ISABELLA BANK CORPORATION

October 15, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Dear Ms. Johnson:

Re: Basel III Proposals

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

I am writing on behalf of Isabella Bank Corporation ("IBC" or the "Corporation"), a $1.38 billion financial services corporation, and its wholly owned subsidiary Isabella Bank. We are a community bank that serves what is best described as a rural area. Our market consists of several large universities, professional services, light manufacturing, and agricultural production. Our loan customer base is approximately 60% commercial and 40% consumer. Additionally, we sell mortgages in the secondary market with servicing retained; the approximate amount of residential mortgage loans sold and serviced is $306.0 million as of June 30, 2012. We are proud that IBC has been profitable every year since its inception in 1988. Additionally, the Corporation did not participate in the Capital Access program, commonly known as TARP. The Corporation's current Tier 1 capital consists solely of common equity and its only Tier 2 Capital consists of the allowance for loan losses to risk weighted assets of 1.25% (the maximum amount allowable under BASEL).

Residential Mortgage Lending

The Corporation has numerous concerns with the proposed treatment of residential mortgage lending.

Balloon Mortgages

The proposed rule assigns different risk weights to residential mortgage exposures based on (1) whether the mortgage is a "traditional" mortgage (Category 1) or not (Category 2); and (2) using the loan-to-value (LTV) ratio of the mortgage to determine the exact risk weighting. Category 1 mortgages vary from 35 to 100 percent, with higher risk weights associated with higher LTV ratios. Category 2 mortgages range from 100 to 200 percent, with higher risk weights likewise depending on higher LTV ratios. Specifically, the Corporation has concerns with the Notice of Proposed Regulation (NPR) default treatment of all balloon mortgages as Category 2 loans.

1. The preamble to the proposed rule asserts that Category 2 mortgages are subject to higher risk weights because they "generally are of higher risk," whereas Category 1 mortgages "reflect those underwriting and product features that have demonstrated a lower risk of default through supervisory experience and observations from the recent foreclosure crisis." The assertion that balloon mortgages are generally of a higher risk was made without any empirical evidence to support the claim.

2. The Corporation offers a full array of mortgage products including fixed rate Freddie Mac loans, 5 and 7 year balloon mortgages, and 1 year adjustable rate mortgages (ARMs). All loans are underwritten using the same credit criteria. Currently our mix of residential mortgages serviced is 55.0% sold to Freddie Mac and 45.0% are balloon mortgages held on our books, with less than 1.0% in ARM mortgages. The customer's choice of mortgage products is primarily based on:

    - The borrower's perceived cost of the different products.
    - The borrower's long-term intention of holding the real estate being financed.
    - The property's eligibility for financing through Freddie Mac.

    The last factor is of particular importance since many properties in rural areas are ineligible for long-term, fixed-rate financing through Freddie Mac due to property acreage that exceeds the allowable limits, property use (mixed residential and commercial including agricultural), or the inability to meet the strict appraisal guidelines imposed by Freddie Mac. Given the unacceptable interest rate risk of long-term, fixed-rate mortgage loans being held on our balance sheet, particularly in the current historically low interest rate environment, balloon mortgages are essential to meet the financial needs of our customers.

3. With the exception of collateral accepted, IBC residential balloon mortgages are underwritten using the traditional debt to income ratio of not more 28% for servicing housing debt and combined household debt service not to exceed 36%, which criteria is stricter than the criteria used for loans sold to Freddie Mac. The Corporation has historically required LTV not to exceed 80.0% unless private mortgage insurance is obtained by the borrower. While IBC did incur abnormally high charge-offs starting in June 2008, our average loan loss to the balance of outstanding balloon mortgages from June 30, 2008 through June 20, 2012 was 0.74%[1]. This loss ratio is lower than the Corporation's loan charge-off ratio for its entire loan portfolio during the same time

[1] The full analysis of Isabella Bank's balloon mortgage loss history is available to the Federal Reserve of FDIC upon request.

period. Given that the average value of residential real estate in our market has declined by over 35% and the unemployment rate in our market has exceeded the national average during this period, our loss history does not suggest that the Corporation's balloon products are in fact riskier than long-term, fixed-rate financing.

For balloon mortgages, which are secured and subject to extensive underwriting requirements, to be risk weighted at or above unsecured credit card loans, consumer loans, commercial operating and real estate loans, and leveraged buy-out loans defies explanation and would seem to be contrary to stated public policy.

As an alternative to automatically classifying all balloon mortgages as Category 2 loans under the NPR, I suggest that the Banking Agencies consider using the definition of "Qualified Mortgages" as required by the Dodd-Frank Act. While the final definition of a Qualified Mortgage (QM) has not been issued by the Consumer Financial Protection Bureau, the use of the definition would eliminate what appears to be an arbitrary inclusion of balloon mortgages as Category 2 loans and be consistent with public policy.

1-4 Family Residential Mortgages

Another area of concern is the NPR risk weighting treatment of 1-4 Family Residential Mortgages Loans (FRM) and the use of LTV as the sole determination of the risk weight to be applied and the exclusion of any consideration of the credit enhancement provided by private mortgage insurance. At IBC, the primary factors that are considered when underwriting a residential mortgage loan, in order of importance, include:

- The debt to income ratio.
- Credit payment history.
- Net worth.
- Loan to value.
- Employment history.

LTV is only one criterion that is considered when deciding whether a particular loan is an acceptable credit risk and in the case of IBC is less important than the consumer's debt to income and credit history. The liquidation of collateral to satisfy a debt is always considered a secondary source of repayment. For example, a loan with an LTV of 60% is a poor credit if the borrower is unable to service the loan.

An alternative to using LTV as the sole determinant of risk weighting and the treatment of all balloon mortgages as Category 2 would be to consider seasoned residential mortgages, which have a satisfactory repayment record, as automatically qualified as Category 1 loans. A three-year period of satisfactory performance should provide sufficient evidence that the mortgage is not high risk.

IBC typically requires private mortgage insurance (PMI) if the LTV exceeds 80%. The proposal does not recognize PMI "due to the varying degree of financial strength of mortgage providers." The Banking Agencies solicited comment on whether to recognize PMI for purposes of calculating the LTV ratio of a residential mortgage. It is our view that PMI has increased credit availability to credit worthy borrowers and has been instrumental in assisting their access to mortgage loans. PMI provides credit enhancement that plainly reduces the risk of loss on the underlying mortgage. The Corporation also recognizes that the creditworthiness of the insurance provider is a critical factor as to whether an insurer can meet its obligation. Banks may use a variety of factors, including external credit ratings and assessments, to make this risk determination. As provided by the Dodd-Frank Act however, a bank may not rely exclusively on external credit ratings; it must also supplement external ratings "with a degree of due diligence processes and additional analyses that are appropriate for the bank's size, complexity, and risk profile."

Junior Liens

Finally, the proposed treatment of all junior liens as Category 2 loans with loss exposures of 100% or more is unwarranted. Home equity lines of credit and other junior liens are at worst unsecured lines of credit and should be risk rated no higher than unsecured commercial or consumer debt. To compound the issue the NPR would require IBC, if it holds two or more mortgage loans on the same residential property, to treat all of the loans on the property as Category 2 if one of the loans is Category 2. This part of the proposal does not make intuitive or practical sense upon application in practice. How does a second lien behind our first lien make our primary loan any more risky than another institution's second lien? Based on the proposed requirement, IBC would be better off, from a risk based capital point of view, if a different institution holds the junior lien. Since the same underwriting standards discussed above are used to determine if a borrower is a good risk, the risk based capital requirement for these loans should never exceed 100%.

The overall treatment of residential mortgages by the NPR appears to be a reaction to very poor underwriting standards by some institutions that led to the creation of the housing bubble, it's subsequent collapse, and the severe recession the collapse created. While IBC did suffer higher than historical losses on its residential loans from 2008 to 2011, the losses were not catastrophic. Our "secret" was using traditional underwriting standards combined with using appraisers who were conservative. From IBC's point of view, the NPR, as written, is an overreaction to this sad period of the banking industry's history. When the Banking Agencies propose risk weighting secured residential mortgages higher than unsecured consumer and commercial loans, that is an overreaction. The NPR comes at the very same time that the housing sector of the economy is showing signs of recovery. This proposal, if enacted as currently written, may very well lengthen the time it takes for this important sector to recover.

Equity Capital

Capital Standards

IBC appreciates and supports the need for the industry to hold higher levels of capital. Furthermore, it supports the imposition of a common tangible equity to tangible assets leverage ratio (CET1). The NPR requires a 4.50% CET1 minimum with additional 2.50% risk based assets capital conservation buffer. The 2.50% capital conservation buffer also applies to Tier 1 capital and risked based capital. The Corporation is concerned, especially for smaller community banks like ours, that the de facto minimum capital requirement to be considered "well capitalized" by our examiners will become the combination of CET1 and the capital conservation buffer plus an additional "safety" amount over that total which is typical in today's practice. The general perception of the industry has been that smaller banks were never allowed to operate, except under a memorandum of understanding, with capital levels anywhere close to the currently prescribed minimums. Based on historical practices, we are concerned that the imposition of CET1 combined with the conservation buffer will result in banks like Isabella Bank having to hold capital in excess of the "minimum" 7.0% without regard to our risk profile. A more practical approach would be to eliminate the capital conservation buffer, leaving CET1 at 4.5% and raising the Tier 1 and risk based capital requirements to be adequately capitalized.

Allowance for Loan Losses

If the Banking Agencies decide to leave the proposed capital standards, including the imposition of a capital conservation buffer as proposed, then IBC requests that the Banking Agencies remove the limitation on the allowance for loan losses to risk assets of 1.25%. Given that the NPR effectively increases the minimum risk based capital requirements to 10.5% while increasing risk based assets for almost all banks, the arbitrary limitation on the allowance for loan losses appears unnecessary. At a minimum, it would be a more reasonable limitation that the allowance for loan losses be based on a percentage of risked based loans, not assets. The imposition of a limit for the allowance to risk based assets has always been inconsistent with the accounting requirements for the allowance, which is management's estimation of the losses inherent in our loan portfolio.

Accumulated Other Comprehensive Income

The NPR's most troublesome provision is the inclusion of accumulated other comprehensive income (AOCI) in equity capital. IBC would need to prepare for such an eventuality by holding capital of some undetermined amount in excess of the new minimum capital ratios plus the capital conservation buffer. In effect, by not continuing the sterilization of gains and losses on available for sale investment securities, the NPR would impose a new de facto buffer in addition to the capital conservation buffer. IBC's capital could fall due to changes in interest rates below the level needed to avoid the negative consequences for failure to maintain its capital conservation buffer, not due to credit losses but merely as a result of rising interest rates.

ASC 320 Accounting for Certain Investments in Debt and Equity Securities, issued in 1993, changed the accounting for investment securities and was undertaken mainly in response to concerns expressed by regulators and others about the recognition and measurement of investments in debt securities, particularly those held by financial institutions. Accounting oversight authorities questioned the appropriateness of using the amortized cost method for certain investments in debt securities in light of certain trading and sales practices. The Statement required classification of investments as held to maturity (HTM) which is carried at amortized cost, available for sale (AFS) which are carried at fair market value, and trading which are carried at market value. The basic tenet of the Standard is that investments held as HTM could not be sold, with few exceptions. AFS investments could be sold thus providing a source of liquidity. AFS investments are recorded at amortized cost for income statement purposes with unrealized gains and losses due to changes in interest rates recognized through other comprehensive income, with losses related to an issuer's credit worthiness charged directly to net income.

Since the fourth quarter of 2008, interest rates have been at extraordinarily low levels. In general, over the past four years Isabella Bank's non-maturity deposits have increased while loans have increased at a more moderate rate with the excess liquidity invested in investment securities. Mindful of the need for dependable liquidity sources, Isabella Bank has classified all of its investments as AFS. Isabella Bank's investment portfolio as a percentage of assets has increased by 10.0% while loans have declined by a similar amount. IBC invests conservatively with purchased investments primarily consisting of only highly rated municipal bonds and government owned agencies. Isabella Bank currently has unrealized AOCI of $9.0 million or 7.5% of its equity.

The increase in non-maturity deposits as a funding source for investments and loans presents an interest rate risk challenge; interest rates will rise--when and how quickly is unknown. Isabella Bank has been managing this risk through a strategy of extending the duration of its Federal Home Loan Bank borrowings and securing long-term brokered deposits. Isabella Bank is currently asset sensitive. Since unrealized gains and losses of these liabilities cannot be recognized through their sale (unless the entire Corporation is sold), these liabilities will be carried at cost until they mature. The difference in the accounting treatment of investments and liabilities that fund the investments gives rise to the fundamental issue with the NPR treatment of AOCI. It is the accounting treatment of fixed rate AFS investments versus the treatment of fixed rate and term liabilities that fund the AFS investments. The accounting treatment does not recognize the economic reality of the transaction. When interest rates rise, AFS investments will create unrecognized AOCI losses that will be deducted from CET1 without the corresponding gains on liabilities being recognized in CET1.

I believe the reason that the NPR eliminated the sterilization of AOCI is the concern that in the current extraordinarily low interest rate environment banks may be replacing credit risk through lending with interest rate risk through investing. The Banking Agencies' concern ignores the ability of banks to increase their interest rate risk through extending the maturity of their loans or using short term liabilities to fund assets. The isolation and inclusion of one component of interest rate risk in CET1 will distort an institution's capital ratios without capturing the institution's real economic value. If the Banking Agencies decide to include AOCI as part of equity capital, banks will respond by classifying long-term investment securities as HTM eliminating volatility from capital, but at a cost of increasing liquidity risk. If investments are held until they mature their classification as either AFS or HTM does not change the income earned over the life of the investment. In conclusion, given the net market value of bank assets less liabilities (the economic value of the organization) is not impacted by whether an investment is recorded as HTM or AFS, why should the book value of equity for regulatory purposes change as result of an investment classification?

I respectfully suggest that unless the entire balance sheet is "marked to market" the Banking Agencies monitor interest rate risk through their normal exam process or develop a standardized interest rate risk model and set regulatory parameters for interest rate risk.

Respectfully submitted on behalf of Isabella Bank Corporation's Board of Directors.

ISABELLA BANK CORPORATION

Dennis P Angner

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