts are caused by the following:

Mortgage Servicing Assets (MSAs) $2,927,000

Minority Common Equity Interests now included in Tier 1 Capital $4,147,000

Deferred Tax Assets $1,080,950

Total assets categorized to be eliminated from capital by the proposal* $8,154,950

*A safe harbor of 15% of Tier 1 Capital is allowed. This reduces the

impact by

$1,947,900

Net decrease in Tier 1 Capital Ratio by the proposal $6,207,050

Our Tier 1 Capital Ratio at June 30, 2012 was 10.18%, and our Tier 1 Capital was $11,986,000. The proposal will eliminate 51.8% of University Bank's Tier 1 Capital. Because our primary regulator already requires 10% Tier 1 Capital as a minimum to be deemed adequately capitalized, the proposal will cause the FDIC to put severe restrictions on our business. Our counterparties may stop buying our mortgage loans that we originate. Our entire mortgage origination business may have to be shut down as a result.

Limiting Mortgage Servicing Assets (MSAs) in Capital and Penalizing them with 250% Risk Weight

This proposal is unwise, because MSAs are already marked to market quarterly and have a ready market where they are bought and sold. In our case, if we suffer a decline in MSA market values due to a drop in long term mortgage interest rates, over the following six months, the bank's earnings are higher than the amount of the MSA write down we suffer. As a result, declines in the value of MSAs actually improve the bank's net earnings and capital. Penalizing these assets and subtracting them from capital is unwarranted.

The impact of this proposal will be to discourage all banks from holding MSAs. MSAs will be sold to non-banks and the shadow banking system will grow rapidly. This is contrary to public policy. In addition, by discouraging us from securitizing loans ourselves, this will encourage us to sell whole loans servicing released to Wells Fargo Bank, our correspondent. Since Wells Fargo Bank already has a 35% market share of all new mortgages originated, this will increase their market share to unprecedented levels, and because there are substantial economies of scale in the mortgage origination business, this couldgive them a potential monopoly over mortgage origination. This is contrary to public policy. The proposal should be amended to NOT exclude MSAs from Tier 1 Capital. The existing limits on investment in MSAs that prevent a bank from investing more than 50% of Tier 1 Capital. The current rules are sufficient and work well and should not be overturned.

Presently, MSAs are limited to 50% of Tier I capital for banks and 100% for savings and loans, and there is no limitation on the combined total of the three asset classes (DTAs, MSAs and Minority Common Equity Interests). Thus, if a bank is at, above or approaching either the 10% or 15% thresholds, it would either stop producing or buying new servicing assets or price the underlying loans to take into account the deduction from capital.

Lastly, requiring a 250% risk weighting for an asset that is already marked to market quarterly is rather unreasonably punitive. The proposal should be modified to treat MSAs as 100% risk weighting assets. Penalizing them twice further discourages banks from retaining these assets and encourages their accumulation in shadow banking enterprises. The separation of the customer relationship from the originator of the mortgage and community banks, is contrary to public policy.

Limiting Minority Common Equity Interests now included in Tier 1 Capital

An arcane but important problem with the proposed regulation is that it eliminates the ability of banks to include minority common equity interests in Tier 1 Capital. These are now currently allowed when the bank holds more than 50% of a subsidiary. University Bank has three mortgage subsidiaries in which it owns 80%, 80% and 87.5% of the common stock of these subsidiaries. These subsidiaries conduct most of the day to day operations of University Bank, contain most of the operational risk and credit risk and are critical to the bank's health and business plan. I am at a complete loss to understand why the regulators would penalize common stock investments in our bank's subsidiaries that are not held by the bank itself. Common stock is common stock. Why do you care who owns it, because in the event of a business reverse, the common stockholders of the subsidiaries, including the outside investors in those subsidiaries, will share in suffering any loss generated. This capital is truly capital of the bank and greatly underpins the bank's strength.

It is not possible for us to unwind these investments, nor can we sell common stock at our parent holding company level to buy out these minority investors. We attracted outside capital into the bank by selling stakes in these subsidiaries at a time when no one would invest in the bank itself because these subsidiaries have compelling business plans and profits. Many banks have organized their mortgage banking activities through majority owned but not wholly owned subsidiaries, as we did. We were only able to attract the excellent caliber of senior management to these subsidiaries because we were able to offer minority equity stakes to them. These individuals would not have come to work for the bank otherwise. Hiring talent of high caliber is the first and foremost challenge of community banks in remaining competitive, and this new rules discourages that.

Limiting the inclusion of Minority Common Equity Interests now included in Tier 1 Capital is bad public policy because it reduces the ability of community banks to raise outside capital and reduces the pool of capable talent that community banks can recruit to work in their banks. The proposal should be modified to fully include Minority Common Equity Interests now included in Tier 1 Capital so that they remain included in Tier 1 Capital.

Limiting Deferred Tax Assets in a Pool With Other Assets Limited to 15% of Tier 1 Capital

Current capital rules limit Deferred Tax Assets to no more than 10% of Tier 1 Capital. This is a good policy that works well and should be maintained. However, the new proposal to limit Deferred Tax Assets, MSAs and other assets to a 15% pool, where Tier 1 Capital is reduced dollar for dollar once the 15% limit is reached is bad public policy and should be removed from the proposed policy because it amplifies all the problems discussed above. If the asset should qualify as Tier 1 Capital, it should qualify. Further limitations on it are unwarranted if it is a capital qualifying asset, since all the other assets in the pool are also currently limited (for example, MSAs to 50% of Tier 1 Capital).

Proposal to Eliminate Safe Harbor for Buy-Back Provisions In Loan Purchase Contracts of Up to 120 Days

Under the Basel III Standardized proposal, if a banking organization provides a credit enhancing representation or warranty on assets it sold or otherwise transferred to third parties, including in cases of early default clauses or premium-refund clauses, the banking organization would treat such an arrangement as an off-balance sheet guarantee and apply a 100 percent credit conversion factor to the transferred loans while credit-enhancing representations and warranties are in place. Under the current general risk-based capital framework, risk based capital charges do not apply to mortgages once they are sold to third parties, as long as the seller provided representations and warranties to take back mortgages end within 120 days of sale of the mortgages.

Currently, any loan buy-back provision not greater than 120 days in a loan purchase contract falls under a safe harbor that excludes that asset from being included in total assets and risk weighted assets of the bank. The new rule that requires loans sold to secondary market investors to be carried on our books if there is a buyback clause of up to 120 days in during would have a catastrophic impact on University Bank, because we originate on average about $70 million a month in mortgages most of which are subject to a maximum 120 day early default buy-back provision in the loan purchase contracts. This could double, triple or quadruple the amount of assets and/or risk based assets of the bank, and is not modeled in the ratio analysis above. If implemented in the final rule, and we were unable to renegotiate these provisions, we would have to radically scale back our mortgage origination business, since we are unable to raise capital except through retained earnings (all community banks under $1 billion in assets are also unable to raise capital from the investment community). This proposed rule is particularly odious in that our bank has realized very few losses from its mortgage pipeline over the years because of the careful job we do in underwriting each loan twice prior to closing. The bank carries specific reserves for buy-back risk that are more than sufficient to model the impact of this operational risk. No change in the current rule is needed or warranted!

The impact of this proposal will be to discourage all banks from originating mortgage loans except in modest amounts. Because of the onerous and expensive nature of numerous new mandates on mortgage origination, this will place community banks at a severe disadvantage in originating mortgage loans and they will lose significant market share. Mortgage loans will be originated by non-banks and the shadow banking system will grow rapidly. This is contrary to public policy.

Ongoing Limitation of Allowance for Loan Losses at 1.25% of Portfolio Loans

Current regulations as well as the proposed regulations exclude from Tier 2 capital the amount of the Allowance for Loan & Lease Losses (ALLL) above 1.25% of Portfolio Loans. When banks are prudent and building reserves to be conservative, this policy penalizes them and as a result, this policy discourages prudent banking. This is a policy that is flawed and should be changed by removing the cap on ALLL counting towards Tier 2 capital. In fact, the economic provision included in the ALLL, ought to included in Tier 1 Capital. We urge the regulators to change the current and proposed policy in this manner.

Fair Value Accounting Flowing Through to Capital Levels of Community Banks

The proposal requires banks to mark to market all unrealized gains and losses in their bond portfolio, and flow these gains and losses through to Tier 1 Capital.

I've been of the opinion for years that mark to market valuation accounting is at its core, intellectually dishonest.

There is no such thing as a True Value for something. The market, as Warren Buffett enjoys pointing out, swings ever wildly between optimism and pessimism and if it is at True Value for even a minute during these swings it is by accident. In fact there is no True Value for something and since markets come and go, the only anchor of reality is cost.

By having banks and other firms mark to market assets, we just unhinge value from cost and when the crowd is optimistic, the prices are too high and when the crowd is pessimistic the prices of things are too low. Now that the bankers and other investors who have to publish SEC financial statements have learned the truth of this by experiencing the first really big down cycle, they will avoid risk until the bargains are so great that there is no risk and the cycle will begin again because as markets rise, investors will get ever more optimistic, and drive values to bubble levels. Previously, everything was great because firms only accrued gains from mark to market during the bubble phase. If mark to market accounting for securities held by community banks is established, no sane banker (especially banks who are leveraged 10-1 on their equity) will buy any even slightly risky assets and will stay in T-Bills or other safe government debt and the downward spiral of prices and the economy will not abate, the next time a financial panic ensues. Thanks for your role in bringing this highly destabilizing pro-cyclical intellectually dishonest construct more into the core of the banking system. Your latest tweak to the intellectually dishonest construct is also by definition intellectually dishonest. As a result today, all financial statements tell investors, is that investors are pessimistic or optimistic. They don't inform us if the business makes a profit or not. So, through your machinations you have rendered financial statements to be quite useless.

Let's examine carefully an example of mark to market accounting for bonds, to see just how ridiculous it is. The True Value of a CMO based on future cash flows in late 2008 meant it ought to be priced on a 20% yield yet because the market then was very pessimistic, yet the bank was to mark it closer to the "market price" which is just a throw-away bid that some scared of failing later today investment bank threw out there of 25% yield, so the CMO should be marked to market lower than the True Value, or 22% yield somewhat between the two. Ridiculous! Or, maybe the True Value based on the cost of funds, a decent return on equity and the actual risk of loss in the instrument is an 8% yield but because everyone is so scared they demand 15% or 20% or 25% yield, and if they bought it would have to mark it down immediately to 20% or 22%. Ridiculous! If the investor was correct and they made 8% for five years and then got all their money back, if their cost of funds was lower than that they would have a profit. The fact that the market for CMOs priced them at 20%

to 25% less than four years ago and today prices them at yield a fraction of that proves my point that the True Value of a security cannot be determined and marketing to market assets is an exercise in mark to myth.

What's the point of all the mark to market giant profits and giant losses in the interim period other than to generate stock speculation based on waves of pessimism and optimism? They inform us not at all and don't tell us anything useful with respect to the fundamental question of: does the company have a good business model that makes profits. I close my remarks on Fair Market Valuation of Bonds Impacting Capital of Banks with an appropriate quote:

"The things that will destroy America are prosperity at any price, peace at any price, safety first instead of duty first, the love of soft living and the get rich quick theory of life."

- Theodore Roosevelt

We've drifted a long way away from this sound advice. Do we really need to enhance the importance of the get rich quick theory of life in our financial statements and capital accounts? We need to stay with cost accounting for our capital accounts and should revert to cost accounting for our financial statements immediately, too.

Credit Unions Not Subject to the Basel 3 Rules

While we love credit unions and serve 4% of the entire credit union movement in the U.S. as their back office outsourcer for mortgage servicing, the application of the Basel 3 rules to banks and savings and loans, but not to credit unions, makes an unfair and uneven playing field that will over time destroy the community banking industry in the U.S., which is an unwise policy choice. We believe that the best public policy is that credit unions and community banks both thrive. We believe that credit unions AND community banks that have no international operations should both not be subject to the Basel 3 rules. If the poor policy choice is made to subject community banks to the Basel 3 rules, than credit unions should also be fully subject to these same rules.

Bert Ely & Alex Pollack wrote recently in American Banker: "Credit unions, besides being in the same business as banks, have the same structure of mostly small, local organizations. But that industry is not small in the aggregate: Its assets exceed $1 trillion. In other words, the regulators already propose to exempt $1 trillion in banking assets from the bureaucracy of Basel III. To get to $1 trillion in assets, starting with the smallest bank and working upward, it would take about 6,000 banks. Therefore, for Basel III to be logically consistent, you must exempt the 6,000 smallest banks just as you exempt credit unions. Or, alternately, if you do not exempt community banks, then you cannot logically exempt credit unions. If Basel III is applied to community banks, but not to credit unions, then it is not only conceptually and operationally cumbersome and burdensomely expensive, but it is self-contradictory as public policy. The preferred policy is obviously to exempt both of these
very similar cases. To summarize, the complexity of Basel III is irrelevant to 90% of U.S. banks, and should not be imposed on them."

We agree.

Conclusion

The proposal, by significantly raising the capital required to be held by community banks and by increasing the compliance burden on community banks, significantly undermines their business model and will result in a rapid reduction in the number of banks in the U.S. It will dramatically concentrate the origination of residential mortgage loans in fewer hands and grow the role of the shadow banking system. This is contrary to public policy because 10% of the banking assets held by community banks, provide 30% of the small business loans in the U.S. All net job growth in the U.S. comes from small business. By creating the illusion of safety by dramatically raising capital requirements for community banks, the proposal will ensure undermine the safety and soundness of the community banking industry as a whole, cause economic stagnation for years and is contrary to public policy.

It is for exactly these reasons that the typical community bank's stock now trades for 2/3rds of book value. Investors are saying we are all worth more dead than alive. Your new regulation will ensure that outcome. If University Bank, one of the healthiest and most profitable community banks based on its ratios in the U.S. will be so severely impacted by this regulation, imagine the impact on the typical community bank? The people who implement this policy on the community banking industry will go down in the history books as buffoons and blunderers. They will make President Hoover look good. Do you really want that to be your legacy to our country?

Regards,

Stephen Lange Ranzini

University Bank