

BankFinancial CORP  
Form 10-K  
March 11, 2013  
Table of Contents

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

FORM 10-K

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934  
For the fiscal year ended December 31, 2012  
or  
 TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
1934

For transition period from \_\_\_\_\_ to \_\_\_\_\_  
Commission File Number 0-51331

BANKFINANCIAL CORPORATION  
(Exact Name of Registrant as Specified in Charter)

Maryland (State or Other Jurisdiction of Incorporation)	75-3199276 (I.R.S. Employer Identification No.)
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15W060 North Frontage Road, Burr Ridge, Illinois 60527  
(Address of Principal Executive Offices)  
Registrant's telephone number, including area code: (800) 894-6900

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

Title of Each Class: Common Stock, par value \$0.01 per share	Name of Each Exchange on Which Registered: NASDAQ Global Select Stock Market
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Securities registered pursuant to Section 12(g) of the Act: None

Indicate by check mark whether the issuer is a well-known seasoned issuer as defined in Rule 405 of the Securities Act. Yes  No

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

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 the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting



BANKFINANCIAL CORPORATION  
 Form 10-K Annual Report  
 Table of Contents

	Page Number
 <u>PART I</u>	
Item 1. <u>Business</u>	<u>1</u>
Item 1A. <u>Risk Factors</u>	<u>10</u>
Item 1B. <u>Unresolved Staff Comments</u>	<u>15</u>
Item 2. <u>Properties</u>	<u>15</u>
Item 3. <u>Legal Proceedings</u>	<u>15</u>
Item 4. <u>Mine Safety Disclosures</u>	<u>15</u>
 <u>PART II</u>	
Item 5. <u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	<u>15</u>
Item 6. <u>Selected Financial Data</u>	<u>18</u>
Item 7. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>20</u>
Item 7A. <u>Quantitative and Qualitative Disclosure about Market Risk</u>	<u>44</u>
Item 8. <u>Financial Statements and Supplementary Data</u>	<u>44</u>
Item 9. <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	<u>98</u>
Item 9A. <u>Controls and Procedures</u>	<u>98</u>
Item 9B. <u>Other Information</u>	<u>98</u>
 <u>PART III</u>	
Item 10. <u>Directors and Executive Officers of the Registrant</u>	<u>98</u>
Item 11. <u>Executive Compensation</u>	<u>98</u>
Item 12. <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	<u>98</u>
Item 13. <u>Certain Relationships and Related Transactions</u>	<u>98</u>
Item 14. <u>Principal Accountant Fees and Services</u>	<u>98</u>
 <u>PART IV</u>	
Item 15. <u>Exhibits and Financial Statement Schedules</u>	<u>99</u>
<u>Signatures</u>	<u>103</u>

Table of Contents

PART I

ITEM 1. BUSINESS

Forward Looking Statements

This Annual Report on Form 10-K contains, and other periodic and current reports, press releases and other public stockholder communications of BankFinancial Corporation may contain, forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, that involve significant risks and uncertainties. Forward-looking statements may include statements relating to our future plans, strategies and expectations, as well as our future revenues, earnings, losses, financial performance, financial condition, asset quality metrics and future prospects. Forward looking statements are generally identifiable by use of the words “believe,” “may,” “will,” “should,” “could,” “expect,” “estimate,” “intend,” “anticipate,” “project,” “plan,” or similar expressions. Forward looking statements speak only as of the date made. They are frequently based on assumptions that may or may not materialize, and are subject to numerous uncertainties that could cause actual results to differ materially from those anticipated in the forward looking statements. We intend all forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995, and are including this statement for the purpose of invoking these safe harbor provisions.

Factors that could cause actual results to differ materially from the results anticipated or projected and which could materially and adversely affect our operating results, financial condition or future prospects include, but are not limited to: (i) the failure of the real estate market to recover or further declines in real estate values that adversely impact the value of our loan collateral and other real estate owned ("OREO"), asset dispositions and the level of borrower equity in their investments; (ii) the persistence or worsening of adverse economic conditions in general and in the Chicago metropolitan area in particular, including high or increasing unemployment levels, that could result in increased delinquencies in our loan portfolio or a decline in the value of our investment securities and the collateral for our loans; (iii) results of supervisory monitoring or examinations by regulatory authorities, including the possibility that a regulatory authority could, among other things, require us to increase our allowance for loan losses or adversely change our loan classifications, write-down assets, reduce credit concentrations or maintain specific capital levels; (iv) interest rate movements and their impact on customer behavior and our net interest margin; (v) less than anticipated loan growth due to a lack of demand for specific loan products, competitive pressures or a dearth of borrowers who meet our underwriting standards; (vi) changes, disruptions or illiquidity in national or global financial markets; (vii) the credit risks of lending activities, including risks that could cause changes in the level and direction of loan delinquencies and charge-offs or changes in estimates relating to the computation of our allowance for loan losses; (viii) monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and Federal Reserve Board; (ix) factors affecting our ability to access deposits or cost-effective funding, and the impact of competitors' pricing initiatives on our deposit products; (x) the impact of new legislation or regulatory changes, including the Dodd-Frank Act, on our products, services, operations and operating expenses; (xi) higher federal deposit insurance premiums; (xii) higher than expected overhead, infrastructure and compliance costs; (xiii) changes in accounting principles, policies or guidelines; and (xiv) our failure to achieve expected synergies and cost savings from acquisitions.

These risks and uncertainties, as well as the Risk Factors set forth in Item 1A below, should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. We do not undertake any obligation to update any forward-looking statement in the future, or to reflect circumstances and events that occur after the date on which the forward-looking statement was made.

BankFinancial Corporation

BankFinancial Corporation, a Maryland corporation headquartered in Burr Ridge, Illinois (the “Company”), became the owner of all of the issued and outstanding capital stock of BankFinancial, F.S.B. (the “Bank”) on June 23, 2005, when we consummated a plan of conversion and reorganization that the Bank and its predecessor holding companies, BankFinancial MHC, Inc. and BankFinancial Corporation, a federal corporation, adopted on August 25, 2004. BankFinancial Corporation, the Maryland corporation, was organized in 2004 to facilitate the mutual-to-stock conversion and to become the holding company for the Bank upon its completion.

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As part of the mutual-to-stock conversion, BankFinancial Corporation, the Maryland corporation, sold 24,466,250 shares of common stock in a subscription offering for \$10.00 per share. The separate corporate existences of BankFinancial MHC and BankFinancial Corporation, the federal corporation, ceased upon the completion of the mutual-to-stock conversion. For a further discussion of the mutual-to-stock conversion, see our Prospectus as filed on April 29, 2005 with the Securities and Exchange Commission (“SEC”) pursuant to Rule 424(b)(3) of the Rules and Regulations of the Securities Act of 1933 (File Number 333-119217).

We manage our operations as one unit, and thus do not have separate operating segments. Our chief operating decision-makers use consolidated results to make operating and strategic decisions.

## Table of Contents

### BankFinancial, F.S.B.

The Bank is a full-service, community-oriented federal savings bank principally engaged in the business of commercial, family and personal banking, and it offers our customers a broad range of loan, deposit, and other financial products and services through 20 full-service Illinois based banking offices located in Cook, DuPage, Lake and Will Counties, and through our Internet Branch, [www.bankfinancial.com](http://www.bankfinancial.com).

The Bank's primary business is making loans and accepting deposits. The Bank also offers our customers a variety of financial products and services that are related or ancillary to loans and deposits, including cash management, funds transfers, bill payment and other online banking transactions, automated teller machines, safe deposit boxes, trust services, wealth management, and general insurance agency services.

The Bank's primary lending area consists of the counties where our branch offices are located, and contiguous counties in the State of Illinois. We derive the most significant portion of our revenues from these geographic areas. Through our Wholesale Commercial Lending and National Commercial Leasing Departments, we also engage in multi-family lending activities in selected metropolitan areas outside our primary lending area and in commercial leasing activities on a nationwide basis.

We originate deposits predominantly from the areas where our branch offices are located. We rely on our favorable locations, customer service, competitive pricing, our Internet Branch and related deposit services such as cash management to attract and retain these deposits. While we accept certificates of deposit in excess of the Federal Deposit Insurance Corporation ("FDIC") deposit insurance limits, we generally do not solicit such deposits because they are more difficult to retain than core deposits and at times are more costly than wholesale deposits.

### Lending Activities

Our loan portfolio consists primarily of investment and business loans (multi-family, nonresidential real estate, commercial, construction and land loans, and commercial leases), which represented 78.9% of our total loan portfolio of \$1.030 billion at December 31, 2012. At December 31, 2012, \$352.0 million, or 33.6%, of our total loan portfolio consisted of multi-family mortgage loans; \$264.7 million, or 25.3%, of our total loan portfolio consisted of nonresidential real estate loans; \$61.4 million, or 5.9%, of our total loan portfolio consisted of commercial loans; \$139.8 million, or 13.3%, of our total loan portfolio consisted of commercial leases; and \$8.6 million or 0.8%, of our total loan portfolio consisted of construction and land loans. \$218.6 million, or 20.9%, of our total loan portfolio consisted of one-to-four family residential mortgage loans (of which \$58.3 million, or 5.6% were loans to investors in non-owner occupied single-family homes), including home equity loans and lines of credit.

### Deposit Activities

Our deposit accounts consist principally of savings accounts, NOW accounts, checking accounts, money market accounts, certificates of deposit, and IRAs and other retirement accounts. We provide commercial checking accounts and related services such as cash management. We also provide low-cost checking account services. We rely on our favorable locations, customer service, competitive pricing, our Internet Branch and related deposit services such as cash management to attract and retain deposit accounts.

At December 31, 2012, our deposits totaled \$1.282 billion. Interest-bearing deposits totaled \$1.148 billion and noninterest-bearing demand deposits totaled \$134.6 million, which included \$5.8 million in internal checking accounts such as bank cashier's checks and money orders. Savings, money market and NOW account deposits totaled \$842.5 million, and certificates of deposit totaled \$305.3 million, of which \$212.9 million had maturities of one year or less.

### Related Products and Services

The Bank's Wealth Management Group provides investment, financial planning and other wealth management services to our customers through arrangements with a third-party broker-dealer. The Bank also provides trust and financial planning services through the Trust Department that we acquired in the Downers Grove National Bank transaction. The Bank's wholly-owned subsidiary, Financial Assurance Services, Inc. ("Financial Assurance"), sells property and casualty insurance and other insurance products on an agency basis. During the year ended December 31, 2012, Financial Assurance reported net income of \$69,000. At December 31, 2012, Financial Assurance had three full-time employees. The Bank's other wholly-owned subsidiary, BF Asset Recovery Corporation, is in the business of

holding title to and selling certain Bank-owned real estate acquired through collection action, and reported a loss of \$5.3 million for the year ended December 31, 2012.

Website and Stockholder Information

The website for the Company and the Bank is [www.bankfinancial.com](http://www.bankfinancial.com). Information on this website does not constitute part of this Annual Report on Form 10-K.

The Company makes available, free of charge, its Annual Report on Form 10-K, its Quarterly Reports on Form 10-Q, its Current Reports on Form 8-K and amendments to such reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities

## Table of Contents

Exchange Act of 1934, as amended (“Exchange Act”), as soon as reasonably practicable after such forms are filed with or furnished to the SEC. Copies of these documents are available to stockholders at BankFinancial’s web site, [www.bankfinancial.com](http://www.bankfinancial.com), under Stockholder Information, and at the SEC’s web site, [www.sec.gov](http://www.sec.gov).

### Competition

We face significant competition in originating loans and attracting deposits. The Chicago Metropolitan Area and some other areas in which we operate have a high concentration of financial institutions, many of which are significantly larger institutions that have greater financial resources than we have, and many of which are our competitors to varying degrees. Our competition for loans and leases comes principally from commercial banks, savings banks, mortgage banking companies, the U.S. Government, credit unions, leasing companies, insurance companies, real estate conduits and other companies that provide financial services to businesses and individuals. Our most direct competition for deposits has historically come from commercial banks, savings banks and credit unions. We face additional competition for deposits from online financial institutions and non-depository competitors such as the mutual fund industry, securities and brokerage firms and insurance companies.

We seek to meet this competition by emphasizing personalized service and efficient decision-making tailored to individual needs. In addition, we reward long-standing relationships with preferred rates and terms on deposit products based on existing and prospective lending business. We do not rely on any individual, group or entity for a material portion of our loans or our deposits.

### Employees

At December 31, 2012, we had 332 full-time employees and 34 part-time employees. The employees are not represented by a collective bargaining unit and we consider our working relationship with our employees to be good.

### Supervision and Regulation

#### General

As a federally chartered savings bank, the Bank is regulated and supervised primarily by the Office of the Comptroller of the Currency (“OCC”). The Bank is also subject to regulation by the FDIC in more limited circumstances because the Bank’s deposits are insured by the FDIC. This regulatory and supervisory structure establishes a comprehensive framework of activities in which a financial institution may engage, and is intended primarily for the protection of the FDIC’s deposit insurance fund, depositors and the banking system. Under this system of federal regulation, financial institutions are periodically examined to ensure that they satisfy applicable standards with respect to their capital adequacy, assets, management, earnings, liquidity and sensitivity to market interest rates. The OCC examines the Bank and prepares reports for the consideration of its Board of Directors on any identified deficiencies. After completing an examination, the OCC issues a report of examination and assigns a rating (known as an institution’s CAMELS rating). Under federal law and regulations, an institution may not disclose the contents of its reports of examination or its CAMELS ratings to the public.

The Bank is a member of, and owns stock in, the Federal Home Loan Bank of Chicago (“FHLBC”), which is one of the 12 regional banks in the Federal Home Loan Bank System. The Bank also is regulated by the Board of Governors of the Federal Reserve System (“FRB”) with regard to reserves it must maintain against deposits, dividends and other matters. The Bank’s relationship with its depositors and borrowers also is regulated in some respects by both federal and state laws, especially in matters concerning the ownership of deposit accounts, and the form and content of the Bank’s consumer loan documents.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), which was signed by the President on July 21, 2010, provided for the transfer of the authority for regulating and supervising federal savings banks from the Office of Thrift Supervision (“OTS”), the Bank’s previous regulator, to the OCC. The Dodd-Frank Act also provided for the transfer of authority for regulating and supervising savings and loan holding companies and their non-depository subsidiaries from the OTS to the FRB. The transfers occurred on July 21, 2011. The Dodd-Frank Act also created a new federal agency, the Consumer Financial Protection Bureau (“CFPB”), as an independent bureau within the FRB system, to conduct rule-making, supervision, and enforcement of federal consumer financial protection and fair lending laws and regulations. The CFPB has examination and primary enforcement authority in connection with these laws and regulations for depository institutions with total assets of more than \$10 billion.



Depository institutions with \$10 billion or less in total assets, such as the Bank, continue to be examined for compliance with these laws and regulations by their primary federal regulators, and remain subject to their enforcement authority.

The Dodd-Frank Act also broadened the base for FDIC assessments for deposit insurance, permanently increased the maximum amount of deposit insurance to \$250,000 per depositor and provided non-interest bearing transaction accounts with unlimited deposit insurance through December 31, 2012. The Dodd-Frank Act increased shareholder influence over boards of directors by requiring companies to give shareholders a non-binding vote on executive compensation and so-called “golden parachute” payments. The legislation directed the FRB to promulgate rules prohibiting excessive compensation paid to company executives, regardless of whether the company is publicly traded. The Dodd-Frank Act also provided for originators of certain securitized loans to retain a percentage of the risk for transferred credits, directed the FRB to regulate pricing of certain debit card interchange

Table of Contents

fees, repealed restrictions on paying interest on checking accounts and contained a number of reforms related to mortgage origination.

There can be no assurance that laws, rules and regulations, and regulatory policies will not change in the future, which could make compliance more difficult or expensive or otherwise adversely affect our business, financial condition, results of operations or prospects. Any change in these laws or regulations, or in regulatory policy, whether by the OCC, the FDIC, the FRB, the CFPB or Congress, could have a material adverse impact on the Company, the Bank and their respective operations. The following summary of laws and regulations applicable to the Bank and Company is not intended to be exhaustive and is qualified in its entirety by reference to the actual laws and regulations involved.

**Federal Banking Regulation**

**Business Activities.** As a federal savings bank, the Bank derives its lending and investment powers from the Home Owners' Loan Act, as amended, and the regulations, pronouncements or guidance of the OCC. Under these laws and regulations, the Bank may invest in mortgage loans secured by residential and nonresidential real estate, commercial business and consumer loans, certain types of securities and certain other loans and assets. Specifically, the Bank may originate, invest in, sell, or purchase unlimited loans on the security of residential real estate, while loans on nonresidential real estate generally may not, on a combined basis, exceed 400% of the Bank's total capital. In addition, secured and unsecured commercial loans and certain types of commercial personal property leases may not exceed 20% of the Bank's assets; however, amounts in excess of 10% of assets may only be used for small business loans. Further, the Bank may generally invest up to 35% of its assets in consumer loans, corporate debt securities and commercial paper on a combined basis, and up to the greater of its capital or 5% of its assets in unsecured construction loans. The Bank may invest up to 10% of its assets in tangible personal property, for rental or sale.

Certain leases on tangible personal property are not aggregated with commercial or consumer loans for the purposes of determining compliance with the limitations set forth for those investment categories. The Bank also may establish subsidiaries that may engage in activities not otherwise permissible for the Bank directly, including real estate investment and insurance agency activities. A violation of the lending and investment limitations may be subject to the same enforcement mechanisms of the primary federal regulator as other violations of a law or regulation.

**Capital Requirements.** Federal regulations require federal savings banks to meet three minimum capital standards: a ratio of tangible capital to adjusted total assets of 1.5%; a ratio of Tier 1 (core) capital to adjusted total assets of 4.0% (3% for institutions receiving the highest rating on the CAMELS rating system); and a ratio of total capital to total risk-adjusted assets of 8.0%. The prompt corrective action standards discussed below, in effect, establish a minimum 2% tangible capital standard. The OCC is also authorized to establish individual minimum capital requirements for federal savings banks in excess of the above minimum capital standards.

The risk-based capital standard for federal savings banks requires the maintenance of Tier 1, or core capital, 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 assets, are multiplied by a risk-weight factor of 0% to 100%, assigned by the capital regulations based on the risks inherent in the type of asset. Core capital is defined as common stockholders' equity (including retained earnings), certain noncumulative 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 currently include cumulative perpetual preferred stock, long-term preferred stock, mandatory convertible securities, subordinated debt and intermediate-term preferred stock, allowance for loan and lease losses up to a maximum of 1.25% of risk-weighted assets and up to 45% of net 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. Additionally, a savings bank that retains credit risk in connection with an asset sale may be required to maintain additional regulatory capital because of the recourse back to the savings bank.

At December 31, 2012, the Bank's capital exceeded all applicable regulatory requirements and was well capitalized. Proposed Capital Regulations The federal banking agencies have proposed regulations that would substantially amend the capital regulations currently applicable to us. The proposed regulations would implement the "Basel III" regulatory

capital reforms and changes required by the Dodd-Frank Act. “Basel III” refers to various documents released by the Basel Committee on Banking Supervision. As published, the proposed regulations contemplated a general effective date of January 1, 2013, and, for certain provisions, various phase-in periods and later effective dates. However, the federal banking agencies have announced that the proposed regulations will not be effective on January 1, 2013. The agencies have not adopted final rules or published any modifications to the proposed regulations. The proposed regulations as published are summarized below. It is not possible to predict when or in what form final regulations may be adopted.

The proposed regulations include new minimum capital ratios, to be phased in until fully effective on January 1, 2015, and would refine the definitions of what constitutes “capital” for purposes of calculating those ratios. The proposed new minimum capital

Table of Contents

ratios would be: (1) a new common equity Tier 1 capital ratio of 4.5%; (2) a Tier 1 capital ratio of 6% (increased from 4%); (3) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4%. The proposed regulations would also establish a “capital conservation buffer” requirement of 2.5% above each of the new regulatory minimum capital ratios to be phased in starting on January 1, 2016 and fully effective on January 1, 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if any of its capital levels fell below the buffer amount.

The proposed regulations also implement other revisions to the current capital rules, such as recognition of all unrealized gains and losses on available for sale debt and equity securities, and provide that instruments that will no longer qualify as capital would be phased out over time.

The federal banking agencies also proposed revisions, effective January 1, 2015, to the prompt corrective action framework, which is designed to place restrictions on insured depository institutions if their capital levels show signs of weakness. Under the prompt corrective action requirements, insured depository institutions would be required to meet the following in order to qualify as “well capitalized:” (1) a common equity Tier 1 risk-based capital ratio of 6.5%; (2) a Tier 1 risk-based capital ratio of 8% (increased from 6%); (3) a total risk-based capital ratio of 10% (unchanged from current rules); and (4) a Tier 1 leverage ratio of 5% (unchanged from the current rules).

The proposed regulations set forth certain changes for the calculation of risk-weighted assets, effective January 1, 2015. In particular, the proposed regulations would establish risk-weighting categories generally ranging from 0% for U.S. government and agency securities to 600% for certain equity exposures. Specifics include, among others:

- For residential mortgage exposures, changing the current 50% risk weight for high-quality seasoned mortgages and 100% risk-weight for all other mortgages to risk weights between 35% and 200% depending upon the LTV ratio and other factors (but VA and FHA guaranteed loans would have 0% risk weight).

- Applying a 150% risk weight instead of a 100% risk weight for certain high volatility commercial real estate acquisition, development and construction loans.

- Assigning a 150% risk weight to exposures (other than residential mortgage exposures) that are 90 days past due.

- Providing for a 20% credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable (currently set at 0%).

- Certain increased capital requirements for counterparty credit risk relating to over-the-counter derivatives, repos and securities financing transactions.

The Company and the Bank have adopted Capital Plans that require the Bank to maintain a Tier 1 leverage ratio of at least 8% and a total risk-based capital ratio of at least 12%. The minimum capital ratios set forth in the Capital Plans will be increased and other minimum capital requirements will be established if and as necessary to comply with the Basel III requirements as such requirements become applicable to the Company and the Bank. In accordance with the Capital Plans, neither the Company nor the Bank will pursue any acquisition or growth opportunity, declare any dividend or conduct any stock repurchase that would cause the Bank’s total risk-based capital ratio and/or its Tier 1 leverage ratio to fall below the established minimum capital levels. In addition, the Company will continue to maintain its ability to serve as a source of financial strength to the Bank by holding at least \$5.0 million of cash or liquid assets for that purpose.

**Loans-to-One-Borrower.** A federal savings bank generally may not make a loan or extend credit to a single or related group of borrowers in excess of 15% of unimpaired capital and surplus. An additional amount may be loaned, equal to 10% of unimpaired capital and surplus, if the loan is secured by readily marketable collateral, which generally does not include real estate. As of December 31, 2012, the Bank was in compliance with the loans-to-one-borrower limitations.

**Qualified Thrift Lender Test.** As a federal savings bank, the Bank is subject to a qualified thrift lender (“QTL”) test. Under the QTL test, the Bank must maintain at least 65% of its “portfolio assets” in “qualified thrift investments” in at least nine months of the most recent 12-month period. “Portfolio assets” generally means the total assets of a savings institution, less the sum of specified liquid assets up to 20% of total assets, goodwill and other intangible assets, and the value of property used in the conduct of the federal savings bank’s business.

“Qualified thrift investments” include various types of loans made for residential and housing purposes, investments related to those purposes, including certain mortgage-backed and related securities, and loans for personal, family, household and certain other purposes up to a limit of 20% of portfolio assets. “Qualified thrift investments” also include 100% of an institution’s credit

5

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Table of Contents

card loans, education loans and small business loans. The Bank also may satisfy the QTL test by qualifying as a “domestic building and loan association” as defined in the Internal Revenue Code of 1986. At December 31, 2012, the Bank satisfied the QTL test. A federal savings bank that fails the QTL test must operate under specified restrictions, including limits on growth, branching, new investment and dividends. As a result of the Dodd-Frank Act, noncompliance with the QTL test is subject to regulatory enforcement action as a violation of law.

Capital Distributions. The regulations of the OCC govern capital distributions by a federal savings bank, which include cash dividends, stock repurchases and other transactions charged to the institution’s capital account. A federal savings bank must file an application for approval of a capital distribution if:

- the total capital distributions for the applicable calendar year exceed the sum of the institution’s net income for that year to date plus the federal savings bank’s retained net income for the preceding two years;
- the institution would not be at least adequately capitalized following the distribution;
- the distribution would violate any applicable statute, regulation, agreement or OCC-imposed condition; or
- the institution is not eligible for expedited treatment of its filings.

Even if an application is not otherwise required, every federal savings bank that is a subsidiary of a holding company must still file a notice with the FRB at least 30 days before the board of directors declares a dividend or approves a capital distribution. At December 31, 2012, the Bank would be required to file an application for approval of a capital distribution to the Company.

The FRB may disapprove a notice or application if:

- the federal savings bank would be undercapitalized following the distribution;
- the proposed capital distribution raises safety and soundness concerns; or
- the capital distribution would violate a prohibition contained in any statute, regulation or agreement.

Liquidity. A federal savings bank is required to maintain a sufficient amount of liquid assets to ensure its safe and sound operation.

Community Reinvestment Act and Fair Lending Laws. All federal savings banks have a responsibility under the Community Reinvestment Act (“CRA”) and related federal regulations to help meet the credit needs of their communities, including low- and moderate- income neighborhoods. In connection with its examination of a federal savings bank, the OCC is required to evaluate and rate the federal savings bank’s record of compliance with the CRA. In addition, the Equal Credit Opportunity Act and the Fair Housing Act prohibit lenders from discriminating in their lending practices based on the characteristics specified in those statutes. A federal savings bank’s failure to comply with the provisions of the CRA could, at a minimum, result in regulatory restrictions on its activities. The failure to comply with the Equal Credit Opportunity Act and the Fair Housing Act could result in enforcement actions by the OCC, as well as other federal regulatory agencies and the Department of Justice. The Bank’s CRA performance has been rated as “Outstanding,” the highest possible rating, in the CRA Performance Evaluations of the Bank that have been conducted since 1999.

Privacy Standards. Financial institutions are subject to regulations implementing the privacy protection provisions of the Gramm-Leach-Bliley Act. These regulations require the Bank to disclose its privacy policy, including identifying with whom it shares “nonpublic personal information” to customers at the time of establishing the customer relationship and annually thereafter. In addition, the Bank is required to provide its customers with the ability to “opt-out” of or consent to having the Bank share their nonpublic personal information with unaffiliated third parties before it can disclose such information, subject to certain exceptions. The implementation of these regulations did not have a material adverse effect on the Bank. The Gramm-Leach-Bliley Act also allows each state to enact legislation that is more protective of consumers’ personal information.

The OCC and other federal banking agencies have adopted guidelines establishing standards for safeguarding customer information to implement certain provisions of the Gramm-Leach-Bliley Act. The guidelines describe the agencies’ expectations for the creation, implementation and maintenance of an information security program, which would include administrative, technical and physical safeguards appropriate to the size and complexity of a financial institution and the nature and scope of its activities. The standards set forth in the guidelines are intended to ensure the security and confidentiality of customer records and information, to protect against any anticipated threats or hazards

to the security or integrity of such records, and to protect against unauthorized access to or use of such records or other information that could result in substantial harm or inconvenience to any customer. The Bank has implemented these guidelines, and such implementation has not had a material adverse effect on our operations.

Transactions with Related Parties. A federal savings bank's authority to engage in transactions with its "affiliates" is limited by OCC regulations and by Sections 23A and 23B of the Federal Reserve Act and its implementing regulation, Regulation W. The term "affiliates" for these purposes generally means any company that controls or is under common control with an insured depository institution, although subsidiaries of federal savings banks are generally not considered affiliates for the purposes of Sections 23A and 23B of the Federal Reserve Act. The Company is an affiliate of the Bank. In general, transactions with affiliates

Table of Contents

must be on terms that are as favorable to the federal savings bank as comparable transactions with non-affiliates. In addition, certain types of these transactions are restricted to an aggregate percentage of the federal savings bank's capital. Collateral in specified amounts must usually be provided by affiliates in order to receive loans from the federal savings bank. Federal regulations also prohibit a federal savings bank from lending to any of its affiliates that are engaged in activities that are not permissible for bank holding companies, and from purchasing the securities of any affiliate, other than a subsidiary.

The Bank's authority to extend credit to its directors, executive officers and 10% stockholders, as well as to entities controlled by such persons, is currently governed by the requirements of Sections 22(g) and 22(h) of the Federal Reserve Act and Regulation O of the Federal Reserve Board. Among other things, these provisions require that extensions of credit to insiders be made on terms that are substantially the same as, and follow credit underwriting procedures that are not less stringent than, those prevailing for comparable transactions with unaffiliated persons and that do not involve more than the normal risk of repayment or present other unfavorable features, and not exceed certain limitations on the amount of credit extended to such persons, individually and in the aggregate, which limits are based, in part, on the amount of the Bank's capital. In addition, extensions of credit in excess of certain limits must receive the prior approval of the Bank's Board of Directors.

Enforcement. The OCC has primary enforcement responsibility over federal savings banks, and this includes the authority to bring enforcement action against the Bank and all "institution-affiliated parties," including stockholders, 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 the removal of officers and/or directors, receivership, conservatorship or the termination of deposit insurance. Civil monetary penalties cover a wide range of violations and actions, and range up to \$25,000 per day, unless a finding of reckless disregard is made, in which case penalties may be as high as \$1 million per day. The FDIC also has the authority to recommend to the OCC that an enforcement action be taken with respect to a particular savings institution. If action is not taken by the OCC, the FDIC has authority to take action under specified circumstances.

Standards for Safety and Soundness. Federal law requires each federal banking agency to prescribe certain standards for all insured depository institutions. These standards relate to, among other things, internal controls, information systems and audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, compensation and other operational and managerial standards as the agency deems appropriate. The federal banking agencies adopted Interagency Guidelines Prescribing Standards for Safety and Soundness to implement the safety and soundness standards required under federal law. 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. The guidelines address internal controls and information systems, internal audit systems, credit underwriting, loan documentation, interest rate risk exposure, asset growth, compensation, fees and benefits. If the appropriate federal banking agency determines that an institution fails to meet any standard prescribed by the guidelines, the agency may require the institution to submit to the agency an acceptable plan to achieve compliance with the standard.

Prompt Corrective Action Regulations. Under the prompt corrective action regulations, the OCC is required and authorized to take supervisory actions against undercapitalized federal savings banks. For this purpose, a federal savings bank is placed in one of the following five categories based on the federal savings bank's capital:

- well-capitalized (at least 5% leverage capital, 6% tier 1 risk-based capital and 10% total risk-based capital);
- adequately capitalized (at least 4% leverage capital, 4% tier 1 risk-based capital and 8% total risk-based capital);
- undercapitalized (less than 3% leverage capital, 4% tier 1 risk-based capital or 8% total risk-based capital);
- significantly undercapitalized (less than 3% leverage capital, 3% tier 1 risk-based capital or 6% total risk-based capital); and
- critically undercapitalized (less than 2% tangible capital).

Generally, the banking regulator is required to appoint a receiver or conservator for a federal savings bank that is "critically undercapitalized." The regulations also provide that a capital restoration plan must be filed with the OCC



within 45 days of the date a bank receives notice that it is “undercapitalized,” “significantly undercapitalized” or “critically undercapitalized.” A parent holding company for the institution involved must guarantee performance under the capital restoration plan up to the lesser of the institution’s capital deficiency when deemed undercapitalized or 5% of the institution’s assets. In addition, numerous mandatory supervisory actions become immediately applicable to the federal savings bank, including, but not limited to, restrictions on growth, investment activities, capital distributions and affiliate transactions. The OCC may also take any one of a number of discretionary supervisory actions against undercapitalized federal savings banks, including the issuance of a capital directive and individual minimum capital requirements and the replacement of senior executive officers and directors. The recently proposed rules that would increase regulatory capital requirements would adjust the prompt corrective action categories accordingly.

Table of Contents

At December 31, 2012, the Bank met the criteria for being considered “well-capitalized” as defined in the prompt corrective action regulations.

Interest on Deposits. Federal laws and regulations previously prohibited depository institutions from paying interest on commercial checking accounts. The Dodd-Frank Act authorized the payment of interest on commercial checking accounts, effective July 21, 2011.

Insurance of Deposit Accounts. The Bank’s deposits are insured up to applicable limits by the Deposit Insurance Fund of the FDIC. Under the FDIC’s risk-based assessment system, insured institutions are assigned to one of four risk categories based on supervisory evaluations, regulatory capital levels and certain other factors, with less risky institutions paying lower assessments. An institution’s assessment rate depends upon the category to which it is