University Bank

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November 21, 2018

Via Electronic Submission

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation,
550 17th Street, NW,
Washington, DC 20429

Re: RIN 3064-AE91, Regulatory Capital Rule: Capital Simplification for Qualifying Community Banking Organizations

Dear Mr. Feldman:

University Bank[1] is pleased to comment on the Regulatory Capital Rule: Capital Simplification for Qualifying Community Banking Organizations.

1. The Rule's Unfair and Unwise Treatment of Mortgage Servicing Rights (MSRs)

As written, the rule severely discriminates against community banks involved in residential mortgage banking and we believe implements the law in an unfair manner.

For community banks, a key consideration is that as regulation and technology requirements to be competitive have increased substantially, community banks cannot even compete in certain key lines of business without a critical mass and scope of business activity far outside of one principal market.[2]

In particular, in the residential mortgage business, where University Bank specializes, to compete effectively, originators must have at least $250 million a year in closings. This is driven by

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[1] Founded in 1890, University Bank® is the 15th oldest bank headquartered in Michigan. We are proud to have been selected as the "Community Bankers of the Year" by both American Banker magazine and the American Bankers Association and as the second fastest growing business of any type in the Greater Detroit Region by Crain's Detroit Business. As of 9/30/2018, University Bank was managing over $21.6 billion in financial assets for over 125,000 customers and our 394 employees make us the 5th largest bank based in Michigan. University Bank is a state chartered community bank, with on balance sheet assets totaling approximately $265.6 Million. We operate one branch office in Ann Arbor Michigan.

[2] American Banker, "Don't let community banking go from endangered to extinct", by Stephen Lange Ranzini (October 17 2017). The text of this article is appended to this comment letter as an endnote.

regulation. The cost of the technology required to operate compliantly is large[3], and these costs must be spread over many transactions. This means that community banks cannot achieve critical mass to be competitive serving only their primary market area and must originate mortgage loans outside their primary market area.

Another implication is that a moderate level of mortgage servicing rights must be accumulated to be competitive. If a community bank cannot securitize and only sells its residential loans when originated as whole loans to correspondents, it will not achieve as profitable levels of loan origination margin (gain on sale), and in the current environment where margins are compressed a bank that cannot securitize will be not only unprofitable, but uncompetitive. To avoid this, community banks must have the ability to securitize and deliver the loans directly to agencies such as FNMA, FHLMC, FHLBs and GNMA. To do this often requires accumulation of mortgage servicing rights, because not all loan types have co-issue sale of mortgage servicing right (MSR) options available. Once a bank has mortgage servicing rights, it cannot cost effectively sell them in blocks of less than $500 million, or it will achieve a subpar price, and again, make its new loan originations unprofitable, as the estimated fair market value of the MSRs, which is equal to the estimated sales price of the MSRs, must be taken into account when setting pricing for new loan originations. An investment of $500 million in MSRs, is equal to roughly $5 million in the current market.

Last year, University Bank sold a portfolio of MSRs since the penalty it was incurring on its Tier 1 Capital grew too large. These restrictions on the ability of our bank to count Mortgage Servicing Rights towards the bank's capital base caused us to sell over $500 million of Mortgage Servicing Rights to a Wall Street backed hedge fund, which disconnects customers from the bank that originated their mortgage loan to the detriment of those home owners. This disconnection of customers from the bank that originated their mortgage loans is bad public policy.

The proposed rule exempts only community banks that have less than 25% of their Community Bank Leverage Ratio (CBLR) invested in MSRs. Since a minimum $5 million investment in MSRs will typically be required to be competitive in the residential mortgage origination business, this means that any community bank that wants to compete in the residential mortgage origination business that has less than $20 million of CBLR will routinely fail to be exempted from the rule. We estimate that University Bank's CBLR will be about $24.4 million. We currently hold $12.75 million of MSRs, so will not benefit from this rule. Although our bank's equity is $24.8 million, our Tier 1 Capital is currently just $19.3 million due to the massive haircuts to Tier 1 Capital that we must take due to the limits on counting MSRs in Tier 1 Capital.

In addition, the FDIC has an institutional bias against MSRs, and admits this in the proposed rule writing that during the last recession, the market for MSRs was not liquid. The reality is that the market for *every type* of whole loan and even every type of non-agency Mortgage Backed Security was not liquid. One could not have sold *any* portfolio loans at a reasonable price either, and the market would have required a massive haircut to sell portfolio loans.

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[3] Our community bank's mortgage loan origination software cost $1.8 million and requires constant changes and a staff of three full-time programmers, and a compliance department with three full-time compliance officers including a compliance lawyer to support it. The software we use is used by 70% of mortgage loan originators industry-wide.

On the other hand, the FDIC has repeatedly warned banks of the risks of investment portfolios that rely on long term fixed rate investments, in an era of unusually low long term interest rates. MSRs are among the few assets that rise in value when long term interest rates rise. Our bank's ALCO analysis has indicated for years now that the optimum mix of MSRs to reduce our bank's exposure to fluctuations in long term interest rates is closer to an amount that would be equal to 70% of our Tier 1 Capital. Since the regulation is so punitive towards MSRs we carry a lower amount. If we carried a higher level it would actually decrease our residual enterprise risk. The proposed capital rule encourages banks to structure their portfolio of risks in a non-optimal manner to obtain this regulatory benefit.

We do not believe that the FDIC should use this rule to manage banks' ALCO risks. There are better ways to do that through the examination process using the Sensitivity to Market Risk CAMELS component. The data available through the long form Risk-Based Capital calculation is insufficient to correctly even estimate a bank's ALCO risks to changes in interest rates. Our own bank is a good example of this. Our Call Report data is useless to the FDIC to calculate our ALCO risks. It is only through our quarterly ALCO Reporting, which is subject to the examination process to ensure it is a good model and useful for correctly managing a bank's risks, that our bank's ALCO risks can be correctly measured and managed.

Lastly, because the purchase of a home is the largest transaction a customer will engage in during their lifetime, if community banks are unable to effectively compete for residential mortgage originations, you are condemning community banks to destruction, a path already 75% completed.[4]

The new capital rule must take this into account when setting exemptions. Therefore, we recommend the following additional rule:

#1) Do not penalize community banks for originating residential mortgage loans, which requires them to build a portfolio of mortgage servicing rights. Exempt the first $5 million of investment in MSRs from the calculation and do not include any MSRs not counted as capital for Tier 1 leverage purposes.

While calculating this would be a minor burden, it would be far preferable to do this for our bank than to be excluded from the benefits of this rule.

2. Comments on the Off-Balance Sheet Qualifying Criterion

It is unclear from the proposed rule whether or not sales of when issued Mortgage Backed Securities, contracts to sell residential loans held for sale or in process of origination and other traditional hedging techniques related to residential mortgage origination hedging would be included or not be included in the 25% off-balance sheet the qualifying criterion. Since these transactions lower credit risk of a bank, and do not increase it, we believe the FDIC should welcome this activity and not penalize it.

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[4] Ibid.

In our case at University Bank, we routinely have about $70 million of loans held for sale hedged or sold pending delivery and during seasonal high points as much as $100 million, and have on balance sheet assets totaling approximately $265.6 Million. Therefore, University Bank would not qualify for the exemption under the proposed rule if the rule is implemented to penalize banks involved in mortgage banking hedging and loans sales. Engaging in this activity dramatically lowers University Bank's interest rate risk. Even in major interest rate market shifts, we have had nominal impact on our profits, because we engage in a prudent hedging strategy to neutralize the risk of holding long term fixed rate residential mortgage loans until we can deliver them to the secondary market.

Therefore, we recommend the following additional rule:

#2) Do not penalize community banks for originating residential mortgage loans, which requires them to sell loans held for sale and engage in routine pipeline hedging. Exempt these contracts from the pool of assets subject to the Off-Balance Sheet Qualifying Criterion.

3. The Rule's Unfair and Unwise Treatment of Minority Interests (equity of a consolidated subsidiary that is not owned by the qualifying community banking organization) **by Excluding them from the CBLR**

Common stock investment in a subsidiary of a bank can serve as a source of strength for a bank and a source of new capital. In the case of our own bank, it was indeed easier to raise new capital for our bank's newly formed niche subsidiary of the bank than for the bank itself. Our bank has over $3.25 million of common stock invested by third party investors in a niche mortgage banking subsidiary of our bank that holds over $59 million in assets that under current Basel 3 rules cannot be counted as capital. All 100% of this equity investment can be used to offset any losses incurred at this subsidiary. Ironically, this subsidiary also holds over $9.5 million of the bank's $12.75 million total investment in MSRs.

Last year, the FFIEC banking regulators proposed a Basel 3 Capital rule change that would allow the inclusion of minority interest up to 10% of Tier 1 Capital. While this rule has not yet been implemented, it is our understanding that the rule is highly likely to be finalized early in the coming year, as the comments on this rule change were uniformly favorable, and the regulators have decided to implement it (by at least issuing this rule change for public comment).

It mystifies us why the same approach would not be used in this rule. The FDIC should encourage methods than enable community banks to raise capital. Raising capital for a subsidiary is often easier than raising capital for the bank itself and it should be encouraged and not discouraged.

Therefore, we recommend the following additional rule:

#3) Allow the inclusion of common stock minority interest up to 10% of CBLR, where the subsidiary holds risk weighted assets of at least the amount of common stock minority interest being included.

While calculating this would be a minor burden, it would be far preferable to do this for our bank than to be excluded from the benefits of this rule.

We also note that the proposed rule's treatment of MSRs and Deferred Tax Assets (DTAs) are in synch with the proposed rule not yet finalized that changes their Basel 3 Capital Treatment to enabling their inclusion up to 25% of Tier 1 Capital, so we find it inconsistent to not use the proposed 10% standard of that proposed rule, for this rule, to maintain intellectual consistency between the various rules.

4. Comment on the Proposed CBLR Calibration

Setting a fixed 9% ratio for the CBLR exemption is less than ideal. We believe that the rule adopted should enable the FDIC board to act in a procyclic manner. When the economy is stressed but in recovery, an 8% ratio would be appropriate, to encourage the economic recovery by encouraging banks to lend and expand. When the economy is near the end of the economic cycle (as it is currently), a 10% ratio would be appropriate. This would encourage retention of capital to better survive a downtown. Therefore we recommend that:

#4) The CBLR Ratio should be flexible and in a range of between 8% and 10% and set in a procyclic manner by the FDIC's Board.

5. Comment on Less than 9% CBLR Ratios

The rule proposes the following ratios:

- Adequately capitalized – CBLR of 7.5 percent or greater;
- Undercapitalized – CBLR of less than 7.5 percent; and
- Significantly undercapitalized – CBLR of less than 6 percent.

These ratios are set too high. In an economic downturn historically, banks were deemed to be undercapitalized when their capital ratios were 6% or less. This equated to a CAMELS 3 rating. Under 5% was a CAMELS 4 or 5 rating, depending upon various other factors. The CBLR should mirror this traditional framework and not increase capital ratios for CAMELS downgrades. Banks can quickly see their capital ratios move by 1.5% due to growth and loan losses in a recession. The proposed rule will result in unnecessary regulatory intervention in too many community banks that are actually fundamentally healthy. If these ratios are set too high, it may unnecessarily cause the collapse of otherwise sound community banks. Therefore we recommend that:

#5) The rule should adopt the following ratios:

- **Adequately capitalized – CBLR of 6.0 percent or greater;**
- **Undercapitalized – CBLR of less than 6.0 percent; and**
- **Significantly undercapitalized – CBLR of less than 5 percent.**

If you have any questions about the material presented in this comment letter, I am available to assist you in any way as follows:

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Sincerely,

[redacted]

Stephen Lange Ranzini
President & CEO
University Bank*+ & University Bancorp, Inc.
Ann Arbor, MI USA

* University Bank is a Member FDIC and an Equal Housing Lender. University Bank is a wholly-owned subsidiary of University Bancorp, which is listed on the OTCQB stock market under symbol UNIB. We are proud to be noted by American Banker newspaper as the:

- #3 top performing publicly traded bank in the U.S. in 2017 based on Average ROE;
- #1 top performing publicly traded bank in the U.S. in 2016 & 2015, based on Average ROE;
- #2 top performing publicly traded bank in the U.S. based over the period 2014 to 2012, based on Average ROE.

University Bank's five year average Return on Equity is 19.1% and our Return on Equity in 2017 was 28.3%. University Bank's ten year annual average revenue growth was 32.5%.

+The American Bankers Association, through its Corporation for American Banking subsidiary, has endorsed University Bank's subsidiary, Midwest Loan Services Inc., to provide residential mortgage subservicing services to member banks and their borrowers nationwide. Midwest is known for friendly, responsive service and industry-leading technology that help lenders retain customers, reduce costs and ensure regulatory and operational compliance. Midwest's mortgage customers have 14x fewer complaints than the industry average according to the Consumer Financial Protection Bureau's complaint database.

American Banker

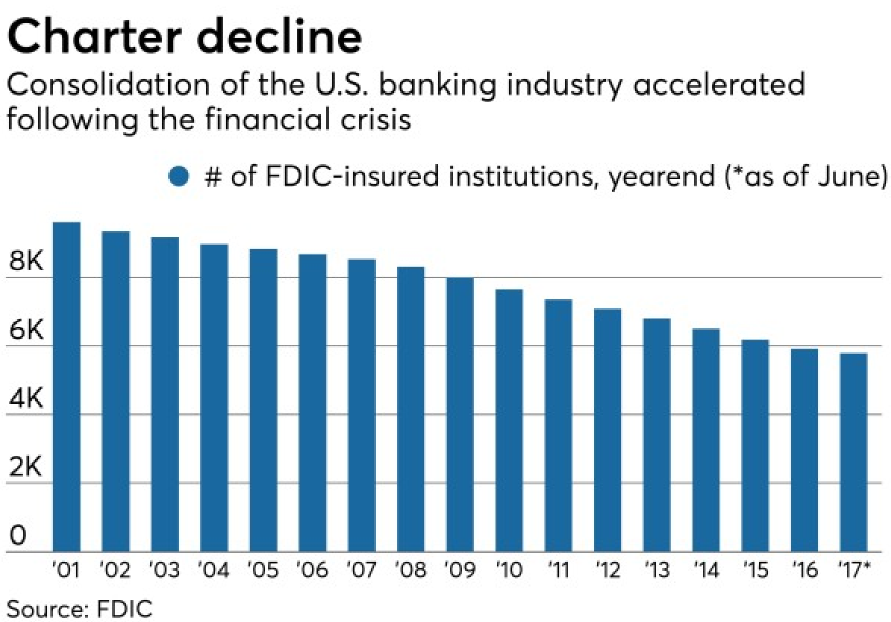
Don’t let community banking go from endangered to extinct

By Stephen Lange Ranzini
Published October 17 2017, 12:00pm EDT

When I entered community banking 29 years ago, bank regulation was focused on two things: The accuracy of financial reports in the bank’s call report, and the bank’s ability to detect and guard against insiders stealing money from the institution.

Back in 1988, the banking industry was still expanding. The number of banks and savings and loans, as well as that for credit unions, was each around 20,000 — and growing every year. The call reports in July 1988 were about 10 pages long versus the over 100 pages our community bank must file today. Some community banks now get to use a “short” form, which runs 80 pages.

The focus of bank regulation today is completely different. Its goal is to ensure that banks don't fail. To achieve this objective, banks must establish committees and follow best practices and complete a lot of documentation of their every move. I met with a customer the other day. It was only the fourth such meeting I have had within the past 12 months. Bank executives have become desk-bound, engaged in constant box-checking and “administrivia.” As expected, this new reality has raised regulatory costs.



Another key factor driving regulatory costs higher is a philosophy that detailed legal disclosures are beneficial to consumers — as best exemplified by mortgage disclosures that now stack six to nine inches high — yet these documents are expensive to create and in the real world consumers don’t actually read them. Yet, to comply and produce all these complicated disclosures, institutions must establish and maintain very expensive systems, much of which have fixed costs and only some are variable in cost.

Because of these rising regulatory and compliance disclosure costs, the median return on equity for FDIC-insured banks in the U.S. has fallen to 9%; there are many banks under $100 million in assets with an ROE below 4%. Since the financial markets require a 9% ROE for investment in bank equity, half the banks in the U.S. are now worth more dead than alive, making them ripe for merger. On average, both one credit union and one bank are sold each business day. The peak of roughly 20,000 banks has fallen to below 5,800.

Why are these low-profit banks and credit unions desirable merger or acquisition candidates? Each regulation has costs that are relatively fixed. For example, if a regulation costs $100,000 a year for a bank to comply and that bank has 1,000,000 transactions, the cost comes to $0.10 per transaction. If a bank has 1,000 transactions, the cost is $100 per transaction. The larger bank can buy the business of the smaller bank, take out the second set of regulatory costs and substantially increase the profit per transaction of the combined bank. To be able to succeed in such an environment banks must seek ever larger volumes of business and achieve economies of scale.

Under this scenario, any regulation is good for the business model of large or acquisition-focused banks and credit unions. To be clear, the number of institutions in the industry was on the decline before the passage of the Dodd-Frank Act in 2010, but that trend continued following implementation of the regulatory reform law. The law supposedly targeted the biggest financial firms, which had brought the economy to its knees with their risky activities, but just look at the response by Goldman Sachs CEO Lloyd Blankfein when he was questioned about the effect the then-still-pending legislation: “We will be among the biggest beneficiaries of reform.”

The current regulatory policy and philosophy drives the growth of ever-larger, harder-to-manage and harder-to-regulate megabanks, while community banks have been left to be picked up by acquirers. Unless those policies change, that trend will persist for President Trump’s entire term in office. Assuming President Trump wins reelection, by the time he would leave office in 2025, there would be only 2,000 banks and 2,000 credit unions left. By then it would be too late to rescue the community banking industry in the U.S.

A policy designed to ensure that banks don’t fail which actually just helps along the failure of 75% of banks and credit unions, is obviously not successful and therefore must be changed.

While it is a laudatory goal to want banks to be so well-run and able to control risks that none fail, in the real world this is a clear policy failure. The system that encouraged the growth of the industry for decades also fostered growth in the number of banks and credit unions. Access to credit from a diverse array of sources at the grassroots level is a strong positive social good and key to the success of the American economy.

Centralizing credit among a few powerful megabanks is not just risky. It’s bad for our economy and slows economic growth rates. It also threatens our democracy over the long term, since money can translate into power and trillion-dollar pools of money can easily warp the political process. While banks and credit unions routinely failed under the old system, more new ones always sprung up and took their place. This cycle of creative destruction was healthy for a dynamic economy.

For large systemically important institutions, preventing failure perhaps makes more sense, and the full scale of current regulation and best practices for the biggest companies is appropriate. However if we want to foster a community banking and community credit union industry in the U.S., we need to radically rethink our regulatory approach.

Stephen Lange Ranzini the CEO & president of University Bancorp in Ann Arbor, Mich.
www.americanbanker.com/opinion/dont-let-community-banking-go-from-endangered-to-extinct