Andover Bank
A Better Way.....
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October 12, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal
Reserve System
20th Street and Constitution Ave. N.W.
Washington, D.C. 20551

Office of the Comptroller of the Currency
250 E. Street S.W.
Mail Stop 2-3
Washington, D.C. 20219

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

Re: Basel III Capital Proposals

Ladies and Gentleman:

Thank you for the opportunity to provide comment on the Basel III proposals that were recently approved by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

Andover Bank is a local, independent community bank in Northeast Ohio Founded in 1884. We are currently over $340 million in assets and have 8 offices, 7 in Ashtabula County and 1 in eastern Lake County. As of June 30, 2012 the Bank had Tier 1 Leverage Capital of 8.97%, Tier 1 Risk Based Capital of 19.66%, and Total Risk Based Capital of 20.66%.

The Bank serves the financial needs of the local residents in primarily rural communities by providing a full range of personal and commercial banking products including consumer, mortgage, and commercial loans; checking, savings, certificates of deposit, and IRA's. We like most community banks in the country want to be assured that we are able to continue serving our communities as we have in the past.

I would like to say that the capital requirements of Basel III, while they may be appropriate for large domestic banks and foreign banks, are not appropriate for community banks. I am highly concerned about the cost of compliance and the effects Basel III will have on our ability to continue supporting economic development opportunities in our area. The complexity of the proposal will require significant investment in personnel and technology software. Presently we do not have the staffing and technology in place to generate the granularity needed to report under Basel III

Following are items of the proposal in which I have concerns:

1. Unrealized gains and losses on available for sale ("AFS") securities flowing through regulatory capital.

   With historically low market rates and unrealized gains on the balance sheet of most financial institutions, this proposal would serve to increase regulatory capital in the short term. As interest rates rise, the capital resulting from the inclusion of unrealized gains would quickly reverse and move in the opposite direction. Presently our investment portfolio stands at $145 million and the unrealized gain is $6.2 million. A 100 basis point upward rate shock would reduce the unrealized gain on the portfolio by $5.9 million to $0.3 million. This type of volatility is unacceptable and would result in our capital ratios changing quite dramatically. We could be forced to shrink our balance sheet as the economy improves and rates begin to rise. We may be forced to sell our available for sale securities and record all future purchases in held to maturity. Additionally, we would need to invest in shorter duration securities having less price volatility and lower yields. This would limit the bank's ability to manage the investment portfolio in a manner appropriate for earnings, liquidity, and interest rate risk management.

2. Increased risk weighting for residential mortgage loans.

   Andover Bank provides a significant number of residential mortgage loans to people in our market area and historically has experienced limited losses on these types of loans. While economic conditions and the recent housing bubble have resulted in large losses on residential mortgage loans, these loans have historically been considered of low credit risk. The required additional capital to support this type of lending when considering the underlying credit risk makes the cost of housing this type of loan considerably more expensive and would result in increased credit cost to the consumer. Also, the methodology for determining risk weighting is quite onerous and applies not only to new mortgages, but also existing mortgages. This would require additional bank staff to go through old loan files to determine the appropriate risk weight for each loan. In addition, we may not have collected the data necessary on existing loans to assign proper risk categories.

3. Change in risk weighting for home equity and second lien loans.

   Andover Bank presently holds about $19.5 million in second lien loans on residential properties. These types of loans have been profitable for the Bank and the Banks historical losses have been minimal. Risk weighting on these types of loans as high as 200% will restrict availability of credit and increase the cost of that credit for consumers. As compared to large domestic banks, community banks tend to be more familiar with their customers and the risks associated with these types of loans.

4. Proposal to increase risk weights on delinquent loans.

   Although Andover Bank is currently fortunate to have few delinquencies, the situation could change based on a further deteriorating economy. Delinquent loans are presently considered in the Allowance for Loan and Lease Loss ("ALLL") analysis. The bank already sets aside reserve allocations for loans based on their status. This rule serves to require banks to set aside capital twice for loans that are past due. The rule could act to reduce the banks willingness to restructure loans or work as long with borrowers to resolve credit issues.

5. Proposal to increase risk weights on high volatility real estate loans.

   The bank presently holds about $9.0 million in commercial real estate loans, but is presently focused on growing this segment of the loan portfolio. The risks associated with these types of loans are already assessed in the ALLL analysis and the increased level of required reserves provides the capital necessary to protect the Bank from the inherent risk of these loans.

6. Rule requiring banks to hold capital for credit enhancing representations and warranties on 1-4 family residential home loans that have been sold into the secondary market.

   Our Bank currently services approximately $54 million in residential mortgage loans and the dollar amount of these loans required to be repurchased has been minimal. Any loans repurchased have been the result of a disagreement over underwriting rules or appraisal values. The Basel III rules state that we need to set aside capital on 100% of the serviced loans for potential future liabilities that to date have been insignificant. The Bank is already questioning the viability of continuing in the mortgage servicing business and this rule would only add to our list of reasons for exiting.

Changes to the risk weighting of the various assets seem to be an overreaction to recent economic events and could cause community banks to re-evaluate the types of loans they are willing to originate based on the cost of capital needed to support those loans. These rules will serve to determine what loan sectors receive funding. Andover Bank's ability to continue serving our community and supporting the local economy is dependent on our capital. The higher capital levels required by Basel III along with the increased risk weighting to the types of loans our customers demand will severely limit our ability to continue the services we provide to our community.

The Basel III rules may be necessary for very large and foreign financial institutions that have historically operated with less capital and have a dramatically different risk profile than community banks. These rules were meant for large complex banks, not small community banks. The implementation of Basel III as proposed would significantly and negatively alter the services community could provide for their customers. Community banks did not cause the economic downturn we are in and should be exempted from the increased capital requirements and regulatory burden of Basel III.

Sincerely,

Edward B. Debevec
Chief Financial Officer