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March 26, 2007

Office of the Comptroller of the Currency
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Washington, DC 20219

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. 05-16
regs.comments@occ.treas.gov

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

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

comments@FDIC.gov

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:

The Illinois League of Financial Institutions (ILFI) is a statewide banking trade association dedicated to furthering the viability of thrifts and community banks in Illinois. Please accept the thanks of the Illinois League on your willingness as regulators to support the proposed Basel1-A version.

The ILFI community banking members must compete not only against other community banks but also against Regionals, Super-Regionals, Nationals and International banks. These institutions 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 community banks are managed. No banker can focus his/her attention on only a sample of the items on the bank's balance sheet in order to be competitive and satisfy regulators. **IT IS THEREFORE NECESSARY THAT ALL ASSETS ON THE BANK'S BALANCE SHEET BE ADDRESSED FOR RISK-WEIGHTING SENSITIVITY.**

Prior to assuming the post of President of the ILFI, I served as an Assistant Commissioner of the Illinois Office of Banks and Real Estate. As a banking regulator for more than 15 years, I observed numerous instances of across-the-board regulation and the unintended consequences of such actions. This approach and inflexible standards can penalize otherwise well-capitalized community based thrifts and banks. One unintended consequence would be to give large regional and multi-state banks an unfair advantage over smaller community based entities. Another would be to force the smaller community based bank or thrift to ration credit to the community based not on the credit worthiness of the borrower but rather by the effect the transaction might have on the capital composition.

My experience as a bank regulator and my subsequent experience as a banking trade group executive have made it abundantly clear to me that the possible effects of legislation and regulation rest in a thorough analysis of the details. In this case, an in-depth analysis of bank balance sheets provides helpful insight.

Please review the table below.

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

	<u>Balance</u>	<u>% of Assets</u>
Cash & Due from Banks	425,568,158	3.6%
Securities	2,606,656,410	22.2%
Loans:		
<u>Secured by 1-4 Family Residential:</u>		
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	<u>2,018,995,053</u>	<u>17.2%</u>
Total Assets	<u><u>11,765,275,270</u></u>	<u><u>100.0%</u></u>

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 **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. ASSETS NOT ADDRESSED IN THE NPR:

- **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 $\leq 20\%$ could be in the 20% bucket; those with LTV Ratios of $\leq 40\%$ could be in the 35% bucket; those with LTV Ratios of $\leq 50\%$ could be in the 50% bucket; those with LTV Ratios of $\leq 75\%$ 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.
- **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.** 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 the 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 approach taken 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, amortization 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.
- **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%.
- **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.
- **Interest-Earning Deposits (CDs) \leq \$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.

- **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.
- **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.
- **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 at 100%.

As stated earlier, all 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%

Most community banks 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 be 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 I-A formula allow for **all** options in regards to all assets on a bank's balance sheet. Basel I-A 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 I-A 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 community banks to have all options** and give us with the ability to compete against Basel II banks.

- STANDARDIZED APPROACH

Adoption of parts of the Standardized Approach in lieu of addressing assets not identified in the NPR should be permitted to 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

Basel I-A Banks should be given the option **to remain under the Basel 1 Accord** or to **partially or fully adopt the Basel I-A 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 I-A in its entirety, is a viable and necessary option. Give us the ability of choice.

- SECOND LIENS AND HELOCS

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 to change, small community banks would be hardest hit since they use the FHLB System as a critical source of funding.

CONCLUSIONS:

NO FINAL RULE WITHOUT FURTHER DISUCSSIONS

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 II international and U.S. banks is critical. In order to do so, we must have a **comprehensive Basel I-A** formula that allows for risk-weighting of **ALL ASSETS** on the balance sheet. The time is now to get the job done.

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 I-A framework and to the ability of a successful competitive banking environment.

The ILFI once again, wishes to thank the regulators for their support of a proposed Basel I-A. 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. Community banking is the backbone of commerce in this State. A practical understanding of the effects these capital guidelines would have on banking and thrift entities as well as an approach that accounts for ALL of the assets in a bank's balance sheet are essential to the continued viability of these institutions. 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.

Yours very truly,



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