FEDERAL TRUST CORP
Form 10-K
March 15, 2007

U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

x **Annual report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934**

for the fiscal ended December 31, 2006.

o **Transition report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934**

for the transition period from _____________ to _____________.

Commission file number: 33-27139.

FEDERAL TRUST CORPORATION

(Exact name of registrant as specified in its charter)

Florida	**59-2935028**
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
312 West 1st Street Sanford, Florida	**32771**
(Address of principal executive office)	*(Zip Code)*

Registrant s telephone number, including area code: (407) 323-1833

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:

Common Stock, par value $.01 per share

(Title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes	No
o	x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes	No
o	x

Note - Checking the box above will not relieve any registrant required to file reports pursuant to section 13 or 15(d) of the Exchange Act from their obligations under those Sections.

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes	No
x	o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will no be contained, to the best of registrant s knowledge, indefinitive proxy or information statements incorporated by reference in Part III of the Form 10-K or any amendment to the Form 10-K. o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer o Accelerated filer x Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

Yes	No
o	x

Revenues for the fiscal year ended December 31, 2006: $46,068,000

The aggregate market value of the common stock of the Registrant held by non-affiliates of the Registrant (8,365,460 shares) on June 30, 2006, was approximately $91,184,000. The closing price of Registrant s common stock on June 30, 2006 was $10.90 per share. For the purposes of this response, directors, officers and holders of 5% or more of the Registrant s common stock are considered the affiliates of the Registrant at that date.

The number of shares outstanding of the Registrant s common stock, as of March 9, 2007 was 9,388,825 shares.

DOCUMENTS INCORPORATED BY REFERENCE:

1. Portions of the Proxy Statement for the 2007 Annual Meeting of Shareholders filed electronically with the Securities and Exchange Commission on or about April 15, 2007. (Part III)

TABLE OF CONTENTS

Federal Trust Corporation and Subsidiaries (Registrant).

(1) The material required by Items 9 through 11 and item 14 is hereby incorporated by reference from Registrant s definitive Proxy Statement, pursuant to Instruction E 3 of Form 10-K.

PART I

ITEM 1. BUSINESS

General

Federal Trust Corporation (Federal Trust) was organized in February 1989 for the purpose of becoming the unitary savings and loan holding company of Federal Trust Bank (the Bank), a federally-chartered stock savings bank. Federal Trust essentially has two wholly-owned operating subsidiaries, the Bank and Federal Trust Mortgage Company (the Mortgage Company) collectively referred to as the Subsidiaries. Federal Trust and its Subsidiaries are collectively referred to herein as the Company. As a savings and loan holding company, Federal Trust has greater flexibility than the Bank to diversify and expand its business activities, either through newly formed subsidiaries or through acquisitions.

Federal Trust is a legal entity separate from its Subsidiaries. Federal Trust s corporate headquarters are located at 312 West 1st Street, Sanford, Florida 32771, and its telephone number is (407) 323-1833. To date, the principal source of Federal Trust s revenues, on an unconsolidated basis, is earnings of the Bank and the Mortgage Company. Various regulatory restrictions and tax considerations limit, directly or indirectly, the amount of dividends the Bank can pay to Federal Trust. In addition, federal law restricts the Bank in the making of investments in or loans to Federal Trust or its affiliates. See Regulation and Supervision.

Subsidiaries

Federal Trust Bank is chartered as a Federal-stock savings bank and is primarily engaged in the business of obtaining funds in the form of customer deposits and Federal Home Loan Bank (FHLB) advances and investing such funds in permanent loans on residential and commercial real estate and, as well as in various types of construction, commercial and consumer loans and in investment securities. The Federal Deposit Insurance Corporation (FDIC), an agency of the United States Government, insures through the Deposit Insurance Fund (DIF), all depositors of the Bank up to $100,000 in accordance with the rules and regulations of the FDIC. The Bank is subject to comprehensive regulation, examination and supervision by the Office of Thrift Supervision (OTS) and the FDIC, which is intended primarily for the benefit of depositors. See Regulation and Supervision.

Federal Trust Mortgage Company was formed in May 2005 as a wholly-owned subsidiary of Federal Trust. The Mortgage Company commenced operations on January 2, 2006 to provide residential loan products for customers of the Bank, to produce mortgage loans to be sold to third party purchasers, to buy and sell mortgages in the secondary market and to service the residential loans, including the Bank s portfolio. When the Mortgage Company commenced operations, the mortgage origination and servicing staff of the Bank were transferred to the Mortgage Company.

Federal Trust Statutory Trust I (the Statutory Trust I) - was formed in September 2003, for the sole purpose of issuing $5,000,000 of trust preferred securities. In accordance with Financial Accounting Standards Interpretation No. 46 *Consolidation of Variable Interest Entities,* Federal Trust accounts for the Statutory Trust under the equity method of accounting.

Critical Accounting Policies

Our financial condition and results of operations are sensitive to accounting measurements and estimates of matters that are inherently uncertain. When applying accounting policies in areas that are subjective in nature, we use our best judgment to arrive at the carrying value of certain assets. The most sensitive accounting measurement we applied is related to the valuation of the loan portfolio and the adequacy of the allowance for loan losses.

A number of factors impact the carrying value of the loan portfolio including the calculation of the allowance for loan losses, the valuation of underlying collateral, the timing of loan charge-offs and the amount and amortization of loan fees and deferred origination costs. We believe that the determination of the allowance for loan losses represents a critical accounting policy. The allowance for loan losses is maintained at a level management considers to be adequate to absorb probable loan losses inherent in the portfolio, based on evaluations of the collectibility and historical loss experience of loans. Credit losses are charged and recoveries are credited to the allowance. Provisions for loan losses are based on our review of the historical loan loss experience and such factors which, in management s judgment, deserve consideration under existing economic conditions in estimating probable credit losses. The allowance is based on ongoing assessments of the probable estimated losses inherent in the loan portfolio.

Our methodology for assessing the appropriate allowance level consists of several key elements described in the section Lending Activities Allowance for Loan Losses . The allowance for loan losses is also discussed as part of Results of Operations and in Notes 1 and 3 to the consolidated financial statements. The significant accounting policies are discussed in Note 1 to the consolidated financial statements.

Forward Looking Statements

Readers should note, in particular, that this document contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), that involve substantial risks and uncertainties, including the risks described in Item 1A of this Form 10-K. When used in this document, or in the documents incorporated by reference herein, the words anticipate, believe, estimate, may, intend and expect and similar expressions identify certain of such forward-looking statements. Actual results, performance or achievements could differ materially from those contemplated, expressed or implied by the forward-looking statements contained herein. Actual results may differ materially, depending upon a variety of important factors, including competition, inflation, general economic conditions, changes in interest rates and changes in the value of collateral securing loans we have made, among other things.

Strategy

Our operating strategy has been and continues to be focused on building a strong community bank branch network serving Central Florida with competitive deposit products, which fund the origination and acquisition of residential mortgage loans, and the expansion of our commercial loan portfolio. Residential loans are typically secured by a first mortgage on a dwelling and commercial loans are secured by real estate located and operated primarily in our market area and where appropriate, the working assets of the borrower (such as accounts receivable, inventory, and equipment). We also provide loans to consumers secured by the equity in their homes.

Our lending activities are funded by core deposit generation through our expanding branch network, borrowings from the Federal Home Loan Bank, and in the brokered deposit market when rates are favorable. To the extent possible, we attempt to control interest rates paid on deposits; however, outside factors such as economic, environmental, competitive and liquidity needs will have an effect on the cost of funds. Our principal sources of earnings is interest on loans, securities, and overnight deposits, fees on checking and loan accounts and sales of loans and investments held for sale. Our principal expenses are interest paid on deposits and other borrowings, personnel and other operating expenses.

Market Area and Competition

We have nine full-service branch offices located in: Sanford, Winter Park, New Smyrna Beach, Casselberry, Deltona, Orange City, Lake Mary, Port Orange and Eustis, Florida. Sanford, which is located approximately 20 miles northeast of downtown Orlando, is the second largest city in Seminole County and is the county seat. Winter Park is located 13 miles southeast of Sanford and approximately seven miles northeast of downtown Orlando. Our market area encompasses Orange, Seminole, Lake, and Volusia Counties in Central Florida. The total population of the four County areas is estimated at 1.9 million, with the majority in Orange and Seminole Counties. The Casselberry and Lake Mary branches are located in Seminole County between our Sanford and Winter Park Offices. New Smyrna Beach and Port Orange are located in Volusia County near the Atlantic Ocean, south of Daytona Beach, Florida. Eustis is located in Lake County, 26 miles west of our Sanford branch. Deltona and Orange City are both located in the Western part of Volusia County along the Interstate 4 corridor between Orlando and Daytona Beach. During 2006, we opened our Lake Mary branch in January, Port Orange branch in July and Eustis branch in October. We plan to open two additional branches in the second half of 2007, our Palm Coast branch in Flagler County and the Edgewater branch in Eastern Volusia County. Our administrative and operation offices are housed in Sanford.

Our primary market area is Orange, Seminole, Volusia and Lake Counties, and to a lesser extent Flagler and Osceola Counties. Although best known as a tourist destination, with over 20 million visitors a year, the Central Florida area has become a center for industries such as aerospace and defense, electro-optics and lasers, computer simulated training, computer networking and data management. In addition, motion picture production, professional and amateur sports, and distribution makes the local economy more diverse each year. Many companies, including some in the Fortune 500, have chosen the greater Orlando area as a base for corporate, regional, and divisional headquarters.

The area is also home to the University of Central Florida with an enrollment of 47,000, one of the fastest growing schools in the state university system, as well as Valencia Community College and Seminole Community College whose combined enrollment exceeds 80,000. Winter Park is home to Rollins College, Florida s oldest college. In addition, Stetson University, Florida s first private university is located in Volusia County.

We experience substantial competition in attracting and retaining deposits and in lending funds. The primary factors in competing for deposits are customer service, branch locations and interest rates. Direct competition for deposits comes from other savings institutions, commercial banks and nontraditional financial service providers, including insurance companies, consumer finance companies, brokerage houses and credit unions. Additional significant competition for deposits comes from corporate and government securities and money market funds. The primary factors in competing for loans are loan structure, interest rates and loan origination fees. Competition for origination of real estate loans normally comes from other savings institutions, commercial banks, mortgage bankers, insurance companies and real estate investment trusts.

Consolidation within the banking industry, and in particular within Florida, has remained constant over the past several years. As of June 30, 2006, the five largest out-of-state bank holding companies in Florida controlled approximately 57% of the bank deposits. Federal Trust is one of the largest independent financial institutions with headquarters and all of our branch locations in the Central Florida market place. At the same time that we have seen continued consolidation of local community banks, seasoned banking executives continue to spearhead the formation of new community banks with aggressive capital and growth plans.

Geographic deregulation also has had a material impact on the banking industry. Legislation in Florida and on the national level, has removed most of the final barriers to interstate banking. Under Florida Law, bank holding companies are permitted to acquire existing non *de novo* banks across state lines. A bank holding company may consolidate its interstate subsidiary banks into branches and merge with a bank in another state, depending on state laws.

Lending Activities

General. Our residential lending has traditionally included the origination, purchase and sale of mortgage loans for the purchase, refinance or constructing of residential real property, primarily secured by first liens on such property. In January 2006, the residential origination and underwriting functions were transferred to the Mortgage Company. These loans are typically conventional home loans or lot loans which are not insured by the Federal Housing Agency (FHA) or partially secured by the Veterans Administration (VA). Loans with fixed rates beyond five years are generally sold into the secondary market. Loans with fixed rates of five years or less are generally considered for portfolio. Interest rates for construction loans are generally tied to the prime rate and float daily during the construction period and are converted to either fixed or adjustable permanent mortgages upon completion. To a lesser extent, we also make home equity loans with second liens, which generally float daily with the prime rate. Other consumer related loans are savings loans secured by certificates of deposit at an interest rate above the rate paid on the certificate.

Since 2000, we have increased our commercial real estate lending and cross marketing of business accounts. Commercial loans are comprised of loans to small businesses secured by real estate used in the enterprise and, where appropriate, the working assets of the business. We also make real estate loans for the acquisition and development of land for residential, and income producing projects. Commercial loans are generally priced on a floating prime rate basis or fixed at repricing intervals not to exceed five years. As a matter of policy, commercial loans are generally guaranteed by the borrowers principals.

Credit Risk. Since our primary business is the origination and acquisition of real estate secured loans, that activity entails potential credit losses which are beyond our control, the magnitude of which depends on a variety of economic factors affecting borrowers. While guidelines have been instituted and credit review procedures have been put into place to protect us from credit losses, some losses may inevitably occur. During 2006, we recognized $39,000 in charge-offs, and $21,000 in recoveries from prior charge-offs.

Loan Portfolio Composition. Our net loan amount, which is total loans plus premiums paid for loans purchased less loans in process, deferred loan origination fees and costs and allowance for loan losses, totaled $603.9 million at December 31, 2006, representing 84% of total assets at such date. At December 31, 2005, our net loan portfolio was $630.8 million or 86% of total assets.

Residential mortgage loans, not including construction and lot loans, still comprise the largest group of loans in our loan portfolio, amounting to $356.1 million or 56% of the total loan portfolio at December 31, 2006, down from $400.0 million or 57% of the total loan portfolio at December 31, 2005. The decrease in the residential loan portfolio in 2006 was primarily due to the decrease in the volume of residential origination and purchase loan activity, due to the flat yield curve. As a result, the volume of loan prepayments exceeded the volume of new loans added to our portfolio. We offer and purchase adjustable rate mortgage (ARM) loans with maturities up to 30 years. As of December 31, 2006, approximately 97% of the residential loan portfolio loans were ARM loans and 3% were fixed-rate. Fixed-rate loans are generally underwritten to secondary market standards to insure liquidity and interest-rate risk protection. Residential lot loans amounted to $42.7 million or 7% of total loans at December 31, 2006. These loans are secured by developed lots ready for construction of single-family homes. As a result of the softening in the housing market during 2006, we also reduced our residential construction loans to $36.6 million or 6% of total loans at December 31, 2006, from $81.6 million or 12% of total loans at the end of 2005. These loans are generally on property in Southwest Florida and throughout the state and are underwritten directly to the individual or family for their primary residence or second home.

Commercial real estate secured loans amounted to $93.1 million or 15% of the total loan portfolio at December 31, 2006. This portfolio includes loans to businesses to finance their office, manufacturing or retail facilities. Commercial land, development and construction loans amounted to $88.6 million or 14% of total loans. The land loans are generally larger parcels of property held for future development. The development and construction loans include loans for the acquisition and development of both residential and commercial projects. The construction loans are made directly to the builders of single and multi-family homes for pre-sold or speculative units. We also finance the construction of commercial facilities, generally for the owner/operator.

Commercial loans at December 31, 2006, were $15.3 million or 2% of total loans. These loans are generally secured by the assets of the borrower including accounts receivable, inventory and fixed assets, including company owned real estate and are usually also guaranteed by the owners.

Consumer loans, consisting of installment loans and savings account loans at December 31, 2006, were $125,000 or less than 1% of the total loan portfolio.

The following table sets forth information on our loan portfolio by type (in thousands):

	At December 31,									
	2006		2005		2004		2003		2002	
	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total
Residential lending:										
Mortgages	$ 356,133	56.4%	$ 399,973	56.6%	$ 374,581	70.8%	$ 302,083	75.4%	$ 246,235	79.2%
Lot loans	42,676	6.7	40,203	5.7	41,369	7.8	20,816	5.2	8,742	2.8
Construction	36,570	5.8	81,572	11.5	5,405	1.0	780	0.2	1,822	0.6
Total Residential lending	435,379	68.9	521,748	73.8	421,355	79.6	323,679	80.8	256,799	82.6
Commercial lending:										
Real estate secured	93,095	14.7	71,253	10.1	56,267	10.6	47,918	12.0	32,061	10.3
Land, development and construction	88,586	14.0	90,794	12.8	38,091	7.2	16,524	4.1	14,598	4.7
Commercial loans	15,308	2.4	22,529	3.2	13,257	2.5	11,639	2.9	6,568	2.1
Total Commercial lending	196,989	31.1	184,576	26.1	107,615	20.3	76,081	19.0	53,227	17.1
Consumer loans	125		447	0.1	657	0.1	864	0.2	969	0.3
Total loans	632,493	100.0%	706,771	100.0%	529,627	100.0%	400,624	100.0%	310,995	100.0%
Add (deduct):										
Allowance for loan losses	(5,098)		(4,477)		(3,835)		(2,779)		(2,110)	
Net premiums, discounts, deferred fees and costs	3,567		4,584		3,524		3,346		2,902	
Loans in process	(27,045)		(76,051)		(7,985)		(2,790)		(3,189)	
Net loans	$ 603,917		$ 630,827		$ 521,331		$ 398,401		$ 308,598	

Contractual Repayments. Scheduled contractual principal repayments of loans do not reflect the actual life of such assets. The average life of loans is substantially less than their average contractual terms because of prepayments. In addition, due-on-sale clauses on loans generally give the Bank the right to declare a conventional loan immediately due and payable in the event, among other things, that the borrower sells the real property subject to the mortgage and the loan is not repaid. The average life of mortgage loans tends to increase, however, when home sale activity decreases as we experienced in 2006, or when current mortgage loan rates are substantially higher than rates on existing mortgage loans. Conversely, the average life decreases when home sale activity increases and rates on existing mortgages are substantially lower than current mortgage loan rates. Residential lot loans generally mature in less than five years and are typically repaid or convert to a construction loan when the owner begins construction of the residence. Construction loans generally mature in one year or less.

The following table shows the contractual maturities of the Bank s loan portfolio at December 31, 2006. Loans that have adjustable rates are shown as amortizing to final maturity rather than when the interest rates are next subject to change. The table does not include prepayments or scheduled principal repayments (in thousands):

	Residential	Commercial	Consumer	Total Loans
Amounts due:				
Within 1 year	$ 21,406	$ 112,412	$ 82	$ 133,900
1 to 3 years	40,828	54,387	36	95,251
3 to 5 years	30,792	20,001	7	50,800
5 to 10 years	38,542	8,425		46,967
10 to 20 years	100,724	1,660		102,384
Over 20 years	203,087	104		203,191
Total due after 1 year	413,973	84,577	43	498,593
Total amounts due	$ 435,379	$ 196,989	$ 125	$ 632,493

Loans Due After December 31, 2007. The following table sets forth at December 31, 2006, the dollar amount of all loans due after December 31, 2007, classified according to whether such loans have fixed or adjustable interest rates (in thousands):

	Due after December 31, 2007		
	Fixed	Adjustable	Total
Residential lending	$ 14,760	$ 399,213	$ 413,973
Commercial lending	24,253	60,324	84,577
Consumer loans	41	2	43
Total	$ 39,054	$ 459,539	$ 498,593

Purchase, Origination, and Sale of Loans. Florida has historically experienced a rate of population growth in excess of national averages. The real estate development and construction industries in Florida, however, have been sensitive to cyclical changes in economic conditions and the demand for and supply of residential units. In 2006, the demand for real estate mortgage loans declined, and the rapid increase in home prices has slowed and the inventory of homes for sale has increased.

Our loan portfolio consists of purchased and originated loans. When loans are acquired in the secondary market, the loan packages are generally between $2 million to $25 million in single-family residential mortgages, comprised of new and seasoned ARM loans. While we prefer to purchase loan packages comprised of Florida real estate, because of pricing and the limited number of Florida loan packages that are available, we have also purchased packages of loans outside of Florida. The loan packages undergo an individual loan underwriting review prior to purchases. Due to the unfavorable interest rate environment from the flat yield curve, we purchased only $62.7 million in loans during 2006, significantly less then the $207.1 million purchased in 2005. During 2006, all of the loans we purchased were for residential properties located in Florida.

Loans that the Bank and the Mortgage Company originate are generally on real estate located in our primary lending area of Central Florida. Sources for residential mortgage loan originations include direct solicitation by employed loan originators, depositors, other existing customers, advertising and referrals from real estate brokers, mortgage brokers and developers. Our residential mortgage loans are originated in accordance with written underwriting standards approved by the Board of Directors of the Bank. Most fixed rate loan originations are eligible for sale to Fannie Mae and other investors in the secondary market.

Commercial and commercial real estate loan originations are primarily attributable to Bank loan officers and referrals from existing customers, while consumer loan originations are attributable largely to depositors and walk-in customers and referrals. In addition, if the size of a particular loan request exceeds our legal or internal lending limit, we may sell a participation in that loan to a correspondent bank. From time to time, we also purchase participations from other correspondent banks.

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The following table sets forth the amount of loans originated, purchased, sold and repaid during the periods indicated (in thousands):

	For the Year Ended December 31,			
	2006	**2005**	**2004**	**2003**
Originations:				
Mortgage loans:				
Loans on existing property	$ 45,766	$ 51,285	$ 62,999	$ 44,416
Land, Development and Construction loans	115,817	64,197	66,719	20,681
Total mortgage loans	161,583	115,482	129,718	65,097
Commercial loans	7,181	8,555	7,337	12,373
Consumer loans	1,290	478	635	701
Total loans originated	170,054	124,515	137,690	78,171
Purchases	62,668	207,136	178,482	176,828
Total loans originated and purchased	$ 232,722	$ 331,651	$ 316,172	$ 254,999
Sales and principal repayments:				
Loans sold	(27,972)	(24,407)	(28,632)	(39,560)
Principal repayments	(231,660)	(200,509)	(158,537)	(125,810)
Total loans sold and principal repayments	$ (259,632)	$ (224,916)	$ (187,169)	$ (165,370)
(Decrease) increase in total loans (before net items)	$ (26,910)	$ 106,735	$ 129,003	$ 89,629

Loan Underwriting. Our lending activities are subject to strict underwriting standards and loan origination procedures prescribed by Board of Directors of the Bank and management. All loan applications are evaluated by staff at the administrative and operations office in Sanford to ensure compliance with our underwriting standards. Loan applications are obtained to determine the borrower s ability to repay, and the more significant items on these applications are verified through the use of credit reports, financial statements and confirmations. Our lending policy for real estate loans generally requires that collateral be appraised by an independent, outside appraiser who is approved by the Board of Directors of the Bank. Loans originated or acquired by the Mortgage Company are in accordance with the Banks underwriting standards, or to the standards set by the secondary market agencies or other correspondent banks that are purchasing the loan. While the Mortgage Company generally retains the servicing on the loans it originates, it does not hold the loans for its own portfolio.

Loans are approved at various management levels up to and including the Loan Committee of the Board of Directors of the Bank. Loan approvals are made in accordance with delegated authority levels approved by our Board of Directors. Generally, loans less than $300,000 are approved by authorized officers and underwriters. Loans in excess of $300,000 to $4,000,000 require the concurrence of three or more authorized officers. Loans greater than $4,000,000 require approval of the Board of Directors Loan Committee of the Bank. For loan approvals, the aggregate loans to the borrower and their related interest are used for determination of the appropriate lending authority required for any new loans or renewals.

To ensure that underwriting standards and loan policies are being followed, an internal loan review process is in place. In 2006, we engaged a firm to perform an independent review of our portfolio. Additionally, our external auditor and the OTS perform testing of the Bank s underwriting, credit grading and credit quality.

General Lending Policies. Our policy for real estate loans is to have a valid mortgage lien on real estate securing a loan and to obtain a title insurance policy, which insures the validity and priority of the lien. Borrowers must also obtain hazard insurance policies prior to closing, and when the property is in a flood prone area, flood insurance is required.

While our policy is to lend up to 80% of appraised value, we are permitted to lend up to 100% of the appraised value of real property securing a residential mortgage loan. However, if the amount of a conventional, residential loan (including a construction loan or a combination construction and permanent loan) originated or refinanced exceeds 90% of the appraised value, federal regulations require that private mortgage insurance be obtained on that portion of the principal amount of the loan that exceeds 80% of the appraised value of the property. We originate fully amortizing and interest-only single family residential mortgage loans up to a 97% loan-to-value ratio if the required private mortgage insurance is obtained. Loans over 97% loan-to-value ratio, if originated, would be under special community support programs or one of the Federal Housing Administration, Veterans Administration or USDA Rural Housing Service or insurance programs. The loan-to-value ratio on a home loan secured by a junior lien generally does not exceed 100%, including the amount of the first mortgage on the collateral. With respect to home loans granted for construction or combination construction/permanent financing, we will lend up to 95% of the appraised value of the property on an as completed basis. The loan-to-value ratio on multi-family residential and commercial real estate loans is generally limited to 80% of value. Loans that exceed our policy are monitored, reported to the Board and do not exceed our regulatory limits.

Neither the Bank nor the Mortgage Company has originated, or purchased any loans to borrowers with low credit scores, which are typically referred to as sub-prime borrowers, over the past five years. In addition, we have not originated or purchased any loans with below market interest rates that result in increasing loan balances or negative amortization. Finally, we have not originated or hold any reverse equity mortgages.

The maximum amount that could have been loaned by the Bank to one borrower and the borrower s related entities at December 31, 2006, was approximately $8.8 million. We have no loans in our portfolio that exceed our loans to one borrower limit.

Consumer loans are considered to be loans to natural persons for personal, family or household purposes, and these loans may be unsecured, secured by personal property or secured by liens on real estate.

Federal savings and loan association regulations permit the Bank to invest in loans secured by non-residential or commercial real estate up to four times our regulatory capital. At December 31, 2006, this limit allowed us to invest in non-residential or commercial real estate loans in an aggregate amount up to $222.6 million. At such date, we had $93.1 million in loans secured by non-residential or commercial real estate.

The risk of non-payment of loans is inherent in all loans. To address this risk, we carefully evaluate all loan applicants and attempt to minimize our credit risk exposure by use of thorough loan application and approval procedures that we have established for each category of loan. In determining whether to make a loan, we consider the borrower s credit history, analyze the borrower s income and ability to service the loan, and evaluate the need for collateral to secure recovery in the event of default. An allowance for loan losses is maintained based upon assumptions and judgments regarding the ultimate collectability of loans in our portfolio and a percentage of the outstanding balances of specific loans when their ultimate collectability is considered questionable.

Income from Lending Activities/Loan Servicing. Fees are earned in connection with loan commitments and originations, loan modifications, late payments, assumptions related to changes of property ownership and for miscellaneous services related to loans. We also receive fees for servicing loans owned by other financial institutions. At December 31, 2006, we were servicing $56.1 million in loans for other institutions, which produces servicing income, net of amortization of mortgage servicing rights. During 2002, we executed a seven-year agreement to have a third party begin servicing our residential mortgage loans. This third party charges standard servicing and administration fees for these services.

Commitment, loan fees, and direct costs typically are charged at the time of loan origination and may be a flat fee or a percentage of the amount of the loan. Under current accounting standards such fees cannot be recognized as income and are deferred and taken into income over the contractual life of the loan, using a level yield method. If a loan is prepaid or refinanced, all remaining deferred fees with respect to such loan are taken into income at that time.

Non-performing Loans and Foreclosed Assets. When a borrower fails to make a required payment on a loan, we attempt to collect the payment by contacting the borrower through our in-staff commercial loan officers or through our third party servicer for residential loans. If a payment on a loan has not been received by the end of a grace period, notices are sent at that time, with follow-up contacts made thereafter. In most cases, the delinquencies are cured promptly. If the delinquency exceeds 90 days and is not cured through normal collection procedures, more formal measures are instituted to remedy the default, including the commencement of foreclosure proceedings. If foreclosure is affected, the property is sold at a public auction in which we typically participate as a bidder. If we are the successful bidder, the acquired real estate property is then included in our foreclosed assets account until it is sold. When assets are acquired through foreclosure, they are recorded at the lower of cost or fair value less estimated selling costs at the date of acquisition and any write-down resulting therefrom is charged to the allowance for loan losses. At December 31, 2006, we had one foreclosed asset with a book value of $36,000. Under federal regulations, we are permitted to finance sales of foreclosed assets by loans to facilitate , which may involve more favorable interest rates and terms than generally would be granted under our underwriting guidelines. At December 31, 2006, we had no loans to facilitate the sale of foreclosed assets.

Loans are placed on non-accrual status when, in the judgment of management, the probability of collection of interest is deemed to be insufficient to warrant further accrual of interest. When a loan is placed on non-accrual status, previously accrued, but unpaid interest is deducted from interest income. Our policy is to not accrue interest on loans as soon as it is determined that repayment of all principal and interest is not likely, however, not later than 90 days past due.

Non-accrual loans at December 31, 2006, were $12.0 million. Included in the total were $4.0 million in construction loans to 27 individual borrowers for single family homes, substantially all of which are in Lee County, Florida. Construction on eight of these loans, with a balance of $1.5 million, is either completed or in process. Construction has not commenced on the remaining nineteen loans with a total balance of $2.5 million. As a result of the weakness in the Florida housing market during 2006, we reduced our residential construction loans from $81.6 million at December 31, 2005 to $36.6 million at the end of 2006. We continuously monitor the portfolio and, if the loan matures prior to the commencement or completion of construction, we negotiate with the borrower to either extend the loan or to convert the credit to a lot loan for future sale or construction; in some cases, we commence foreclosure.

The December 31, 2006 non-accrual loans also include $3.1 million in residential mortgages. Of this total, $2.3 million is comprised of foreign national borrowers, a majority of whom reside in the United Kingdom. These loans are for fifteen residential properties all located in Central Florida, of which ten are for single family residences, four are for condominiums and one is a lot loan. The increase in the foreign national delinquencies was due to a slowdown in the market for investor properties in and around the Central Florida resort areas and the well publicized increase in Florida property taxes and hazard insurance on these investment properties. The Bank has had extensive experience and has been very successful over the past ten years with our foreign national loan product. Because of the location and size of these residential properties and our prior experience with this product, we believe the current delinquencies will be successfully resolved with minimal losses.

Included in the $4.8 million of commercial non-accrual loans is a $4.0 million or 14% participation in a loan secured by several contiguous residential parcels fronting the Gulf of Mexico, in the Florida panhandle. The borrower is planning to develop the site for a high rise residential condominium project. Due to the weakness in the Florida panhandle condominium market and the effects of hurricane Katrina in 2005, the borrower has delayed construction and is seeking additional equity investors. Foreclosure action has been initiated, however, negotiations are continuing with the borrower for an acceptable workout plan.

Management is aggressively pursuing resolutions to these non-performing assets as quickly as possible. The amount and timing of losses, if any, cannot be determined at the present time and we believe that the allowance for loan losses is adequate to absorb potential losses on the loans, all of which are all secured by real estate in Florida.

The following table sets forth certain information regarding our non-accrual loans and foreclosed assets, the ratio of such loans and foreclosed assets to total assets as of the date indicated, and certain other related information (in thousands):

	At December 31,				
	2006	2005	2004	2003	2002
Non-accrual loans:					
Mortgage:					
Construction	$ 3,952	$ 158	$ 5	$ 229	$ 293
Residential	3,140	1,240	1,862	6,167	5,221
Commercial					
Total mortgage loans	7,092	1,398	1,867	6,396	5,514
Commercial loans	4,878	720	720		
Consumer loans			13		65
Total non-accrual loans	$ 11,970	$ 2,118	$ 2,600	$ 6,396	$ 5,579
Total non-accrual loans to total loans	1.9%	0.3%	0.5%	1.6%	1.8%
Total non-accrual loans to total assets	1.7%	0.3%	0.4%	1.4%	1.5%
Total allowance for loss to total non-accrual loans	42.6%	211.4%	147.5%	43.4%	37.8%
Total foreclosed assets	$ 36	$ 556	$ 326	$ 1,007	$ 858
Total non-accrual loans and foreclosed assets to total assets	1.7%	0.4%	0.5%	1.6%	1.7%

At December 31, 2006, we had no accruing loans which were contractually past due 90 days or more as to principal and interest and no troubled debt restructurings as defined by Statement of Financial Accounting Standards No. 15. Nonaccrual loans for which interest has been reduced totaled approximately $12.0 million and $2.1 million at December 31, 2006 and 2005, respectively. For the year ended December 31, 2006, interest income that would have been recorded under the original terms of non-accrual loans and interest income actually recognized is summarized below (in thousands):

Interest income that would have been recorded	$ 446
Interest income recognized	46
Interest income foregone	$ 400

Classified Assets Potential Problem Loans. Federal regulations and the Bank s policies require the classification of loans and other assets, such as debt and equity securities, considered to be of lesser quality as substandard, doubtful or loss assets. An asset is considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets include those characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all of the weaknesses inherent in those classified substandard, with the added characteristic that the weaknesses present make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. Assets classified as loss are those considered uncollectible and of such little value that their continuance as assets without the establishment of a specific loss reserve is not warranted. In addition, our policies require that assets which do not currently expose the insured institution to sufficient risk to warrant classification as substandard but possess other weaknesses are designated special mention by management.

If an asset is classified, the estimated fair value of the asset is determined and if that value is less than the carrying value of the asset, the difference is established as a specific reserve. If an asset is classified as loss, the amount of the asset classified as loss is reserved. General reserves or general valuation allowances represent loss allowances which have been established to recognize the inherent risk associated with lending activities but, unlike specific reserves, are not allocated to particular assets.

At December 31, 2006, there were twelve loans for a total of $9.2 million that were graded special mention and 79 loans for $14.1 million classified substandard. There were no loans graded doubtful or loss at December 31, 2006.

Loan Review

An internal review of the portfolio is conducted on a quarterly basis and requires updated financial statements and income tax returns yearly. During 2006, an independent firm was hired to review our commercial loan portfolio to assess the underwriting, credit grading and credit quality of the portfolio. Additionally, our external auditor and the OTS perform testing of the Bank s underwriting, credit grading, and credit quality. Based on these inspections, we then grade our loans using the classifications as outlined above.

Provisions for Loan Losses

A provision for loan losses is generally charged to earnings based upon management s evaluation of the inherent losses in our loan portfolio. During 2006, our gross loans decreased by $26.9 million and we recognized a $638,000 provision for loan losses. Also during 2006, we recognized $39,000 in charge-offs against our allowance, but collected $21,000 in recoveries from prior charge-offs.

While we believe that our allowance for loan losses is adequate as of December 31, 2006, the provisions are based on the current and anticipated future operating conditions, thereby causing these estimates to be susceptible to changes that could result in a material adjustment to results of operations in the near term. The amount needed in the allowance for loan losses is based on the particular circumstances of the individual non-performing loans, including the type, amount, and value of the collateral, if any. In addition, the overall composition and amount of the performing loans in the portfolio at the time of evaluation is considered to determine the adequacy of the allowance, and, as a result, will vary over time. Although more emphasis is being placed on originating new commercial, commercial real estate, land and development loans, the composition of our loan portfolio continues to be concentrated primarily in residential mortgage loans, which tend to have a lower risk of loss. Loan repayments are dependent on loan underwriting and also on economic, operating and other conditions that may be beyond our control. Therefore, actual losses in future periods could differ materially from amounts provided in the current period and could result in a material adjustment to operations.

Allowance for Loan Losses

A number of factors are considered when establishing our allowance for loan losses. For loan loss purposes, the loan portfolio is segregated into the following broad segments: residential real estate loans to United States citizens; residential real estate loans to foreign borrowers; commercial real estate loans; land development and construction loans; commercial business loans and other loans. A general allowance for losses is then provided for each of the aforementioned categories, which consists of two components. General loss percentages are calculated based upon historical analyses. A supplemental portion of the allowance is calculated for inherent losses which probably exist as of the evaluation date even though they might not have been identified by the more objective processes used for the portion of the allowance described above. This is due to the risk of error and/or inherent imprecision in the process. This portion of the allowance is particularly subjective and requires judgments based on qualitative factors which do not lend themselves to exact mathematical calculations such as; trends in delinquencies and nonaccruals; migration trends in the portfolio; trends in volume, terms, and portfolio mix; new credit products and/or changes in the geographic distribution of those products; changes in lending policies and procedures; collection practices; examination results from bank regulatory agencies; external loan reviews, and our internal credit review function; changes in the outlook for local, regional and national economic conditions; concentrations of credit; and peer group comparisons.

Large commercial loans that exhibit probable or observed credit weaknesses are subject to individual review. Where appropriate, reserves are allocated to individual loans based on our estimate of the borrower s ability to repay the loan given the availability of collateral, other sources of cash flows, and available legal options. Included in the review of individual loans, are those that are impaired as provided in Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* as amended. Any specific reserves for impaired loans are measured based on the fair market value of the underlying collateral. We evaluate the collectibility of both principal and interest when assessing the need for a special reserve. Specific reserves on individual loans and historical loss rates are reviewed throughout the year and adjusted as necessary based on changing borrower and collateral conditions and actual collection and charge-off experience. Historical loss rates are applied to other commercial loans not subject to specific reserve allocations.

Homogenous loans, such as installment and residential mortgage loans are not individually reviewed by management except in the case of delinquencies. Reserves are established for each pool of loans based on the expected net charge-offs. Loss rates are based on the average net charge-off history and an analysis of the risks and trend information by loan category.

Historical loss rates for commercial and consumer loans may be adjusted for significant factors that, in management s judgment, reflect the impact of any current conditions or loss recognition. Based on these procedures, management believes that the allowance for loan losses is adequate to absorb estimated loan losses associated with the loan portfolio at December 31, 2006. Actual results could differ from these estimates. However, since the allowance is affected by management s judgments and uncertainties, there is the likelihood that materially different amounts would be reported under different conditions or assumptions. To the extent that the economy, collateral values, reserve factors, or the nature and volume of problem loans change, we may need to adjust the provision for loan losses. In addition, federal regulatory agencies, as an integral part of the examination process, periodically review our allowance for loan losses. Such agencies may require us to recognize additions to the allowance level based upon their judgment of the information available to them at the time of their examination. Material additions to our provision for loan losses would result in a decrease in net earnings and capital.

At December 31, 2006, the allowance for loan losses was $5.1 million, or 42.6% of non-performing loans and .84% of total loans net of loans in process (LIP) compared to $4.5 million, or 211.4% of non-performing loans and .71% of total loans net of LIP at December 31, 2005. The allowance at December 31, 2006, consisted of reserves for the performing loans in the portfolio and reserves against certain loans based on management s evaluation of these loans. As the amount of commercial loans in the portfolio continues to increase, the allowance will be adjusted accordingly.

The following table sets forth information with respect to our allowance for loan losses during the periods indicated. The allowances shown in the table below should not be interpreted as an indication that charge-offs in future periods will occur in these amounts or proportions or that the allowance indicates future charge-off amounts or trends ($ in thousands):

	At December 31, 2006	2005	2004	2003	2002
Average loans outstanding, net of LIP	$ 621,670	$ 579,811	$ 447,773	$ 366,488	$ 279,934
Allowance at beginning of year	4,477	3,835	2,779	2,110	1,765
Charge-offs:					
Residential real estate loans	(25)		(106)	(30)	(173)
Construction loans	(14)				(10)
Commercial real estate loans					
Commercial loans			(48)		(39)
Consumer loans		(10)		(1)	(36)
Total loans charged-off	(39)	(10)	(154)	(31)	(258)
Recoveries	21	2	30	50	158
Net (charge-offs) recoveries	(18)	(8)	(124)	19	(100)
Provision for loan losses	639	650	1,180	650	445
Allowance at end of year	$ 5,098	$ 4,477	$ 3,835	$ 2,779	$ 2,110
Ratio of net charge-offs (recoveries) to average loans outstanding, net of LIP	.00%	.00%	.03%	(.01)%	.04%
Ratio of allowance to period-end total loans, net of LIP	.84%	.71%	.74%	.70%	.69%
Period-end total loans, net of LIP	$ 605,448	$ 630,720	$ 521,642	$ 397,834	$ 307,806

The following table represents information regarding our total allowance for loan losses, as well as the allocation of such amounts to the various categories of loans ($ in thousands):

	At December 31, 2006		2005		2004		2003		2002	
	Amount	% of Loans to Total Loans	Amount	% of Loans to Total Loans	Amount	% of Loans to Total Loans	Amount	% of Loans to Total Loans	Amount	% of Loans to Total Loans
Residential lending	$ 2,671	68.9%	$ 2,337	73.8%	$ 2,488	79.6%	$ 1,886	80.8%	$ 1,409	82.6%
Commercial lending	2,427	31.1	2,130	26.1	1,055	20.3	825	19.0	566	17.1
Consumer loans		.0	10	.1	292	.1	68	.2	135	.3
Total allowance for loan losses	$ 5,098	100.0%	$ 4,477	100.0%	$ 3,835	100.0%	$ 2,779	100.0%	$ 2,110	100.0%

Investment Activities

Mortgage-Backed Securities. We purchase mortgage-backed securities and other collateralized mortgage obligations, which are guaranteed as to principal and interest by FNMA and FHLMC, agencies of the Federal government. We also purchased mortgage-backed securities issued by entities that are not Federal Government agencies. The securities are permissible investments for a savings institution and are acquired primarily for their liquidity, yield, and credit characteristics. Such securities may be used as collateral for borrowings. The mortgage-backed securities that are purchased are backed by either fixed-rate or adjustable-rate mortgage loans. At December 31, 2006, these securities totaled $27.0 million.

Other Investments. As a condition of our membership in the Federal Home Loan Bank of Atlanta we are required to own FHLB stock. The other investments in the portfolio, with the exception of the corporate equity securities, are eligible for inclusion in our liquidity base when calculating our regulatory liquidity requirement. We also purchase municipal bonds and corporate equity and debt securities. At December 31, 2006, we did not have any securities pledged to the FHLB as collateral under its short-term credit agreement.

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to: (1) the length of time and the extent to which fair value has been less than cost; (2) the financial condition and near-term prospects of the issuer; and (3) our intent and ability to retain the investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

During 2004, we recorded an other-than-temporary impairment write-down of approximately $1,055,000. The charge related to our $9.5 million investment in Freddie Mac and Fannie Mae adjustable rate preferred stock, which is included in our investment securities, available for sale portfolio. These investment grade securities declined in value in 2004 primarily due to the record low interest rates, which caused the dividend payment to decline from the original rates at the time of issuance. During 2005, we sold 42,000 shares of Freddie Mac and Fannie Mae preferred stock with a total book value of $2.0 million and recognized a net loss on the sales of less than $6,000. During 2006, we sold the remaining 93,000 shares of Freddie Mac preferred stock with a total book value of $3.7 million and recognized a net loss of less than $24,000. In 2006 we also sold 135,000 shares of Fannie Mae preferred stock with a total book value of $5.7 million and recognized a net loss of approximately $24,000. At December 31, 2006, the par value, the carrying value, and the market value of the remaining Fannie Mae preferred stock was $2.8 million. Subsequent to December 31, 2006, we were notified that all of the remaining shares of Fannie Mae preferred stock that we own, were being called by the end of March 2007 at par value.

The following table sets forth the carrying values of our total investments and liquidity as of the dates indicated (in thousands):

	At December 31,		
	2006	2005	2004
Short-term investments:			
Interest-earning deposits	$ 1,585	$ 6,424	$ 3,836
Debt securities:			
Government agency	8,855	4,798	2,977
Municipal bonds	14,056	12,321	1,056
Corporate debt	5,289	5,068	3,915
Mortgage-backed securities	26,960	21,807	24,152
Trust preferred securities	6,489		
Equity securities:			
FHLB stock	9,591	10,273	7,385
Corporate equity	3,909	6,086	9,072
Total investment portfolio	$ 76,734	$ 66,777	$ 52,393

The following table sets forth the remaining maturity and weighted-average yields as of December 31, 2006 and 2005 ($ in thousands):

	One Year or less		Over 1 yr to 5 Years		Over 5 Years to 10 Years		More than 10 Years		Total	
	Carrying Value	Yield	Carrying Value	Yield	Carrying Value	Yield	Carrying Value	Yield	Carrying Value	Yield
At December 31, 2006:										
Interest-earning deposits	$ 1,585	5.15%	$	%	$	%	$	%	$ 1,585	5.15%
FHLB stock (*)							9,591	5.90	9,591	5.90
Government agency securities			994	5.79	3,539	5.97	4,322	6.82	8,855	6.36
Municipal bonds										