January 10, 2006

Office of the Comptroller of the Currency
250 E Street, S.W.
Mailstop 1-5
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. 2005-40
regs.comments@ots.treas.gov

Re: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications
70 FR 61068 (October 20, 2005)

Dear Mesdames and Sirs:

McHenry Savings Bank would like to thank the regulators for their support of a proposed Basel I-A. 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 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 truly reflect the risk associated with 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 **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.

GENERAL COMMENTS

The efforts required to comply with much of the proposed Basel I-A risk weighting would not be burdensome for McHenry Savings Bank. The ability to collect data in today's technological environment is not difficult. Programs can be established through third party service providers, such as Fiserv, that already collect our bank's data to give us current loan-to-value ratios on all assets and provide the necessary reports for compliance.

There are some community banks that might not choose to accept the additional workload associated with an advanced approach, and so McHenry Savings Bank agrees that Basel I should remain as an option for those institutions. We also believe that in order to reflect specialization in various assets and not impose undue burden for converting completely from Basel I to I-A, banks should be allowed to adopt portions of Basel I-A while maintaining portions of Basel I.

We believe that the idea of using the Basel I-A formula for the purposes of serving as the floor on the transitional capital charges for Basel II banking organizations is good. This would allow for further study of the impacts of Basel I-A and Basel II.

UNADDRESSED ISSUES

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

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

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

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

- **Bank Land and Buildings (Bank's Property)**: Currently, these assets are weighted in the 100% basket. No mention of change of treatment for risk weighting has been noted in the ANPR 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 consultants. The net book value of those assets ≤ 50% of appraised value could be in the 20% basket; the additional net book value of those assets ≤ 70% could be in the 75% basket; and the remainder of the net book value of those assets ≥ 70% could be in the 100% basket. 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.

- **Prepaid Assets**: Currently, these assets are weighted in the 100% basket. No mention of change of treatment for risk weighting has been noted in the ANPR 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% basket and the remaining 50% in the 100% basket.

- **Interest-Earning Deposits (CDs) ≤ $100,000**: Currently, these assets are weighted in the 20% basket. No mention of change of treatment for risk weighting has been noted in the ANPR 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% basket. Any dollar amount above the $100,000 limit should remain in the 20% basket.

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

- **Other Fixed Assets**: Examples of "other fixed assets" include bank-owned automobiles, furniture and fixtures, and software. Currently, these assets are weighted in the 100% basket. No mention of change of treatment for risk weighting has been noted in the ANPR for these assets. Autos could be treated

> by using the LTV methodology and a comparison of net book value to "Black Book" values at wholesale levels. Furniture, fixtures and software could be treated by assigning 50% of **net** book value to the 20% basket and the remaining net book value to the 100% basket.

As stated earlier, all assets on a banks balance sheet should be considered for true risk weighting.

SPECIFIC COMMENTS

McHenry Savings Bank appreciates the opportunity to respond to the other specific capital rules suggested in the ANPR as follows.

A. Increase the Number of Risk-Weight Categories

We support the addition of more baskets in order to more accurately align capital requirements with risk and would like to see more added below the 100% risk level. No significant burden would be placed on McHenry Savings Bank as a result of reporting within an expanded risk weighting system.

The addition of baskets over 100% and the assets required to be considered for those baskets should be carefully considered and limited.

B. Use of External Credit Ratings

We believe that the use of nationally recognized statistical rating organizations would more properly identify risk within a bank's investment portfolio.

We agree with the expanded eligible financial collateral and guarantor analysis in the ANPR.

C. Mortgage Loans

We believe that mortgages should be placed in baskets as recommended in the ANPR.

D. Consumer Loans

We recommend that **consumer loans** (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.

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. A spreadsheet could be prepared by the bank using third-party vendor parameters to generate current values. An e-mail to the Black Book company on a monthly or quarterly basis listing the criteria would prompt an e-mail back to the bank giving current values for the autos, boats, RV, Motor Homes, Airplanes, etc. Current principal balances could be downloaded and listed on the spreadsheet and a formula would compare principal balance to the current value and calculate the LTV ratios. These ratios then could be placed easily within a multiple of baskets for risk-weighting.

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

Risk weighting for consumer loans **using FICO scores might be a suitable alternative** for those banks that might choose to use the scores. The drawbacks however, must be reviewed. FICO scoring is proprietary (secret) and the components of the scoring are not fully known. In scoring, income is not considered. Reliance upon FICO scores alone does not reflect the true risk in the consumer loan product as it only measures how a person has handled debt to date, not how they will repay a new loan. It works against the poor and those who have experienced unusual financial catastrophes like medical emergencies and natural disasters. FICO scoring tends to bury those very persons who are in need of reasonably-priced credit with what used to be considered usurious interest rates. The use of FICO scores even penalizes people who seek financing, as a lowering of scores occurs due to credit inquiries. McHenry Savings Bank's Board of Directors does not allow its loan officers to underwrite loans based solely on FICO scores.

E. 350% Risk Basket

We believe that **adding a 350% basket is far too aggressive**. This basket should not be applied to loans. Also, there seems to be no justification for a high basket for commercial real estate exposures with highly volatile characteristics. Analysis would need to be done as to the definition of such an asset and to the amount of ALLL and capital currently in place.

F. One-To-Four Family Mortgages First and Second Liens.

We believe that mortgages should be placed in buckets as recommended.

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 is obtained at the inception of a loan to provide for 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.

The use of PMI to reduce the numerator in the LTV is logical and appropriate so long as the insurer is a non-affiliated entity and maintains a rating of A or higher.

Using FICO scores as a tool in combination with LTV in order to further refine risk weighting might result in a broader means of rating loans, keeping in mind the prior comments concerning FICO scores.

We believe that **home equity lines of credit and home equity loans** should be weighted the same whether the first mortgage is held at the same institution or another institution. It is our opinion that LTV is LTV regardless of where the first mortgage loan is held.

G. Small Business Loans

We believe that small business loans can be separated into two categories. The first category would include collateralized small business loans. Any such small business loan should be risk-weighted based upon the LTV of eligible collateral into several baskets. The second category would include non-collateralized small business loans. These loans could 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% basket, these loans should be risk-weighted into lower baskets, taking into consideration an analysis of the above factors.

H. Unsecured Commercial Loans

We believe that unsecured commercial loans should not all be left in the 100% basket. As stated in the section above concerning small business loans, consideration for lower baskets should be given upon analytical review of the personal guarantees of the borrower, terms of the loans, total dollar amounts of the loans, amortization schedules, and past history of the borrower. McHenry Savings Bank does not have any loans on our books that are rated.

We believe that tracking of the guarantees and other items listed above should be optional for institutions that do not want to assume added burden for the risk-weighting.

I. Multifamily Residential Mortgages

We believe that multifamily residential mortgages should be risk-weighted based upon LTV ratios and the number of units. As McHenry Savings Bank does not currently have any of these assets on the books, we defer to others concerning more details.

J. Past-Due Loans

Loans 90 days or more past due or in nonaccrual status should not be placed in a high basket. These loans should remain in the basket according to their type. The allowance for loan and lease losses (ALLL) that banks must maintain already adequately addresses potential losses that may exist over collateral values. The LTV ratio must be considered. The ALLL formula requires all past-due and impaired assets to be individually analyzed for losses, and for amounts to be specifically set-aside in the allowance. Similarly, assigning a weighting of more than 100% to loans that are 90 days or more past due or in non-accrual status is not reasonable. Banks would be penalized by such treatment.

K. Use of Collateral and Guarantees to Mitigate Risk

We agree with expanding the types of eligible collateral to include all long and short-term debt securities that have NRSRO ratings of at least investment grade. We also agree with the ANPR to recognize as an eligible guarantor any entity whose long-term senior debt has been assigned an external credit rating of at least investment grade by an NRSRO.

L. Leverage Ratio

We believe that the leverage ratio may ultimately become unnecessary if the internal risk-weighting system is fully implemented. The countries of the European Union and others do not have a leverage ratio. The current parameters of the leverage ratio may need to remain in place for now, but a study should be done as to whether it should be lowered in the future.

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
President and CEO