FEDERAL TRUST CORP
Form 10KSB
March 30, 2004
Table of Contents

U.S. 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 December 31, 2003	**Commission File Number 33-27139**

FEDERAL TRUST CORPORATION

(Exact name of registrant as specified in its charter)

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

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

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

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

Common Stock, par value $.01 per share

(Title of Class)

Indicate by check mark 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 and (2) has been subject to such filing requirements for the past 90 days. YES x NO ¨

Check if disclosure of delinquent filers pursuant to Item 405 of Regulation S-B is not contained in this form, 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-KSB or any amendment to this Form 10-KSB. x

Revenues for the fiscal year ended December 31, 2003: $23,279,000

The aggregate market value of the common stock of the Registrant held by non-affiliates of the Registrant (4,161,747 shares) on March 24, 2004, was approximately $32,211,922. The average bid and ask price of Registrant s common stock on March 24, 2004 was $7.74 per share. For the purposes of this response, directors, officers and holders of 5% or more of the Registrant s common stock are considered the affiliates of the Registrant at that date.

The number of shares outstanding of the Registrant s common stock, as of March 9, 2004 was 6,661,813 shares.

DOCUMENTS INCORPORATED BY REFERENCE:

1. Portions of the Proxy Statement for the 2004 Annual Meeting of Shareholders filed electronically with the Securities and Exchange Commission on or about April 15, 2004. (Part III)

Table of Contents

TABLE OF CONTENTS

Federal Trust Corporation and Subsidiary (Registrant   ).

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

Table of Contents

PART I

ITEM 1. DESCRIPTION OF BUSINESS

General

Federal Trust Corporation (Federal Trust) was organized in February 1989 for the purpose of becoming the unitary savings and loan holding company of Federal Trust Bank (the Bank), a federally-chartered stock savings bank. Federal Trust, the Bank and the Bank s subsidiaries are collectively referred to herein as the Company . The Company s headquarters are located in Sanford, Florida. Federal Trust conducts business as a savings and loan holding company, and its principal asset is the capital stock of the Bank. As a savings and loan holding company, Federal Trust has greater flexibility than the Bank to diversify and expand its business activities, either through newly formed subsidiaries or through acquisitions.

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

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

Subsidiary

The Bank is chartered as a Federal-stock savings bank and is primarily engaged in the business of obtaining funds in the form of deposits and Federal Home Loan Bank (FHLB) advances and investing such funds in permanent loans on residential and to a lesser extent commercial real estate, in various types of commercial, construction and consumer loans and in investment securities.

The Federal Deposit Insurance Corporation (FDIC), an agency of the United States Government, insures through the Savings Association Insurance Fund (SAIF), all depositors of the Bank up to $100,000 in accordance with the rules and regulations of the FDIC. The Bank is subject to comprehensive regulation, examination and supervision by the Office of Thrift Supervision (OTS) and the FDIC, which is intended primarily for the benefit of depositors. See Regulation and Supervision.

Critical Accounting Policies

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

A variety of factors impact the carrying value of the loan portfolio including the calculation of the allowance for loan losses, the valuation of underlying collateral, the timing of loan charge-offs and the amount and amortization of loan fees and deferred origination costs.

We believe that the determination of the allowance for loan losses represents a critical accounting policy. The allowance for loan losses is maintained at a level management considers to be adequate to absorb probable loan losses inherent in the portfolio, based on evaluations of the collectibility and historical loss experience of loans. Credit losses are charged and recoveries are credited to the allowance. Provisions for loan losses are based on our review of the historical loan loss

Table of Contents

experience and such factors which, in management s judgment, deserve consideration under existing economic conditions in estimating probable credit losses. The allowance is based on ongoing assessments of the probable estimated losses inherent in the loan portfolio. Our methodology for assessing the appropriate allowance level consists of several key elements described below.

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

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

Historical loss rates for commercial and consumer loans may be adjusted for significant factors that, in management s judgment, reflect the impact of any current conditions or loss recognition. Factors which management considers in the analysis include the effects of the local economy, trends in the nature and volume of loans (delinquencies, charge-offs, nonaccrual and problem loans), changes in the internal lending policies and credit standards, collection practices, and examination results from bank regulatory agencies and our internal credit review function. An unallocated reserve is maintained to recognize the imprecision in estimating and measuring loss when evaluating reserves for individual loans or pools of loans. Specific reserves on individual loans and historical loss rates are reviewed throughout the year and adjusted as necessary based on changing borrower and collateral conditions and actual collection and charge-off experience.

Based on the procedures discussed above, management believes that allowance for loan losses were adequate to absorb estimated loan losses associated with the loan portfolio at December 31, 2003. Actual results could differ from these estimates. However, since the allowance is affected by management s judgment and uncertainties, there is the likelihood that materially different amounts would be reported under different conditions or assumptions. To the extent that the economy, collateral values, reserve factors, or the nature and volume of problem loans change, we may need to adjust the provision for loan losses. Material additions to our provision for loan losses would result in a decrease in net earnings and capital.

The allowance for loan losses is also discussed as part of Results of Operations and in Note 3 to the consolidated financial statements. The significant accounting policies are discussed in Note 1 to the consolidated financial statements.

Forward Looking Statements

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

Strategy

Our current operating strategy includes residential and commercial real estate, commercial and consumer loan origination, bulk loan/asset purchases and core deposit generation in the local community along with wholesale funding, if needed, to obtain deposits at a lower rate than our local market is willing to provide. Adjustable rate loans are originated and purchased

Table of Contents

to help us manage our interest rate spreads. The real estate lending emphasis is on origination of residential loans in our market area, retaining loans appropriate for portfolio and selling other originated loans into the secondary market. We also purchase residential loan packages on properties throughout the United States to help diversify our risk. To the extent possible, we attempt to control interest rates paid on deposits; however, outside factors such as economic, environmental, competitive and liquidity needs will have an effect on the cost of deposits. Our principal sources of earnings are interest on loans, securities, and overnight deposits, fees on checking accounts and sales of loans held for sale. Our principal expenses are interest paid on deposits and other borrowings and operating expenses.

Market Area and Competition

The Company has six offices: in Sanford, Winter Park, New Smyrna Beach, Casselberry, Deltona and Orange City Florida. Sanford, which is located approximately 20 miles northeast of downtown Orlando, is the second largest city in Seminole County with a population estimated at 36,000. Winter Park, a city of 25,000 residents, is located 13 miles southeast of Sanford and approximately 7 miles northeast of downtown Orlando, in the heart of the greater metropolitan Orlando area which encompasses Orange, Seminole, Lake, and Osceola Counties in central Florida. The total population of the four County area is estimated at $1.6 million, with the majority in Orange and Seminole Counties. New Smyrna Beach is located in Volusia County on the Atlantic Ocean approximately 33 miles northeast of our Sanford office and 15 miles south of Daytona Beach, Florida. Casselberry is located in Seminole County between our Sanford and Winter Park Offices. Deltona and Orange City are both located in Volusia County along the Interstate 4 corridor between Orlando and Daytona Beach. The Company s administrative and operation offices are in Sanford.

Our primary market area is Orange, Seminole and Volusia Counties, and to a lesser extent Lake and Osceola Counties. Although best known as a tourist destination, with over 20 million visitors a year, the Central Florida area has become a center for industries such as aerospace and defense, electro-optics and lasers, computer simulated training, computer networking and data management. In addition, motion picture production, professional and amateur sports, and distribution make the local economy more diverse each year. Many companies, including some in the Fortune 500, have chosen the greater Orlando area as a base for corporate, regional, and divisional headquarters. The area is also home to the University of Central Florida with an enrollment of 36,000, one of the fastest growing schools in the state university system, as well as Valencia Community College and Seminole Community College whose combined enrollment exceeds 85,000. Winter Park is home to Rollins College, the oldest college in Florida founded in 1885.

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

Consolidation within the banking industry, and in particular within Florida, has been dramatic over the past eight years. As of September 30, 2002, the four largest banking institutions in the state controlled approximately 52% of the bank deposits. In 1980, the four largest controlled less than 33% of the deposits.

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

5

Table of Contents

Lending Activities

General. Until recently, our primary lending activity was the acquisition and the origination of government insured or guaranteed or conventional loans for the purchase or construction of residential real property, which loans are secured by first liens on such property. Conventional loans are loans which are not insured by the Federal Housing Administration (FHA) or partially guaranteed by the Veterans Administration (VA). Within this category, the largest portion of our loans are made to homeowners on the security of single-family dwellings. As part of our corporate strategy more emphasis is being placed on making commercial real estate, commercial business, and residential development and lot loans. To a lesser extent, we also make home equity, and other consumer loans.

Credit Risk. The Bank s primary business is the origination and acquisition of loans to families and small businesses. That activity entails potential credit losses, the magnitude of which depends on a variety of economic factors affecting borrowers which are beyond the control of the Bank. While the Bank has instituted guidelines and credit review procedures to protect it from credit losses, some losses may inevitably occur.

Short-term balloon mortgage loans are sometimes used to allow borrowers the option of waiting until interest rates are more favorable for a long term fixed rate loan. If interest rates rise, these loans may require renewals if borrowers fail to qualify for a long term fixed rate loan at maturity and there is no assurance that a borrower s income will be sufficient to service the renewal. Management recognizes the risks associated with this type of lending, but we believe that the policies and procedures that we have in place lowers the general risk.

Loan Portfolio Composition. Our net loan portfolio, which is total loans plus premiums paid for loans purchased less loans in process, deferred loan origination fees and costs and allowance for loan losses, totaled $398.4 million at December 31, 2003, representing 85% of total assets at such date. At December 31, 2002, our net loan portfolio was $308.6 million or 84% of total assets.

Residential mortgage loans, not including construction loans, still comprise the largest group of loans in our loan portfolio, amounting to $302.1 million or 75.4% of the total loan portfolio at December 31, 2003. We offer fixed-rate and ARM loans with maturities up to 30 years. As of December 31, 2003, approximately 86% of these loans were ARM loans and 14% of these loans were fixed-rate. Fixed-rate loans are generally underwritten to secondary market standards to insure liquidity and interest rate risk protection.

Table of Contents

Commercial real estate loans, including land loans, amounted to $78.2 million or 19.5% of the total loan portfolio at December 31, 2003. Commercial real estate loans consist of $47.4 million of loans secured by other non-residential property and $30.8 million of loans secured by undeveloped land as of December 31, 2003.

Construction loans amounted to $7.1 million or 1.8% of total loans. The Company makes residential and commercial real estate construction loans usually on property throughout central Florida.

At December 31, 2003, consumer loans, consisting of installment loans and savings account loans, amounted to $864,000 or .2% of the total loan portfolio.

Commercial loans at December 31, 2003, amounted to $12.4 million, or 3.1% of total loans. Commercial loans are generally secured by the assets of the borrower including accounts receivable, inventory, and fixed assets, including company owned real estate and are usually also guaranteed by the owners.

The following table sets forth information on our loan portfolio by type.

	At December 31,									
	2003		2002		2001		2000		1999	
	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total
	($ in thousands)									
Mortgage loans:										
Residential	$ 302,083	75.4%	$ 246,234	79.2%	$ 203,729	74.3%	$ 164,387	70.4%	$ 141,137	71.9%
Commercial	78,209	19.5	44,766	14.4	32,315	11.8	28,343	12.1	20,981	10.7
Construction	7,079	1.8	12,258	3.9	32,212	11.7	35,014	15.0	31,518	16.1
Total mortgage loans	387,371	96.7	303,258	97.5	268,256	97.8	227,744	97.5	193,636	98.7
Consumer loans	864	.2	969	.3	3,111	1.1	4,436	1.9	2,676	1.3
Commercial loans	12,389	3.1	6,768	2.2	3,078	1.1	1,505	0.6		
Total loans	400,624	100.0%	310,995	100.0%	274,445	100.0%	233,685	100.0%	196,312	100.0%
Add (deduct):										
Loans in process	(2,790)		(3,189)		(10,813)		(10,885)		(9,967)	
Net premiums, discounts, deferred fees and costs	3,346		2,902		2,320		1,729		1,753	

Allowance for loan losses	(2,779)	(2,110)	(1,765)	(1,634)	(1,438)
Net loans	$ 398,401	$ 308,598	$ 264,187	$ 222,895	$ 186,660

Contractual Repayments. Scheduled contractual principal repayments of loans do not reflect the actual life of such assets. The average life of loans is substantially less than their average contractual terms because of prepayments. In addition, due-on-sale clauses on loans generally give the Company the right to declare a conventional loan immediately due and payable in the event, among other things, that the borrower sells the real property subject to the mortgage and the loan is not repaid. The average life of mortgage loans tends to increase, however, when current mortgage loan rates are substantially higher than rates on existing mortgage loans and, conversely, decrease when rates on existing mortgages are substantially higher than current mortgage loan rates. As of December 31, 2003, the Company had $7.1 million in construction loans, the majority of which mature in one year or less.

Table of Contents

The following table shows the contractual maturities of the Bank s loan portfolio at December 31, 2003. Loans that have adjustable rates are shown as amortizing to final maturity rather than when the interest rates are next subject to change. The table does not include prepayments or scheduled principal repayments.

	Mortgage Loans		Consumer	Commercial	Total Loans
	Residential	Other	Loans	Loans	Receivable
			(In thousands)		
Amounts due:					
Within 1 year	$ 5,364	5,872	244	8,062	19,542
1 to 3 years	223	20,557	32	975	21,787
3 to 5 years	763	35,045	511	3,352	39,671
5 to 10 years	29,024	10,562	77		39,663
10 to 20 years	14,949	4,478			19,427
Over 20 years	251,760	8,774			260,534
Total due after 1 year	296,719	79,416	620	4,327	381,082
Total amounts due	$ 302,083	85,288	864	12,389	400,624

Loans Due After December 31, 2004. The following table sets forth at December 31, 2003, the dollar amount of all loans due after December 31, 2004, classified according to whether such loans have fixed or adjustable interest rates.

	Due after December 31, 2004		
	Fixed	Adjustable	Total
		(In thousands)	
Mortgage loans:			
Residential	$ 49,126	247,593	296,719
Other	34,109	45,307	79,416
Consumer loans	362	258	620
Commercial loans	4,327		4,327
Total	$ 87,924	293,158	381,082

Purchase, Origination, and Sale of Loans. Historically, Florida has experienced a rate of population growth in excess of national averages. However, the real estate development and construction industries in Florida have been sensitive to cyclical changes in economic conditions and the demand for and supply of residential units. Our real estate mortgage loan origination volume could be affected by changes in interest rates and in the real estate development and construction industries.

Our loan portfolio consists of purchased and originated loans. When loans are acquired in the secondary market, we generally purchase loan packages of $5 million to $25 million of single-family residential mortgages, comprised of new and seasoned ARM loans. While we prefer to purchase loan packages comprised of Florida real estate, because of pricing and the limited number of Florida loan packages that are available, we also purchase packages of loans outside of Florida. The loan packages undergo an individual loan underwriting review prior to closing.

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

Table of Contents

Consumer loan originations are attributable largely to depositors and walk-in customers and referrals, while commercial and commercial real estate loan originations are primarily attributable to Bank loan officers and referrals. All of the Bank s loan applications are evaluated by the Bank s staff at the administrative and operations office in Sanford to ensure compliance with our underwriting standards. See Lending Activities - Loan Portfolio Composition - Loan Underwriting Policies.

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

	For the Year Ended December 31,				
	2003	2002	2001	2000	1999
Originations:					
Mortgage loans:					
Loans on existing property	$ 55,310	$ 79,373	$ 70,969	$ 56,575	$ 29,804
Construction loans	9,787	27,674	64,437	41,513	22,670
Total mortgage loans	65,097	107,047	135,406	98,088	52,474
Commercial loans	12,373	33,077	5,751	14,834	9,311
Consumer loans	701	529	2,469	2,161	1,108
Total loans originated	78,171	140,653	143,626	115,083	62,893
Purchases	176,828	97,897	53,933	29,802	55,177
Total loans originated and purchased	$ 254,999	$ 238,550	$ 197,559	$ 144,885	$ 118,070
Sales and principal repayments:					
Loans sold	(39,560)	(28,072)	(33,764)	(24,598)	(30,431)
Principal repayments	(125,810)	(173,928)	(123,035)	(82,914)	(50,773)
Total loans sold and principal repayments	$ (165,370)	$ (202,000)	$ (156,799)	$ (107,512)	$ (81,204)
Increase in total loans (before net items)	$ 89,629	$ 36,550	$ 40,760	$ 37,373	$ 36,866

Loan Underwriting. Lending activities are subject to strict underwriting standards and loan origination procedures prescribed by our Board of Directors and management. Loan applications are obtained to determine the borrower s ability to repay, and the more significant items on these applications are verified through the use of credit reports, financial statements and confirmations. Our lending policy for real estate loans generally requires that collateral be appraised by an independent, outside appraiser approved by the Board of Directors.

Loans are approved at various management levels up to and including the Board of Directors. Loan approvals are made in accordance with a Chart of Delegated Authority approved by our Board of Directors. Generally, loans less than $300,000 are approved by authorized officers and underwriters. Loans in excess of $300,000 to $2,000,000 require the concurrence of three or more authorized officers. Loans greater than $2,000,000 require approval of the Loan Committee. For loan approvals, the aggregate loans to the borrower and their related interest are used for determination of the appropriate lending authority required for any new loans or renewals.

To ensure that underwriting standards and loan policies are being followed, an internal and an external loan review process has been put in place.

Table of Contents

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

We are permitted to lend up to 100% of the appraised value of real property securing a mortgage loan. However, if the amount of a conventional, residential loan (including a construction loan or a combination construction and permanent loan) originated or refinanced exceeds 90% of the appraised value, federal regulations require that private mortgage insurance be obtained on that portion of the principal amount of the loan that exceeds 80% of the appraised value of the property. We originate single family residential mortgage loans up to a 97% loan-to-value ratio if the required private mortgage insurance is obtained. Loans over 97% loan-to-value ratio, if originated, would be under special community support programs or one of the Federal Housing Administration, Veterans Administration or USDA Rural Housing Service or insurance programs. The loan-to-value ratio on a home loan secured by a junior lien generally does not exceed 100%, including the amount of the first mortgage on the collateral. With respect to home loans granted for construction or combination construction/permanent financing, we will lend up to 95% of the appraised value of the property on an as completed basis. The loan-to-value ratio on multi-family residential and commercial real estate loans is generally limited to 80% of value. Consumer loans are considered to be loans to natural persons for personal, family or household purposes, and these loans may be unsecured, secured by personal property or secured by liens on real estate which, when aggregated with prior liens, equals or exceeds the appraised value of the collateral property.

The maximum amount that could have been loaned by the Bank to one borrower and the borrower s related entities at December 31, 2003, was approximately $4.7 million. We have no loans in our portfolio that exceed our loans to one borrower limit.

Federal regulations also permit by the Bank to invest, in the aggregate, up to four times our regulatory capital in loans secured by non-residential or commercial real estate. At December 31, 2003, this limit allowed us to invest in non-residential or commercial real estate loans in an aggregate amount up to $124.6 million. At such date, we had $78.2 million in loans secured by non-residential or commercial real estate.

Income from Lending Activities/Loan Servicing. Fees are earned in connection with loan commitments and originations, loan modifications, late payments, assumptions related to changes of property ownership and for miscellaneous services related to loans. We also receive fees for servicing loans owned by others. At December 31, 2003, we were servicing $92.7 million in loans for other institutions, which produces servicing income, net of amortization of mortgage servicing rights. Income from these activities varies from period to period with the volume and type of loans originated, sold and purchased, which in turn is dependent upon prevailing mortgage interest rates and their effect on the demand for loans in the Company s market area. During 2003, the Company made a strategic decision to have a third party begin servicing our residential mortgage loans on behalf of the Company. This third party charges standard servicing and administration fees for these services.

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

Non-performing Loans and Foreclosed Assets. When a borrower fails to make a required payment on a loan, the Company attempts to collect the payment by contacting the borrower. If a payment on a loan has not been received by the end of a grace period (usually 15 days from the payment due date), notices are sent at that time, with follow-up contacts made thereafter. In most cases, the delinquencies are cured promptly. If the delinquency exceeds 90 days and is not cured through normal collection procedures, more formal measures are instituted to remedy the default, including the commencement of foreclosure proceedings.

If foreclosure is effected, the property is sold at a public auction in which we may participate as a bidder. If we are the successful bidder, the acquired real estate property is then included in our foreclosed assets account until it is sold. Under federal regulations, we are permitted to finance sales of foreclosed assets by loans to facilitate, which may involve more favorable interest rates and terms than generally would be granted under our underwriting guidelines. At December 31, 2003, the Company had no loans to facilitate.

Table of Contents

Loans are placed on non-accrual status when, in the judgment of management, the probability of collection of interest is deemed to be insufficient to warrant further accrual. When a loan is placed on non-accrual status, previously accrued, but unpaid interest is deducted from interest income. Our policy is to not accrue interest on loans past due 90 days or more.

Assets acquired as a result of foreclosure or by deed-in-lieu of foreclosure are classified as foreclosed assets until they are sold. When assets are acquired, they are recorded at the lower of cost or fair value less estimated selling costs at the date of acquisition and any write-down resulting therefrom, is charged to the allowance for losses on loans.

The following table sets forth certain information regarding our non-accrual loans and foreclosed assets, the ratio of such loans and foreclosed assets to total assets as of the date indicated, and certain other related information. There were no troubled debt restructuring or accruing loans more than 90 days delinquent at any of the dates presented ($ in thousands).

	At December 31,				
	2003	**2002**	**2001**	**2000**	**1999**
Non-accrual loans:					
Mortgage:					
Construction	$ 229	$ 293	$ 418	$ 248	$
Residential	6,167	5,221	2,629	1,999	2,027
Commercial			481	773	629
Total mortgage	6,396	5,514	3,528	3,020	2,656
Commercial loans			39		
Consumer loans		65	22	23	
Total non-accrual	$ 6,396	$ 5,579	$ 3,589	$ 3,043	$ 2,656
Total non-accrual loans to total loans	1.6%	1.8%	1.3%	1.4%	1.4%
Total non-accrual loans to total assets	1.4%	1.5%	1.2%	1.2%	1.3%
Total allowance for loss to total non-accrual loans	43.4%	37.8%	49.2%	53.7%	54.1%
Foreclosed assets:					
Assets acquired by foreclosure	$ 1,007	$ 858	$ 714	$ 431	$ 295
Total foreclosed assets	$ 1,007	$ 858	$ 714	$ 431	$ 295
Total non-accrual loans and foreclosed assets to total assets	1.6%	1.7%	1.4%	1.4%	1.4%

At December 31, 2003, the Bank had no accruing loans which were contractually past due 90 days or more as to principal and interest and no troubled debt restructurings as defined by Statement of Financial Accounting Standards No. 15. Nonaccrual loans for which interest has been reduced totaled approximately $6.4 million, $5.6 million and $3.6 million at December 31, 2003, 2002 and 2001, respectively. For the year ended December 31, 2003, interest income that would have been recorded under the original terms of nonaccrual loans and interest income actually recognized is summarized below (in thousands):

Interest income that would have been recorded	$ 468
Interest income recognized	(111)
Interest income foregone	$ 357

Table of Contents

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

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

No assets were classified doubtful or loss at December 31, 2003. The following table sets forth information concerning the number and dollar amount of assets classified as special mention or substandard at December 31, 2003:

	Special Mention		Substandard	
	Number	Amount	Number	Amount
	($ in thousands)			
Loans	8	$ 1,128	78	$ 8,249

Provisions for Loan Losses

A provision for loan losses is generally charged to earnings based upon management s evaluation of the inherent losses in our loan portfolio. During 2003, our gross loans increased by $89.8 million and management charged $650,000 to our provision for loan losses. Also during 2003, we recognized $31,000 in charge-offs against our allowance but collected $50,000 in recoveries from prior charge-offs.

Although we believe that our present allowance for loan losses is adequate as of December 31, 2003, the provisions are based on the current and anticipated future operating conditions, thereby causing these estimates to be susceptible to changes that could result in a material adjustment to results of operations in the near term. The amount needed in the allowance for loan losses is based on the particular circumstances of the individual non-performing loans, including the type, amount, and value of the collateral, if any. In addition, the overall composition and amount of the performing loans in the portfolio at the time of evaluation is considered to determine the adequacy of the allowance, and, as a result, will vary over time. Although more emphasis is being placed on originating new commercial real estate loans, the composition of our loan portfolio continues to be concentrated primarily on residential mortgage loans, which tend to have a lower risk of loss. Loan repayments are dependent on loan underwriting and also on economic, operating and other conditions that may be beyond the Bank s control. Therefore, actual losses in future periods could differ materially from amounts provided in the current period and could result in a material adjustment to operations.

In addition to the continuing internal assessment of the loan portfolio, our loan portfolio is also subject to examination by the Company s primary regulator, the OTS, which will periodically review the loan portfolio and access the adequacy of the allowance for loan losses.

During 2003, our total non-accrual loans increased by approximately $817,000.

12

Table of Contents

Allowance for Losses on Loans

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

Specific allowances are provided in the event that the specific collateral analysis on each classified loan indicates that the probable loss upon liquidation of collateral would be in excess of the general percentage allocation. The provision for loan losses is debited or credited in order to bring the allowance for loan losses to the required level as determined above.

The allowance for loan losses at December 31, 2003 was $2.8 million, or 43.4% of non-performing loans and .70% of total loans net of loans in process (LIP) compared to $2.1 million, or 37.8% of non-performing loans and .69% of total loans net of LIP at December 31, 2002. The allowance at December 31, 2003 consisted of reserves for the performing loans in the portfolio and reserves against certain loans based on management s evaluation of these loans. As the amount of commercial loans in the portfolio increases, the allowance will be adjusted accordingly.

Although we believe that we use the best information available to determine the allowance, unforeseen market conditions could result in adjustments and net earnings could be significantly affected if circumstances differ substantially from the assumptions used in making the final determination. Future additions to our allowance for loan losses will be the result of periodic loan, property, and collateral reviews and thus cannot be predicted in advance. In addition, federal regulatory agencies, as an integral part of the examination process, periodically review our allowance for loan losses. Such agencies may require us to recognize additions to the allowance level based upon their judgment of the information available to them at the time of their examination.

Table of Contents

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

	At December 31,				
	2003	2002	2001	2000	1999
Average loans outstanding, net of LIP	$ 366,488	$ 279,934	$ 245,069	$ 214,755	$ 176,152
Allowance at beginning of year	2,110	1,765	1,634	1,438	1,136
Charge-offs:					
Residential real estate loans	(30)	(173)	(211)	(150)	(36)
Construction loans		(10)	(27)		
Commercial real estate loans					(3)
Commercial loans		(39)	(187)		
Consumer loans	(1)	(36)			
Total loans charged-off	(31)	(258)	(425)	(150)	(39)
Recoveries	50	158	16	17	21
Net recoveries (charge-offs)	19	(100)	(409)	(133)	(18)
Provision for loan losses	650	445	540	329	320
Allowance at end of year	$ 2,779	$ 2,110	$ 1,765	$ 1,634	$ 1,438
Ratio of net (recoveries) charge-offs to average loans outstanding	(.01)%	.04%	.17%	.06%	.01%
Ratio of allowance to period-end total loans, net of LIP	.70%	.69%	.67%	.73%	.77%
Period-end total loans, net of LIP	$ 397,834	$ 307,806	$ 263,632	$ 222,800	$ 186,660

Table of Contents

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

	At December 31,									
	2003		2002		2001		2000		1999	
	Amount	% of Loans to Total Loans	Amount	% of Loans to Total Loans	Amount	% of Loans to Total Loans	Amount	% of Loans to Total Loans	Amount	% of Loans to Total Loans
Residential real estate loans	$ 1,886	75.4%	$ 1,409	79.2%	$ 1,097	74.3%	$ 723	70.4%	$ 713	71.9%
Commercial and commercial real estate loans	825	22.6	566	16.6	456	12.9	750	12.7	550	10.7
Construction and consumer loans	68	2.0	135	4.2	212	12.8	161	16.9	175	17.4
Total allowance for loan losses	$ 2,779	100.0%	$ 2,110	100.0%	$ 1,765	100.0%	$ 1,634	100.0%	$ 1,438	100.0%

Investment Activities

Mortgage-Backed Securities. We purchase mortgage-backed securities, which are guaranteed as to principal and interest by FNMA and FHLMC, agencies of the Federal government. The securities are permissible investments for a savings institution and were acquired primarily for their liquidity, yield, and credit characteristics. Such securities may be used as collateral for borrowings. The mortgage-backed securities that were purchased are backed by either fixed-rate or adjustable- rate mortgage loans. At December 31, 2003, these securities totaled $15.8 million.

Other Investments. We also purchase municipal bonds and corporate equity and debt securities and are required to invest in the FHLB common stock. At December 31, 2003, the Company did not have any securities pledged to the FHLB as collateral under its short-term credit agreement.

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

	At December 31,		
	2003	2002	2001
Short-term investments:			

Interest-earning deposits	$ 666	$ 14,515	$ 8,608
Debt securities:			
Government agency	1,963		
Municipal bonds	5,988	205	2,097
Corporate debt		2,164	
Mortgage-backed securities	15,755	11,725	7,496
Equity securities:			
FHLB stock	5,660	2,860	3,075
Corporate equity	9,909	7,426	4,355
Total investment portfolio	$ 39,941	$ 38,895	$ 25,631

Table of Contents

The following table sets forth the remaining maturity and weighted-average yields as of December 31, 2003 and 2002:

	Less than One Year		Five Through Ten Years		More than Ten Years		Total	
	Carrying Value	Yield	Carrying Value	Yield	Carrying Value	Yield	Carrying Value	Yield
			($ in thousands)					
At December 31, 2003:								
Interest-earning deposits	$ 666	1.00%	$	%	$	%	$ 666	1.00%
FHLB stock	5,660	3.50					5,660	3.50
Government agency securities			1,963	2.81			1,963	2.81
Municipal bonds					5,988	4.92	5,988	4.92
Mortgage-backed securities							15,755	4.57
Corporate equity securities							9,909	4.91
	$ 6,326	3.24%	$ 1,963	2.81%	$ 5,988	4.92%	$ 39,941	4.40%
At December 31, 2002:								
Interest-earning deposits	$ 14,515	1.00%	$	%	$	%	$ 14,515	1.00%
FHLB stock	2,860	5.00					2,860	5.00
Corporate debt security			2,164	9.33			2,164	9.33
Municipal bonds			205	4.63			205	4.63
Mortgage-backed securities							11,725	4.90
Corporate equity securities							7,426	5.38
	$ 13,375	1.57%	$ 2,369	8.92%	$	%	$ 21,520	5.51%

Impact of Interest Rates on the Investment Portfolio. From 2001 through the first half of 2003, both long and short term interest rates moved steadily lower as a result of Federal Reserve action, the weak global economy, terrorist activities and the overseas military actions. As interest rates fell, all financial institutions experienced a dramatic increase in residential loan refinancing activity coupled with a general slowdown in commercial loan originations. During this period, we also experienced a similar increase in prepayments in our mortgage-backed securities portfolio. To replenish our investment portfolio, we purchased other mortgage-backed investments which had lower yields than the previous issues.

In the second half of 2003, long-term interest rates increased from the June 2003 lows, while the Federal Reserve kept short-term rates at historical lows. The increase in market rates in the second half of 2003 resulted in a decrease in the market value of our investment portfolio. At December 31, 2003, the Company had unrealized pretax losses of $511,000 in the investment portfolio, as compared to unrealized pretax gains of $24,000 at December 31, 2002. Management does not consider the unrealized loss at the end of 2003 to be a permanent impairment of value of the portfolio.

As a condition of our membership in the Federal Home Loan Bank of Atlanta we are required to own FHLB stock. The other investments in the portfolio, with the exception of the corporate equity securities, are eligible for inclusion in our liquidity base when calculating our regulatory liquidity requirement.

Sources of Funds

General. Deposits are our primary source of funds for use in lending and for other general business purposes. In addition to deposits, funds are obtained from normal loan amortization and prepayments, and from operations. Contractual loan payments are a relatively stable source of funds, while deposit inflows and outflows and loan prepayments are significantly influenced by general market interest rates and economic conditions. Borrowings are also used on a short-term basis to compensate for seasonal or other reductions in normal sources of funds. Borrowings are also be used on a longer term basis to support expanded lending or investment activities. Borrowings by Federal Trust can also be used by the Bank as an additional source of capital. At December 31, 2003, there was approximately $4 million in debt in Federal Trust that is utilized as capital by the Bank.

Deposits. Our primary deposit products include fixed-rate certificate accounts, money-market deposit accounts and both noninterest and interest-bearing transaction accounts. We have a number of different programs that are designed to attract both short-term and long-term deposits.

Deposits have generally been obtained from residents in our primary market area and, to a lesser extent, nationwide, through a network of deposit brokers. The principal methods used to attract in market deposit accounts have included offering a wide variety of services and accounts, competitive interest rates and convenient office locations, including access to automated teller machines (ATMs) and Internet Banking. We currently operate six ATM s and our customers also have access to the Star7 (previously Honor) and other shared ATM networks. We also offer customers Internet Banking with access to their accounts, funds transfer, and bill paying. On occasion we utilize brokered deposits and also some negotiated- rate certificates of deposit less than $100,000 acquired through the internet, which electronically allows us to display our rates on certificates to individual investors nationwide. Our personnel then deal directly with investors who telephone or write for information concerning certificates of deposit.

The following table shows the distribution of, and certain other information relating to, our deposits by type as of the dates indicated ($ in thousands).

	At December 31,					
	2003		2002		2001	
	Amount	Percent of Deposits	Amount	Percent of Deposits	Amount	Percent of Deposits
Noninterest-bearing checking accounts	$ 6,352	2.0%	$ 6,112	2.2%	$ 5,135	2.3%
Interest-bearing checking accounts	15,566	4.9	12,094	4.3	1,348	0.6
Money-market accounts	76,047	24.2	68,893	24.7	32,368	14.4
Savings accounts	8,714	2.8	9,319	3.4	1,923	0.8
Subtotal	106,679	33.9	96,418	34.6	40,774	18.1
Time deposits:						
Less than 1.00%	236	0.1				
1.00% to 1.99%	95,193	30.3	25,963	9.3%		
2.00% to 2.99%	84,104	26.7	54,144	19.4	26,283	11.7
3.00% to 3.99%	14,588	4.6	52,840	19.0	33,585	14.9
4.00% to 4.99%	9,174	2.9	29,319	10.5	69,515	30.8
5.00% to 5.99%	2,915	0.9	16,892	6.1	31,206	13.8
6.00% to 6.99%	1,234	0.4	2,355	0.9	22,669	10.1
7.00% to 7.99%	507	0.2	600	0.2	1,368	0.6
Total time deposits	207,951	66.1	182,113	65.4	184,626	81.9

Total deposits	$ 314,630	100.0%	$ 278,531	100.0%	$ 225,400	100.0%

Table of Contents

The following table shows the average amount of and the average rate paid on each of the following categories during the periods indicated ($ in thousands).

	Year Ended December 31,					
	2003		2002		2001	
	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
Noninterest bearing checking accounts	$ 7,102	%	$ 5,837	%	$ 5,230	%
Money-market and interest-bearing checking accounts	92,525	1.91	56,066	2.87	22,880	3.60
Savings	9,446	1.73	7,621	1.82	1,269	4.33
Time deposits	188,975	2.73	176,721	3.83	166,453	5.76
Total deposits	$ 298,048	2.38%	$ 246,245	3.46%	$ 195,832	5.35%

The variety of deposit accounts that we offer has increased our ability to retain deposits and has allowed us to be competitive in obtaining new funds, although the threat of disintermediation (the flow of funds away from savings institutions into direct investment vehicles such as government and corporate securities) still exists. Our ability to attract and retain deposits and our cost of funds have been, and will continue to be, significantly affected by competition and market interest rates.

On a weekly basis, we review the rates offered by other deposit institutions in our market area and make adjustments to the rates we offer to meet our funding needs and to be competitive with the local market. Our deposits increased to $314.6 million at December 31, 2003, from $278.5 million at December 31, 2002.

The following table sets forth jumbo certificates of $100,000 and over at December 31, 2003, maturing as follows (in thousands):

	Amount
Due three months or less	$ 23,473
Due over three months to six months	21,586
Due over six months to one year	41,774
Due over one year	26,687
	$ 113,520

Federal Home Loan Bank Advances. The Company is permitted to obtain advances from the FHLB of Atlanta, upon the security of the capital stock of the FHLB of Atlanta that we own and certain of our home mortgage loans and other assets (principally, securities which are obligations of, or guaranteed by, the U.S. government or agencies thereof), provided certain standards related to creditworthiness have been met. Such advances may be made pursuant to several different credit programs. Each credit program has its own interest rate based on the range of maturities. The FHLB has limitations on the total amount and terms of advances available to the Bank based on, among other things, asset size, capital strength, earnings and the amount of collateral available to be pledged for such advances. Prepayment of FHLB advances would incur prepayment penalties. At December 31, 2003, we had $107.7 million in borrowings outstanding.

Table of Contents

A summary of advances from the Federal Home Loan Bank of Atlanta are as follows ($ in thousands):

Maturing During the Year Ending December 31,	Interest Rate	At December 31, 2003	2002	2001
2002	2.56*	$		5,000
2002	5.95			5,000
2002	6.39			5,000
2002	5.45			5,000
2003	6.39		5,000	5,000
2003	1.30*		17,000	
2004	1.15*	25,500		
2005	2.00	25,000		
2006	1.24**	5,000		
2006	.58**	5,000		
2007	5.22	2,200	2,200	
2007	1.26**	5,000	5,000	
2008	1.98**	5,000		
2008	1.12**	5,000		
2008	1.01**	5,000		
2011	3.73***	25,000	25,000	25,000
		$ 107,700	54,200	50,000

* Daily advance or adjustable rate.
** FHLB has the option to call every three months beginning at certain dates.
*** FHLB has a one-time call option in December 2004.

The security agreement with FHLB includes a blanket floating lien requiring the Company to maintain qualifying first mortgage loans as pledged collateral in an amount equal to at least, when discounted at 75% of the unpaid principal balances, 100% of these advances. The FHLB stock is also pledged as collateral for these advances.

The overnight, variable rate advances reprice daily and may be repaid at any time without penalty. Fixed rate advances incur a prepayment penalty if repaid prior to maturity, and the interest rate is fixed for the term of the advance.

Table of Contents

Other Borrowings. The Company had a line of credit agreement with a commercial bank that permitted the Company to borrow up to $6,000,000. The line of credit bore interest at the prime lending rate plus 50 basis points and was secured by all the Bank s common stock. Borrowings under the line of credit agreement was to mature five years after the date of the borrowing. At December 31, 2002 and 2001, the outstanding balances under the line of credit agreement was approximately $915,000 and $2,115,000, respectively.

During 2003, the Company entered into a new loan agreement with another correspondent bank. Under this agreement, the Company can borrow up to $6,000,000 under a revolving line of credit (LOC) for general operations and up to $2,000,000 on a separate nonrevolving line of credit (ESOP LOC) for common stock purchases relating to the Company s Employee Stock Ownership Plan. Both lines are secured by all the Bank s common stock and both have interest rates of prime minus 12.5 basis points as long as the Company maintains certain loan-to-book value percentages. The Company used the proceeds from the LOC, in part, to pay off the old line of credit. The new loan agreement also has certain covenants that the Company is required to meet. The following summarizes the balances and other information pertaining to these loans at December 31, 2003 ($ in thousands):

	Outstanding Balance	Available Balance	Interest Rate	Interest Due	Principal Due
LOC	$ 4,212	1,788	3.875%	Quarterly	Beginning in June 2005 principal amortizes over 10 year schedule-due June 2015
ESOP LOC	1,005	995	3.875%	Quarterly	Annual principal repayments of 10% of outstanding balance increasing 5% per year, due in full in June 2009
Total	$ 5,217	2,783			

Total interest expense on other borrowings for the years ended December 31, 2003, 2002 and 2001, was approximately $137,000, $84,000 and $187,000, respectively.

Junior Subordinated Debentures. On September 17, 2003, the Statutory Trust I sold adjustable-rate Trust Preferred Securities due September 17, 2033 in the aggregate principal amount of $5,000,000 (the Trust Preferred Securities) in a pooled trust preferred securities offering. The interest rate on the Trust Preferred Securities adjusts quarterly, to a rate equal to the then current three-month London Interchange Bank Offering Rate (LIBOR), plus 295 basis points (4.05% at December 31, 2003). In addition, Federal Trust contributed capital of $155,000 to the Statutory Trust I for the purchase of the common securities of the Statutory Trust I. The proceeds from these sales were paid to Federal Trust in exchange for $5,155,000 of its adjustable-rate Junior Subordinated Debentures (the Debentures) due September 17, 2033. The Debentures have the same terms as the Trust Preferred Securities. The sole asset of the Statutory Trust I, the obligor on the Trust Preferred Securities, is the Debentures.

Federal Trust has guaranteed the Statutory Trust I s payment of distributions on, payments on any redemptions of, and any liquidation distribution with respect to, the Trust Preferred Securities. Cash distributions on both the Trust Preferred Securities and the Debentures are payable quarterly in arrears on March 17, June 17, September 17 and December 17 of each year.

The Trust Preferred Securities are subject to mandatory redemption: (i) in whole, but not in part, upon repayment of the Debentures at stated maturity or, at the option of Federal Trust, their earlier redemption in whole upon the occurrence of certain changes in the tax treatment or capital treatment of the Trust Preferred Securities, or a change in the law such that the Statutory Trust I would be considered an Investment Company; and (ii) in whole or in part at any time on or after September 17, 2008

Table of Contents

contemporaneously with the optional redemption by Federal Trust of the Debentures in whole or in part. The Debentures are redeemable prior to maturity at the option of Federal Trust: (i) on or after September 17, 2008, in whole at any time or in part from time to time; or (ii) in whole, but not in part, at any time within 90 days following the occurrence and continuation of certain changes in the tax treatment or capital treatment of the Trust Preferred Securities, or a change in law such that the Statutory Trust I would be considered an Investment Company, required to be registered under the Investment Company Act of 1940.

The following table sets forth certain information relating to the Bank s borrowings at the dates indicated:

	At or For the Year Ended December 31,		
	2003	2002	2001
	($ in thousands)		
FHLB advances:			
Average balance outstanding	$ 95,983	$ 48,214	$ 48,300
Maximum amount outstanding at any month end during the year	$ 123,200	$ 54,200	$ 56,000
Balance outstanding at end of year	$ 107,700	$ 54,200	$ 50,000
Weighted average interest rate during the year	2.44%	4.91%	5.13%
Weighted average interest rate at end of year	2.04%	3.05%	4.54%
Other borrowings and junior subordinated debentures:			
Average balance outstanding	$ 7,091	$ 1,688	$ 2,046
Maximum amount outstanding at any month end during the year	$ 14,011	$ 5,915	$ 2,115
Balance outstanding at end of year	$ 13,706	$ 3,054	$ 2,115
Weighted average interest rate during the year	4.63%	4.98%	7.49%
Weighted average interest rate at end of year	3.96%	4.75%	5.25%
Total borrowings:			
Average balance outstanding	$ 103,074	$ 49,902	$ 50,346
Maximum amount outstanding at any month end during the year	$ 137,211	$ 57,615	$ 58,115
Balance outstanding at end of year	$ 121,406	$ 55,115	$ 52,115
Weighted average interest rate during the year	2.59%	4.91%	5.56%
Weighted average interest rate at end of year	2.25%	3.07%	4.57%

Expansion Plans

On February 4, 2002, the Sanford branch office, which originally opened in October 1998, relocated to a new 3,000 square- foot facility with three drive-up lanes and a fourth lane which has a drive-up ATM. The new location is next to the building where the branch originally opened and provides our customers with easier access and extended hours.

On December 23, 2002 the Casselberry branch office opened in a new 3,000 square foot facility with two drive-up lanes and a third lane which has a drive-up ATM. The office is located on Semoran Boulevard (State Road 436) which is a main thorough-fare in Seminole and Orange Counties.

In June, 2003, the Company opened our second Volusia County branch in Deltona, Florida, in a 1,500 square foot, short-term leased facility in a retail plaza. In January 2004, the Company began construction of our permanent Deltona branch, a 2,500 square foot free-standing facility located at a key intersection on an out-parcel of a grocery store and retail plaza. The relocation of the Deltona branch to the permanent location is planned for mid 2004.

In October 2003, the Company opened our third Volusia County branch in Orange City, Florida, in a 3,000 square foot free-standing facility with two drive-up lanes and a third lane which has a drive-up ATM. The office is located on Enterprise Boulevard, which is a main commercial artery in Orange City.

Table of Contents

At present we are in the process of identifying additional branch sites in our primary market area that would open in 2004 or after.

Employees

At December 31, 2003, Federal Trust had no full-time employees, while the Bank and its subsidiary had a total of 74 full-time employees. Management considers relations with its employees to be excellent.

Federal Trust currently maintains a comprehensive employee benefit program providing, among other benefits, hospitalization and major medical insurance, long-term disability insurance, life insurance, education assistance, an employee stock ownership plan (ESOP) and a 401K Plan. These benefits are considered by management to be competitive with employee benefits provided by other major employers in Federal Trust s market areas. Federal Trust s employees are not represented by any collective bargaining group.

Other Subsidiaries

At December 31, 2003, Federal Trust had no subsidiaries other than the Bank except for Statutory Trust I. The total equity investment at December 31, 2003 was $30.9 million.

Bank Subsidiaries

There are no limits on the amount a savings institution may invest in its operating subsidiaries, either separately or in the aggregate. The Bank had one operating subsidiary, FTB Financial, Inc. (FTBF). FTBF, which commenced operations in 1996, engaged in the business of selling insurance annuities, stocks and bond investment products. FTBF ceased operations in September 2003 and had minimal activity over the previous three years. The Bank s other subsidiary, Vantage Mortgage Service Center, Inc. (Vantage) originated residential mortgages (FHA and VA) in the Gainesville, Florida market. Vantage ceased operations during March 2001 and was dissolved in September 2001.

Legal Proceedings

There are no material pending legal proceedings to which the Company is a party, or to which any of its property is subject.

Monetary Policies

The results of our operations are affected by credit policies of monetary authorities, particularly the Federal Reserve Board. The instruments of monetary policy employed by the Federal Reserve Board include open market operations in U.S. government securities, changes in the discount rate on member bank borrowings, changes in reserve requirements against member bank deposits. In view of changing conditions in the national economy and in the money market, as well as the effect of action by monetary and fiscal authorities, including the Federal Reserve Board, no prediction can be made as to our possible future changes in interest rates, deposit levels, loan demand or our business and earnings.

Table of Contents

REGULATION AND SUPERVISION

General

Federal Trust, is a registered savings and loan holding company within the meaning of the Home Owners Loan Act (HOLA). Federal Trust and the Bank operate in a highly regulated environment. The Company s business activities, which are governed by statute, regulation and administrative policies, are supervised by a number of federal regulatory agencies, including the OTS, the Federal Deposit Insurance Corporation (FDIC) and, to a limited extent, the Federal Reserve Board. The following is a brief summary of the more recent legislation which affects Federal Trust and our subsidiaries:

In November 1999, the financial services regulations were significantly reformed with the adoption of the Gramm-Leach-Bliley Act (GLA). The GLA provides for the streamlining of the regulatory oversight functions of the various federal banking agencies. Of significance, is the fact that while the GLA permits bank holding companies that are well managed, well capitalized and that have at least a satisfactory Community Reinvestment Act rating to operate as Financial Holding Companies (FHC), it essentially eliminated the unlimited investment authority of a unitary savings and loan holding company. Savings and loan holding companies are now, for the most part, limited to activities permitted by a bank holding company, a multiple savings and loan holding company, or an FHC.

The GLA also requires financial institutions to permit, with few exceptions, their customers to opt out of having their personal financial information shared with nonaffiliated third parties. The GLA bars financial institutions from disclosing customer account numbers to direct marketers and mandates that institutions provide annual disclosure to their customers regarding the institution s privacy policies and procedures. We have chosen to permit our customers to opt out if they choose to.

Regulation of the Holding Company

Restrictions on the Acquisition of Savings Institutions. Section 1467a of the HOLA provides that no holding company, directly or indirectly or acting in concert with one or more persons, or through one or more subsidiaries, or through one or more transactions, may acquire control of an insured savings institution at any time without the prior approval of the OTS. In addition, any holding company that acquires such control becomes a savings and loan holding company subject to registration, examination and regulation under HOLA and the regulations promulgated thereunder. Control in this context means ownership, control of, or holding proxies representing more than 25% of the voting shares of, an insured institution, the power to control in any manner the election of a majority of the directors of such institution or the power to exercise a controlling influence over the management or policies of the institution.

The OTS also has established certain rebuttable control determinations. An acquiror must file for approval of control with the OTS, or file to rebut the presumptions before surpassing a rebuttable control level of ownership. To rebut the presumption, the acquiror must file a submission with the OTS setting forth the reasons for rebuttal. The submission must be filed when the acquiror acquires more than 25% of any class of voting stock of the savings bank and when they have any of the control factors enumerated in 12 C.F.R. Section 574.4(c) which include, but are not limited to: (i) the acquiror would be one of the two largest shareholders of any class of voting stock; (ii) the acquiror and/or the acquiror s representative or nominees would constitute more than one member of the savings bank s board of directors; and (iii) the acquiror or nominee or management official of the acquiror would serve as the chairman of the board of directors, chairman of the executive committee, chief executive officer, chief operating officer, chief financial officer, or in any similar policy making authority in the savings bank.

Transactions with Affiliates. The authority of Federal Trust to engage in transactions with related parties or affiliates or to make loans to certain insiders, is limited by Sections 23A and 23B of the Federal Reserve Act (FRA) and Regulation W, adopted thereunder. Section 23A limits the aggregate amount of transactions with any individual affiliate to 10% of the capital and surplus of the savings institution and also limits the aggregate amount of transactions with all affiliates 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 described in the FRA and the purchase of low quality assets from affiliates is generally prohibited. Section 23B provides that certain transactions with affiliates, including loans and asset purchases, must be on terms and circumstances, including credit standards, that are substantially the same or at least as favorable to the savings institution as those prevailing at the time for comparable transactions with a non-related party or non-affiliated holding company. In the absence of comparable transactions, such transactions may only occur under terms and circumstances, including credit standards, that in good faith would be offered to or would apply to non-related parties or non-affiliated companies. Regulation W contains certain exceptions for transactions involving industry credit, loan participations and derivative transactions. Notwithstanding Sections 23A and 23B, savings institutions are prohibited from lending to any affiliate that is engaged in activities that are not permissible for bank holding companies under Section 4(c) of the Bank Holding Company Act of 1956. Further, no savings institution may purchase the securities of any affiliate other than a subsidiary.

In addition, Sections 22(g) and 22(h) of the FRA and Regulation O (which set limits on extensions of credit to executive officers, directors and 10% shareholders, as well as companies which such persons control) apply to savings institutions. Among other things, such loans must be made on terms, including interest rates, substantially the same as loans to unaffiliated individuals and which involve no more than the normal risk of collectibility. These regulations also place limits on the amount of loans the Bank may make to such persons. These restrictions apply in addition to certain restrictions on transactions with affiliates contained in the OTS regulations.

Support of Subsidiary Depository Institutions. Under OTS policy, Federal Trust is expected to act as a source of financial strength to and to commit resources to support the Bank. This support may be required at times when, in the absence of such OTS policy, Federal Trust might not be inclined to provide such support. In addition, any capital loans by Federal Trust to the Bank must be subordinate in right of payment to depositors and to certain other indebtedness of the Bank. In the event of bankruptcy, any commitment by a holding company to a federal bank regulatory agency to maintain the capital of a subsidiary depository institution will be assumed by the bankruptcy trustee and will be entitled to a priority of payment.

Under the FDIA, a depository institution of a holding company, can be held liable for any loss incurred by, or reasonably expected to be incurred by, the FDIC, in connection with: (i) the default of a commonly controlled FDIC-insured depository institution; or (ii) any assistance provided by the FDIC to any commonly controlled FDIC-insured depository institution in danger of default. Default is defined generally as the appointment of a conservator or a receiver and in danger of default is defined generally as the existence of certain conditions indicating that a default is likely to occur in the absence of regulatory assistance.

Payment of Dividends. To date, the principal source of cash flow of Federal Trust, including cash flow to pay cash dividends, has been dividends from the Bank. There are statutory and regulatory limitations on the payment of dividends by the Bank. The ability of the Bank to pay a dividend to Federal Trust is governed by the OTS s capital distribution regulation. Under the regulation, the Bank may make a capital distribution without the approval of the OTS, provided the OTS is notified 30 days before declaration of the capital distribution. The Bank must also meet the following requirements: (i) it has a regulatory rating in one of the two top examination categories; (ii) it is not of supervisory concern, and will remain adequately or well-capitalized, as defined in the OTS prompt corrective action regulations, following the proposed distribution; and (iii) the distribution does not exceed the Bank s net income for the calendar year-to-date plus retained net income for the previous two calendar years (less any dividends previously paid). If the Bank does not meet the above-stated requirements, it must obtain the prior approval of the OTS before declaring any proposed distributions. The OTS can prohibit a proposed capital distribution by a savings institution, which would otherwise be permitted by the regulation if the OTS determines that such distribution would constitute an unsafe or unsound practice. Federal Trust did not pay a dividend in 2002, but has paid $.05 per share in dividends during 2003.

34 Act Reporting

As a publicly traded company with its shares of common stock registered under the Securities Act of 1933, Federal Trust is required to file periodic public disclosure reports with the Securities and Exchange Commission, pursuant to the Securities and Exchange Act of 1934, and the regulations promulgated thereunder. A Form 10-KSB is a required annual report that must contain a complete overview of Federal Trust s business, financial, management, regulatory, legal, ownership and organizational status. Federal Trust must file Form 10-KSB by March 31 of each year.

Similarly, Form 10-QSB must contain information concerning Federal Trust on a quarterly basis. Although Form 10-KSB requires the inclusion of audited financial statements, unaudited statements are sufficient for inclusion on Form 10-QSB Additionally, any significant non-recurring events that occur during the subject quarter, as well as changes in securities, any defaults and the submissions of any matters to a vote of security holders, must also be reported on Form 10-QSB.

Table of Contents

Recently, the national securities exchanges, including the American Stock Exchange adopted a rule requiring the audit committees of Boards of Directors of reporting corporations, such as Federal Trust, to undertake certain organizational and operational steps. The Securities and Exchange Commission also adopted a similar rule. These standards require our audit committee to be comprised of independent, non-employee directors who are financially literate. Furthermore, the audit committee has adopted a formal charter defining the scope for its operations. The Securities and Exchange Commission s rule also requires our auditors to review the financial statements contained in our Form 10-QSB s, in addition to our Form 10-KSBs.

The Sarbanes-Oxley Act of 2002 increases the responsibility of the audit committee and imposes significant corporate governance standards on public companies, such as Federal Trust. Included in these standards are requirements that our senior officers certify that our financial statements meet certain standards of completeness and accuracy and that we adopt an ethics policy and that our auditors meet stringent standards of independence.

Regulation of the Bank

Capital Requirements. Both OTS and FDIC have promulgated regulations setting forth capital requirements applicable to depository institutions. The OTS capital regulations require savings institutions to meet three capital standards: (i) a 1.5% tangible capital ratio (defined as the ratio of tangible capital to adjusted total assets); (ii) a 4% leverage (core capital) ratio (defined as the ratio of core capital to adjusted total assets); and (iii) an 8% risk-based capital standard as defined below. At December 31, 2003 the Bank exceeded all required capital standards.

Core capital is defined as common stockholder s equity (including retained earning), certain noncumulative perpetual preferred stock and related surplus, minority interests in equity accounts of consolidated subsidiaries, certain goodwill and certain mortgage servicing rights less certain intangible assets, mortgage servicing rights less certain intangible assets, mortgage servicing rights and investments in nonincludable subsidiaries. Tangible capital is defined in the same manner as core capital, except that all intangible assets (excluding certain mortgage servicing rights) must be deducted. Adjusted total assets is defined as GAAP total assets, minus intangible assets (except those included in core capital). The OTS regulations also require that in calculating the leverage ratio, tangible and risk-based capital standards, savings institutions must deduct investments in and loans to subsidiaries engaged in activities not permissible for a national bank. The Bank had only one subsidiary that is currently inactive, FTB Financial Services, Inc., which was in the business of selling non-FDIC insured annuities.

The OTS risk-based capital standard for savings institutions requires that total capital (comprised of core capital and supplementary capital) be at least 8% of risk-weighted assets. In determining risk-weighted assets, all assets, including certain off-balance sheet assets, are multiplied by a risk-weight of 0% to 100%, as assigned by the OTS capital regulation based on the risks OTS believes are inherent in the type of asset. Generally, zero weight is assigned to risk-free assets, such as cash and unconditionally guaranteed United States Government securities. A weight of 20% is assigned to, among other things, certain obligations of United States Government-sponsored agencies (such as the FNMA and the FHLMC) and certain high quality mortgage-related securities. A weight of 50% is assigned to qualifying mortgage loans and certain other residential mortgaged-related securities. The components of core capital are equivalent to those discussed above. The components of supplementary capital include permanent capital instruments (such as cumulative perpetual preferred stock, mandatory convertible subordinated debt and perpetual subordinated debt), maturing capital instruments (such as mandatory convertible subordinated debt and intermediate-term preferred stock) and the allowance for loan and lease losses. Allowance for loan and lease losses includable in supplementary capital is limited to a maximum of 1.25% of risk-weighted assets. Overall, the amount of capital counted toward supplementary capital cannot exceed 100% of core capital.

The OTS incorporated an interest-rate component as part of the calculation of a savings institution s regulatory capital. Savings institutions with above normal interest-rate risk exposure are subject to a deduction from total capital for purposes of calculating their risk-based capital requirements. A savings institution s interest-rate risk is measured by the decline in the net portfolio value of its assets (i.e. the difference between incoming and outgoing discounted cash flows from assets, liabilities and off-balance sheet contracts) that would result from a hypothetical 200 basis point increase or decrease in market interest rates (whichever results in a lower net portfolio value) divided by the estimated economic value of the savings institution s assets, as calculated in accordance

Table of Contents

with guidelines set forth by the OTS. A savings institution whose measured interest-rate risk exposure exceeds 2% must deduct an interest-rate component in calculating its total capital under the risk-based capital rule. The interest-rate risk component is an amount equal to one-half of the difference between the savings institution s measured interest-rate risk and 2%, multiplied by the estimated economic value of the savings institution s assets. That dollar amount is deducted from the savings institution s total capital in calculating compliance with its risk-based capital requirement. The interest rate-risk rule includes an assessment of exposure to declines in the economic value of a savings institution s capital due to changes in interest rates. Under the rule, there is a three-quarter lag between the reporting date of an institution s financial data and the effective date for the new capital requirement based on that data. Each quarter, the OTS calculates a savings institution s interest-rate risk exposure and advises the savings institution of any interest-rate risk capital component resulting from greater than normal exposure. The rule also provides that the Director of the OTS may waive or defer a savings institution s interest-rate risk component on a case by case basis. As of December 31, 2003, the Bank s interest rate-risk exposure, according to OTS calculations, would not have been above the threshold requiring an additional capital component.

At December 31, 2003, the Bank met each of its capital requirements. The following table sets forth the regulatory capital calculations of the Bank at December 31, 2003 ($ in thousands):

	Tier I		Risk-Based	
	Amount	**Percent of Assets**	**Amount**	**Percent of Assets**
Regulatory capital	$ 31,149	6.8%	$ 33,877	11.6%
Requirement	18,385	4.0	23,391	8.0
Excess	$ 12,764	2.8%	$ 10,486	3.6%

Standards for Safety and Soundness. The FDICIA, as amended by the Reigle Community Development and Regulatory Improvement Act of 1994, requires each federal banking agency to prescribe for all insured depository institutions and their holding companies standards relating to internal controls, information systems and audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, and compensation, fees and benefits and such other operational and managerial standards as the agency deems appropriate. The OTS and the other federal banking agencies have adopted guidelines requiring depository institutions to maintain internal controls and information systems and internal audit systems that are appropriate for the size, nature and scope of the institution s business. The guidelines also establish certain basic standards for loan documentation, credit underwriting, interest rate-risk exposure, and asset growth. The guidelines further provide that savings institutions should maintain safeguards to prevent the payment of compensation, fees and benefits that are excessive or that could lead to material financial loss, and that they should take into account factors such as compensation practices at comparable institutions. The interagency guidelines also include asset quality and earnings standards.

If the OTS determines that a savings institution is not in compliance with the safety and soundness guidelines, it may require the institution to submit an acceptable plan to achieve compliance with the guidelines. A savings institution is required to submit an acceptable compliance plan to the OTS within 30 days after receipt of a request for such a plan. Failure to submit or implement a compliance plan may subject the institution to regulatory sanctions.

Insurance of Deposit Accounts. The FDIC is the administrator for the Savings Association Insurance Fund (SAIF) and the Bank Insurance Fund (BIF), independently setting insurance premiums for each Fund. The Bank s deposit accounts are insured by the SAIF.

The FDIC applies a risk-based assessment system for insured depository institutions that takes into account the risks attributable to different categories and concentrations of assets and liabilities. In accordance with its rule, the FDIC assigns a depository institution to one of three capital categories based on the institution s financial information, as of the reporting period ending seven months before the assessment period. A depository institution s assessment rate depends on the capital category and supervisory category to which it is assigned. There are nine assessment risk classifications (i.e., combinations of capital groups and supervisory subgroups) to which different assessment rates are applied.

Table of Contents

The current regular semi-annual SAIF assessments range between 0% - 0.27% of deposits. The Bank s assessment at December 31, 2003 was .0078 basis points on deposits and the Bank paid approximately $46,000 in SAIF assessments during the year ended December 31, 2003.

Qualified Thrift Lender Test (QTL). The HOLA requires savings institutions to meet a QTL test. The QTL test, requires savings institutions to maintain at least 65% of its portfolio assets (as defined by regulation) in qualified thrift investments, primarily residential mortgages and related investments on a monthly basis in nine out of every 12 months.

As of December 31, 2003, the Bank exceeded the QTL test, maintaining 90.9% of its portfolio assets in qualified thrift investments.

Interstate Banking. Federally chartered savings institutions are allowed to branch nationwide to the extent allowed by federal statute. This ability permits savings institutions with interstate networks to diversify their loan portfolios and lines of business. The OTS authority preempts any state law purporting to regulate branching by federal savings institutions. Prior approval of the OTS is required for a savings institution to branch interstate or intrastate. To obtain supervisory clearance for branching, an applicant s regulatory capital must meet or exceed the minimum requirements established by law and by the OTS regulations. In addition, the savings institution must have a satisfactory record under the Community Reinvestment Act (CRA). The Bank does not conduct interstate branching operations and does not plan to do so in the foreseeable future.

The Reigle-Neal Interstate Banking and Branching Efficiency Act of 1994 (Interstate Act) eliminated many existing restrictions on interstate banking by authorizing interstate acquisitions of financial institutions by bank holding companies without geographic limitations. Under the Interstate Act, existing restrictions on interstate acquisitions of banks by bank holding companies were repealed. Bank holding companies located in Florida are able to acquire any Florida-based bank, subject to certain deposit percentage and other restrictions. The legislation also provides that *de novo* branching by an out-of-state bank is permitted only if it is expressly permitted by the laws of the host state. The authority of a bank to establish and operate branches within a state is subject to applicable state branching laws. Florida law permits interstate branching through the acquisition of a bank in existence for more than three years, but prohibits *de novo* branching by out of state banks.

OTS Assessments. Savings institutions are required by OTS regulation to pay assessments to the OTS to fund the operations of the OTS. The general assessment, to be paid on a semiannually basis, is computed upon the savings institution s total assets, including consolidated subsidiaries, as reported in the institution s latest quarterly thrift financial report. The Bank paid approximately $88,000 in OTS assessments for the year-ended December 31, 2003.

Table of Contents

Federal Home Loan Bank System

The Bank is a member of the Federal Home Loan Bank (FHLB) System which consists of 12 regional FHLBs. The FHLB provides a central credit facility primarily for member institutions. As a member of the FHLB-Atlanta, the Bank is required to acquire and hold shares of capital stock in that FHLB in an amount at least equal to 1% of the aggregate principal amount of its unpaid residential mortgage loans and similar obligations at the beginning of each year, or 1/20th of its advances (borrowings) from the FHLB-Atlanta, whichever is greater. The Bank is in compliance with this requirement and at December 31, 2003, the Bank held $5.7 million in FHLB stock. FHLB advances must be secured by specified types of collateral and may be obtained only for the purpose of providing funds to finance residential housing.

The FHLBs are required to provide funds for the resolution of insolvent savings institutions and to contribute funds for affordable housing