October 27, 2008

Via email

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

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 1-5
Washington, DC 20219

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

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: OTS-2008-0002

Re: Risk-Based Capital Guidelines; Capital Adequacy Guidelines: Standardized Framework; 73 Federal Register 43982; July 29, 2008; **OCC:** Docket ID: OCC-2008-0006, RIN 1557-AD07; **FRB:** Docket No. R-1318; **FDIC:** RIN 3064-AD29; **OTS:** Docket No. 2008-002, RIN 1550-AC19

Ladies and Gentlemen:

I appreciate the opportunity to comment on the Joint Notice of Proposed Rulemaking ("NPR") on Risk-Based Capital Guidelines; Capital Adequacy Guidelines: Standardized Framework (the Standardized Approach), as issued by the Office of the Comptroller of the Currency (OCC), Board of Governors of the Federal Reserve System (Board), Federal Deposit Insurance Corporation (FDIC), and Office of Thrift Supervision (OTS) (collectively, the "Agencies").

I have worked extensively with the American Bankers Association ("ABA") sub committee in the drafting of a comment letter to your Agencies concerning the Standardized Framework for Capital Adequacy Guidelines (Standardized Approach) for application of Basel. Some of the comments in this letter are similar to the comments addressed in the ABA comment letter, as I agree with the comments issued by the ABA.

McHenry Savings Bank would like to thank the regulators for their support of a proposed Standardized Framework for Capital Adequacy Guidelines (Standardized Approach). As President of McHenry Savings Bank ("MSB"), and as a member of the board of directors of the ABA, 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 regional, "super"-regional, nationals and international financial institutions.

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 Therefore, I cannot stress enough that ALL assets of a bank's balance sheet be addressed for risk-weighting sensitivity, and appropriately addressed in the new Accord.

Initial thoughts on some important topics include:

COMPLEXITY AND COST

The acceptance of revised guidelines promises to provide a great benefit to large and small institutions alike. However, it should be noted that the resources available to smaller institutions such as McHenry Savings Bank to follow through on such implementation, both initial set up and ongoing monitoring, may be considered prohibitive, especially in the current economic environment. This should be kept in mind when proposing to finalize any structure that may require substantial manpower and/or out-of-pocket costs to fully implement and maintain.

I believe the Standardized Approach would be a valuable option for banks to consider as another means of assessing risk and measuring capital levels. There will be many banks, however, that will prefer not to expend the resources in order to adopt a system that may yield a more risk-sensitive allocation of capital. Thus, I appreciate the fact that the Standardized Approach will be optional for most banks, and I urge the Agencies to retain this flexibility in the final rule.

OPERATIONAL RISK

It is my opinion that an operational risk factor should **not** be included in this Accord. The inclusion of a weighting for "operational" risk would be extremely burdensome for community banks. Operational risk should be addressed in the Safety and Soundness examination process (and therefore in the CAMELS ratings), which will result in the level of Leveraged Capital required. However, if operational risk is to remain, then the proposal to tie in operational risk to gross income is both peculiar and inadequate as a means of assessing an institution's management of such risk. The level of gross income is impacted by a diverse array of factors, many of which have no bearing whatsoever on any inherent risk in an institution's operational practices. Furthermore, institutions already undergo substantial scrutiny (and incur substantial out-of-pocket costs) associated with operational risk through extensive AICPA-mandated procedures, performed annually by all independent auditors as part of rendering an opinion on an institution's financials and operations. To enforce an additional burden in this area appears excessive.

COMMERCIAL INSTRUMENT RISK

The analysis of risk inherent in commercial instruments should be distinguished between the risk in commercial investment vehicles (i.e. debt securities) and commercial real estate credits. Sound underwriting practices form a solid basis for averting undue risk in a commercial real estate loan portfolio. Such controls as an institution can establish and monitor internally with its loan portfolio may not always be evident in the underlying structure of certain investment vehicles. Therefore, such a distinction should be considered and evaluated before finalization of the guidelines.

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.

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%

It is important to note the following significant information from the above table:

- 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. **THIS 29.6% IS OBVIOUSLY A LARGER PERCENTAGE OF TOTAL ASSETS THAN RESIDENTIAL LENDING AT 23.2% BUT IS NOT SPECIFICALLY 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, the calculation of which should be easily manageable and not duly complex:

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

- **Corporate Exposures**: The rule should provide more granularity in risk weights for the major categories of corporate exposures. One way to achieve this would be to use loan-to-value (LTV) ratios to risk-weight corporate exposures such as multi-family residential mortgages and commercial real estate (CRE).

- **Retail Exposures**: The rule should clarify what a "well-diversified portfolio" is for purposes of the rules governing regulatory retail exposures. While a lower risk weight for retail exposures is appropriate, banks will have a difficult time knowing whether that risk weight applies without further clarification of what meets the "well-diversified" standard.

- **Operational Risk**: The rule should provide flexibility to banking organizations by including a more refined measurement of capital needed for operational risk where appropriate. We recommend that the final rule allow banks to make a voluntary choice among three options:

(1) the NPR's proposed Basic Indicator Approach (BIA), (2) the International Accord's Alternative Standardized Approach option, and (3) the Advanced Measurement Approaches (AMA) as outlined in NPR.

I also recommend that the final rule allow any bank using the Standardized Approach to have the flexibility to use the Basel I capital rules for *de minimis* exposures. The approach taken in the Standardized Approach (as well as in Advanced Internal Ratings-Based approach) uses a principle of conservatism. While this is potentially useful, I recommend that the rule state in addition that a bank may elect to assign capital based on Basel I for asset classes that, in the aggregate, do not exceed some specified percentage of capital. This would minimize an impact that otherwise may cause a bank to conclude that the burden of adopting the Standardized Approach for all assets outweighs the benefits in terms of enhanced risk management and sensitivity. This practice would also allow banks to progress toward more risk-sensitive capital rules as soon as they meet essentially all of the requirements.

While I generally agree with the NPR's treatment of exposures to depository institutions, I recommend that the final rule clearly state that exposures evidenced by certificates of deposit of less than or equal to an amount that is fully insured by FDIC insurance should be risk-weighted at 0 percent instead of 20 percent. I understand that the regulators are concerned that there is the possibility of fraud in these transactions and thus are inclined to keep such exposures at 20 percent. However, I strongly believe that the regulators should send a strong, consistent signal that any obligation backed by the full faith and credit of the U.S. is essentially risk-free and therefore deserving of a 0 percent risk weight. Any transaction is susceptible to fraud; however, this concern should be kept separate from the underlying characteristics of the exposure at issue. Fraud by its very nature is a localized event. It can and should be addressed on a case-by-case basis, with no system-wide adverse effect on the risk-weighting of insured CDs.

Please refer to the following table for an illustration of our comments:

CORRESPONDENT BANK DEPOSITS

PORTION OF TOTAL BALANCE	RISK-WEIGHT
First $250,000	0%
Remaining balance	20%

Risk weights: Corporate exposures. The NPR would permit a bank to elect one of two methods to risk-weight corporate exposures. A bank could either (1) risk-weight all of its corporate exposures at 100 percent without regard to external ratings; or (2) risk-weight a corporate exposure based on its applicable external or applicable inferred rating.

If a corporate exposure has no external rating, that exposure could not receive a risk weight lower than the risk weight that corresponds to the lowest issuer rating of the obligor's sovereign of incorporation.

I believe the proposed approach fails to recognize the variety of risks in corporate exposures. Just as residential mortgage loans present different risks depending on the loan-to-value (LTV) ratio, so too do corporate exposures. Thus, I recommend that the final rule reflect LTVs in the risk weight for corporate exposures. I recognize that corporate exposures (such as loans secured by CRE and multi-family housing) as a group present different risk characteristics than do residential mortgage loans, and thus I propose a different – and more conservative – set of risk weights for CRE than is used for residential mortgages. Below is one option that our members believe fairly reflects the risks arising from corporate exposures with varying LTV ratios:

LTV Ratios	Risk Weight
Up to 20 percent	20 percent
Over 20 percent up to and including 40 percent	35 percent
Over 40 percent up to and including 50 percent	50 percent
Over 50 percent up to and including 75 percent	75 percent
Over 75 percent	100 percent

If this (or a similar) approach is used, the regulation would need to explain how "value" is to be calculated. I recommend that a bank have the option of using the appraised value as of the date of origination or basing capital charges on an updated value of the collateral securing a corporate exposure. This would create a strong incentive for banks to retain high-quality, low-risk assets on their books and would be consistent with the objective of better matching regulatory capital to actual risk.

Risk weights: Regulatory retail exposures. I support applying a 75 percent risk weight to retail exposures, but I am concerned that the open-ended nature of this approach will severely diminish the utility of this provision. As proposed, it has a "you know it when you see it" quality, making it effectively impossible for a bank to know whether a loan qualifies for the 75 percent risk weight. Moreover, this is likely to result in significant variations from agency to agency and examiner to examiner, thereby further diminishing the extent to which this approach results in reliable risk-sensitive capital assignments.

Similarly, I believe the cap of $1 million for all exposures to any one borrower will result in exposures being treated as corporate exposures in many cases where the lower risk weighting assigned to retail exposures would be more appropriate. I note by way of comparison that the New Accord uses a limit of €1 million, which currently is worth approximately $1.34 million. Such a higher limit (not tied to a fluctuating foreign currency, of course) is appropriate here as well. To avoid the infeasibility of having a floating cap while at the same time preserving comparability to the rules applied abroad, I suggest that the U.S. regulators set the cap in the final rule at a figure that is consistent with the dollar equivalent of €1 million. That cap could then be adjusted annually as needed to preserve comparability.

The final rule also needs to address what happens to the retail exposure portfolio if an asset in that portfolio exceeds the threshold. Presumably, that asset would be included in the corporate exposure portfolio for purposes of the capital rule without tainting the entire retail exposure portfolio, but I request that the final rule make this clear.

I recommend that the final rule not require that geographic diversification be a mandatory or sole criterion for defining a "well diversified portfolio." Banks will likely have natural markets that they serve and indeed often are criticized for lending out of that market. If geographic diversity is a test for diversification, smaller banks would likely find the retail exposure classification of little value. If a bank wishes to demonstrate diversification stemming from a geographically dispersed portfolio, that should be permitted.

Risk-Weights: Residential Mortgage Exposures. The proposal uses LTVs to risk-weight first-lien residential mortgage loans secured by property that is owner-occupied or rented, prudently underwritten, not past due more than 90 days, and performing according to its original terms. Stand-alone junior lien residential mortgages also are risk-weighted according to LTV. Exposures that are more than 90 days past due would receive a risk weight of 150 percent (or 100 percent if they have an LTV of no more than 90 and meet other qualifying criteria).

I support using LTV ratios to assign capital. Prudently underwritten residential mortgage loans historically have been low-risk assets, particularly when the borrower has a significant amount of equity in the home. I encourage the regulators to adopt the proposal, with the following changes.

First, banks should have the option of determining "value" in an LTV calculation based on original or updated appraisals of residential mortgages. As previously noted, this would better match risk to the capital assignment. This flexibility would further encourage and reward banks that keep closer tabs on the collateral.

However, it is very important that this be only an option and that a bank that wishes to use just the asset valuation at origination NOT be required to reappraise collateral, as the cost of such a requirement can outweigh any benefit.

Second, while I recognize that pool-level PMI presents practical difficulties in determining which assets are protected, such PMI nevertheless can provide meaningful protection and should be considered when determining the loan amount. Pool-level PMI allocated proportionately among the loans with an appropriate discount should offset loan value in LTV. At a minimum, pool-level PMI should be considered under Pillar 2 when evaluating the adequacy of a bank's capital irrespective of the regulatory minimum capital standards under Pillar 1.

The regulators invite comment on whether factors in addition to LTV should be considered when determining the appropriate risk weights. While there are other factors (such as FICO scores or HMDA data) that lenders often use to determine risk, I believe there is a tradeoff between additional refinement and burden. Using LTV ratios without additional risk determinants strikes an appropriate balance.

The regulators also invite comment on two alternatives for calculating the LTV ratio. The proposal requires a separate calculation for both funded and unfunded amounts, while the alternative calculates only a single LTV ratio representing a combined funded and unfunded amount. I believe there are pros and cons to both the NPR's proposed and alternative calculation for the LTV ratio in determining mortgage risk-weighted exposures. Bankers see no difference in complexity between the alternatives, as both methods use the same input data. The preference for either of these LTV ratio calculations is likely to be bank-specific.

Community banks like mine, on the other hand, believe the proposed approach better captures the risks more commonly seen in their mortgage portfolios. These banks are likelier to have proportionately more home equity lines of credit (HELOCs) than negative amortization products. There is likely to be less of a correlation between the performance of a HELOC and the funded portion of a loan than there is between the negative amortization features of a funded loan. Accordingly, these banks believe it would be appropriate to apply a final rule that treats the two components separately.

Given the relatives merits of both approaches, I recommend that the final rule permit a bank to select the option that is most appropriate for its operations.

Risk-Weights: Past Due Exposures. The NPR would risk-weight exposures that are more than 90 days past due or on nonaccrual at 150 percent (or 100 percent in the case of residential mortgage loans meeting certain criteria, as noted above). The Agencies seek comment on whether, for those banking organizations that are required to maintain specific provisions, it would be appropriate to follow the New Accord treatment and vary the risk weight depending on the amount of specific provisions the banking organization

For specific reserves for impaired assets, I believe that those banks that establish such reserves (and thereby recognize immediate hits to earnings and capital) should not have to add capital. In establishing a specific reserve against a specific exposure, a bank has carefully evaluated the potential loss, subject to auditor and supervisor review. The risk is already addressed in the reserves, in that the specific reserve is deducted from regulatory capital. In fact, extra capital is already required, in addition to the deducted special reserve, in an amount equal to the risk weight applied to the residual exposure (the exposure less the specific reserve). With this conservative capital treatment, there is no need for a higher risk weighting for the residual exposure. Any additional capital requirement would simply be a pro-cyclical burden.

Risk-Weights: Fannie Mae and Freddie Mac debt. Under the current rules, government-sponsored enterprise (GSE) mortgage-backed securities and debt securities receive a risk weight of 20 percent.

The regulators recently proposed lowering the risk weight to 10 percent for (a) securities (excluding common or preferred stock) issued by, or other direct claims on, Fannie Mae and Freddie Mac and (b) that portion of assets including claims on and the portions of claims that are guaranteed by those GSEs. We **support a lower risk weight**.

We also believe it is very important to provide comparable risk weights treatment for FHL Bank debt held by banks, to prevent the unintended consequence of widening the spread between FHL Bank debt and comparable debt issued by Fannie Mae and Freddie Mac. This will create consistency of treatment with all GSEs that support the housing market.

Risk-Weights: Bank premises. Currently, bank land and buildings are risk-weighted at 100 percent. No mention of change of treatment for risk-weighting has been noted in the NPR for these assets. It is important to some community banks to have the option to adjust the risk weight based on the book value of these assets. For instance, the net book value of those assets less than or equal to 50 percent of appraised value could be risk-weighted at 20 percent; the additional net book value of those assets less than or equal to 70 percent could be risk-weighted at 75 percent; and the remainder of the net book value of those assets greater than 70 percent could be risk-weighted at 100 percent.

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.

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%

With the auditing profession's continued movement toward fair value accounting for an institution's balance sheet, it is once again stressed that the investment in brick and mortar is subject to a much more fluid application of risk assessment than simply categorizing all such assets at 100%. This is especially true for mature institutions in relatively stable real estate markets, whose fixed asset net book value is far exceeded (even in these times) by appraisals or other market valuation measures. The capital guidelines would be remiss in failing to recognize the inherent value in these assets (oftentimes significant depending on location, competition and market conditions).

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%

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%

Operational risk. The Agencies propose to use the Basic Indicator Approach (BIA), which requires banks to allocate capital in an amount equal to 15 percent of the average positive annual gross income computed over the previous three years, multiplied by 12.5. Comment is invited on whether banks should have the option of using the Advanced Measurement Approaches (AMA).

I believe that capital is **not** the best means to deal with operational risk. Far more important is the risk-management capability to deal with operational losses and the availability of insurance or other protections against such losses. The proposed BIA, by focusing solely on gross revenues as a proxy for operational risk, may not adequately correspond to the risk exposure. Thus, I will continue to oppose inclusion of an operational risk component in the Pillar 1 formula and feel that this risk can only be appropriately addressed through Pillar 2 supervision.

CONCLUSION

I appreciate the opportunity to comment on the Standardized Approach Framework NPR. While I appreciate the Agencies' efforts to find the appropriate balance between adequate risk assessment and feasible workability (especially at the community bank level), it is also vital for the Agencies' to recognize the issues addressed herein, especially (a) the complexity and cost of administering an internal program, (b) the impracticality of measuring operational risk as set forth, and if it is to remain, then the need for further study and refinement of its measurement, (c) the identification and segregation of specific assets (such as those that are "commercial" in nature) for more accurate risk measurement, and (d) the inclusion of ALL of an institution's assets in any overall measurement formula that is ultimately decided upon.

I believe that a Standardized Approach, duly thought out and utilizing practical assessment methodologies, will be a welcome alternative for many banks, and will bring much needed consistency in the U.S. pertaining to the risk-based capital framework. Thank you for considering my comments and recommendations.

Sincerely,

Kathleen E. Marinangel, CEO and President

McHenry Savings Bank