

CITIZENS COMMUNITY BANCORP
Form 10KSB
December 29, 2004

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-KSB

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended **September 30, 2004** OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

Commission File Number: 0-23406

CITIZENS COMMUNITY BANCORP

(Exact name of small business issuer as specified in its charter)

United States

20-0663325

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

2174 EastRidge Center, Eau Claire, Wisconsin

54701

(Address of principal executive offices)

(Zip Code)

Registrant's telephone number, including area code: (715) 836-9994

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

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

Common Stock, par value \$0.01 per share

(Title of Class)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES NO

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

The registrant's revenues for the fiscal year ended September 30, 2004 were \$11.0 million.

As of December 16, 2004, there were issued and outstanding 3,041,750 shares of the registrant's common stock. The aggregate market value of the voting stock held by non-affiliates of the registrant on this date, computed by reference to the average of the closing price of such stock, was \$10.24 million, based on 677,846 shares. (The exclusion from such amount of the market value of the shares owned by any person shall not be deemed an admission by the registrant that such person is an affiliate of the registrant.)

DOCUMENTS INCORPORATED BY REFERENCE

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Part II of Form 10-KSB- Annual Report to Stockholders for the fiscal year ended September 30, 2004.

Part III of Form 10-KSB - Portions of the Proxy Statement for the 2005 Annual Meeting of Stockholders.

Transitional Small Business Disclosure Format (check one) Yes No

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PART I

Item 1. Description of Business

General

Historically, Citizens Community Federal (the "Bank") was a federal credit union. The Bank accepted deposits and made loans to members, who were the people who live, work or worship in the Wisconsin counties of Chippewa and Eau Claire, and parts of Pepin, Buffalo and Trempealeau. In addition, this included businesses and other entities located in these counties, and members and employees of the Hocak Nation. In December 2001, the Bank converted to a federal mutual savings bank in order to better serve our customers and the local community through the broader lending ability of a federal savings bank, and to expand our customer base beyond the limited field of membership permitted for credit unions. As a federal savings bank, the Bank has expanded authority in structuring residential mortgage and consumer loans, and the ability to make commercial loans, although the Bank does not currently have any immediate plans to commence making commercial loans. In 2004, Citizens Community Federal reorganized into the mutual holding company form of organization. The Bank is a federally chartered stock savings institution with ten full service offices.

Citizens Community Bancorp ("Citizens Community Bancorp" or the "Company") is incorporated under Federal law to hold all of the stock of Citizens Community Federal. Citizens Community Bancorp is a unitary savings and loan holding company and is subject to regulation by the Office of Thrift Supervision. Citizens Community Bancorp has no significant assets other than all of the outstanding shares of common stock of Citizens Community Federal, the net proceeds of the Reorganization it kept and its loan to the Citizens Community Bancorp Employee Stock Ownership Plan.

At September 30, 2004, the Company had total assets of \$162.0 million, total deposits of \$128.0 million and stockholders' equity of \$19.6 million. The Company and the Bank are examined and regulated by the Office of Thrift Supervision, its primary federal regulator. The Company and the Bank are also regulated by the FDIC. The Bank is required to have certain reserves set by the Federal Reserve Board and is a member of the Federal Home Loan Bank of Chicago, which is one of the 12 regional banks in the Federal Home Loan Bank System.

Forward Looking Statements

This document, including information incorporated by reference, contains forward-looking statements about the Company and its subsidiaries which we believe are within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements include, without limitation, statements with respect to anticipated future operating and financial performance, growth opportunities, interest rates, cost savings and funding advantages expected or anticipated to be realized by management. Words such as "may," "could," "should," "would," "believe," "anticipate," "estimate," "expect," "intend," "plan" and similar expressions are intended to identify these forward-looking statements. Forward-looking statements by the Company and its management are based on beliefs, plans, objectives, goals, expectations, anticipations, estimates and the intentions of management and are not guarantees of future performance. The Company disclaims any obligation to update or revise any forward-looking statements based on the occurrence of future events, the receipt of new information, or otherwise. The important factors we discuss below, as well as other factors discussed under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations" and identified in our filings with the SEC and those presented elsewhere by our management from time to time, could cause actual results to differ materially from those indicated by the forward-looking statements made in this document:

- the strength of the United States economy in general and the strength of the local economies in which we conduct operations;
- the effects of, and changes in, trade, monetary and fiscal policies and laws, including interest rate policies of the Federal Reserve Board;
- inflation, interest rate, market and monetary fluctuations;

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- the timely development of and acceptance of our new products and services and the perceived overall value of these products and services by users, including the features, pricing and quality compared to competitors' products and services;
- the willingness of users to substitute our products and services for products and services of our competitors;
- the impact of changes in financial services' laws and regulations (including laws concerning taxes, banking, securities and insurance);
- the impact of technological changes;
- acquisitions;

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- changes in consumer spending and saving habits; and
- our success at managing the risks involved in the foregoing.

The Company disclaims any obligation to update or revise any forward-looking statements based on the occurrence of future events, the receipt of new information, or otherwise.

Market Area

The Bank is a community-oriented financial institution offering a variety of financial services to meet the needs of the communities we serve. The Bank is headquartered in Eau Claire, Wisconsin, and has ten retail offices primarily serving Eau Claire, Buffalo, Jackson, Sauk, Barron and Chippewa counties in Wisconsin and Blue Earth and Washington Counties in Minnesota. The geographic market area for loans and deposits is principally northwestern and central Wisconsin and south central Minnesota.

The local economy is historically based on manufacturing, but has moved to a more service-oriented economy in the last four decades. Median household income and per capita income for our market area are below the state and national averages, reflecting the lack of urban nature of the market and availability of high paying white collar and technical jobs. As of September 2004, our market area reported an unemployment rate of 4.8%, as compared to the national average of 5.4%. Major employers in our market area include Chippewa Valley Technical College, Consumers Co-op Association, University of Wisconsin – Eau Claire and Taylor Corporation.

Competition

The Bank faces strong competition in originating real estate and other loans and in attracting deposits. Competition in originating real estate loans comes primarily from other savings institutions, commercial banks, credit unions and mortgage bankers. Other savings institutions, commercial banks, credit unions and finance companies provide vigorous competition in consumer lending.

The Bank attracts deposits through its branch office system. Competition for those deposits is principally from other savings institutions, commercial banks and credit unions located in the same community, as well as mutual funds and other alternative investments. The Bank competes for these deposits by offering superior service and a variety of deposit accounts at competitive rates. Based on branch deposit data provided by the FDIC at September 30, 2004, the Bank's share of deposits was approximately 8.05% in Eau Claire County and less than 1.1% in all other market area counties.

Selected Consolidated Financial Information

This information is incorporated by reference from pages 2 and 3 of the 2004 Annual Report to Stockholders attached hereto as Exhibit 13 ("Annual Report").

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Yields Earned and Rates Paid

This information contained under the section captioned "Average Balance, Net Interest Income, Yield Earned and Rates Paid" is incorporated herein by reference from page 10 of the Annual Report.

Rate/Volume Analysis

This information is incorporated by reference from page 11 of the Annual Report.

Average Balance, Interest and Average Yields and Rates

This information contained under the section captioned "Average Balance, Net Interest Income, Yield Earned and Rates Paid" is incorporated herein by reference from page 10 of the Annual Report.

Lending Activities

General. The Bank's first mortgage loans carry a fixed rate of interest. First mortgage loans generally are long-term and amortize on a monthly basis with principal and interest due each month. A majority of the Bank's first mortgage loans also contain a payable on demand clause, which allows the Bank to call the loan due after a stated period, usually between two and five years from origination. The Bank also has home equity loans in its portfolio, which have an interest rate that adjusts based on the prime rate. At September 30, 2004, the net loan portfolio totaled \$152.4 million, which constituted 94.1% of total assets.

Mortgage loans up to \$200,000 and consumer loans may be approved at various levels by loan officers and senior management. The President may approve loans up to \$2.2 million. Loans outside our general underwriting guidelines must be approved by the board of directors.

At September 30, 2004, the maximum amount which the Bank could have loaned to any one borrower and the borrower's related entities was approximately \$2.2 million. The largest lending relationship to a single borrower or a group of related borrowers consisted of two loans to a single borrower with a total balance of \$466,000. The loans were current as of September 30, 2004.

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Loan Portfolio Composition. The following table presents information concerning the composition of the Bank's loan portfolio in dollar amounts and in percentages (before deductions for loans in process,

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deferred fees and discounts and allowances for losses) as of the dates indicated.

At September 30,

	2004		2003		2002		2001		2000	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
(Dollars in Thousands)										
<u>Real Estate Loans:</u>										
First mortgages	\$ 89,841	58.8%	\$ 71,108	57.5%	\$ 54,505	52.2%	\$43,026	45.8%	\$40,061	43.9%
Second mortgages	5,398	3.5	4,661	3.8	5,687	5.4	1,638	1.7	1,780	2.0
Multi-family and commercial	321	0.2	239	0.3	147	0.1	—	—	—	—
Total real estate loans	95,560	62.5	76,008	61.6	60,339	57.7	44,664	47.5	41,841	45.9
<u>Consumer Loans:</u>										
Automobile	25,808	16.9	26,905	21.7	29,882	28.6	26,403	28.1	25,606	28.0
Secured personal loans	27,607	18.0	17,028	13.8	10,615	10.2	18,738	20.0	19,298	21.1
Unsecured personal loans	3,955	2.6	3,633	2.9	3,604	3.5	4,119	4.4	4,523	5.0
Total consumer loans	57,370	37.5	47,566	38.4	44,101	42.3	49,260	52.5	49,427	54.1
Total loans	152,930	100.0%	123,574	100.0%	104,440	100.0%	93,924	100.0%	91,268	100.0%
<u>Less:</u>										
Allowance for loan losses	554		467		349		306		333	
Total loans receivable, net	\$152,376		\$123,107		\$104,091		\$93,618		\$90,935	

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The following table shows the composition of the Bank's loan portfolio by fixed- and adjustable-rate at the dates indicated.

At September 30,

	2004		2003		2002		2001		2000	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
(Dollars in Thousands)										
<u>Fixed Rate Loans</u>										
Real estate										
First mortgages(1)	\$ 89,841	58.8%	\$ 71,108	57.5%	\$ 54,505	52.2%	\$43,026	45.8%	\$40,061	43.9%
Second mortgages	4,772	3.1	4,099	3.3	5,303	5.1	1,148	1.2	1,304	1.4

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Multi-family and commercial	321	0.2	239	0.3	147	0.1	—	—	—	—
Total real estate loans	94,934	62.1	75,446	61.1	59,955	57.4	44,174	47.0	41,365	45.3
Consumer loans	57,370	37.5	47,566	38.5	44,101	42.2	49,260	52.5	49,427	54.2
Total fixed rate loans	152,304	99.6	123,012	99.6	104,056	99.6	93,434	99.5	90,792	99.5
Adjustable Rate Loans										
Real estate										
First mortgages	—	—	—	—	—	—	—	—	—	—
Second mortgages	626	0.4	562	0.4	384	0.4	490	0.5	476	0.5
Multi-family and commercial	—	—	—	—	—	—	—	—	—	—
Total real estate loans	626	0.4	562	0.4	384	0.4	490	0.5	476	0.5
Consumer	—	—	—	—	—	—	—	—	—	—
Total adjustable rate loans	626	0.4	562	0.4	384	0.4	490	0.5	476	0.5
Total loans	152,930	100.0%	123,574	100.0%	104,440	100.0%	93,924	100.0%	91,268	100.0%
Less:										
Allowance for loan losses	554		467		349		306		333	
Total loans receivable, net	\$152,376		\$123,107		\$104,091		\$93,618		\$90,935	

(1) Includes \$81.6 million in 2004, \$66.4 million in 2003, \$51.2 million in 2002, \$47.3 million in 2001 and \$39.3 million in 2000 of loans with a payable on demand clause.

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The following schedule illustrates the contractual maturity of the Bank's loan portfolio at September 30, 2004. Mortgages which have adjustable or renegotiable interest rates are shown as maturing in the period during which the contract is due. The schedule does not reflect the effects of possible prepayments or enforcement of due-on-demand clauses.

Real Estate						Consumer					
First Mortgage(1)	Second Mortgage	Multi-Family and Commercial		Automobile		Secured Personal		Unsecured Personal		Total	
Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate	Amount	Weighted Average Rate

(Dollars in Thousands) Due During Years Ending September 30,

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	2005(2)\$	
17,4537.88 9,1037.68 9528.98 28,7617.81 2010-20113805.92 3198.20 5,2757.29 5,8417.17 237.60 11,8387.21 2012-202640,7206.09 3,9497.80 1036.66 727.98 10,7657.10 6	55,6156.41	
	6.42	141
	7.25	
	48,290	
	6.42	\$89,841
	6.27	\$ 5,398
	7.72	\$ 321
	6.80	\$25,808
	7.81	\$27,607
	7.27	\$ 3,955
	11.03	\$152,930

6.88

- (1) Includes \$81.6 million of loans with a payable on demand clause.
- (2) Includes home equity lines of credit, credit card loans, loans having no stated maturity and overdraft loans.

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The total amount of loans due after September 30, 2005 which have predetermined interest rates is \$150 million, while the total amount of loans due after such date which have floating or adjustable interest rates is \$0.

First Mortgage Lending. The Bank focuses its lending efforts primarily on the origination of loans secured by first mortgages on owner-occupied, one- to four-family residences in our market area. At September 30, 2004, one- to four-family residential mortgage loans totaled \$89.8 million, or 58.7% of the gross loan portfolio.

The Bank generally underwrites its one- to four-family loans based on the applicant's employment and credit history, their debt to income ratio and the appraised value of the subject property. Presently, the Bank generally lends up to 80% of the appraised value for one- to four-family residential loans, up to 70% for non-owner occupied residential loans. For loans used to purchase the property with a loan-to-value ratio in excess of 80%, the Bank requires private mortgage insurance in order to reduce our exposure below 80%. Properties securing one- to four-family loans are appraised by independent fee appraisers approved by the board of directors to the extent the loan exceeds \$50,000. In-house appraisals, prepared by persons other than the originating loan officer, may be used for loans of less than \$50,000, or loans of less than \$100,000 if the loan-to-value ratio is less than 50%. The Bank requires its borrowers to obtain evidence of clear title and hazard insurance, and flood insurance, if necessary.

The Bank currently originates most of its one- to four-family mortgage loans on a fixed-rate basis. The Bank's pricing strategy for mortgage loans includes setting interest rates that are consistent with customer demands and the Bank's internal needs. Our one- to four-family loans are not assumable. Most mortgage loans include a payable on demand clause, which allows the loan to be called at any time after the demand date. The demand date is set based on the loan to value ratio and other underwriting criteria, and is usually two to five years from the date of origination. During the year ended September 30, 2004, the Bank originated \$43.6 million of one- to four-family loans which included the payable on demand clause. Fixed-rate loans secured by one- to four-family residences have contractual maturities of up to 30 years, and are generally fully amortizing, with payments due monthly.

Second Mortgage Lending. The Bank also offers second mortgage loans and home equity lines of credit. Home equity lines of credit totaled \$626,000 and comprised 0.4% of the gross loan portfolio at September 30, 2004. These loans may be originated in amounts, together with the amount of the existing first mortgage, of up to 80% of the value of the property securing the loan. A loan may go over 80% of the value of the property securing the loan if the Bank holds the first mortgage. Home equity lines of credit are originated with an adjustable rate of interest, based on the prime rate of interest plus a margin, fixed for the first year and adjustable monthly thereafter. Home equity lines of credit have up to a 10 year draw period and require the payment of 1.5% of the outstanding loan balance per month during the draw period, which amount may be reborrowed at any time during the draw period. Once the draw period has lapsed, the payment is fixed based on the loan balance at that time. At September 30, 2004, unfunded commitments on these lines of credit totaled \$554,000.

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The Bank also offers second mortgage loans with a fixed rate of interest. These loans may be amortized up to 15 years with a balloon payment at three, five or 10 years. At September 30, 2004, fixed-rate second mortgage loans totaled \$4.8 million, or 3.1% of the gross loan portfolio.

Multi-family and Commercial Real Estate Lending. As part of the acquisition of the Chippewa Falls branch on November 1, 2002, the Bank obtained a nominal amount of multi-family and commercial real estate loans. Currently, the Bank has no plans to originate any new commercial or multi-family loans, but may consider doing so in future. At September 30, 2004, multi-family and commercial real estate loans totaled \$321,000, or 0.2% of the loan portfolio.

The Bank does not generally maintain an insurance escrow account for loans secured by multi-family and commercial real estate, although it may maintain a tax escrow account for these loans. In order to monitor the adequacy of cash flows on income-producing properties, the borrower is requested or required to provide periodic financial information.

Loans secured by multi-family and commercial real estate properties are generally larger and involve a greater degree of credit risk than one- to four-family residential mortgage loans. These loans typically involve larger balances to single borrowers or groups of related borrowers. Because payments on loans secured by multi-family and commercial real estate properties are often dependent on the successful operation or management of the properties, repayment of such loans may be subject to adverse conditions in the real estate market or the economy. If the cash flow from the project is reduced, or if leases are not obtained or renewed, the borrower's ability to repay the loan may be impaired.

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Consumer Lending. Consumer loans generally have shorter terms to maturity, which reduces the Bank's exposure to changes in interest rates, and carry higher rates of interest than do one- to four-family residential mortgage loans. In addition, management believes that offering consumer loan products helps to expand and create stronger ties to our existing customer base by increasing the number of customer relationships and providing cross-marketing opportunities. At September 30, 2004, consumer and other loans totaled \$57.4 million, or 37.5% of the gross loan portfolio. The Bank offers a variety of secured consumer loans, including new and used auto loans, boat and recreational vehicle loans, and loans secured by savings deposits, and also offers a limited amount of unsecured loans. The Bank originates consumer and other loans primarily in its market areas.

Auto loans totaled \$25.8 million at September 30, 2004, or 16.9% of gross loans. Auto loans may be written for up to five years for a new car and four years for a used car with fixed rates of interest. Loan-to-value ratios are up to 100% of the sales price for new autos and 100% of the retail value on used autos, based on a valuation from official used car guides. In addition, the Bank may, on occasion, originate auto secured loans in excess of 100% loan-to-value ratio based upon the credit quality of the borrower.

Auto loans may also be originated through the Bank's indirect lending program. Indirect auto loans are made using the same underwriting guidelines as auto loans originated directly by the Bank.

The Bank also originates secured loans on an indirect basis through One Source, an indirect dealer program. These secured consumer loans consist of loans for a wide variety of products, including automobiles, recreational vehicles, pianos, all terrain vehicles, televisions and sewing machines. One Source is currently comprised of 200 active dealers with businesses located throughout the Bank's market area. In some instances, the participating dealer may receive a premium rate for the amount over the Bank's initial interest rate. The loans are generally originated with terms from 30 to 36 months and carry fixed rates of interest. The Bank follows its internal underwriting guidelines in evaluating loans obtained through One Source including credit scoring to approve loans. At September 30, 2004, the indirect lending portfolio totaled \$23.6 million.

The Bank also originates unsecured consumer loans consisting primarily of credit card loans totaling \$886,000 at September 30, 2004, overdraft protection loans totaling \$556,000 at September 30, 2004 and loans made through the Freedom Loan program. The Freedom Loan program offers unsecured loans to consumers with a fixed rate of interest for a maximum term of 48 months for amounts not to exceed \$20,000 per individual. At September 30, 2004, loans originated through the Freedom Loan program totaled \$2.1 million.

Consumer and other loans may entail greater risk than do one- to four-family residential mortgage loans, particularly in the case of consumer loans which are secured by rapidly depreciable assets, such as automobiles and recreational vehicles. In these cases, any repossessed collateral for a defaulted loan may not provide an adequate source of repayment of the outstanding loan balance. As a result, 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.

Loan Originations and Repayments

The Bank originates loans through marketing efforts and our existing and walk-in customers. The ability to originate loans is dependent upon customer demand for loans in the Bank's market areas. Demand is affected by competition and the interest rate environment. Since becoming a savings bank, the Bank has significantly increased its origination of residential real estate loans. During the past few years, the Bank, like many other financial institutions, has experienced significant prepayments on loans due to the low interest rate environment prevailing in the United States. In periods of economic uncertainty, the ability of financial institutions, including the Bank, to originate or purchase large dollar volumes of real estate loans may be substantially reduced or restricted, with a resultant decrease in interest income.

Since the Bank has not purchased or sold any loans, the Bank does not service any loans other than those the Bank originates.

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The following table shows the loan origination, purchase, sale and repayment activities of the Bank for the periods indicated.

	Year Ended September 30,		
	2004	2003	2002
	(In Thousands)		
<u>Originations by type:</u>			
Real estate(1)	\$43,604	\$48,369	\$36,530
Non-real estate - consumer	46,044	38,995	35,271

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	89,648	87,364	71,801
Total loans originated			
Repayments:			
Principal repayments	60,292	68,129	61,110
Loans transferred to other real estate	—	101	175
Net increase (decrease)			
	\$29,356	\$19,134	\$10,516

(1) Real estate loans include loans with a payable on demand feature of \$35.0 million in 2004, \$42.2 million in 2003 and \$31.7 million in 2002. Real estate loans also include home equity lines of credit of \$203,000 in 2004, \$163,000 in 2003 and \$0 in 2002.

Asset Quality

Procedures. When a borrower fails to make a payment on a mortgage loan on or before the due date, a late notice is mailed five days after the due date. When the loan is 10 days past due, a loan officer will begin contacting the borrower by phone. This process will continue until satisfactory payment arrangements have been made. If the loan becomes two payments and ten days past due, a notice of right-to-cure default is sent. If the loan becomes over 90 days delinquent, a drive-by inspection is done while further attempts to contact the borrower by phone are made. After the loan is 120 days past due, and acceptable arrangements have not been made, the Bank will generally refer the loan to legal counsel, with instructions to prepare a notice of intent to foreclose. This notice allows the borrower up to 30 days to bring the loan current. During this 30 day period, the Bank will still attempt to contact the borrower to implement satisfactory payment arrangements. If the loan becomes 150 days past due and satisfactory arrangements have not been made, foreclosure will be instituted.

For consumer loans a similar process is followed, with the initial written contact being made once the loan is five days past due. Follow-up contacts are generally on an accelerated basis compared to the mortgage loan procedure.

The Bank divides its loans into two categories, mortgage loans and non-mortgage loans. For all loans in both categories, the Bank employs a dual loss reserve strategy. First, using a running five-year history, all loans are assigned an inherent loss reserve. Next, each loan (mortgage and non-mortgage) that becomes over 61 days delinquent is reviewed by senior management. In addition, the Bank assesses several factors including negative change in income, negative change in collateral, negative change in employment and other characteristics.

The procedure for charging off consumer loans does not differentiate between the different types of consumer loans. The Bank's loan underwriting is based on the borrowers' ability to pay, and not on the value of the collateral. All closed-end consumer loans are either charged off or recognized as a specific loss after they become delinquent 120 days. All open-end consumer loans are charged off or recognized as a specific loss after they become delinquent 180 days. Consumer loans with collateral are charged off or recognized as a specific loss down to collateral resale value less 10 percent if repossession of collateral is assured.

In lieu of charging off the entire balance, loans with non-real estate collateral may be written down to the value of the collateral, if repossession is assured and in process. For open-end and closed-end loans secured by real estate, a current assessment of value will be made no later than 180 days past due. Any outstanding loan balance in excess of the value of the property, less selling costs, is charged off.

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Delinquent Loans. The following table sets forth our loan delinquencies by type, number and amount at September 30, 2004.

	Loans Delinquent For:					
	60-89 Days		90 Days and Over		Total Delinquent Loans	
	Number	Amount	Number	Amount	Number	Amount
	(Dollars in Thousands)					
Real estate	2	\$140	7	\$300	9	\$ 440
Consumer(1)	98	244	96	402	194	646
Total	100	\$384	103	\$702	203	\$1,086

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(1) Includes credit card accounts.

Non-performing Assets. The table below sets forth the amounts and categories of non-performing assets in our loan portfolio. Loans are placed on non-accrual status when the loan becomes more than 90 days delinquent. At all dates presented, we had no troubled debt restructurings which involve forgiving a portion of interest or principal on any loans or making loans at a rate materially less than that of market rates. Foreclosed assets owned include assets acquired in settlement of loans.

	At September 30,				
	2004	2003	2002	2001	2000
	(Dollars in Thousands)				
Non-accruing loans:					
One- to four-family	\$ 300	\$ 162	\$ 51	\$ —	\$ —
Consumer(1)	397	400	483	404	396
Total	697	562	534	404	396
Foreclosed assets:					
One- to four-family	—	—	73	—	—
Consumer	—	—	—	—	—
Total	—	—	73	—	—
Total non-performing assets	\$ 697	\$ 562	\$ 607	\$ 404	\$ 396
Total as a percentage of total assets	0.43%	0.43%	0.53%	0.37%	0.40%

(1) Includes credit card accounts.

For the years ended September 30, 2004 and 2003, gross interest income which would have been recorded had the non-accruing loans been current in accordance with their original terms amounted to \$38,000 and \$21,000, respectively. No amount was included in interest income on these loans for these periods.

Other Loans of Concern. In addition to the non-performing assets set forth in the table above, as of September 30, 2004, there was also an aggregate of \$311,000 of loans with respect to which known information about the possible credit problems of the borrowers have caused management to have doubts as to the ability of the borrowers to comply with present loan repayment terms and which may result in the future inclusion of such items in the non-performing asset categories. These loans are not considered "classified" due to their delinquency status; however, they are identified as "watch" loans. They are not reserved for in the allowance for loan losses other than as part of the inherent portion. These loans have been considered in management's determination of the adequacy of our allowance for loan losses.

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Classified Assets. Federal regulations provide for the classification of loans and other assets, such as debt and equity securities considered by the Office of Thrift Supervision to be of lesser quality, as "substandard," "doubtful" or "loss." An asset is considered "substandard" if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. "Substandard" assets include those characterized by the "distinct possibility" that the insured institution will sustain "some loss" if the deficiencies are not corrected. Assets classified as "doubtful" have all of the weaknesses inherent in those classified "substandard," with the added characteristic that the weaknesses present make "collection or liquidation in full," on the basis of currently existing facts, conditions, and values, "highly questionable and improbable." Assets classified as "loss" are those considered "uncollectible" and of such little value that their continuance as assets without the establishment of a specific loss reserve is not warranted.

When an insured institution classifies problem assets as either substandard or doubtful, it may establish general allowances for loan losses in an amount deemed prudent by management and approved by the board of directors. General allowances represent loss allowances which have been established to recognize the inherent risk associated with lending activities, but which, unlike specific allowances, have not been allocated to particular problem assets. When an insured institution classifies problem assets as "loss," it is required either to establish a specific allowance for losses equal to 100% of that portion of the asset so classified or to charge off such amount. An institution's determination as to the classification of its assets and the amount of its valuation allowances is subject to review by the Office of Thrift Supervision and the FDIC, which may order the establishment of additional general or specific loss allowances.

In connection with the filing of our periodic reports with the Office of Thrift Supervision and in accordance with our classification of assets policy, we regularly review the problem assets in our portfolio to determine whether any assets require classification in accordance with applicable regulations. On the basis of management's review of our assets, at September 30, 2004, the Bank had classified \$568,000 of the loans in its portfolio as substandard, all of which was included in non-performing assets, \$0 as doubtful and \$0 as loss. The total amount classified represented 2.9% of the Company's equity capital and 0.4% of assets at September 30, 2004.

Provision for Loan Losses. The Bank recorded a provision for loan losses for the year ended September 30, 2004 of \$396,000, compared to \$406,000 for the year ended September 30, 2003. The provision

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for loan losses is charged to income to bring the allowance for loan losses to reflect probable incurred losses based on the factors discussed below under "Allowance for Loan Losses." The provision for loan losses for the year ended September 30, 2004 was based on management's review of such factors which indicated that the allowance for loan losses reflected probable incurred losses in the loan portfolio as of the year ended September 30, 2004.

Allowance for Loan Losses. The Bank maintains an allowance for loan losses to absorb probable incurred losses in the loan portfolio. The allowance is based on ongoing, quarterly assessments of the estimated probable incurred losses in the loan portfolio. In evaluating the level of the allowance for loan losses, management considers the types of loans and the amount of loans in the loan portfolio, historical loss experience, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, and prevailing economic conditions.

At September 30, 2004, the allowance for loan losses was \$554,000 or 0.36% of the total loan portfolio. Assessing the allowance for loan losses is inherently subjective as it requires making material estimates, including the amount and timing of future cash flows expected to be received on impaired loans, that may be susceptible to significant change. In the opinion of management, the allowance, when taken as a whole, reflects estimated probable loan losses in our loan portfolios.

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The following table sets forth an analysis of our allowance for loan losses.

	Year Ended September 30,				
	2004	2003	2002	2001	2000
	(Dollars in Thousands)				
Balance at beginning of period	\$ 467	\$ 349	\$ 306	\$ 333	\$ 269
Charge-offs:					
One- to four-family	—	(16)	(2)	(13)	—
Consumer	(342)	(297)	(340)	(266)	(178)
Total charge-offs	(342)	(313)	(342)	(279)	(178)
Recoveries:					
Consumer	33	25	10	22	40
Total recoveries	33	25	10	22	40
Net charge-offs	(309)	(288)	(332)	(257)	(138)
Other – obtained through acquisition	—	—	—	—	—
Additions charged to operations	396	406	375	230	202
Balance at end of period	\$ 554	\$ 467	\$ 349	\$ 306	\$ 333
Ratio of allowance for loan losses to net loans outstanding at end of period	0.36%	0.38%	0.34%	0.33%	0.37%
Ratio of net charge-offs during the period to average loans outstanding during the period	0.22%	0.25%	0.33%	0.27%	0.16%
Ratio of net charge-offs during the period to average non-performing assets	49.05%	49.23%	65.61%	64.25%	35.48%

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The distribution of our allowance for losses on loans at the dates indicated is summarized as follows:

At September 30,

2004

2003

2002

2001

2000

Amount
of Loan
Loss
Allow-
ance

Loan
Amounts
by
Category

Percent
of Loans
in Each
Category
to Total
Loans

Amount
of Loan
Loss
Allow-
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Loan
Amounts
by
Category

Percent
of Loans
in Each
Category
to Total
Loans

Amount
of Loan
Loss
Allow-
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Loan
Amounts
by
Category

Percent
of Loans
in Each
Category
to Total
Loans

Amount
of Loan
Loss
Allow-
ance

Loan
Amounts
by
Category

Percent
of Loans
in Each
Category
to Total
Loans

Amount
of Loan
Loss
Allow-
ance

Loan
Amounts
by
Category

Percent
of Loans
in Each
Category
to Total
Loans

(Dollars in Thousands) Real

estate\$ 61\$ 95,56062%\$ 9\$ 75,76961%\$ 4\$ 60,19258%\$ 4\$44,66448%\$ 1\$41,84146%Consumer49057,37038 43347,80539 34044,24842 29349,26052 30949,42754 Unallocated 3

25

5

9

	—
	23
	—
	—
Total	\$554
	\$152,930
	100%
	\$ 467
	\$123,574
	100%
	\$349
	\$104,440
	100%
	\$306
	\$93,924
	100%
	\$333
	\$91,268
	100%

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Investment Activities

Federally chartered savings institutions have the authority to invest in various types of liquid assets, including United States Treasury obligations, securities of various federal agencies, including callable agency securities, certain certificates of deposit of insured banks and savings institutions, certain bankers' acceptances, repurchase agreements and federal funds. Subject to various restrictions, federally chartered savings institutions may also invest their assets in investment grade commercial paper and corporate debt securities and mutual funds whose assets conform to the investments that a federally chartered savings institution is otherwise authorized to make directly.

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The chief financial officer has the basic responsibility for the management of our investment portfolio, subject to the direction and guidance of the investment committee. The chief financial officer considers various factors when making decisions, including the marketability, maturity and tax consequences of the proposed investment. The maturity structure of investments will be affected by various market conditions, including the current and anticipated slope of the yield curve, the level of interest rates, the trend of new deposit inflows, and the anticipated demand for funds via deposit withdrawals and loan originations and purchases.

The general objectives of our investment portfolio are to provide liquidity when loan demand is high, to assist in maintaining earnings when loan demand is low and to maximize earnings while satisfactorily managing risk, including credit risk, reinvestment risk, liquidity risk and interest rate risk.

Our investment securities have historically consisted solely of certificates of deposit of insured savings institutions. At September 30, 2004, we had no investment securities, except FHLB stock.

The following table sets forth the composition of the Bank's investment securities and interest-bearing deposits at the dates indicated.

At September 30,						
2004		2003		2002		
Book Value	% of Total	Book Value	% of Total	Book Value	% of Total	
(Dollars in Thousands)						
Investment securities:						
FHLB stock	\$828	100.00%	\$671	100.00%	\$ 553	100.00%
Interest-bearing deposits with banks						
	\$ —	—%	\$ —	—%	\$1,485	100.00%

Sources of Funds

General. The Bank's sources of funds are deposits, borrowings, payment of principal and interest on loans, interest earned on or maturation of other investment securities and funds provided from operations.

Deposits. The Bank offers a variety of deposit accounts to both consumers and businesses having a wide range of interest rates and terms. Deposits consist of savings accounts, money market deposit accounts and demand accounts and certificates of deposit. The Bank solicits deposits primarily in its market areas and from financial institutions and has accepted a limited amount of brokered deposits. At September 30, 2004, the Bank had \$3.8 million of brokered deposits. The Bank primarily relies on competitive pricing policies, marketing and customer service to attract and retain these deposits. The Bank from time to time participates in an auction for brokered deposits to assist in finding the lowest cost deposits possible. The Bank constantly searches for the most cost-effective source of funds, either through brokered deposits, or through marketing our own rates to protect our margin and maintain our sales culture.

The flow of deposits is influenced significantly by general economic conditions, changes in money market and prevailing interest rates and competition. The variety of deposit accounts we offer has allowed us to be competitive in obtaining funds and to respond with flexibility to changes in consumer demand. We have become more susceptible

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to short-term fluctuations in deposit flows, as customers have become more interest rate conscious. We try to manage the pricing of our deposits in keeping with our asset/liability management, liquidity and profitability objectives, subject to competitive factors. Based on experience, management believes that the Bank's deposits are relatively stable sources of funds. Despite this stability, the ability to attract and maintain these deposits and the rates paid on them has been and will continue to be significantly affected by market conditions.

The following table sets forth deposit flows during the periods indicated.

Year Ended September 30,			
	2004	2003	2002
(Dollars in Thousands)			
Opening balance	\$114,963	\$104,429	\$ 98,128
Net deposits	10,208	7,358	2,442
Interest credited	2,805	3,176	3,859
Ending balance	\$127,976	\$114,963	\$104,429

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Net increase (decrease)	\$ 13,013	\$ 10,534	\$ 6,301
Percent increase (decrease)	11.3%	10.1%	6.4%

The following table sets forth the dollar amount of savings deposits in the various types of deposit programs we offered at the dates indicated.

At September 30,

2004		2003		2002	
Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total

(Dollars in Thousands) Transaction Accounts and Savings Deposits: Demand accounts \$ 11,447 8.94% \$ 10,559 9.19% \$ 9,373 8.97% Savings accounts 15,420 12.05 15,096 13.13 13,634 13.06 Money market accounts 23,629

	18.46
	15,849
	13.79
	11,556
	11.07
Total non-certificates 50,496	
	39.46
	41,504
	36.11
	34,563
	33.10

Certificates: 6-12 month CDs 17,274 13.50 19,204