March 22, 2007

Office of the Comptroller of the Currency
250 E Street, S.W.
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Washington, DC 20219

Attention: Docket No. 05-16
regs.comments@occ.treas.gov

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal
Reserve System
20th Street & Constitution Av, N.W.
Washington, DC 20551

Attention: Docket No. R-1238
regs.comments@federalreserve.gov

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

comments@FDIC.gov

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, DC 20552

Attention: No. 2005-49
regs.comments@ots.treas.gov

Re: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications
71 FR 77446-518 (December 26, 2006)

Dear Mesdames and Sirs:

McHenry Savings Bank would like to thank the regulators for their support of a proposed Basel1a. As President of McHenry Savings Bank (MSB) and as a member of the board of directors of America's Community Bankers, I have spent a considerable amount of time testifying before The House Financial Institutions and Consumer Credit Financial Services subcommittee, the Senate Banking, Housing and Urban Affairs subcommittee, and speaking with regulators both nationally and internationally concerning the need for changes to the Basel I Accord. The competitive benefits for community banks provided by such a change are enormous. The opportunity to reflect the true risk associated with all of a bank's assets is critical.

McHenry Savings Bank is a privately held stock savings bank, chartered in the State of Illinois, operating in McHenry County, Illinois. McHenry County is saturated with an excessive number of banks and other financial service providers in a very competitive climate. We find ourselves competing not only against other community banks like ourselves, but against Regionals, Super-Regionals, Nationals and International banks.

We can remain competitive in this saturated market **only if** the capital limitations imposed by the current Basel Accord are modified to more accurately reflect the prudent manner in which we manage risk at our bank IT IS THEREFORE NECESSARY THAT **ALL ASSETS** OF OUR BALANCE SHEET BE ADDRESSED FOR RISK-WEIGHTING SENSITIVITY.

We have read the Notice of Proposed Rulemaking (NPR) as published on December 5, 2006. Although the NPR goes far in addressing mortgage loan assets, we are very disappointed that other assets that make up the greatest portion of U.S. banks' balance sheets have not been addressed. Most of these assets reside in the 100% risk-weighted bucket. I cannot stress enough that it is imperative that every asset on a bank's balance sheet be addressed in the new accord.

McHenry Savings Bank has been closely held by our family for almost 40 years. It is a community bank with a community attitude, serving those who are typically passed over by large, often impersonal institutions. Since 1988 the Basel Accord has forced our investments into limited products, greatly reducing profitability. While our leverage ratio has never been threatened – we are and have always been well capitalized as to our leverage ratio – we have been hamstrung by our risk-weighted capital, forgoing millions of dollars in income just to maintain our assets in income-limiting buckets.

Basel 1 was finalized in 1988, almost 20 years ago, and it has hindered the income-generating capacity of our bank since its inception. We have waited almost twenty (20) years for an opportunity to change the way our assets are risk-weighted, and it is clear that this is the moment. I doubt that another opportunity will present itself for years to come, so it is imperative that you to consider these recommendations and structure Basel 1a in a manner more beneficial to the American banking system. With your help, we can turn what threatens to be the continuation of a restrictive policy into one that better serves the American depositor, borrower and overall community banking system. We cannot afford to wait another 20 years in order to get it right. **Now** is the time.

We would like to stress the **importance of risk-weighting every asset on a bank's balance sheet** when finalizing the proposed formula for Basel 1a. The Notice of Proposed Rulemaking (NPR) addresses some of the assets, but not all. Some of the missing ones that need to be addressed are:

- Commercial Real Estate Loans
- Consumer Loans
- Commercial and Industrial Loans
- Bank Land and Buildings
- Prepaid assets
- Interest-Earning Deposits (CDs) $\leq$ $100,000
- Correspondent Bank Deposits
- Other Fixed Assets

Illustrated below is a table of **aggregated ASSET balances of all U.S. Institutions** as of September 30, 2006. This data was collected from all FDIC Call Reports and OTS TFR reports as provided by Highline Data.

Please review the table below.

AGGREGATE BALANCE AND % DATA – ALL U.S. INSTITUTIONS

	Balance	% of Assets
Cash & Due from Banks	425,568,158	3.6%
Securities	2,606,656,410	22.2%
Loans:		
Secured by 1-4 Family Residential:		
Secured by First Liens	1,956,617,077	16.6%
Secured by Junior Liens	219,029,337	1.9%
Home Equity Loans - Revolving	554,860,247	4.7%
Construction & Land Development	511,557,879	4.3%
Secured by 5+ Residential	199,407,461	1.7%
Secured by Commercial Mortgages	888,550,672	7.6%
Commercial & Industrial Loans:	1,027,712,028	8.7%
Consumer Loans to Individuals	858,297,213	7.3%
Premises & Fixed Assets	109,587,297	0.9%
Intangible Assets	388,436,438	3.3%
Other Assets	2,018,995,053	17.2%
Total Assets	11,765,275,270	100.0%

SOME SIGNIFICANT DATA TO NOTE FROM THE ABOVE TABLE IS AS FOLLOWS:

- 1-4 family **Residential Mortgage Loans** represent only **16.6%** of total assets held by U.S. banks.

- **Junior Liens and Home Equity Loans** represent only another **6.6%** of total assets held by U.S. banks.

- The **total percentage of Residential assets** to total assets represents only **23.2%** of total assets held by U.S. banks.

- **Other loans** including commercial mortgages, Commercial and Industrial loans, Consumer Loans to Individuals, 5+ Residential and Construction and Land Development loans represent **29.6%** of total assets held by U.S. banks.

- **29.6% is A LARGER PERCENTAGE OF TOTAL ASSETS THAN RESIDENTIAL LENDING AT 23.2% AND IS NOT ADDRESSED BY THE NPR.**

- The **"other assets"** categories represent an additional **21.4%** percent of total assets held by U.S. banks and **THESE ARE NOT ADDRESSED BY THE NPR.**

We have made recommendations for risk-weighting these OTHER ASSETS not addressed in the NPR that we feel would be easily manageable and not duly complex.

Please consider our comments for approaching a change in methodology as follows:

A. <u>ASSETS NOT ADDRESSED IN THE NPR:</u>

- **Commercial Real Estate Loans**: These assets should be risk-weighted based upon loan-to-value (LTV) ratios. Currently these assets are weighted in the 100% bucket. Those commercial mortgages with LTV Ratios of ≤ 20% could be in the 20% bucket; those with LTV Ratios of ≤ 40% could be in the 35% bucket; those with LTV Ratios of ≤ 50% could be in the 50% bucket; those with LTV Ratios of ≤ 75% could be in the 75% bucket; and those with higher LTV Ratios could be in the 100% bucket. This methodology would be consistent with that used for mortgage loans with the common factor being an outside third-party appraisal.

  Please refer to the table below for an illustration of our comments.

COMMERCIAL REAL ESTATE LOANS

LOAN-TO-VALUE RATIOS	RISK WEIGHT
Up to 20%	20%
Over 20% up to and including 40%	35%
Over 40% up to and including 50%	50%
Over 50% up to and including 75%	75%
Over 75%	100%

- **Consumer Loans.** We recommend that for those **consumer loans** that are collateral based (automobiles, boats, recreational vehicles, motorcycles, trucks, airplanes, and others) **should be risk-weighted based upon LTV ratios**. We have found that collateral is the most reliable basis for determining risk and collection of debt once such an item is repossessed.

  Please refer to the table below for an illustration of our comments.

CONSUMER LOANS

LOAN-TO-VALUE RATIOS	RISK WEIGHT
Up to 25%	20%
Over 25% up to and including 60%	50%
Over 60%	100%

  For consumer loans, it is **easy for institutions to collect the LTV ratios at inception of the loan**. Those banks that choose to do so could update the LTV on a quarterly or annual basis if they wish to undertake the additional burden.

  We **do not object** to allowing banks **to choose** between an LTV method and the method of assessing a borrower's creditworthiness by FICO scores or debt-to-income ratios for consumer loans.

  As to the **consumer loan** portfolios, it would be our recommendation to allow the risk-weighting to be an **opt-in option** for banks. Banks should be able to choose to allow for more risk sensitivity by using the LTV approach or to choose to leave the portfolio in the 100% risk-weighted bucket and have less complexity.

- **Multi-family Residential Mortgages.** Multi-family residential mortgages currently receive a risk-weighting of 100 percent. We believe that multifamily residential mortgages should be risk-weighted based upon LTV ratios and risk buckets similar to the table for 1-4 family residential mortgages.

- **Commercial and Industrial Loans (Small Business Loans).** We believe that small business loans can be separated and viewed as **two categories**.

  The **first** category would include **collateralized commercial small business loans**. Any such small business loan should be risk-weighted based upon the LTV of eligible collateral and spread amongst the various buckets.

  The **second** category would include **non-collateralized commercial and small business loans**. These loans should be risk-weighted on the credit assessment of the personal guarantors, terms of the loan, total dollar amount of the loans, amortizations schedules and past history of the borrower. Rather than place all of these into a 100% bucket, these loans should be risk-weighted into lower buckets, taking into consideration an analysis of the above factors.

- **Bank Land and Buildings (Bank's Property)**: Currently, these assets are weighted in the 100% bucket. No mention of change of treatment for risk-weighting has been noted in the NPR for these assets. Value must be placed upon these assets and consideration must be given to measuring the book value of these assets against the appraisals done by independent third parties. The net book value of those assets $\leq$50% of appraised value could be in the 20% bucket; the additional net book value of those assets $\leq$70% could be in the 75% bucket; and the remainder of the net book value of those assets $\geq$70% could be in the 100% bucket. Most bank properties are situated on prime locations and are well-maintained facilities. A sale of these assets would generally bring a profit and not a loss to the institutions. Risk-weighting modifications **must** be accomplished in this asset category.

  Please refer to the table below for an illustration of our comments.

BANK LAND AND BUILDINGS

NBV AS % OF APPRAISAL	RISK WEIGHT
Up to 50%	20%
Over 50% up to and including 70%	75%
Over 70%	100%

- **Private Mortgage Backed Securities** – The risk weighting on positions in these instruments currently ranges from 20% through 200%. Due to the fact that the underlying assets in these instruments is primarily 1-4 family mortgage loans, we suggest that the maximum risk weighting placed on these loan securitizations correspond to the mid-range weighting on 1-4 family mortgage loans, or 50%.

  Please refer to the table below for an illustration of our comments.

PRIVATE MORTGAGE BACKED SECURITIES

LONG-TERM RATING	RISK WEIGHT
AAA or AA rating	20%
A rating	35%
Less than A rating	50%

- **Correspondent Bank Deposits**: Currently, these assets are weighted in the 20% bucket. No mention of change of treatment for risk-weighting has been noted in the NPR for these assets. The first $100,000 of deposits in each correspondent bank should be in the 0% bucket. The remainder should be kept in the 20% bucket.

  Please refer to the table below for an illustration of our comments

CORRESPONDENT BANK DEPOSITS

PORTION OF TOTAL BALANCE	RISK-WEIGHT
First $100,000	0%
Remaining balance	20%

- **Interest-Earning Deposits (CDs) ≤ $100,000**: Currently, these assets are weighted in the 20% bucket. No mention of change of treatment for risk-weighting has been noted in the NPR for these assets. These interest-bearing deposits in other financial institutions are backed by the Federal Deposit Insurance Corporation. As a result, these assets should be risk-weighted in the 0% bucket. Any dollar amount above the $100,000 limit should remain in the 20% bucket.

  Please refer to the table below for an illustration of our comments.

INTEREST-EARNING DEPOSITS

PORTION OF TOTAL BALANCE	RISK-WEIGHT
First $100,000	0%
Remaining balance	20%

- **Prepaid Assets**: Currently, these assets are weighted in the 100% bucket. No mention of change of treatment for risk-weighting has been noted in the NPR for these assets. Prepaid assets generally provide little risk to a financial institution. A conservative approach would be to place 50% of those assets in the 20% bucket and the remaining 50% in the 100% bucket.

  Please refer to the table below for an illustration of our comments.

PREPAID ASSETS

PORTION OF TOTAL BALANCE	RISK-WEIGHT
First 50%	20%
Remaining 50%	100%

- **Other Fixed Assets**: Examples of "other fixed assets" include bank-owned vehicles, furniture, fixtures and equipment, and software. Currently, these assets are weighted in the 100% bucket. No mention of change of treatment for risk-weighting has been noted in the NPR for these assets.

- **Bank-owned autos** should be treated by using the LTV methodology and a comparison of net book value to "Black Book" values at wholesale levels.

  Please refer to the table below for an illustration of our comments.

BANK-OWNED AUTOMOBILES

LOAN-TO-BLACK BOOK VALUE RATIOS	RISK WEIGHT
Up to 25%	20%
Over 25% up to and including 60%	50%
Over 60%	100%

- **Furniture, fixtures, equipment and software** could be treated by assigning 50% of **net** book value to the 20% bucket and the remaining net book value to the 100% bucket.

  Please refer to the table below for an illustration of our comments.

FURNITURE, FIXTURES, EQUIPMENT & SOFTWARE

% OF NET BOOK VALUE	RISK WEIGHT
First 50%	20%
Remaining balance	100%

As stated earlier, <u>all</u> assets on a banks balance sheet should be considered for true risk-weighting.

B. ASSETS ADDRESSED IN THE NPR:

- One-To-Four Family First Mortgage Loans

We believe that mortgages should be placed in buckets as recommended in the NPR. We also believe that a 10% bucket should be included. Please review the table below for an illustration of our comments:

1-4 FAMILY FIRST MORTGAGE LOANS

LOAN-TO-VALUE RATIOS	RISK-WEIGHT
Up to 30%	10%
Over 30% up to and including 60%	20%
Over 60% up to and including 80%	35%
Over 80% up to and including 85%	50%
Over 85% up to and including 90%	75%
Over 90%	100%

McHenry Savings Bank would **not** consider it a significant burden to collect data supporting LTV ratios on one-to-four family mortgage loans. An **appraisal** obtained at the inception of a loan should be used as the denominator for the determination of initial LTV. We do not believe that the purchase price should the factor for the determination of the initial LTV.

To re-evaluate LTV ratios on seasoned loans, banks should have the option of comparing current principal balances to either the original or updated appraisals. The choice of methodology would most likely be based on the level of each bank's desire to more closely align risk with capital requirements.

C. OTHER COMMENTS

- OPTIONS VERSUS COMPLEXITY

It is critical that the Basel 1a formula allow for **all** options in regards to all assets on a banks balance sheet. Basel 1a is, after all, a risk-based ASSET formula, and banks are made to risk-weight **all** assets. Complexity is an issue that many smaller community banks feel is a down-side risk to a more comprehensive Basel 1a formula. This issue can be addressed by the allowance of an **opt-out approach** for some of the 100% weighted asset categories. The choice to opt-out, thus allowing for some classes of assets to remain in the 100% category, is a conservative approach. **Allow us all options** and leave us with the ability to compete against Basel 11 banks.

- STANDARDIZED APPROACH

Adoption of parts of the Standardized Approach in lieu of addressing assets not identified in the NPR should be permitted as this would provide banks with a more risk-sensitive alternative than is currently provided for in the NPR. The inclusion of a weighting for "operational" risk would be extremely burdensome for community banks.

- OPT-IN OR OPT-OUT OF CERTAIN MODELING

We believe that Basel 1a Banks be given the option **to remain under the Basel 1 Accord** or to **partially** or **fully adopt the Basel 1a proposal.** A partial adoption might include only the proposed changes to the residential mortgage capital requirements, allowing for concerns regarding competitive disadvantages. A partial adoption might include adopting all components of the revised NPR for Basel 1a except for consumer loans which for some banks might prove burdensome and for others might not prove burdensome. Allowing for a class of assets such as consumer loans to remain in the 100% bucket is a conservative approach. Allowing banks to choose to adopt the new revised Basel 1a in its entirety, is a viable and necessary option. Please give us the ability of choice.

- SECOND LIENS AND HELOCS

We believe that banks should be able to treat first and second liens as separate risks if they are carried by the same bank. The first lien carries less risk and is more likely to be repaid in full, so it should carry a lower risk-weighting than the second lien and should be weighted separately. Tables as proposed by the Agencies seem appropriate with the inclusion of a 60% or less bucket.

- FHLB AND GSE REQUIREMENTS

We oppose any change to the weighting of GSE securities. We especially would oppose any differentiation for Federal Home Loan Banks versus "rated" GSEs such as Fannie Mae and Freddie Mac. Were the ratings change, small community banks would be hardest hit as they use the FHLB System as a critical source of funding.

CONCLUSIONS:

NO FINAL RULE WITHOUT FURTHER DISCUSSIONS

We believe that it is imperative to have further discussions before a final ruling is implemented. The ability for community banks to compete against Basel 11 international and U.S. banks is critical. In order to do so, we must have a **comprehensive Basel 1a** formula that allows for risk-weighting of **ALL ASSETS** on the balance sheet. The time is now to get the job done.

The efforts required to comply with much of the proposed Basel 1a risk-weighting would not be burdensome for McHenry Savings Bank. Allowing a choice of options for community banks would solve the complexity issue.

We urge the regulators to address more of these issues prior to issuing the prior rule. We believe that this broader view is critical to the successful implementation of the Basel 1a framework and to the ability of a successful competitive banking environment.

Thank you for the opportunity to comment on the proposed rulemaking. It is important to have a working alliance between the regulators and the banking industry concerning matters of such great importance. Please call or e-mail with any questions that you may have.

Sincerely,

Kathleen E. Marinangel
McHenry Savings Bank
President and CEO