FIRST CAPITAL INC
Form 10-K
March 28, 2007
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Fiscal Year Ended December 31, 2006

OR

¨ 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: 0-25023

FIRST CAPITAL, INC.

(Exact name of registrant as specified in its charter)

Indiana	**35-2056949**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
220 Federal Drive, N.W., Corydon, Indiana	**47112**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (812) 738-2198

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

Title of each class	Name of each exchange on which registered
Common Stock, par value $0.01 per share	**Nasdaq Global Market**

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

---

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes ¨ No 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 x

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 x No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ¨

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

Large Accelerated Filer ¨ Accelerated Filer ¨ Non-accelerated Filer x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ¨ No x

The aggregate market value of the voting and non-voting common equity held by non-affiliates was $47.9 million, based upon the average bid and asked price of $18.39 as quoted on the Nasdaq Stock Market as of the last business day of the registrant s most recently completed second fiscal quarter.

The number of shares outstanding of the registrant s common stock as of March 8, 2007 was 2,840,275.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the 2006 Annual Report of Stockholders and of the Proxy Statement for the 2007 Annual Meeting of Stockholders are incorporated by reference in Parts II and III, respectively, of this Form 10-K.

Table of Contents

INDEX

Table of Contents

This report contains certain forward-looking statements within the meaning of the federal securities laws. These statements are not historical facts, rather statements based on First Capital, Inc. s current expectations regarding its business strategies, intended results and future performance. Forward-looking statements are preceded by terms such as expects,   believes,   anticipates,   intends and similar expressions.

Management s ability to predict results or the effect of future plans or strategies is inherently uncertain. Factors which could affect actual results include interest rate trends; the general economic climate in the specific market area in which First Capital operates, as well as nationwide; First Capital s ability to control costs and expenses; competitive products and pricing; loan delinquency rates and changes in federal and state legislation and regulation. These factors should be considered in evaluating the forward-looking statements and undue reliance should not be placed on such statements. Except as may be required by applicable law or regulation, First Capital assumes no obligation to update any forward-looking statements.

PART I

ITEM 1. BUSINESS

General

First Capital, Inc. (also referred to as the Company or First Capital) was incorporated under Indiana law in September 1998. The Company was organized for the purpose of becoming the holding company for First Federal Bank, A Federal Savings Bank (also referred to as the Bank) upon the Bank s reorganization as a wholly owned subsidiary of the Company resulting from the conversion of First Capital, Inc., M.H.C. (MHC), from a federal mutual holding company to a stock holding company. On January 12, 2000, the Company completed a merger of equals with HCB Bancorp, the former holding company for Harrison County Bank. The Bank changed its name to First Harrison Bank in connection with the merger. On March 20, 2003, the Company consummated its acquisition of Hometown Bancshares, Inc. (Hometown), a bank holding company located in New Albany, Indiana. The acquisition expanded the Company s presence in the New Albany and Floyd County, Indiana market area and expanded the banking services provided to the existing customers of Hometown.

The Company has no significant assets, other than all of the outstanding shares of the Bank and the portion of the net proceeds from the offering retained by the Company, and no significant liabilities. Management of the Company and the Bank are substantially similar and the Company neither owns nor leases any property, but instead uses the premises, equipment and furniture of the Bank in accordance with applicable regulations.

The Bank is regulated by the Office of Thrift Supervision (OTS) and the Federal Deposit Insurance Corporation (FDIC). The Bank s deposits are federally insured by the FDIC under the Deposit Insurance Fund (DIF). The Bank is a member of the Federal Home Loan Bank (FHLB) System.

Availability of Information

The Company s annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and any amendments to such reports filed or furnished pursuant to Section 13(a) or 15(d) of the Exchange Act are made available free of charge on the Company s website, www.firstharrison.com, as soon as practicable after the Company electronically files such material, or furnishes it to, the Securities and Exchange Commission. The contents of the Company s website shall not be incorporated by reference into this Form 10-K or into any reports the Company files with or furnishes to the Securities and Exchange Commission.

Market Area and Competition

The Bank considers Harrison, Floyd, Clark and Washington counties in Indiana its primary market area. All of its offices are located in these four counties, which results in most of the Bank s loans being made in these four counties. The main office of the Bank is located in Corydon, Indiana, 35 miles west of Louisville, Kentucky. The Bank aggressively competes for business with local banks, as well as large regional banks. Its most direct competition for deposit and loan business comes from the commercial banks operating in these four counties. The Bank is the leader in deposit market share in Harrison County, its primary county of operation.

Lending Activities

General. The Bank is in the process of transforming its balance sheet from that of a traditional thrift institution to that of a commercial bank. On the asset side, this is being accomplished by selling in the secondary market the newly-originated qualified fixed-rate residential mortgage loans while retaining variable rate residential mortgage loans in the portfolio. This transformation is enhanced by an expanded commercial lending staff dedicated to growing commercial real estate and commercial business loans. The Bank also continues to originate consumer loans and residential construction loans for the loan portfolio.

Table of Contents

Loan Portfolio Analysis. The following table presents the composition of the Bank s loan portfolio by type of loan at the dates indicated.

	At December 31,									
	2006		2005		2004		2003		2002	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
	(Dollars in thousands)									
Mortgage Loans:										
Residential[1]	$ 173,806	50.86%	$ 178,329	53.93%	$ 179,816	55.10%	$ 176,569	55.77%	$ 145,467	65.79%
Land	12,581	3.68	7,772	2.35	6,696	2.05	7,771	2.45	4,821	2.18
Commercial real estate	48,520	14.20	38,896	11.76	38,654	11.84	42,936	13.56	16,760	7.58
Residential construction[2]	17,435	5.10	19,513	5.90	23,215	7.11	25,077	7.92	9,783	4.42
Total mortgage loans	252,342	73.84	244,510	73.94	248,381	76.10	252,353	79.70	176,831	79.97
Consumer Loans:										
Home equity and second mortgage loans	39,483	11.55	36,951	11.18	35,385	10.84	27,656	8.73	18,640	8.43
Automobile loans	15,637	4.57	14,526	4.39	13,726	4.20	12,863	4.06	9,598	4.34
Loans secured by savings accounts	2,263	0.66	1,950	0.59	1,611	0.49	1,248	0.39	1,249	0.56
Unsecured loans	2,895	0.85	2,932	0.89	2,307	0.71	1,855	0.59	1,193	0.54
Other[3]	4,406	1.29	5,142	1.56	4,154	1.27	4,543	1.43	4,176	1.89
Total consumer loans	64,684	18.92	61,501	18.61	57,183	17.51	48,165	15.20	34,856	15.76
Commercial business loans	24,730	7.24	24,626	7.45	20,866	6.39	16,162	5.10	9,440	4.27
Total gross loans	341,756	100.00%	330,637	100.00%	326,430	100.00%	316,680	100.00%	221,127	100.00%
Less:										
Due to borrowers on loans in process	6,029		6,197		6,933		10,085		3,887	
Deferred loan fees net of direct costs	(168)		(117)		(67)		(38)		26	
Allowance for loan losses	2,320		2,104		2,478		2,433		1,218	
Total loans, net	$ 333,575		$ 322,453		$ 317,086		$ 304,200		$ 215,996	

(1) Includes conventional one- to four-family and multi-family residential loans.
(2) Includes construction loans for which the Bank has committed to provide permanent financing.
(3) Includes loans secured by lawn and farm equipment, mobile homes and other personal property.

3

Table of Contents

Residential Loans. The Bank s lending activities have concentrated on the origination of residential mortgages, both for sale and retention in the Bank s loan portfolio. Residential mortgages secured by multi-family properties are an immaterial portion of the residential loan portfolio. Substantially all residential mortgages are collateralized by properties within the Bank s market area.

The Bank offers both fixed-rate mortgage loans and adjustable rate mortgage (ARM) loans typically with terms of 15 to 30 years. The Bank uses loan documents approved by the Federal National Mortgage Corporation (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) whether the loan is originated for investment or sale in the secondary market.

Historically, the Bank has retained its residential loan originations in its portfolio. Retaining fixed-rate loans in its portfolio subjects the Bank to a higher degree of interest rate risk. See *Item 1A. Risk Factors Above Average Interest Rate Risk Associated with Fixed-Rate Loans* for a further discussion of the risks of rising interest rates. Beginning in 2004, one of the Bank s strategic goals was to expand its mortgage business by originating mortgage loans for sale, while offering a full line of mortgage products to prospective customers. This practice increases the Bank s lending capacity and allows the Bank to more effectively manage its profitability since it is not required to predict the prepayment, credit or interest rate risks associated with retaining either the loan or the servicing asset. During 2005, the Bank hired a mortgage banking manager, charged with hiring more mortgage originators and increasing the Bank s secondary market business in Southern Indiana. For the year ended December 31, 2006, the Bank originated and funded $24.5 million of residential mortgage loans for sale in the secondary market. The Bank also originated $4.9 million of residential mortgage loans as an agent for a third-party mortgage company. The third-party mortgage company funded such originations and the Bank received a fee for each loan funded by the third party mortgage company. For a full discussion of the Bank s mortgage banking operations, see *Item 1. Business Mortgage Banking Activities*.

ARM loans originated have interest rates that adjust at regular intervals of one year, with 2.0% annual and 6.0% lifetime caps, and at intervals of five years with 1.5% per adjustment period and 6.0% lifetime caps, based upon changes in the prevailing interest rates on United States Treasury Bills. The Bank may occasionally use below market interest rates and other marketing inducements to attract ARM loan borrowers. The majority of ARM loans provide that the amount of any increase or decrease in the interest rate is limited to 2.0% (upward or downward) per adjustment period and generally contains minimum and maximum interest rates. Borrower demand for ARMs versus fixed-rate mortgage loans is a function of the level of interest rates, the expectations of changes in the level of interest rates and the difference between the interest rates and loan fees offered for fixed-rate mortgage loans and interest rates and loan fees for ARM loans. The relative amount of fixed-rate and ARM loans that can be originated at any time is largely determined by the demand for each in a competitive environment.

The Bank s lending policies generally limit the maximum loan-to-value ratio on fixed-rate and ARM loans to 80% of the lesser of the appraised value or purchase price of the underlying residential property unless private mortgage insurance to cover the excess over 80% is obtained, in which case the mortgage is limited to 95% (or 97% under a Freddie Mac program) of the lesser of appraised value or purchase price. The loan-to-value ratio, maturity and other provisions of the loans made by the Bank are generally reflected in the policy of making less than the maximum loan permissible under federal regulations, in accordance with established lending practices, market conditions and underwriting standards maintained by the Bank. The Bank requires title, fire and extended insurance coverage on all mortgage loans originated. All of the Bank s real estate loans contain due on sale clauses. The Bank generally obtains appraisals on all its real estate loans from outside appraisers.

Construction Loans. Although the Bank originates construction loans that are repaid with the proceeds of a limited number of mortgage loans obtained by the borrower from another lender, the majority of the construction loans that the Bank originates are permanently financed in the secondary market by the Bank. Construction loans originated without a commitment by the Bank to provide permanent financing are generally originated for a term of six to 12 months and at a fixed interest rate based on the prime rate.

The Bank originates speculative construction loans to a limited number of builders that are operating and based in the Bank s primary market area and with whom the Bank has well-established business relationships. At December 31, 2006, speculative construction loans, for which there is not a commitment for permanent financing in place at the time the construction loan was originated, amounted to $5.2 million. The Bank limits the number of speculative construction loans outstanding to any one builder based on the builder s capacity to service the debt.

Most construction loans are originated with a loan-to-value ratio not to exceed 80% of the appraised estimated value of the completed property. The construction loan documents require the disbursement of the loan proceeds in increments as construction progresses. Disbursements are based on periodic on-site inspections by an independent appraiser.

Construction lending is inherently riskier than one- to four-family mortgage lending. Construction loans, on average, generally have higher loan balances than one- to four-family mortgage loans. In addition, the potential for cost overruns because of the inherent difficulties in estimating construction costs and, therefore, collateral values and the difficulties and costs associated with monitoring construction progress, among other things, are major contributing factors to this greater credit risk. Speculative construction loans have the added risk that there is not an identified buyer for the completed home when the loan is originated, with the risk that the builder will have to service the construction loan debt and finance the other carrying costs of the completed home for an extended time period until a buyer is identified. Furthermore, the demand for construction loans and the ability of construction loan borrowers to service their debt depends highly on the state of the general economy, including market interest rate levels and the state of the economy of the Bank s primary market area. A material downturn in economic conditions could be expected to have a material adverse effect on the credit quality of the construction loan portfolio.

Commercial Real Estate Loans. Commercial real estate loans are generally secured by small retail stores, professional office space and, in certain instances, farm properties. Commercial real estate loans are generally originated with a loan-to-value ratio not to exceed 75% of the appraised value of the property. Property appraisals are performed by independent appraisers approved by the Bank s board of directors. The Bank attempts to originate commercial real estate loans at variable interest rates based on the United States Treasury Bill rate for terms ranging from ten to 15 years and with interest rate adjustment intervals of five years. The Bank also originates fixed-rate balloon loans with a short maturity, but a longer amortization schedule.

Commercial real estate lending affords the Bank an opportunity to receive interest at rates higher than those generally available from one- to four-family residential lending. However, loans secured by such properties usually are greater in amount, more difficult to evaluate and monitor and, therefore, involve a greater degree of risk than one- to four-family residential mortgage loans.

Because payments on loans secured by multi-family and commercial properties are often dependent on the successful operation and management of the properties, repayment of such loans may be affected by adverse conditions in the real estate market or the economy. The Bank seeks to minimize these risks by limiting the maximum loan-to-value ratio to 75% and strictly scrutinizing the financial condition of the borrower, the quality of the collateral and the management of the property securing the loan. The Bank also obtains loan guarantees from financially capable parties based on a review of personal financial statements.

Commercial Business Loans. Commercial business loans are generally secured by inventory, accounts receivable and business equipment such as trucks and tractors. Many commercial business loans also have real estate as collateral. The Bank generally requires a personal guaranty of payment by the principals of a corporate borrower, and reviews the personal financial statements and income tax returns of the guarantors. Commercial business loans are generally originated with loan-to-value ratios not exceeding 75%.

Aside from lines of credit, commercial business loans are generally originated for terms not to exceed seven years with variable interest rates based on the prime lending rate. Approved credit lines totaled $29.7 million at December 31, 2006, of which $17.6 million was outstanding. Lines of credit are originated at fixed and variable interest rates for one-year renewable terms.

A director of the Bank is a shareholder of a farm implement dealership that contracts with the Bank to provide sales financing to the dealership s customers. The Bank does not grant preferential credit under this arrangement. All sales contracts are presented to the Bank on a 50% recourse basis, with the dealership responsible for the sale and disposition of any repossessed equipment. During the year ended December 31, 2006, the Bank granted approximately $826,000 of credit to customers of the dealership and such loans had an aggregate outstanding balance of $1.9 million at December 31, 2006. At December 31, 2006, 5 loans were delinquent 30 days or more with an aggregate outstanding balance of $48,000.

Commercial business lending generally involves greater risk than residential mortgage lending and involves risks that are different from those associated with residential and commercial real estate lending. Real estate lending is generally considered to be collateral-based lending with loan amounts based on predetermined loan-to-collateral values and liquidation of the underlying real estate collateral is viewed as the primary source of repayment in the event of borrower default. Although commercial business loans are often collateralized by equipment, inventory, accounts receivable or other business assets, the liquidation of collateral in the event of a borrower default is often an insufficient source of repayment because accounts receivable may be uncollectible and inventories and equipment may be obsolete or of limited use, among other things. Accordingly, the repayment of a commercial business loan depends primarily on the creditworthiness of the borrower (and any guarantors), while liquidation of collateral is a secondary, and often insufficient, source of repayment. The Bank has three commercial lenders and one commercial credit analyst committed to growing commercial business loans to facilitate the changes desired in the Bank s balance sheet. The Bank also uses an outside loan review company to review selected commercial credits on a semi-annual basis.

Consumer Loans. The Bank offers a variety of secured or guaranteed consumer loans, including automobile and truck loans, home equity loans, home improvement loans, boat loans, mobile home loans and loans secured by savings deposits. In addition, the Bank offers unsecured consumer loans. Consumer loans are generally originated at fixed interest rates and for terms not to exceed seven years. The largest portion of the Bank s consumer loan portfolio consists of home

Table of Contents

equity and second mortgage loans followed by automobile and truck loans. Automobile and truck loans are originated on both new and used vehicles. Such loans are generally originated at fixed interest rates for terms up to five years and at loan-to-value ratios up to 80% of the blue book value in the case of used vehicles and 80% of the purchase price in the case of new vehicles.

Home equity and second mortgage loans are originated at either fixed or adjustable rates of interest for terms of five to ten years. The loan-to-value ratio on such loans is limited to 95%, taking into account the outstanding balance on the first mortgage loan.

The Bank s underwriting procedures for consumer loans includes an assessment of the applicant s payment history on other debts and ability to meet existing obligations and payments on the proposed loans. Although the applicant s creditworthiness is a primary consideration, the underwriting process also includes a comparison of the value of the security, if any, to the proposed loan amount. The Bank underwrites and originates the majority of its consumer loans internally, which management believes limits exposure to credit risks relating to loans underwritten or purchased from brokers or other outside sources.

Consumer loans generally entail greater risk than do residential mortgage loans, particularly in the case of consumer loans which are unsecured or secured by assets that depreciate rapidly, such as automobiles. In the latter case, repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment for the outstanding loan and the remaining deficiency often does not warrant further substantial collection efforts against the borrower. In addition, consumer loan collections are dependent on the borrower s continuing financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans. Such loans may also give rise to claims and defenses by the borrower against the Bank as the holder of the loan, and a borrower may be able to assert claims and defenses that it has against the seller of the underlying collateral.

Table of Contents

Loan Maturity and Repricing

The following table sets forth certain information at December 31, 2006 regarding the dollar amount of loans maturing in the Bank s portfolio based on their contractual terms to maturity, but does not include potential prepayments. Demand loans, loans having no stated schedule of repayments and no stated maturity, and overdrafts are reported as due in one year or less. Loan balances do not include undisbursed loan proceeds, unearned income and allowance for loan losses.

	Within One Year	After One Year Through 3 Years	After 3 Years Through 5 Years	After 5 Years Through 10 Years	After 10 Years Through 15 Years	After 15 Years	Total
			(Dollars in thousands)				
Mortgage loans:							
Residential	$ 9,882	$ 19,562	$ 16,351	$ 41,199	$ 30,244	$ 56,568	$ 173,806
Commercial real estate and land loans	13,003	13,868	10,283	8,676	8,477	6,794	61,101
Residential construction(1)	17,435						17,435
Consumer loans	15,659	22,470	23,097	2,913	285	260	64,684
Commercial business	12,541	6,724	2,753	1,672	656	384	24,730
Total gross loans	$ 68,520	$ 62,624	$ 52,484	$ 54,460	$ 39,662	$ 64,006	$ 341,756

(1) Includes construction loans for which the Bank has committed to provide permanent financing. The contractual maturities reflect the principal payments due following the period of construction.

The following table sets forth the dollar amount of all loans due after December 31, 2007, which have fixed interest rates and have floating or adjustable interest rates.

	Fixed Rates	Floating or Adjustable Rates
	(Dollars in thousands)	
Mortgage loans:		
Residential	$ 121,485	$ 42,439
Commercial real estate and land loans	18,252	29,846
Residential construction		
Consumer loans	27,505	21,520
Commercial business	8,917	3,272
Total gross loans	$ 176,159	$ 97,077

Loan Solicitation and Processing. A majority of the loans originated by the Bank are made to existing customers. Walk-ins and customer referrals are also a source of loan originations. Upon receipt of a loan application, a credit report is ordered to verify specific information relating to the loan applicant s employment, income and credit standing. A loan applicant s income is verified through the applicant s employer or from the applicant s tax returns. In the case of a real estate loan, an appraisal of the real estate intended to secure the proposed loan is undertaken, generally by an independent appraiser approved by the Bank. The mortgage loan documents used by the Bank conform to secondary market standards.

The Bank requires that borrowers obtain certain types of insurance to protect its interest in the collateral securing the loan. The Bank requires either a title insurance policy insuring that the Bank has a valid first lien on the mortgaged real estate or an opinion by an attorney regarding the validity of title. Fire and casualty insurance is also required on collateral for loans.

Table of Contents

The Bank s lending practices generally limit the maximum loan to value ratio on conventional residential mortgage loans to 80% (or 90% under a Freddie Mac program) of the appraised value of the property as determined by an independent appraisal or the purchase price, whichever is less, and 75% for commercial real estate loans.

Loan Commitments and Letters of Credit. The Bank issues commitments for fixed- and adjustable-rate single-family residential mortgage loans conditioned upon the occurrence of certain events. Such commitments are made in writing on specified terms and conditions and are honored for up to 60 days from the date of application, depending on the type of transaction. The Bank had outstanding loan commitments of approximately $12.9 million at December 31, 2006.

As an accommodation to its commercial business loan borrowers, the Bank issues standby letters of credit or performance bonds usually in favor of municipalities for whom its borrowers are performing services. At December 31, 2006, the Bank had outstanding letters of credit of $4.1 million.

Loan Origination and Other Fees. The Bank, in most instances, receives loan origination fees or discount points. Loan fees and points are a percentage of the principal amount of the mortgage loan that is charged to the borrower for funding the loan. The Bank usually charges a fixed origination fee on one- to four-family residential real estate loans and long-term commercial real estate loans. On residential construction loans, the Bank usually charges one point. Current accounting standards require loan origination fees and certain direct costs of underwriting and closing loans to be deferred and amortized into interest income over the contractual life of the loan. Deferred fees and costs associated with loans that are sold are recognized as income at the time of sale. The Bank had $168,000 of net deferred loan costs at December 31, 2006.

Mortgage Banking Activities. Mortgage loans originated and funded by the Bank and intended for sale in the secondary market are carried at the lower of aggregate cost or market value. Aggregate market value is determined based on the quoted prices under a best efforts sales agreement with a third party. Net unrealized losses are recognized through a valuation allowance by charges to income. Realized gains on sales of mortgage loans are included in noninterest income.

Commitments to originate and fund mortgage loans for sale in the secondary market are considered derivative financial instruments to be accounted for at fair value. The Bank s mortgage loan commitments subject to derivative accounting are fixed rate mortgage commitments at market rates when initiated. At December 31, 2006, the Bank had commitments to originate $1.7 million in fixed-rate mortgage loans intended for sale in the secondary market after the loans are closed. Fair value is estimated based on fees that would be charged on commitments with similar terms.

The Bank also serves as an agent for a third-party mortgage company. In this role, the Bank accepts and processes mortgage loan applications and performs other loan origination activities, except funding, on behalf of the third-party mortgage company. The third-party mortgage company funds such loans and the Bank receives a fee for each loan funded. The fee is typically 1.5% to 2.0% of the loan principal amount.

Delinquencies. The Bank s collection procedures provide for a series of contacts with delinquent borrowers. A late charge is assessed and a late charge notice is sent to the borrower after the 15th day of delinquency. After 20 days, the collector places a phone call to the borrower. When a payment becomes 60 days past due, the collector issues a default letter. If a loan continues in a

Table of Contents

delinquent status for 90 days or more, the Bank generally initiates foreclosure or other litigation proceedings.

Nonperforming Assets. Loans are reviewed regularly and when loans become 90 days delinquent, the loan is placed on nonaccrual status and the previously accrued interest income is reversed unless, in the opinion of management, the outstanding interest remains collectible. Typically, payments received on a nonaccrual loan are applied to the outstanding principal and interest as determined at the time of collection of the loan when the likelihood of further loss on the loan is remote. Otherwise, the Bank applies the cost recovery method and applies all payments as a reduction of the unpaid principal balance.

The following table sets forth information with respect to the Bank s nonperforming assets at the dates indicated. At each date shown, the Bank had no restructured loans within the meaning of Statement of Financial Accounting Standards (SFAS) No. 15.

	At December 31,				
	2006	2005	2004	2003	2002
	(Dollars in thousands)				
Loans accounted for on a nonaccrual basis:					
Residential real estate	$ 797	$ 792	$ 882	$ 964	$ 494
Commercial real estate	2,192	805	485	1,056	36
Commercial business	48	92	525	569	
Consumer	208	217	183	48	77
Total	3,245	1,906	2,075	2,637	607
Loans past due 90 days on accrual status:					
Residential real estate	776	663	706	1,825	385
Commercial real estate		409	671	575	228
Commercial business	144	48	70	78	8
Consumer	205	173	38	188	151
Total	1,125	1,293	1,485	2,666	772
Foreclosed real estate, net	941	749	442	225	102
Total nonperforming assets	$ 5,311	$ 3,948	$ 4,002	$ 5,528	$ 1,481
Total loans delinquent 90 days or more to net loans	1.31%	0.99%	1.12%	1.74%	0.64%
Total loans delinquent 90 days or more to total assets	0.96%	0.73%	0.84%	1.30%	0.45%
Total nonperforming assets to total assets	1.16%	0.90%	0.94%	1.35%	0.48%

The increase in nonperforming assets during 2003 is primarily the result of $3.3 million in impaired loans that were acquired in the Hometown merger.

The Bank accrues interest on loans over 90 days past due when, in the opinion of management, the estimated value of collateral and collection efforts are deemed sufficient to ensure full recovery. The Bank recognized $132,000 in interest income on nonaccrual loans for the fiscal year ended December 31, 2006.

Table of Contents

Classified Assets. The OTS has adopted various regulations regarding problem assets of savings institutions. The regulations require that each insured institution review and classify its assets on a regular basis. In addition, in connection with examinations of insured institutions, OTS examiners have the authority to identify problem assets and, if appropriate, require them to be classified. There are three classifications for problem assets: substandard, doubtful and loss. Substandard assets have one or more defined weaknesses and are characterized by the distinct possibility that the insured institution will sustain some loss if the deficiencies are not corrected. Doubtful assets have the weaknesses of substandard assets with the additional characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss. An asset classified as loss is considered uncollectible and of such little value that continuance as an asset of the institution is not warranted. If an asset or portion thereof is classified as loss, the insured institution establishes specific allowances for loan losses for the full amount of the portion of the asset classified as loss. All or a portion of general loan loss allowances established to cover possible losses related to assets classified substandard or doubtful can be included in determining an institution s regulatory capital, while specific valuation allowances for loan losses generally do not qualify as regulatory capital.

Current accounting rules require that impaired loans be measured based on the present value of expected future cash flows discounted at the loan s effective interest rate, or if expedient, at the loan s observable market price or the fair value of collateral if the loan is collateral dependent. A loan is classified as impaired by management when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due in accordance with the terms of the loan agreement. If the fair value, as measured by one of these methods, is less than the recorded investment in the impaired loan, the Bank establishes a valuation allowance with a provision charged to expense. Management reviews the valuation of impaired loans on a quarterly basis to consider changes due to the passage of time or revised estimates. Assets that do not expose the Bank to risk sufficient to warrant classification in one of the aforementioned categories, but which possess some weaknesses, are required to be designated special mention by management.

An insured institution is required to establish and maintain an allowance for loan losses at a level that is adequate to absorb estimated credit losses associated with the loan portfolio, including binding commitments to lend. General allowances represent loss allowances which have been established to recognize the inherent risk associated with lending activities. When an insured institution classifies problem assets as loss, it is required either to establish an allowance for losses equal to 100% of the amount of the assets, or charge off the classified asset. The amount of its valuation allowance is subject to review by the OTS, which can order the establishment of additional general loss allowances. The Bank regularly reviews the loan portfolio to determine whether any loans require classification in accordance with applicable regulations.

Table of Contents

At December 31, 2006, 2005 and 2004, the aggregate amounts of the Bank s classified assets at those dates were as follows:

	At December 31,		
	2006	2005	2004
	(Dollars in thousands)		
Classified assets:			
Loss	$	$	$
Doubtful	42	151	1,135
Substandard	4,741	4,158	2,807
Special mention	4,421	2,692	2,679

Loans classified as impaired in accordance with SFAS 114, *Accounting by Creditors for Impairment of a Loan*, included in the above regulatory classifications and the related allowance for loan losses are summarized below at the dates indicated:

	At December 31,		
	2006	2005	2004
	(Dollars in thousands)		
Impaired loans with related allowance	$ 1,657	$ 2,415	$ 2,046
Impaired loans with no allowance	2,713	784	1,514
Total impaired loans	$ 4,370	$ 3,199	$ 3,560
Allowance for loan losses:			
Related to impaired loans	516	290	820
Related to other loans	1,804	1,814	1,658

Foreclosed Real Estate. Foreclosed real estate held for sale is carried at the lower of fair value minus estimated costs to sell, or cost. Costs of holding foreclosed real estate are charged to expense in the current period, except for significant property improvements, which are capitalized. Valuations are periodically performed by management and an allowance is established by a charge to non-interest expense if the carrying value exceeds the fair value minus estimated costs to sell. The net income from operations of foreclosed real estate held for sale is reported in non-interest income. At December 31, 2006, the Bank had foreclosed real estate totaling $941,000.

Allowance for Loan Losses. Loans are the Company s largest concentration of assets and continue to represent the most significant potential risk. In originating loans, the Bank recognizes that losses will be experienced and that the risk of loss will vary with, among other things, the type of loan made, the creditworthiness of the borrower over the term of the loan, general economic conditions and, in the case of a secured loan, the quality of the collateral. The Bank maintains an allowance for loan losses to absorb losses inherent in the loan portfolio. The allowance for loan losses represents management s estimate of probable loan losses based on information available as of the date of the financial statements. The allowance for loan losses is based on management s evaluation of the loan portfolio, including historical loan loss experience, delinquencies, known and inherent risks in the nature and volume of the loan portfolio, information about specific borrower situations, estimated collateral values and economic conditions.

The loan portfolio is reviewed quarterly by management to evaluate the adequacy of the allowance for loan losses to determine the amount of any adjustment required after considering the loan charge-offs and recoveries for the quarter. Management applies a systematic methodology that incorporates its current judgments about the credit quality of the loan portfolio. In addition, the

Table of Contents

OTS, as an integral part of its examination process, periodically reviews the Bank s allowance for loan losses and may require the Bank to make additional provisions for estimated losses based on its judgments about information available to the OTS at the time of its examination.

The methodology used in determining the allowance for loan losses includes segmenting the loan portfolio by identifying risk characteristics common to groups of loans, determining and measuring impairment of individual loans based on the present value of expected future cash flows or the fair value of collateral, and determining and measuring impairment for groups of loans with similar characteristics by applying loss factors that consider the qualitative factors which may affect the loss rates. The Allowance for Loan Losses Analysis table below shows changes in the breakdown of the allowance for loan losses by loan category. Management continues to refine the methodology used to allocate loan losses by category and the methodology for allocating loan loss allowances by type of loan.

Specific allowances related to impaired loans and other classified loans are established where management has identified significant conditions or circumstances related to a loan that management believes indicate that a loss will occur. The identification of these loans results from the loan review process that identifies and monitors credits with weaknesses or conditions which call into question the full collection of the contractual payments due under the terms of the loan agreement. Factors considered by management include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due.

For loans evaluated on a group basis, management applies loss factors to groups of loans with common risk characteristics (*i.e.*, residential mortgage loans, home equity loans and credit card loans). The loss factors are derived from the Bank s historical loss experience or, where the Bank does not have loss experience, the peer group loss experience. Peer group loss experience is used after evaluating the attributes of the Bank s loan portfolio as compared to the peer group. Loss factors are adjusted for significant environmental factors that, in management s judgment, affect the collectibility of the loan portfolio segment. The significant environmental factors include the levels and trends in charge-offs and recoveries, trends in volume and terms of loans, levels and trends in delinquencies, the effects of changes in underwriting standards and other lending practices or procedures, the experience and depth of the lending management and staff, effects of changes in credit concentration, changes in industry and market conditions and national and local economic trends and conditions. Management evaluates these conditions on a quarterly basis and evaluates and modifies the assumptions used in establishing the loss factors.

The allowance for loan losses was $2.3 million at December 31, 2006, $2.1 million at December 31, 2005 and $2.5 million at December 31, 2004. Management has deemed these amounts as adequate on those dates based on its evaluation methodology. At December 31, 2006, nonperforming loans totaled $4.4 million or 0.96% of total assets. Included in nonperforming loans are loans over 90 days past due secured by one- to-four family residential real estate in the amount of $776,000, commercial business loans totaling $144,000 and consumer loans in the amount of $205,000. These loans are accruing interest as the estimated value of the collateral and collection efforts are deemed sufficient to ensure full recovery.

Table of Contents

The following table sets forth an analysis of the Bank s allowance for loan losses for the periods indicated.

	Year Ended December 31,				
	2006	2005	2004	2003	2002
	(Dollars in thousands)				
Allowance at beginning of period	$ 2,104	$ 2,478	$ 2,433	$ 1,218	$ 1,103
Provision for loan losses	810	563	510	725	305
	2,914	3,041	2,943	1,943	1,408
Allowance for loan losses on loans acquired in the Hometown merger				1,065	
Recoveries:					
Residential real estate	14			4	
Commercial real estate					
Commercial business	4			3	22
Consumer	92	124	56	45	35
Total recoveries	110	124	56	52	57
Charge-offs:					
Residential real estate	87	182	129	172	78
Commercial real estate	57	114	162	6	
Commercial business	115	459	20	55	2
Consumer	445	306	210	394	167
Total charge-offs	704	1,061	521	627	247
Net (charge-offs) recoveries	(594)	(937)	(465)	(575)	(190)
Balance at end of period	$ 2,320	$ 2,104	$ 2,478	$ 2,433	$ 1,218
Ratio of allowance to total loans outstanding at the end of the period	0.68%	0.64%	0.76%	0.77%	0.55%
Ratio of net charge-offs to average loans outstanding during the period	0.18%	0.29%	0.15%	0.21%	0.09%

Table of Contents

Allowance for Loan Losses Analysis

The following table sets forth the breakdown of the allowance for loan losses by loan category at the dates indicated.

	At December 31,									
	2006		2005		2004		2003		2002	
	Amount	Percent of Outstanding Loans in Category	Amount	Percent of Outstanding Loans in Category	Amount	Percent of Outstanding Loans in Category	Amount	Percent of Outstanding Loans in Category	Amount	Percent of Outstanding Loans in Category
	(Dollars in thousands)									
Residential real estate[1]	$ 539	55.96%	$ 474	59.83%	$ 446	62.21%	$ 673	63.69%	$ 375	70.21%
Commercial real estate and land loans	697	17.88	373	14.11	455	13.89	464	16.01	18	9.76
Commercial business	209	7.24	496	7.45	827	6.39	576	5.10	297	4.27
Consumer	875	18.92	761	18.61	750	17.51	720	15.20	528	15.76
Unallocated										
Total allowance for loan losses	$ 2,320	100.00%	$ 2,104	100.00%	$ 2,478	100.00%	$ 2,433	100.00%	$ 1,218	100.00%

(1) Includes residential construction loans.

Table of Contents

Investment Activities

Federally chartered savings institutions have authority to invest in various types of liquid assets, including United States Treasury obligations, securities of various federal agencies and of state and municipal governments, deposits at the applicable FHLB, certificates of deposit of federally insured institutions, certain bankers acceptances and federal funds. Subject to various restrictions, such savings institutions may also invest a portion of their assets in commercial paper, corporate debt securities and mutual funds, the assets of which conform to the investments that federally chartered savings institutions are otherwise authorized to make directly. Savings institutions are also required to maintain minimum levels of liquid assets that vary from time to time. The Bank may decide to increase its liquidity above the required levels depending upon the availability of funds and comparative yields on investments in relation to return on loans.

The Bank is required under federal regulations to maintain a minimum amount of liquid assets and is also permitted to make certain other securities investments. The balance of the Bank s investments in short-term securities in excess of regulatory requirements reflects management s response to the significantly increasing percentage of deposits with short maturities. It is the intention of management to hold securities with short maturities in the Bank s investment portfolio in order to enable the Bank to match more closely the interest-rate sensitivities of its assets and liabilities.

The Bank periodically invests in mortgage-backed securities, including mortgage-backed securities guaranteed or insured by Ginnie Mae, Fannie Mae or Freddie Mac. Mortgage-backed securities generally increase the quality of the Bank s assets by virtue of the guarantees that back them, are more liquid than individual mortgage loans and may be used to collateralize borrowings or other obligations of the Bank. Of the Bank s total mortgage-backed securities portfolio, securities with a book value of $139,000 have adjustable rates as of December 31, 2006.

At December 31, 2006, neither the Company nor the Bank had an investment in securities (other than United States Government and agency securities), which exceeded 10% of the Company s consolidated stockholders equity at that date.

Table of Contents

The following table sets forth the securities portfolio at the dates indicated.

	At December 31,											
	2006				2005				2004			
	Fair Value	Amortized Cost	Percent of Portfolio	Weighted Average Yield(1)	Fair Value	Amortized Cost	Percent of Portfolio	Weighted Average Yield(1)	Fair Value	Amortized Cost	Percent of Portfolio	Weighted Average Yield(1)
					(Dollars in thousands)							
Securities Held to Maturity(2)												
Municipal:												
Due in one year or less	$ 42	$ 40	0.06%	9.76%	$ 39	$ 37	0.05%	9.44%	$ 38	$ 37	0.05%	9.17%
Due after one year through five years	191	183	0.25	9.74	186	179	0.23	9.45	188	180	0.27	9.16
Due after five years through ten years	137	128	0.17	8.14	77	75	0.10	8.19	101	99	0.15	7.38
Due after ten years	784	705	0.96	8.02	892	800	1.02	8.33	883	800	1.21	8.33
Mortgage-backed securities(3)	60	62	0.08	4.28	99	103	0.13	3.45	139	142	0.21	3.71
	$ 1,214	$ 1,118	1.52%		$ 1,293	$ 1,194	1.53%		$ 1,349	$ 1,258	1.89%	
Securities Available for Sale												
Debt securities:												
U.S. agency:												
Due in one year or less	$ 6,939	$ 6,981	9.51%	3.90%	$ 3,471	$ 3,489	4.47%	3.86%	$ 2,022	$ 2,011	3.03%	3.85%
Due after one year through five years	24,541	24,955	34.01	3.98	33,842	34,509	44.17	3.99	25,999	26,055	39.25	3.91
Due after five years through ten years									1,473	1,501	2.26	3.36
Due after ten years through fifteen years	952	1,000	1.36	5.55	933	1,000	1.28	5.39	946	1,000	1.51	5.26
Mortgage-backed securities (3)	19,663	20,045	27.31	4.45	17,643	18,107	23.17	4.00	17,939	18,064	27.21	3.71
Municipal:												
Due in one year or less	916	915	1.25	6.30	568	565	0.72	7.11	115	115	0.17	6.82
Due after one year through five years	6,374	6,414	8.74	5.59	6,218	6,233	7.98	5.19	3,970	3,857	5.81	6.05
Due after five years through ten	5,344	5,339	7.27	6.48	5,585	5,547	7.10	5.60	8,483	8,335	12.55	6.13

years												
Due after ten years	5,178	5,153	7.02	6.70	3,627	3,621	4.64	5.72	2,894	2,852	4.30	7.22
Corporate notes:												
Due in one year or less				N/A	2,450	2,453	3.14	3.49				
Equity securities:												
Mutual funds	1,455	1,478	2.01	N/A	1,384	1,404	1.80	N/A	1,351	1,342	2.02	N/A
	$ 71,362	$ 72,280	98.48%		$ 75,721	$ 76,928	98.47%		$ 65,192	$ 65,132	98.11%	

(1) Yields are calculated on a fully taxable equivalent basis using a marginal federal income tax rate of 34%. Weighted average yields are calculated using average prepayment rates for the most recent three-month period.

(2) Securities held to maturity are carried at amortized cost.

(3) The expected maturities of mortgage-backed securities may differ from contractual maturities because the mortgages underlying the obligations may be prepaid without penalty.

Table of Contents

Deposit Activities and Other Sources of Funds

General. Deposits and loan repayments are the major source of the Bank s funds for lending and other investment purposes. Loan repayments are a relatively stable source of funds, while deposit inflows and outflows and loan prepayments are significantly influenced by general interest rates and money market conditions. Borrowing may be used on a short-term basis to compensate for reductions in the availability of funds from other sources or may also be used on a longer-term basis for interest rate risk management.

Deposit Accounts. Deposits are attracted from within the Bank s primary market area through the offering of a broad selection of deposit instruments, including non-interest bearing checking accounts, negotiable order of withdrawal (NOW) accounts, money market accounts, regular savings accounts, certificates of deposit and retirement savings plans. Deposit account terms vary, according to the minimum balance required, the time periods the funds must remain on deposit and the interest rate, among other factors. In determining the terms of its deposit accounts, the Bank considers the rates offered by its competition, profitability to the Bank, matching deposit and loan products and its customer preferences and concerns. The Bank generally reviews its deposit mix and pricing weekly.

The following table presents the maturity distributions of time deposits of $100,000 or more as of December 31, 2006.

Maturity Period	Amount at December 31, 2006 (Dollars in thousands)
Three months or less	$ 10,749
Over three through six months	7,970
Over six through 12 months	13,868
Over 12 months	17,769
Total	$ 50,356

The following table sets forth the balances of deposits in the various types of accounts offered by the Bank at the dates indicated.

	At December 31, 2006			2005			2004		
	Amount	Percent of Total	Increase/ (Decrease)	Amount	Percent of Total	Increase/ (Decrease)	Amount	Percent of Total	Increase/ (Decrease)
	(Dollars in thousands)								
Non-interest- bearing demand	$ 36,218	10.94%	$ 1,108	$ 35,111	11.07%	$ 1,310	$ 33,801	10.68%	$ 3,266
NOW accounts	52,388	15.82	(2,169)	54,556	17.20	(4,824)	59,380	18.77	14,652
Savings accounts	30,085	9.09	(2,112)	32,197	10.15	(3,803)	36,000	11.38	4,563
Money market accounts	40,522	12.24	2,975	37,547	11.83	5,068	32,479	10.26	(3,645)
Fixed rate time deposits which mature:									
Within one year	100,348	30.29	34,542	65,806	20.74	4,007	61,799	19.53	(19,659)
After one year, but within three years	52,953	15.99	(12,650)	65,603	20.68	(2,798)	68,401	21.61	17,518
After three years, but within five years	17,882	5.40	(7,502)	25,384	8.00	1,765	23,619	7.46	(2,550)
After five years	682	0.21	(242)	924	0.29	64	860	0.27	(186)
Club accounts	65	0.02	(71)	136	0.04	13	123	0.04	35
Total	$ 331,143	100.00%	$ 13,879	$ 317,264	100.00%	$ 802	$ 316,462	100.00%	$ 13,994

Table of Contents

The following table sets forth the amount and maturities of time deposits by rates at December 31, 2006.

		Amount Due				Percent
	Less Than One Year	1 - 3 Years	3 - 5 Years	After 5 Years	Total	of Total
	(Dollars in thousands)					
1.00% 1.99%	$ 5,355	$ 816	$ 196	$	$ 6,367	3.70%
2.00% 2.99%	3,753	3,403	145		7,301	4.25
3.00% 3.99%	15,863	14,738	818	327	31,746	18.47
4.00% 4.99%	36,768	22,855	13,317	193	73,133	42.56
5.00% 5.99%	38,406	10,903	3,391	162	52,862	30.76
6.00% 6.99%	185	235			420	0.24
7.00% 7.99%	18	3			21	0.01
8.00% 8.99%			15		15	0.01
Total	$ 100,348	$ 52,953	$ 17,882	$ 682	$ 171,865	100.00%

Borrowings. Deposits are the primary source of funds for the Bank s lending and investment activities and for its general business purposes. The Bank has at times relied upon advances from the FHLB of Indianapolis to supplement its supply of lendable funds and to meet deposit withdrawal requirements. Advances from the FHLB of Indianapolis are secured by certain first mortgage loans and investment and mortgage-backed securities. The Bank also uses retail repurchase agreements as a source of borrowings.

The FHLB functions as a central reserve bank providing credit for savings and loan associations and certain other member financial institutions. As a member, the Bank is required to own capital stock in the FHLB and is authorized to apply for advances on the security of such stock and certain of its mortgage loans and other assets (principally securities which are obligations of, or guaranteed by, the United States) provided certain standards related to creditworthiness have been met. Advances are made pursuant to several different programs. Each credit program has its own interest rate and range of maturities. Depending on the program, limitations on the amount of advances are based either on a fixed percentage of an institution s net worth or on the FHLB s assessment of the institution s creditworthiness. Under its current credit policies, the FHLB generally limits advances to 20% of a member s assets, and short-term borrowing of less than one year may not exceed 10% of the institution s assets. The FHLB determines specific lines of credit for each member institution.

The following table sets forth certain information regarding the Bank s use of FHLB advances.

	At or For the Years Ended December 31,		
	2006	2005	2004
	(Dollars in thousands)		
Maximum balance at any month end	$ 62,211	$ 65,947	$ 67,488
Average balance	58,562	61,535	63,122
Period end balance	59,461	65,947	65,099
Weighted average interest rate:			
At end of period	4.88%	4.71%	4.84%
During the period	4.92%	4.94%	5.07%

The following table sets forth certain information regarding the Bank s use of retail repurchase agreements.

	At or For the Years Ended December 31, 2006	2005	2004
	(Dollars in thousands)		
Maximum balance at any month end	$ 24,346	$ 13,276	$ 697
Average balance	16,821	7,986	296
Period end balance	19,228	10,704	640
Weighted average interest rate:			
At end of period	5.38%	4.05%	1.99%
During the period	5.00%	3.42%	1.36%

Subsidiary Activities

As of December 31, 2006, the Bank was the Company s only subsidiary. The Bank is wholly owned by the Company.

In December 2006, the Bank sold its property and casualty insurance business. However, the Bank, through its business arrangement with Great American Advisors, continues to offer non FDIC insured investments to compliment the Bank s offering of traditional banking products and services. During 2005, the Bank organized three wholly-owned subsidiaries to manage a portion of the investment securities portfolio. First Harrison Investments, Inc. and First Harrison Holdings, Inc. are Nevada corporations that jointly own First Harrison, LLC, a Nevada limited liability corporation that holds and manages an investment securities portfolio.

Personnel

As of December 31, 2006, the Bank had 121 full-time employees and 26 part-time employees. A collective bargaining unit does not represent the employees and the Bank considers its relationship with its employees to be good.

REGULATION AND SUPERVISION

General

As a savings and loan holding company, the Company is required by federal law to report to, and otherwise comply with the rules and regulations of, the Office of Thrift Supervision. The Bank is subject to extensive regulation, examination and supervision by the Office of Thrift Supervision, as its primary federal regulator, and the Federal Deposit Insurance Corporation, as the deposit insurer. The Bank is a member of the Federal Home Loan Bank System and, with respect to deposit insurance, of the Deposit Insurance Fund managed by the Federal Deposit Insurance Corporation. The Bank must file reports with the Office of Thrift Supervision and the Federal Deposit Insurance Corporation concerning its activities and financial condition in addition to obtaining regulatory approvals prior to entering into certain transactions such as mergers with, or acquisitions of, other savings institutions. The Office of Thrift Supervision and/or the Federal Deposit Insurance Corporation conduct periodic examinations to test the Bank s safety and soundness and compliance with various regulatory requirements. This regulation and supervision establishes a comprehensive framework of activities in which an institution can engage and is intended primarily for the protection of the insurance fund and depositors. The regulatory structure also gives the regulatory authorities extensive discretion in connection with their supervisory and enforcement activities and examination policies, including policies with respect to the classification of assets and the establishment of adequate loan loss reserves for regulatory purposes. Any change in such regulatory requirements and policies, whether by the Office of Thrift Supervision, the Federal Deposit Insurance Corporation or Congress, could have a material adverse impact on the Company, the Bank and their operations. Certain regulatory requirements applicable to the Bank and to the Company are referred to below or elsewhere herein. The description of statutory provisions and regulations applicable to savings institutions and their holding companies set forth below and elsewhere in this document does not purport to be a complete description of such statutes and regulations and their effects on the Bank and the Company and is qualified in its entirety by reference to the actual laws and regulations.

Holding Company Regulation

The Company is a non-diversified unitary savings and loan holding company within the meaning of federal law. Under prior law, a unitary savings and loan holding company, such as the Company, was not generally restricted as to the types of business activities in which it may engage, provided that the Bank continued to be a qualified thrift lender. See Federal Savings Institution Regulation - QTL Test. The Gramm-Leach-Bliley Act of 1999 provided that no company may acquire control of a savings institution after May 4, 1999 unless the company engages only in the financial activities permitted for financial holding companies under law or for multiple savings and loan holding companies as described below. Further, the Gramm-Leach-Bliley Act specified that existing savings and loan holding companies may only engage in such activities. The Gramm-Leach-Bliley Act, however, grandfathered the unrestricted authority for activities with respect to unitary savings and loan holding companies existing prior to May 4, 1999, so long as the holding company s savings institution subsidiary continues to comply with the QTL Test. The Company does qualify for the grandfathering. Upon any non-supervisory acquisition by the Company of another savings institution or savings bank that meets the qualified thrift lender test and is deemed to be a savings institution by the Office of Thrift Supervision, the Company would become a multiple savings and loan holding company (if the acquired institution is held as a separate subsidiary) and would generally be limited to activities permissible for bank holding companies under Section 4(c)(8) of the Bank Holding Company Act, subject to the prior approval of the Office of Thrift Supervision, and certain activities authorized by Office of Thrift Supervision regulation. However, the OTS has issued an interpretation concluding that multiple savings and loan holding companies may also engage in activities permitted for financial holding companies.

A savings and loan holding company is prohibited from, directly or indirectly, acquiring more than 5% of the voting stock of another savings institution or savings and loan holding company, without prior written approval of the Office of Thrift Supervision and from acquiring or retaining control of a depository institution that is not insured by the Federal Deposit Insurance Corporation. In evaluating applications by holding companies to acquire savings institutions, the Office of Thrift Supervision considers factors such as the financial and managerial resources and future prospects of the Company and institution involved, the effect of the acquisition on the risk to the deposit insurance funds, the convenience and needs of the community and competitive effects.

The Office of Thrift Supervision may not approve any acquisition that would result in a multiple savings and loan holding company controlling savings institutions in more than one state, subject to two exceptions: (i) the approval of interstate supervisory acquisitions by savings and loan holding companies; and (ii) the acquisition of a savings institution in another state if the laws of the state of the target savings institution specifically permit such acquisitions. The states vary in the extent to which they permit interstate savings and loan holding company acquisitions.

Table of Contents

Although savings and loan holding companies are not currently subject to specific regulatory capital requirements or specific restrictions on the payment of dividends or other capital distributions, federal regulations do prescribe such restrictions on subsidiary savings institutions as described below. The financial impact of a holding company on its subsidiary institution is a matter that is evaluated by the Office of Thrift Supervision and the agency has authority to order cessation of activities or divestiture of subsidiaries deemed to pose a threat to the safety and soundness of the institution.

***Acquisition of the Company*.** Under the Federal Change in Control Act, a notice must be submitted to the Office of Thrift Supervision if any person (including a company), or group acting in concert, seeks to acquire control of a savings and loan holding company or savings association. Under certain circumstances, a change of control may occur, and prior notice is required, upon the acquisition of 10% or more of the Company s outstanding voting stock, unless the Office of Thrift Supervision has found that the acquisition will not result in control of the Company. Under the Change in Control Act, the Office of Thrift Supervision generally has 60 days from the filing of a complete notice to act, taking into consideration certain factors, including the financial and managerial resources of the acquirer and the competitive effects of the acquisition. Any company that acquires control would then be subject to regulation as a savings and loan holding company.

Federal Savings Institution Regulation

Business Activities. The activities of federal savings banks are governed by federal law and regulations. These laws and regulations delineate the nature and extent of the activities in which federal savings banks may engage. In particular, certain lending authority for federal savings banks, *e.g.*, commercial, non-residential real property loans and consumer loans, is limited to a specified percentage of the institution s capital or assets.

***Capital Requirements*.** The Office of Thrift Supervision capital regulations require savings institutions to meet three minimum capital standards: a 1.5% tangible capital to total assets ratio; a 4% tier 1 capital to total assets leverage ratio (3% for institutions receiving the highest rating on the CAMELS examination rating system); and an 8% risk-based capital ratio. In addition, the prompt corrective action standards discussed below also establish, in effect, a minimum 2% tangible capital standard, a 4% leverage ratio (3% for institutions receiving the highest rating on the CAMELS system) and, together with the risk-based capital standard itself, a 4% Tier 1 risk-based capital standard. The Office of Thrift Supervision regulations also require that, in meeting the tangible, leverage and risk-based capital standards, institutions must generally deduct investments in and loans to subsidiaries engaged in activities as principal that are not permissible for a national bank.

The risk-based capital standard for savings institutions requires the maintenance of Tier 1 (core) and total capital (which is defined as core capital and supplementary capital) to risk-weighted assets of at least 4% and 8%, respectively. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet activities, recourse obligations, residual interests and direct credit substitutes, are multiplied by a risk-weight factor of 0% to 100%, assigned by the Office of Thrift Supervision capital regulation based on the risks believed inherent in the type of asset. Core (Tier 1) capital is generally defined as common stockholders equity (including retained earnings), certain non-cumulative perpetual preferred stock and related surplus and minority interests in equity accounts of consolidated subsidiaries less intangibles other than certain mortgage servicing rights and credit card relationships. The components of supplementary capital (Tier 2 Capital) currently include cumulative preferred stock, long-term perpetual preferred stock, mandatory convertible debt securities, subordinated debt and intermediate preferred stock, the allowance for loan and lease losses limited to a maximum of 1.25% of risk-weighted

Table of Contents

assets, and up to 45% of unrealized gains on available-for-sale equity securities with readily determinable fair market values. Overall, the amount of supplementary capital included as part of total capital cannot exceed 100% of core capital.

The Office of Thrift Supervision also has authority to establish individual minimum capital requirements in appropriate cases upon a determination that an institution s capital level is or may become inadequate in light of the particular circumstances.

At December 31, 2006, the Bank met each of its capital requirements.

The following table presents the Bank s capital position at December 31, 2006.

				Capital	
	Actual Capital	Required Capital	Excess (Deficiency) Amount	Actual Percent	Required Percent
			(Dollars in thousands)		
Tangible	$ 35,922	$ 6,781	$ 29,141	7.95%	1.50%
Tier 1 leverage ratio	35,922	18,082	17,840	7.95	4.00
Tier 1 capital risk-based ratio	35,922	17,146	18,776	12.57	6.00
Total capital risk-based ratio	37,578	22,862	14,716	13.15	8.00

Prompt Corrective Regulatory Action. The Office of Thrift Supervision is required to take certain supervisory actions against undercapitalized institutions, the severity of which depends upon the institution s degree of undercapitalization. Generally, a savings institution that has a ratio of total capital to risk weighted assets of less than 8%, a ratio of Tier 1 (core) capital to risk-weighted assets of less than 4% or a ratio of core capital to total assets of less than 4% (3% or less for institutions with the highest examination rating) is considered to be undercapitalized. A savings institution that has a total risk-based capital ratio less than 6%, a Tier 1 capital ratio of less than 3% or a leverage ratio that is less than 3% is considered to be significantly undercapitalized and a savings institution that has a tangible capital to assets ratio equal to or less than 2% is deemed to be critically undercapitalized. Subject to a narrow exception, the Office of Thrift Supervision is required to appoint a receiver or conservator within specified time frames for an institution that is critically undercapitalized. The regulation also provides that a capital restoration plan must be filed with the Office of Thrift Supervision within 45 days of the date a savings institution is deemed to have received notice that it is undercapitalized, significantly undercapitalized or critically undercapitalized. Compliance with the plan must be guaranteed by any parent holding company in the amount of up to the lessor of 5% of the savings association s total assets when it was deemed to be undercapitalized or the amount necessary to achieve compliance with applicable capital requirements. In addition, numerous mandatory supervisory actions become immediately applicable to an undercapitalized institution, including, but not limited to, increased monitoring by regulators and restrictions on growth, capital distributions and expansion. The Office of Thrift Supervision could also take any one of a number of discretionary supervisory actions, including the issuance of a capital directive and the replacement of senior executive officers and directors. Significantly and critically undercapitalized institutions are subject to additional mandatory and discretionary measures.

Table of Contents

Insurance of Deposit Accounts. The Bank s deposits are insured up to applicable limits by the Deposit Insurance Fund of the Federal Deposit Insurance Corporation. The Deposit Insurance Fund is the successor to the Bank Insurance Fund and the Savings Association Insurance Fund, which were merged in 2006. The Federal Deposit Insurance Corporation recently amended its risk-based assessment system for 2007 to implement authority granted by the Federal Deposit Insurance Reform Act of 2005 (Reform Act). Under the revised system, insured institutions are assigned to one of four risk categories based on supervisory evaluations, regulatory capital levels and certain other factors. An institution s assessment rate depends upon the category to which it is assigned. Risk category I, which contains the least risky depository institutions, is expected to include more than 90% of all institutions. Unlike the other categories, Risk Category I contains further risk differentiation based on the Federal Deposit Insurance Corporation s analysis of financial ratios, examination component ratings and other information. Assessment rates are determined by the Federal Deposit Insurance Corporation and currently range from five to seven basis points for the healthiest institutions (Risk Category I) to 43 basis points of assessable deposits for the riskiest (Risk Category IV). The Federal Deposit Insurance Corporation may adjust rates uniformly from one quarter to the next, except that no single adjustment can exceed three basis points.

The Reform Act also provided for a one-time credit for eligible institutions based on their assessment base as of December 31, 1996. Subject to certain limitations with respect to institutions that are exhibiting weaknesses, credits can be used to offset assessments until exhausted. The Bank s one-time credit is expected to approximate $198,000. The Reform Act also provided for the possibility that the Federal Deposit Insurance Corporation may pay dividends to insured institutions once the Deposit Insurance fund reserve ratio equals or exceeds 1.35% of estimated insured deposits.

In addition to the assessment for deposit insurance, institutions are required to make payments on bonds issued in the late 1980s by the Financing Corporation to recapitalize a predecessor deposit insurance fund. This payment is established quarterly and during the calendar year ending December 31, 2006 averaged 1.28 basis points of assessable deposits.

The Reform Act provided the Federal Deposit Insurance Corporation with authority to adjust the Deposit Insurance Fund ratio to insured deposits within a range of 1.15% and 1.50%, in contrast to the prior statutorily fixed ratio of 1.25%. The ratio, which is viewed by the Federal Deposit Insurance Corporation as the level that the fund should achieve, was established by the agency at 1.25% for 2007.

The Federal Deposit Insurance Corporation has authority to increase insurance assessments. A significant increase in insurance premiums would likely have an adverse effect on the operating expenses and results of operations of the Bank. Management cannot predict what insurance assessment rates will be in the future.

Insurance of deposits may be terminated by the Federal Deposit Insurance Corporation upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the Federal Deposit Insurance Corporation or the Office of Thrift Supervision. The management of the Bank does not know of any practice, condition or violation that might lead to termination of deposit insurance.

Loans to One Borrower. Federal law provides that savings institutions are generally subject to the limits on loans to one borrower applicable to national banks. Generally, subject to certain exceptions, a savings institution may not make a loan or extend credit to a single or related group of borrowers in excess of 15% of its unimpaired capital and surplus. An additional amount may be lent, equal to 10% of unimpaired capital and surplus, if secured by specified readily-marketable collateral.

QTL Test. Federal law requires savings institutions to meet a qualified thrift lender test. Under the test, a savings association is required to either qualify as a domestic building and loan association under the Internal Revenue Code or maintain at least 65% of its portfolio assets (total assets less: (i) specified liquid assets up to 20% of total assets; (ii) intangibles, including goodwill; and (iii) the value of property used to conduct business) in certain qualified thrift investments (primarily residential mortgages and related investments, including certain mortgage-backed securities) in at least 9 months out of each 12 month period. Recent legislation has expanded the extent to which education loans, credit card loans and small business loans may be considered qualified thrift investments.

A savings institution that fails the qualified thrift lender test is subject to certain operating restrictions and may be required to convert to a bank charter. As of December 31, 2006, the Bank maintained 82.3% of its portfolio assets in qualified thrift investments and, therefore, met the qualified thrift lender test.

Limitation on Capital Distributions. Office of Thrift Supervision regulations impose limitations upon all capital distributions by a savings institution, including cash dividends, payments to repurchase its shares and payments to shareholders of another institution in a cash-out merger. Under the regulations, an application to and prior approval of the Office of Thrift Supervision is required prior to any capital distribution if the institution does not meet the criteria for expedited treatment of applications under Office of Thrift Supervision regulations (*i.e.*, generally, examination and Community Reinvestment Act ratings in the two top categories), the total capital distributions for the calendar year exceed net income for that year plus the amount of retained net income for the preceding two years, the institution would be undercapitalized following the distribution or the distribution would otherwise be contrary to a statute, regulation or agreement with the Office of Thrift Supervision. If an application is not required, the institution must still provide prior notice to the Office of Thrift Supervision of the capital distribution if, like the Bank, it is a subsidiary of a holding company. In the event the Bank s capital fell below its regulatory requirements or the Office of Thrift Supervision notified it that it was in need of increased supervision, the Bank s ability to make capital distributions could be restricted. In addition, the Office of Thrift Supervision could prohibit a proposed capital distribution by any institution, which would otherwise be permitted by the regulation, if the Office of Thrift Supervision determines that such distribution would constitute an unsafe or unsound practice.

Standards for Safety and Soundness. The federal banking agencies have adopted Interagency Guidelines prescribing Standards for Safety and Soundness. The guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. If the Office of Thrift Supervision determines that a savings institution fails to meet any standard prescribed by the guidelines, the Office of Thrift Supervision may require the institution to submit an acceptable plan to achieve compliance with the standard.

Transactions with Related Parties. The Bank s authority to engage in transactions with affiliates (*e.g.*, any entity that controls or is under common control with an institution, including the Company and its non-savings institution subsidiaries) is limited by federal law. The aggregate amount of covered transactions with any individual affiliate is limited to 10% of the capital and surplus of the

Table of Contents

savings institution. The aggregate amount of covered transactions with all affiliates is limited to 20% of the savings institution s capital and surplus. Certain transactions with affiliates are required to be secured by collateral in an amount and of a type specified by federal law. The purchase of low quality assets from affiliates is generally prohibited. Transactions with affiliates must generally be on terms and under circumstances, that are at least as favorable to the institution as those prevailing at the time for comparable transactions with non-affiliated companies. In addition, savings institutions are prohibited from lending to any affiliate that is engaged in activities that are not permissible for bank holding companies and no savings institution may purchase the securities of any affiliate other than a subsidiary.

The Sarbanes-Oxley Act of 2002 generally prohibits loans by the Company to its executive officers and directors. However, the law contains a specific exception for loans by the Bank to its executive officers and directors in compliance with federal banking laws. Under such laws, the Bank s authority to extend credit to executive officers, directors and 10% shareholders (insiders), as well as entities such persons control, is limited. The law limits both the individual and aggregate amount of loans the Bank may make to insiders based, in part, on the Bank s capital position and requires certain board approval procedures to be followed. Such loans are required to be made on terms substantially the same as those offered to unaffiliated individuals and not involve more than the normal risk of repayment. There is an exception for loans made pursuant to a benefit or compensation program that is widely available to all employees of the institution and does not give preference to insiders over other employees.

Enforcement. The Office of Thrift Supervision has primary enforcement responsibility over savings institutions and has authority to bring actions against the institution and all institution-affiliated parties, including stockholders, and any attorneys, appraisers and accountants who knowingly or recklessly participate in wrongful action likely to have an adverse effect on an insured institution. Formal enforcement action may range from the issuance of a capital directive or cease and desist order to removal of officers and/or directors to institution of receivership, conservatorship or termination of deposit insurance. Civil penalties cover a wide range of violations and can amount to $25,000 per day, or even $1 million per day in especially egregious cases. The Federal Deposit Insurance Corporation has the authority to recommend to the Director of the Office of Thrift Supervision that enforcement action to be taken with respect to a particular savings institution. If action is not taken by the Director, the Federal Deposit Insurance Corporation has authority to take such action under certain circumstances. Federal law also establishes criminal penalties for certain violations.

Assessments. Savings institutions are required to pay assessments to the Office of Thrift Supervision to fund the agency s operations. The general assessments, paid on a semi-annual basis, are computed based upon the savings institution s (including consolidated subsidiaries) total assets, financial condition and complexity of its portfolio. The OTS assessments paid by the Bank for the fiscal year ended December 31, 2006 totaled $104,578.

Federal Home Loan Bank System

The Bank is a member of the Federal Home Loan Bank System, which consists of (12) regional Federal Home Loan Banks. The Federal Home Loan Bank provides a central credit facility primarily for member institutions. The Bank, as a member of the Federal Home Loan Bank, is required to acquire and hold shares of capital stock in that Federal Home Loan Bank. The Bank was in compliance with this requirement with an investment in Federal Home Loan Bank stock at December 31, 2006 of $3.6 million.

The Federal Home Loan Banks are required to provide funds for the resolution of insolvent thrifts in the late 1980s and to contribute funds for affordable housing programs. These requirements could reduce the amount of dividends that the Federal Home Loan Banks pay to their members and could also result in the Federal Home Loan Banks imposing a higher rate of interest on advances to their members. If dividends were reduced, or interest on future Federal Home Loan Bank advances increased, the Bank s net interest income would likely also be reduced.

Federal Reserve System

The Federal Reserve Board regulations require savings institutions to maintain non-interest earning reserves against their transaction accounts (primarily Negotiable Order of Withdrawal (NOW) and regular checking accounts). The regulations generally provide that reserves be maintained against aggregate transaction accounts as follows: a 3% reserve ratio is assessed on net transaction accounts up to and including $45.8 million; a 10% reserve ratio is applied above $45.8 million. The first $8.5 million of otherwise reservable balances (subject to adjustments by the Federal Reserve Board) are exempted from the reserve requirements. The amounts are adjusted annually. The Bank complies with the foregoing requirements.

FEDERAL AND STATE TAXATION

Federal Taxation

General. The Company and the Bank report their income on a fiscal year basis using the accrual method of accounting and are subject to federal income taxation in the same manner as other corporations with some exceptions, including particularly the Bank s reserve for bad debts, as discussed below. The following discussion of tax matters is intended only as a summary and does not purport to be a comprehensive description of the tax rules applicable to the Bank or the Company. The Bank has not been audited by the Internal Revenue Service (IRS) in the past five years.

Bad Debt Reserve. For taxable years beginning after December 31, 1995, the Bank is entitled to take a bad debt deduction for federal income tax purposes which is based on its current or historic net charge-offs by applying the experience reserve method for banks. For tax years beginning prior to December 31, 1995, the Bank as a qualifying thrift had been permitted to establish a reserve for bad debts and to make annual additions to such reserve, which were deductible for federal income tax purposes. Under such prior tax law, generally the Bank recognized a bad debt deduction equal to 8% of taxable income.

Under the 1996 Tax Act, the Bank was required to recapture all or a portion of its additions to its bad debt reserve made subsequent to the base year (which is the Bank s last taxable year beginning before January 1, 1988). This recapture was required to be made, after a deferral period based on certain specified criteria, ratably over a six-year period commencing in the Bank s calendar 1998 tax year. All post-1987 additions to the statutory bad debt reserve have been recaptured in taxable income as of December 31, 2002.

Potential Recapture of Base Year Bad Debt Reserve. The Bank s bad debt reserve as of the base year is not subject to automatic recapture as long as the Bank continues to carry on the business of banking. If the Bank no longer qualifies as a bank, the balance of the pre-1988 reserves (the base year reserves) are restored to income over a six-year period beginning in the tax year the Bank no longer qualifies as a bank. Such base year bad debt reserve is subject to recapture to the extent that the Bank makes non-dividend distributions that are considered as made from the base year bad debt reserve. To the extent that such reserves exceed the amount that would have been allowed under the experience method (Excess Distributions), then an amount based on the amount distributed will be included in the Bank s taxable income. Non-dividend distributions include distributions in excess of the Bank s current and accumulated earnings and profits, distributions in redemption of stock, and distributions in partial or complete liquidation. However, dividends paid out of the Bank s current or accumulated earnings and profits, as calculated for federal income tax purposes, will not be considered to result in a distribution from the Bank s bad debt reserve. Thus, any dividends to the Company that would reduce amounts appropriated to the Bank s bad debt reserve and deducted for federal income tax purposes would create a tax liability for the Bank. The amount of additional taxable income created from an Excess Distribution is an amount that, when reduced by the tax attributable to the income, is equal to the amount of the distribution. If the Bank makes a non-dividend distribution, then approximately one and one-half times the amount so used would be includable in gross income for federal income tax purposes, assuming a 34% corporate income tax rate (exclusive of state and local taxes). The Bank does not intend to pay dividends that would result in a recapture of any portion of its bad debt reserve.

Corporate Alternative Minimum Tax. The Internal Revenue Code imposes a tax on alternative minimum taxable income (AMTI) at a rate of 20%. The excess of the bad debt reserve deduction claimed by the Bank over the deduction that would have been allowable under the experience method is treated as a preference item for purposes of computing the AMTI. Only 90% of AMTI can be offset by net operating loss carry-overs, of which the Bank currently has none. AMTI is increased by an amount equal to 75% of the amount by which the Bank s adjusted current earnings exceeds its AMTI (determined without regard to this preference and prior to reduction for net operating losses). In addition, for taxable years beginning after June 30, 1986 and before January 1, 1996, an environmental tax of 0.12% of the excess of AMTI (with certain modifications) over $2.0 million is imposed on corporations, including the Bank, whether or not an Alternative Minimum Tax (AMT) is paid. The Bank does not expect to be subject to the AMT.

Dividends Received Deduction and Other Matters. The Company may exclude from its income 100% of dividends received from the Bank as a member of the same affiliated group of corporations. The corporate dividends received deduction is generally 70% in the case of dividends received from unaffiliated corporations with which the Company and the Bank will not file a consolidated tax return, except that if the Company or the Bank own more than 20% of the stock of a corporation distributing a dividend, then 80% of any dividends received may be deducted.

Indiana Taxation

Indiana imposes an 8.5% franchise tax based on a financial institution s adjusted gross income as defined by statute. In computing adjusted gross income, deductions for municipal interest, United States Government interest, the bad debt deduction computed using the reserve method and pre-1990 net operating losses are disallowed. During 2006, the Bank s Indiana state income tax returns for the years 2003 through 2005 were audited, with no changes made.

ITEM 1A. RISK FACTORS

Above average interest rate risk associated with fixed-rate loans

At December 31, 2006, approximately 38.0% of the Bank s assets consisted of residential mortgage loans held for investment. Such loans represented 50.9% of the total loan portfolio at that date. While generally considered to involve less risk than other types of lending, such as commercial mortgage loans, commercial business loans and consumer loans, residential mortgage loans provide relatively lower yields. The Bank s loan portfolio also includes a significant amount of loans with fixed rates of interest. At December 31, 2006, $216.6 million, or 63.4%, of the Bank s total loans receivable had fixed interest rates all of which were held for investment. The Bank offers ARM loans and fixed-rate loans. Unlike

Table of Contents

ARM loans, fixed-rate loans carry the risk that, because they do not reprice to market interest rates, their yield may be insufficient to offset increases in the Bank s cost of funds during a rising interest rate environment. Accordingly, a material and prolonged increase in market interest rates could be expected to have a greater adverse effect on the Bank s net interest income compared to other institutions that hold a materially larger portion of their assets in ARM loans or fixed-rate loans that are originated for committed sale in the secondary market. For a discussion of the Bank s loan portfolio, see *Item 1. Business Lending Activities*.

Commercial business lending risks

At December 31, 2006, the Bank s commercial business loan portfolio amounted to $24.7 million, or 7.2% of total loans. Subject to market conditions and other factors, the Bank intends to expand its commercial business lending activities within its primary market area. Commercial business lending is inherently riskier than one- to four-family mortgage lending. Although commercial business loans are often collateralized by equipment, inventory, accounts receivable or other business assets, the liquidation value of these assets in the event of a borrower default is often an insufficient source of repayment because accounts receivable may be uncollectible and inventories and equipment may be obsolete or of limited use, among other things. See *Item 1. Business Lending Activities Commercial Business Loans*.

Commercial real estate lending risks

At December 31, 2006, the Bank s commercial real estate loan portfolio amounted to $48.5 million, or 14.2% of total loans. Commercial real estate lending is inherently riskier than one- to-four family mortgage lending. Because payments on loans secured by commercial properties often depend upon the successful operation and management of the properties, repayment of such loans may be affected by adverse conditions in the real estate market or the economy, among other things. See *Item 1. Business Lending Activities Commercial Real Estate Loans*.

A downturn in the local economy or a decline in real estate values could hurt the Company s profits.

Nearly all of the Bank s loans are secured by real estate or made to businesses in our primary market area. As a result of this concentration, a downturn in the local economy could cause significant increases in nonperforming loans, which would hurt profit. In recent years, there has been a significant increase in real estate values in our market area. As a result of rising home prices, the Bank s loans have been well collateralized. A decline in real estate values could cause some of the Bank s mortgages to become inadequately collateralized, which would expose the Company to a greater risk of loss.

Strong competition within the Bank s market area could hurt the Company s profit and growth.

The Bank faces intense competition both in making loans and attracting deposits. This competition has made it more difficult for it to make new loans and at times has forced it to offer higher deposit rates. Price competition for loans and deposits might result in the Bank earning less on loans paying more on deposits, which would reduce net interest income. Competition also makes it more difficult to grow loans and deposits. Some of the institutions with which the Bank competes have substantially greater resources and lending limits than it has and may offer services that the Bank does not provide. Competition will likely increase in the future as a result of legislative, regulatory and technological changes and the continuing trend of consolidation in the financial services industry. The Company s profitability depends upon the Bank s continued ability to compete successfully in its market area.

Table of Contents

The Bank and the Company operate in a highly regulated environment and may be adversely affected by changes in laws and regulations.

The Company and the Bank are subject to extensive regulation, supervision and examination by the Office of Thrift Supervision, their chartering authority, and by the Federal Deposit Insurance Corporation, as insurer of the Bank s deposits. The Company and the Bank are both subject to regulation and supervision by the Office of Thrift Supervision. Such regulations and supervision governs the activities in which an institution and its holding company may engage, and are intended primarily for the protection of the insurance fund and depositors. Regulatory authorities have extensive discretion in their supervisory and enforcement activities, including to imposition of restrictions on operations, the classification of assets and determination of the level of allowance for loan losses. Any change in such regulation and oversight, whether in the form of regulatory policy, regulations, legislation or supervisory claim may have a material impact on the Bank s operations.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

Table of Contents

ITEM 2. PROPERTIES

The following table sets forth certain information regarding the Bank s offices as of December 31, 2006.

Location	Year Opened	Net Book Value[(1)]	Owned/ Leased	Approximate Square Footage
		(Dollars in thousands)		
Main Office:				
220 Federal Drive, N.W. Corydon, Indiana 47112	1997	$ 2,205	Owned	12,000
Branch Offices:				
391 Old Capital Plaza, N.E. Corydon, Indiana 47112	1997	10	Leased(2)	425
8095 State Highway 135, N.W. New Salisbury, Indiana 47161	1999	783	Owned	3,500
710 Main Street Palmyra, Indiana 47164	1991	1,058	Owned	6,000
9849 Highway 150 Greenville, Indiana 47124	1986	253	Owned	2,484
1058 North Luther Road Georgetown, Indiana 47122	1995	89	Leased(3)	1,800
317 East U.S. Highway 150 Hardinsburg, Indiana 47125	1996	121	Owned	1,834
4303 Charlestown Crossing New Albany, Indiana 47150	1999	850	Owned	3,500
3131 Grant Line Road New Albany, Indiana 47150	2003	1,450	Owned	12,200
5609 Williamsburg Station Road Floyds Knobs, Indiana 47119	2003	631	Owned	4,160
2744 Allison Lane Jeffersonville, Indiana 47130	2003	1,428	Owned	4,090

(1) Represents the net value of land, buildings, furniture, fixtures and equipment owned by the Bank.

(2) Lease expires April 2010.
(3) Lease expires November 2010.

ITEM 3. LEGAL PROCEEDINGS

At December 31, 2006, neither the Company nor the Bank was involved in any pending legal proceedings believed by management to be material to the Company s financial condition or results of operations. From time to time, the Bank is involved in legal proceedings occurring in the ordinary course of business. Such routine legal proceedings, in the aggregate, are believed by management to be immaterial to the Company s financial condition, results of operations or cash flows.

Table of Contents

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year ended December 31, 2006.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The information regarding the market for First Capital s common equity and related stockholder matters is incorporated herein by reference to First Capital s 2006 Annual Report to Stockholders at *Corporate Information.*

The following table provides certain information with regard to shares repurchased by the Company in the fourth quarter of 2006.

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid Per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
October 1 through October 31, 2006	3,161	$ 18.39	3,161	75,038
November 1 through November 30, 2006	1,875	18.50	1,875	73,163
December 1 through December 31, 2006	25	18.55	25	73,138
Total	5,061	$ 18.43	5,061	73,138

On January 4, 2001, the Company announced a stock repurchase program to purchase up to 101,000 shares of its outstanding common stock. On September 30, 2002, the board of directors authorized an increase in the stock repurchase program in connection with the merger of Hometown Bancshares whereby the Company would purchase up to 345,000 shares of its outstanding common stock. The stock repurchase program expires upon the purchase of the maximum number of shares authorized under the program.

Table of Contents

Stock Performance Graph

The following graph compares the cumulative total shareholder return on First Capital common stock with the cumulative total return on the Nasdaq Index (U.S. Companies) and with the SNL Midwest Thrift Index. Total return assumes the reinvestment of all dividends. The graph assumes $100 was invested at the close of business on December 31, 2001.

	Period Ending					
Index	**12/31/01**	**12/31/02**	**12/31/03**	**12/31/04**	**12/31/05**	**12/31/06**
First Capital, Inc.	$ 100.00	$ 145.56	$ 154.35	$ 158.56	$ 139.77	$ 165.27
NASDAQ Composite Index	100.00	68.76	103.67	113.16	115.57	127.58
SNL Midwest Thrift Index	100.00	128.91	179.09	197.78	193.27	219.35

The stock performance graph shall not be deemed incorporated by reference by any general statement incorporating by reference this proxy statement into any filing under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, except to the extent that the Company specifically incorporates this information by reference, and shall not otherwise be deemed filed under such Acts.

Table of Contents

ITEM 6. SELECTED FINANCIAL DATA

The information required by this item is incorporated herein by reference to the section captioned *Selected Financial and Other Data* in the 2006 Annual Report to Stockholders.

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATION

The information regarding management s discussion and analysis of financial condition and results of operation is incorporated herein by reference to First Capital s 2006 Annual Report to Stockholders in the section captioned *Management s Discussion and Analysis of Financial Condition and Results of Operations.*

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information required by this item is incorporated herein by reference to the section captioned *Management s Discussion and Analysis of Financial Condition and Results of Operations* in the 2006 Annual Report to Stockholders.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements required by this item are incorporated by reference to the Company s Audited Financial Statements and the notes thereto found in First Capital s 2006 Annual Report to Stockholders.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

The Company s management, including the Company s principal executive officer and principal financial officer, have evaluated the effectiveness of the Company s disclosure controls and procedures, as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based upon their evaluation, the principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, the Company s disclosure controls and procedures were effective for the purpose of ensuring that the information required to be disclosed in the reports that the Company files or submits under the Exchange Act with the Securities and Exchange Commission (the SEC) (1) is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and (2) is accumulated and communicated to the Company s management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

ITEM 9B. OTHER INFORMATION

None.

Table of Contents

PART III

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

The information relating to the directors of First Capital, information regarding compliance with Section 16(a) of the Exchange Act and information regarding the audit committee and audit committee financial expert is incorporated herein by reference to First Capital s Proxy Statement for the 2007 Annual Meeting of Stockholders.

Executive Officers Who Are Not Directors

Name	Age[1]	Position
M. Chris Frederick	39	Senior Vice President, Chief Financial Officer and Treasurer
Joel E. Voyles	54	Senior Vice President - Retail and Corporate Secretary
Dennis L. Thomas	50	Senior Vice President - Lending

(1) As of December 31, 2006.

Biographical Information

M. Chris Frederick has been affiliated with the Bank since June 1990 and has served in his present position since 1997.

Joel E. Voyles has been affiliated with the Bank since December 1996 and has served in his present position since 1997.

Dennis L. Thomas has been affiliated with the Bank since January 2000. He was employed by Harrison County Bank from 1981 until the merger with the Bank.

Code of Ethics

The Company maintains a Code of Ethics and Business Conduct that applies to all directors, officers and employees of the Company and its affiliates. See Exhibit 14.0 to this Annual Report on Form 10-K.

ITEM 11. EXECUTIVE COMPENSATION

The information regarding executive compensation, compensation committee interlocks and insider participation and compensation committee report is incorporated herein by reference to First Capital s Proxy Statement for the 2007 Annual Meeting of Stockholders.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT

(a) Security Ownership of Certain Beneficial Owners.

Information required by this item is incorporated herein by reference to the section captioned *Stock Ownership* in the Proxy Statement.

Table of Contents

(b) Security Ownership of Management

Information required by this item is incorporated herein by reference to the section captioned *Stock Ownership* in the Proxy Statement.

(c) Changes in Control

Management of the Company knows of no arrangements, including any pledge by any person or securities of the Company, the operation of which may at a subsequent date result in a change in control of the registrant.

(d) Equity Compensation Plan Information

Equity Compensation Plan Information as of December 31, 2006

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	106,152	$ 14.70	54,971
Equity compensation plans not approved by security holders			
Total	106,152	$ 14.70	54,971

The Company does not maintain any equity compensation plans that have not been approved by security holders.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS

The information relating to certain relationships and related transactions and director independence is incorporated herein by reference to First Capital s Proxy Statement for the 2007 Annual Meeting of Stockholders.

ITEM 14. PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information relating to the principal accountant fees and expenses is incorporated herein by reference to First Capital s Proxy Statement for the 2007 Annual Meeting of Stockholders.

Table of Contents

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(1) The financial statements required in response to this item are incorporated by reference from Item 8 of this report.

(2) All financial statement schedules are omitted as the required information either is not required or applicable, or the required information is contained in the financial statements or related notes.

(3) Exhibits

3.1	Articles of Incorporation of First Capital, Inc. (1)
3.2	Second Amended and Restated Bylaws of First Capital, Inc. (2)
3.2	Third Amended and Restated Bylaws of First Capital, Inc. (8)
10.1	*Employment Agreement with James G. Pendleton (3)
10.2	*Employment Agreement with Samuel E. Uhl (4)
10.3	*Employment Agreement with M. Chris Frederick (4)
10.4	*Employment Agreement with Joel E. Voyles (4)
10.5	*Employee Severance Compensation Plan (3)
10.6	*First Federal Bank, A Federal Savings Bank 1994 Stock Option Plan (as assumed by First Capital, Inc. effective December 31, 1998) (5)
10.7	*First Capital, Inc. 1999 Stock-Based Incentive Plan (6)
10.8	*1998 Officers and Key Employees Stock Option Plan for HCB Bancorp (6)
10.9	*Employment Agreement with William W. Harrod (4)
11.0	Statement Re: Computation of Per Share Earnings (incorporated by reference to Exhibit 13 to this Form 10-K)
13.0	Annual Report to Stockholders
14.0	Code of Ethics and Business Conduct (7)
21.0	Subsidiaries of the Registrant (incorporated by reference to Part I, *Business Subsidiary Activities* of this Form 10-K)
23.0	Consent of Monroe Shine and Co., Inc.
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
32.0	Section 1350 Certification of Chief Executive Officer & Chief Financial Officer

* Management contract or compensatory plan, contract or arrangement.
(1) Incorporated by reference from the Exhibits filed with the Registration Statement on Form SB-2, and any amendments thereto, Registration No. 333-63515.
(2) Incorporated by reference to the Annual Report on Form 10-KSB for the year ended December 31, 2001.
(3) Incorporated by reference to the Quarterly Report on Form 10-QSB for the quarter ended December 31, 1998.
(4) Incorporated by reference to the Annual Report on Form 10-KSB for the year ended December 31, 1999.

(5) Incorporated by reference from the Exhibits filed with the Registration Statement on Form S-8, and any amendments thereto, Registration Statement No. 333-76543.

(6) Incorporated by reference from the Exhibits filed with the Registration Statement on Form S-8, and any amendments thereto, Registration Statement No. 333-95987.

Table of Contents

(7) Incorporated by reference to the Annual Report on Form 10-K for the year ended December 31, 2004.
(8) Incorporated by reference to the Current Report on Form 8-K for the year ended January 22, 2007.

Table of Contents

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

FIRST CAPITAL, INC.

/s/ William W. Harrod
William W. Harrod
President, Chief Executive Officer and Director

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Name	Title	Date
/s/ William W. Harrod William W. Harrod	President, Chief Executive Officer and Director (principal executive officer)	March 23, 2007
J. Gordon Pendleton	Chairman	
/s/ Michael C. Frederick Michael C. Frederick	Chief Financial Officer and Treasurer (principal accounting and financial officer)	March 23, 2007
/s/ Samuel E. Uhl Samuel E. Uhl	Director	March 23, 2007
Mark D. Shireman	Director	

Table of Contents

/s/ Dennis L. Huber Dennis L. Huber	Director	March 23, 2007
/s/ Kenneth R. Saulman Kenneth R. Saulman	Director	March 23, 2007
John W. Buschemeyer	Director	
/s/ Gerald L. Uhl Gerald L. Uhl	Director	March 23, 2007
/s/ James S. Burden James S. Burden	Director	March 23, 2007
/s/ James E. Nett James E. Nett	Director	March 23, 2007
Michael L. Shireman	Director	
/s/ Kathryn W. Ernstberger Kathryn W. Ernstberger	Director	March 23, 2007