McHENRY SAVINGS BANK

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October 27, 2003

BEST IMAGE AVAILABLE

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal
Reserve System
20th Street & Constitution Ave, NW
Washington DC 20551
Attn: Docket No. R-1154

Dear Ms. Johnson;

As you may be aware, the proposal for the Basel II Accord (internal model for determining capital requirements) has a comment period that ends on November 3rd.

I am writing to you as CEO/President of McHenry Savings Bank in McHenry, Illinois. I have been working to inform the regulators, banking trade groups, the Basel committee, the Treasury and others of the importance of this pending proposal to community banks.

My messages continue to be:

- **COMMUNITY BANKS MUST BE ALLOWED TO "OPT-IN" TO THE NEW PROPOSED BASEL II ACCORD, AND**

- **IN ADDITION, THE BASEL I ACCORD AS ADOPTED IN 1988 MUST BE REVISED TO MORE TRULY REFLECT ASSET RISK FOR THOSE INSTITUTIONS THAT CHOOSE NOT TO "OPT-IN" TO BASEL II.**

While talking to industry representatives, I have found that there exists a misconception that community banks do **not** want to be forced to adopt the Basel II Accord as proposed. Please help get the message out that it is critical that we be allowed to **"opt-in"** to this new proposal. The New Accord is trying to more closely link minimum capital requirements with an institution's risk profile. Community banks must retain the option to leverage their capital, regardless of the complexity of the calculations to prove their risk-worthiness. Small institutions will be at a competitive disadvantage to the extent that they cannot deploy capital as efficiently as larger, more sophisticated institutions.

As an alternate approach, I have prepared a **revised "risk-based capital formula"** as enclosed. I have added more buckets and have broken down assets into multiple buckets when taking into consideration collateral values and loan-to-value ratios. These values can be obtained through third party appraisal services or published listings such as Black Book. This proposed formula is provided to open up dialogue on potential revisions. I believe that it more accurately reflects the true risk of assets on our balance sheets.

If capital requirements are changed and new options are developed, institutions should be allowed to choose between developing their own internal risk rating systems or maintaining a **modified** risk-based system with more buckets and division of assets to quantify risk more appropriately.

Thank you for your consideration of my views of the Basel I and proposed Basel II Accord. I believe there is much interest in the community banking industry for change.

Feel free to call me if you would like to discuss this issue further.

Sincerely,

Kathleen E. Marinangel

Kathleen E. Marinangel
CEO/President

Enclosure

Risk-Based Capital (Basel)
Proposed Components and Formula

Supplemental Information

A. The new proposed Basel II Capital Accord internal risk based system will create competitive inequities if smaller institutions are not allowed to "opt-in". Community banks are capable of utilizing their internal resources to adopt the new system. Additionally, outside vendors would most likely develop systems that could be purchased by Community Banks to assist in the process. Community banks **MUST** be allowed to "opt-in".

B. **As an alternative** to adopting the Basel II Capital Accord, the current 1988 Basel I Capital Accord risk-based formula needs to be modified to better reflect the true risk associated with the assets held by financial institutions. This can be accomplished by including more buckets and using collateral values for a finer breakdown of assets based on valuations completed by outside services. This may be done by taking into consideration collateral values and loan-to-value ratios. A new Basel (I.5) could be developed.

C. A sample of the proposed formula is attached. This formula would more closely link minimum capital requirements with an institution's true risk profile.

   1) The asset breakdown recommendations presented have a common factor in that all of the listed assets are collateralized. The collateral can be valued through outside appraisal services or published listings (such as the Black Book).

   2) More asset buckets have been developed for the proposed Basel changes.

   3) Specific assets have been subdivided into tiers based upon loan-to-value considerations to better reflect the true risk of the assets.

   4) Bank buildings and bank land have been valued based upon appraisals. One-half of the appraised value has been placed in the 20% bucket, which is conservative.

PROPOSED RISK-BASED CAPITAL FORMULA
(* INDICATES NEW CATEGORY)

<u>0% Risk Weight Category</u>
- Cash on Hand
- U.S. Treasuries
- * **Interest-Earning Deposits (CD's) ≤ $100,000**

<u>20% Risk Weight Category</u>
- Cash Items
- Correspondent Banks
- Fed Funds Sold
- FHLB Stock
- General Obligation Municipal Investments
- Loans Secured By Deposits
- Money Market Fund Investments
- Municipal Loans
- U.S. Agencies
- U.S. Agency-Issued MBS's
- * **Interest-Earning Deposits (CD's) > $100,000**
- * **1-4 Family First Mortgages with LTV Ratio ≤ 60%**
- * **HE Loans & HELOC's (including 1st Mtg) with LTV Ratio ≤ 60%**
- * **Commercial Mortgages with LTV Ratio ≤ 20%**
- * **Consumer Loans with LTV Ratio ≤ 25%**
- * **Bank Land & Premises - 50% of Appraisal Value**

<u>40% Risk Weight Category</u>
- * **1-4 Family First Mortgages with LTV Ratio > 60% and ≤ 75%**
- * **HE Loans & HELOC's (including 1st Mtg) with LTV Ratio > 60% and ≤ 75%**
- * **Commercial Mortgages with LTV Ratio ≤ 40%**

<u>50% Risk Weight Category</u>
- Other Qualifying Junior Liens
- Private-Issue MBS's
- Qualifying Construction Loans
- Revenue Bond Municipal Investments
- * **1-4 Family First Mortgages with LTV Ratio > 75%**
- * **HE Loans & HELOC's (including 1st Mtg) with LTV Ratio > 75%**
- * **Commercial Mortgages with LTV Ratio ≤ 50%**
- * **Consumer Loans with LTV Ratio > 25% and ≤ 60%**
- * **Commercial Loans with LTV Ratio ≤ 40%**

<u>60% Risk Weight Category</u>
- * **Commercial Mortgages with LTV Ratio ≤ 60%**

<u>80% Risk Weight Category</u>
- * **Commercial Mortgages with LTV Ratio ≤ 80%**

<u>100% Risk Weight Category</u>
- Allowance for Loan & Lease Losses
- Corporate Bond Investments
- Loans Past Due 90+ Days
- All Other Assets
- * **Commercial Mortgages with LTV Ratio > 80%**
- * **Consumer Loans with LTV Ratio > 60%**
- * **Commercial Loans with LTV Ratio > 40%**
- * **Bank Land & Premises - 50% of Appraisal Value**
- * **Unsecured Loans**

Off-Balance Sheet Items (20% Risk Weight)
- Letters of Credit (Cash Collateral)
- Letters of Credit (Other Collateral)

Total Adjusted Assets