

The Impact of Standardized Basel II on Michigan Banks

Prepared for Michigan Bankers Association



Executive Summary

- Basel II bank capital regulations are in the news ...

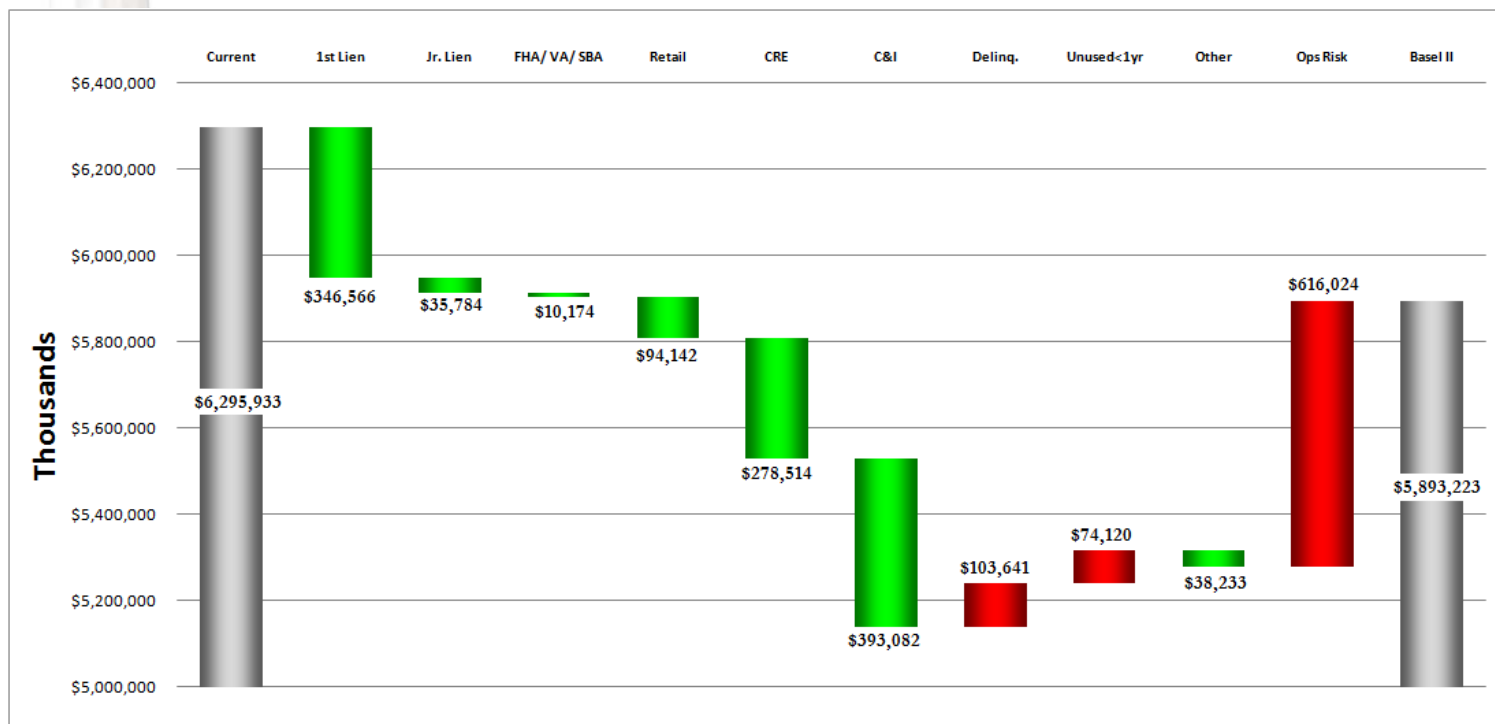


- We estimate that Standardized Basel II compliance will improve the regulatory capital ratios of 88.0% of 133 Michigan banks and thrifts
 - Aggregate potential capital savings for all 133 banks of \$403 million
 - The median Michigan bank would save \$1.2 million or 6.6% of their existing Tier 1 capital requirement
- Implementation is not without its challenges
 - Pillar II reporting can be complex and costly
 - Compliance requires demonstrated capital management capabilities
- Are your members aware of and prepared for these changes?
 - Second Pillar Consulting is uniquely positioned to help banks comply with Pillar II and obtain the capital relief they deserve

Michigan Banks can save up to \$403 million in required capital under Standardized Basel II and improve risk management

Capital savings estimate and asset category contribution

Regulatory Capital Requirement



Source: 2008Q3 Call Reports; SPC estimates

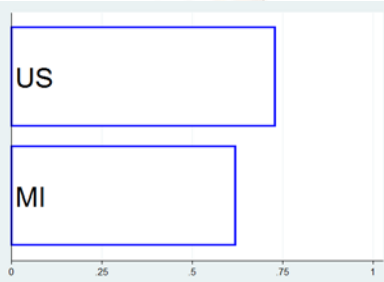
For Mercantile Bank Corporation, a representative Michigan bank, Basel II regulatory capital savings can be stockpiled or deployed

Capital Savings: \$17.0 million or 8.0%

Regulatory Capital Requirement



Capital Savings Percentile



Asset Mix



Capital Metrics and Management

Total Assets (millions)	\$2,207	
Gross Income Margin	2.8%	
Tangible Common Equity	7.8%	
Leverage Ratio	9.3%	
Capital Estimates	Current	Basel II
Tier 1 RBC	9.6%	10.4%
Total RBC	10.9%	11.7%
Potential Use of Basel II Capital Savings		
Special Dividend (\$/share)	\$1.99	
Share Repurchase (7/29/2008 price)		
Number of Shares	2,461,239	
Change in EPS	\$0.43	
Organic Asset Growth (millions)	\$163	

Mercantile Bank Corporation Grand Rapids, MI Highlights

- *Stockpile.* Under Basel II, total RBC increases from 10.9% to 11.7%, an amount equal to \$17.0 million or 8.0% of the existing capital base.
- *Deploy.* Incremental capital can be deployed with a variety of balance sheet actions that preserve the current 10.9% total RBC ratio:
 - Issue a special dividend of \$1.99 per share
 - Repurchase 2,461,239 shares, increasing EPS \$0.43 or 40.8%
 - Organically grow assets by \$163 million

Upon request, Second Pillar Consulting can provide similar information for all 133 Michigan banks free of charge

Michigan banks with the highest percentage changes in regulatory capital under Standardized Basel II

Name	City	Asset Size (\$000's)	Basel II Capital Impact	
			Dollar Change (\$000)	Percent Change
Gogebic Range Bank	Bessemer	\$ 49,155	\$ 1,114	22.3%
Summit Community Bank	East Lansing	\$ 169,732	\$ 2,340	20.0%
Lotus Bank	Novi	\$ 25,110	\$ 1,464	19.8%
Huron Community Bank	East Tawas	\$ 197,837	\$ 3,308	17.5%
First National Bank of Michigan	Kalamazoo	\$ 87,152	\$ 2,564	16.9%
Huron Valley State Bank	Milford	\$ 32,202	\$ 884	16.4%
New Liberty Bank	Plymouth	\$ 118,872	\$ 1,513	15.7%
Central Savings Bank	Sault Sainte Marie	\$ 226,738	\$ 2,855	14.9%
Bank of Birmingham	Birmingham	\$ 64,584	\$ 1,135	13.5%
Northern Michigan Bank & Trust	Escanaba	\$ 205,214	\$ 2,161	13.2%
Lake Michigan Financial Corporation	Holland	\$ 897,256	\$ 10,461	13.0%
Huron National Bank	Rogers City	\$ 53,217	\$ 728	12.4%
Old Mission Bank	Sault Sainte Marie	\$ 88,144	\$ 993	12.2%
Community Shores Bank	Muskegon	\$ 256,900	\$ 2,704	11.9%
MainStreet Savings Bank, FSB (MHC)	Hastings	\$ 106,960	\$ 689	11.9%
Michigan Heritage Bank	Farmington Hills	\$ 181,611	\$ 1,143	11.3%
Paramount Bank	Farmington Hills	\$ 257,962	\$ 1,749	11.3%
Central State Bank	Beulah	\$ 63,941	\$ 987	11.1%
State Bank of Ewen	Ewen	\$ 44,482	\$ 830	11.0%
Traverse City State Bank	Traverse City	\$ 201,963	\$ 1,600	10.9%
Averages		\$ 166,451.60	\$ 2,061.09	14.3%

Source: 2008Q3 Call Reports; SPC estimates

Michigan banks with the lowest or negative percentage changes in regulatory capital under Standardized Basel II

Name	City	Asset Size (\$000's)	Basel II Capital Impact	
			Dollar Change (\$000)	Percent Change
Oxford Bank Corporation	Oxford	\$ 375,865	\$ 320	0.9%
Union Bank	Lake Odessa	\$ 187,188	\$ 118	0.6%
Farmers State Bank of Munith	Munith	\$ 66,316	\$ 33	0.4%
Edgewater Bank	Saint Joseph	\$ 190,520	\$ 71	0.4%
Kalamazoo County State Bank	Schoolcraft	\$ 74,702	\$ (27)	-0.2%
Citizens National Bank of Cheboygan	Cheboygan	\$ 266,350	\$ (63)	-0.3%
Freeland State Bank	Freeland	\$ 52,501	\$ (61)	-0.6%
Citizens State Bank	New Baltimore	\$ 197,898	\$ (240)	-1.2%
Ruth State Bank	Ruth	\$ 29,046	\$ (62)	-1.7%
Citizens State Bank of Ontonagon	Ontonagon	\$ 50,052	\$ (172)	-1.9%
Lapeer County Bank & Trust Company	Lapeer	\$ 251,356	\$ (685)	-2.4%
First State Financial Corporation	Saint Clair Shores	\$ 695,682	\$ (1,842)	-2.6%
FNBH Bancorp, Inc.	Howell	\$ 415,370	\$ (1,462)	-3.6%
Northpointe Bank	Grand Rapids	\$ 291,646	\$ (1,245)	-4.3%
University Bank	Ann Arbor	\$ 113,189	\$ (457)	-4.5%
First National Bancshares, Incorporated	East Lansing	\$ 530,364	\$ (8,893)	-7.1%
West Michigan Bank & Trust	Frankfort	\$ 34,133	\$ (607)	-7.2%
Warren Bancorp, Inc.	Clinton Township	\$ 628,099	\$ (4,713)	-7.2%
Home Federal Savings Bank	Detroit	\$ 15,267	\$ (66)	-8.7%
Auto Club Trust, FSB	Dearborn	\$ 6,171	\$ (1,640)	-22.8%
Averages		\$ 223,586	\$ (1,085)	-3.7%

Source: 2008Q3 Call Reports; SPC estimates

But banks must be prepared to answer the tough risk management questions posed by Basel II compliance

- Do you have a well-functioning risk oversight structure?
- Do you have clear risk management policies and procedures?
- Have you identified the important risks faced by your institution?
- Have you articulated an institutional appetite for risk-taking?
- Do you have accessible data on the risk characteristics of your existing portfolio?
- Do you have accessible data on the past performance of your portfolio?
- Do you have personnel that can fill critical risk assessment gaps?
- Do you actively manage and plan your capital position?
- Are you committed to enhancing your overall risk and capital management?

Second Pillar Consulting can help banks prepare for Basel II compliance

- Our principals have over thirty years of experience in enterprise risk management, regulatory capital compliance, and regulatory relations
 - Supported International Basel II compliance at a top-ten bank
 - Developed analytical and reporting capabilities
 - Created governance structure and supporting policies
 - Led regulatory exams for approval
 - Managed risk in retail banking, commercial banking, and insurance
 - Focused on building strong regulatory relationships
 - Active participants in several Basel II industry and regulatory forums that facilitated drafting the new rules
 - Frequent speakers at industry and regulatory conferences on Basel
 - Several Basel II academic papers written jointly with regulators

Summary

- Second Pillar Consulting is uniquely positioned to help banks comply with Basel II and get the capital relief they deserve
 - Services
 - Detailed Capital Savings Estimate
 - Gap Analysis
 - The Internal Capital Adequacy Assessment Process or ICAAP
 - Education
 - We conduct seminars for institutions and organizations on topics including Basel II compliance, Enterprise Risk Management, Capital Management, and Balance Sheet Strategy
 - Facilitation
 - We are currently coordinating the NPR response for the Risk Management Association and can help organizations and institutions with their response

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