Ottawa Savings Bancorp, Inc.
Form 10-K
March 25, 2014

**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, 2013**

**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 0-51367**

**OTTAWA SAVINGS BANCORP, INC.**

**(Exact Name of Registrant as Specified in Charter)**

| | |
|---|---|
| **United States** | **20-3074627** |
| **(State or other Jurisdiction of Incorporation)** | **(I.R.S. Employer Identification No.)** |

| | |
|---|---|
| **925 LaSalle Street, Ottawa, Illinois** | **61350** |
| **(Address of Principal Executive Offices)** | **(Zip Code)** |

**Registrant's telephone number, including area code: (815) 433-2525**

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

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

**Common Stock, Par Value $0.01 per share**

**(Title of Class)**

Indicate by check mark if the registrant 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 issuer (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 (Section 232.405 of this chapter) 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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

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

Large Accelerated Filer

Accelerated Filer

Non-Accelerated filer (do not check if a smaller reporting company)

Smaller Reporting Company

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

As of June 30, 2013, the aggregate market value of the voting common equity held by non-affiliates of the registrant was approximately $6,817,113 (based on the last sale price of the common stock on the OTC Bulletin Board of $9.00 per share).

The number of shares of Common Stock of the registrant issued and outstanding as of March 25, 2014 was 2,117,979.

**DOCUMENTS INCORPORATED BY REFERENCE**

None

**OTTAWA SAVINGS BANCORP, INC.**

**Form 10-K for Fiscal Year Ended**

**December 31, 2013**

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## PART I

### Forward-Looking Statements

*This report includes forward-looking statements, including statements regarding our strategy, effectiveness of investment programs, evaluations of future interest rate trends and liquidity, expectations as to growth in assets, deposits and results of operations, future operations, market position, financial position, and prospects, plans and objectives of management. These forward-looking statements, which are based on certain assumptions and describe our future plans, strategies and expectations, can generally be identified by use of the words "believe," "expect," "intend," "anticipate," "estimate," "project," or similar expressions. Our ability to predict results or the actual effect of future plans or strategies is inherently uncertain and actual results may differ materially from those predicted in such forward-looking statements. A number of factors, some of which are beyond our ability to predict or control, could cause future results to differ materially from those contemplated. These factors include but are not limited to: recent and future bail out actions by the government; a further slowdown in the national and Illinois economies; a further deterioration in asset values locally and nationwide; volatility of rate sensitive deposits; changes in the regulatory environment; increasing competitive pressure in the banking industry; operational risks; asset/liability matching risks and liquidity risks; continued access to liquidity sources; changes in the securities markets; changes in our borrowers' performance on loans; changes in critical accounting policies and judgments; changes in accounting policies or procedures as may be required by the Financial Accounting Standards Board or other regulatory agencies; changes in the equity and debt securities markets; effect of additional provision for loan losses; fluctuations of our stock price; success of any acquisition or expansion strategies that we may undertake; impact of reputation risk created by these developments on such matters as business generation and retention, funding and liquidity; and political developments, wars or other hostilities that may disrupt or increase volatility in securities or otherwise affect economic conditions. The consequences of these factors, any of which could hurt our business, could include, among others: increased loan delinquencies; an escalation in problem assets and foreclosures; a decline in demand for our products and services; a reduction in the value of the collateral for loans made by us, especially real estate, which, in turn would likely reduce our customers' borrowing power and the value of assets and collateral associated with our existing loans; a reduction in the value of certain assets held by our company; an inability to meet our liquidity needs and an inability to engage in certain lines of business. These risks and uncertainties should be considered in evaluating forward-looking statements, and undue reliance should not be placed on such statements. Except to the extent required by applicable law or regulation the Company does not undertake any obligation to update any forward-looking statement to reflect circumstances or events that occur after the date the forward-looking statements are made. See also "Item 1A. Risk Factors" and other risk factors discussed elsewhere in this Annual Report.*

## ITEM 1. BUSINESS

### General

Ottawa Savings Bancorp, Inc. (the "Company") was incorporated under the laws of the United States on July 11, 2005, for the purpose of serving as the holding company of Ottawa Savings Bank (the "Bank"), as part of the Bank's conversion from a mutual to a stock form of organization. The Company is a publicly traded banking company with assets of $170.6 million at year-end 2013 and is headquartered in Ottawa, Illinois.

In 2005, the Board of Directors of the Bank unanimously adopted a plan of conversion providing for the conversion of the Bank from an Illinois chartered mutual savings bank to a federally chartered stock savings bank and the purchase of all of the common stock of the Bank by the Company. The depositors of the Bank approved the plan at a meeting held in 2005.

In adopting the plan, the Board of Directors of the Bank determined that the conversion was advisable and in the best interests of its depositors and the Bank. The conversion was completed in 2005 when the Company issued 1,223,701 shares of common stock to Ottawa Savings Bancorp MHC (a mutual holding company), and 1,001,210 shares of common stock to the public. As of December 31, 2013, Ottawa Savings Bancorp MHC holds 1,223,701 shares of common stock, representing 57.8% of the Company’s common shares outstanding.

The Bank’s business is to attract deposits from the general public and use those funds to originate and purchase one-to-four family, multi-family and non-residential real estate, construction, commercial and consumer loans, which the Bank primarily holds for investment. The Bank has continually diversified its products to meet the needs of the community.

**Business Strategy**

The Company's business strategy is to operate as a well-capitalized and profitable community savings bank dedicated to providing quality customer service and innovative new products. The Bank operates in a building with 21,000 square feet of office space, five drive-up lanes, and a separate ATM drive-up to provide quality customer service to customers in the community.

Highlights of our business strategy are as follows:

- Continue to emphasize the origination of one-to four-family mortgage loans;
- Aggressively market core deposits;
- Offer a broad range of financial products and services to both retail and commercial customers in the Bank's market area;
- Pursue opportunities to increase non-residential real estate and multi-family lending in the Bank's market area;
- Continue to utilize conservative underwriting guidelines to limit credit risk in the Bank's loan portfolio to achieve a high level of asset quality; and
- Consider expanding into new market areas to grow the Bank's business through the addition of new branch locations and/or through possible acquisitions.

**Market Area and Competition**

The Company is headquartered in Ottawa, Illinois, which is located in north-central Illinois approximately 80 miles southwest of Chicago. Its market area, which benefits from its proximity to Chicago, includes all of LaSalle County.

The Bank faces significant competition for the attraction of deposits and origination of loans. Our most direct competition for deposits and loans has historically come from the several financial institutions operating in our market area and, to a lesser extent, from other financial service companies, such as brokerage firms, credit unions, mortgage companies and mortgage brokers. Our main competitors include a number of significant independent banks. In addition, the Bank faces competition for investors' funds from money market funds and other corporate and government securities. Competition for loans also comes from the increasing number of non-depository financial service companies entering the mortgage and consumer credit market, such as securities companies and specialty finance companies. The Bank believes that its long-standing presence in Ottawa, Illinois and its personal service philosophy enhances its ability to compete favorably in attracting and retaining individual and business customers. The Company actively solicits deposit-related customers and competes for deposits by offering customers personal attention, professional service and competitive interest rates.

**Lending Activities**

*General.* Our loan portfolio consists primarily of one-to-four family residential mortgage loans. To a lesser extent, our loan portfolio includes multi-family and non-residential real estate, commercial, construction and consumer loans. Substantially all of our loans are made within our local market, excluding our purchased loan portfolio.

*Loan Portfolio Composition*. The following table sets forth the composition of our loan portfolio by type of loan as of the dates indicated, including a reconciliation of gross loans receivable after consideration of the undisbursed portion of construction loan funds, the allowance for loan losses and net deferred costs (fees).

| | **At December 31,** | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2013 | | 2012 | | 2011 | | 2010 | | 2009 | |
| | **(Dollars in Thousands)** | | | | | | | | | |
| | Amount | Percent Of Total | Amount | Percent Of Total | Amount | Percent Of Total | Amount | Percent Of Total | Amount | Percent Of Total |
| One-to-four family | $71,314 | 61.83 % | $75,609 | 60.24 % | $80,334 | 60.41 % | $82,442 | 58.75 % | $89,595 | 58.76 |
| Multi-family | 2,507 | 2.17 % | 4,629 | 3.69 % | 5,580 | 4.20 % | 6,237 | 4.44 % | 5,512 | 3.62 |
| Lines of credit | 10,941 | 9.49 % | 13,209 | 10.52 % | 14,219 | 10.69 % | 15,325 | 10.92 % | 14,540 | 9.54 |
| Non-residential real estate | 15,842 | 13.73 % | 18,897 | 15.06 % | 20,058 | 15.08 % | 20,362 | 14.51 % | 21,841 | 14.33 |
| Commercial | 4,075 | 3.53 % | 4,717 | 3.76 % | 5,965 | 4.49 % | 9,795 | 6.98 % | 10,528 | 6.90 |
| Construction | 2,111 | 1.83 % | 105 | 0.08 % | 982 | 0.74 % | 531 | 0.38 % | 3,858 | 2.53 |
| Consumer | 8,554 | 7.42 % | 8,353 | 6.65 % | 5,832 | 4.39 % | 5,637 | 4.02 % | 6,592 | 4.32 |
| Total loans, gross | 115,344 | 100.00 % | 125,519 | 100.00 % | 132,970 | 100.00 % | 140,329 | 100.00 % | 152,466 | 100.00 |
| Undisbursed portion of loan funds | (1,696 ) | | (56 ) | | (171 ) | | (178 ) | | (152 ) | |
| Allowance for loan losses | (2,910 ) | | (3,381 ) | | (4,747 ) | | (4,703 ) | | (3,515 ) | |
| Deferred loan costs (fees), net | (65 ) | | (87 ) | | (80 ) | | (97 ) | | (99 ) | |
| Total loans, net | $110,673 | | $121,995 | | $127,972 | | $135,351 | | $148,700 | |

Listed below are the outstanding balances of purchased loans, which have been included in the table above.

| | **At December 31,** | | | | |
|---|---|---|---|---|---|
| | 2013 | 2012 | 2011 | 2010 | 2009 |
| | **(In Thousands)** | | | | |
| One-to-four family | $648 | $697 | $754 | $796 | $668 |
| Multi-family | 645 | 2,332 | 2,405 | 2,465 | 1,797 |
| Non-residential real estate | 680 | 2,020 | 3,353 | 5,399 | 6,717 |
| Purchased auto loans (included in consumer loans above) | 8,162 | 7,810 | 5,179 | 4,658 | 5,017 |

| | | | | | |
|---|---|---|---|---|---|
| Total | $10,135 | $12,859 | $11,691 | $13,318 | $14,199 |

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*Maturity of Loan Portfolio*. The following tables show the remaining contractual maturity of our loans at December 31, 2013. The tables do not include the effect of possible prepayments or due on sale clause payments.

| | At December 31, 2013 | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| | One-to-four family | Multi-family | Lines of credit | Non-residential real estate | Commercial | Construction | Consumer | Total |
| | (In Thousands) | | | | | | | |
| Amounts due one year or less | $945 | $ 645 | $4,302 | $ 917 | $ 168 | $ 2,111 | $ 128 | $9,216 |
| After one year | | | | | | | | |
| More than one year to three years | 740 | - | 685 | 2,077 | 1,736 | - | 1,338 | 6,576 |
| More than three years to five years | 1,225 | 470 | 889 | 377 | 992 | - | 4,413 | 8,366 |
| More than five years to ten years | 5,598 | - | 3,872 | 2,894 | 870 | - | 2,632 | 15,866 |
| More than ten years to twenty years | 25,826 | 1,298 | 1,142 | 5,637 | 309 | - | 43 | 34,255 |
| More than twenty years | 36,980 | 94 | 51 | 3,940 | - | - | - | 41,065 |
| Total due after December 31, 2014 | 70,369 | 1,862 | 6,639 | 14,925 | 3,907 | - | 8,426 | 106,128 |
| Gross loans receivable | $71,314 | $ 2,507 | $10,941 | $ 15,842 | $ 4,075 | $ 2,111 | $ 8,554 | $115,344 |
| Less: | | | | | | | | |
| Undisbursed portion of loan funds | | | | | | | | (1,696 ) |
| Allowance for loan losses | | | | | | | | (2,910 ) |
| Deferred loan costs (fees), net | | | | | | | | (65 ) |
| Total loans, net | | | | | | | | $110,673 |

| | Due After December 31, 2014 | | |
|---|---|---|---|
| | Fixed | Adjustable | Total |
| | (In Thousands) | | |
| One-to-four family | $38,713 | $ 31,656 | $70,369 |
| Multi-family | 733 | 1,129 | 1,862 |
| Lines of credit | 270 | 6,369 | 6,639 |
| Non-residential real estate | 4,510 | 10,415 | 14,925 |
| Commercial | 3,598 | 309 | 3,907 |
| Consumer | 8,426 | - | 8,426 |
| Total | $56,250 | $ 49,878 | $106,128 |

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*Asset Quality.* Within our investment portfolio we have no subprime or Alt-A backed instruments among our securities. Historically, our lending activity has promoted home ownership in the communities we serve. Our consumer and residential mortgage loans are originated consistent with the underwriting approach described herein. This includes an assessment of each borrower’s personal financial condition, including a review of credit reports and related FICO scores as well as verification of income and assets. The Company does not conduct lending programs that target the subprime market. During the ordinary course of business to achieve our goal of being a community bank, we originate and manage loans in our portfolio to some borrowers with a risk of default higher than customers considered prime. Thus, the extended economic downturn may affect us indirectly, albeit to a lesser extent than it will likely impact those banks and thrifts that produced and retained significant portfolios that targeted such loans and securities. While we believed that the nature of our one-to-four family lending niche and our underwriting standards would limit the impact of the downward turn in the credit cycle on the quality of our assets—particularly in comparison with those institutions that were directly targeting subprime and Alt-A lending—the downturn in the credit cycle resulted in our experiencing higher levels of charge-offs and/or provisions for loan losses, which impacted our results of operations.

*One- to-Four Family Residential Loans*. Our primary lending activity is the origination of mortgage loans to enable borrowers to purchase or refinance existing homes or to construct new residential dwellings in our market area. We offer fixed-rate and adjustable-rate mortgage loans with terms up to 30 years. Borrower demand for adjustable-rate loans versus fixed-rate loans is a function of the level of interest rates, the expectations of changes in the level of interest rates, the difference between the interest rates and loan fees offered for fixed-rate mortgage loans and the initial period interest rates and loan fees for adjustable-rate loans. The relative amount of fixed-rate mortgage loans and adjustable-rate mortgage loans that can be originated or purchased at any time is largely determined by the demand for each in a competitive environment and the effect each has on our interest rate risk. The loan fees charged, interest rates, and other provisions of mortgage loans are determined by us on the basis of our own pricing criteria and competitive market conditions.

We offer fixed rate loans with terms of either 15, 20 or up to 30 years. We traditionally sell 30-year fixed rate loans into the secondary market, resulting in a fixed rate loan portfolio primarily composed of loans with less than 15 to 20 year terms. Our adjustable-rate mortgage loans are based on either a 15, 20 or up to 30 year amortization schedule and interest rates and payments on our adjustable-rate mortgage loans adjust every one, three or five years. Interest rates and payments on our adjustable-rate loans generally are adjusted to a rate that is based on the respective one, three, and five year monthly Constant Maturity Treasury indices (CMT). The maximum amount by which the interest rate may be increased or decreased is generally 1% to 2% per adjustment period, depending on the type of loan, and the lifetime interest rate ceiling is generally 5% over the initial interest rate of the loan. The initial and floor rates for owner occupied properties are 1.875%, 2.875% and 3.875% for the one, three and five year adjustable rate loans, respectively, and 2.875%, 3.875% and 4.875% for non-owner occupied one-to-four family properties, respectively, at this time.

Due to historically low interest rate levels, borrowers generally have preferred fixed-rate loans in recent years. While we anticipate that our adjustable-rate loans will better offset the adverse effects on our net interest income of an increase in interest rates as compared to fixed-rate mortgages, the increased mortgage payments required of adjustable-rate loans in a rising interest rate environment could cause an increase in delinquencies and defaults. The marketability of the underlying property also may be adversely affected in a high interest rate environment. In addition, although adjustable-rate mortgage loans help make our asset base more responsive to changes in interest rates, the extent of this interest rate sensitivity is limited by the annual and lifetime interest rate adjustment limits.

While one-to-four family residential real estate loans are normally originated with up to 30-year terms, such loans typically remain outstanding for substantially shorter periods because borrowers often prepay their loans in full upon sale of the property pledged as security or upon refinancing the original loan. Therefore, average loan maturity is a function of, among other factors, the level of purchase and sale activity in the real estate market, prevailing interest rates and the interest rates payable on outstanding loans.

We originate loans to individuals and purchase loans that finance the construction of residential dwellings for personal use. Our construction loans generally provide for the payment of interest only during the construction phase, which is usually ten months. At the end of the construction phase, most of our loans automatically convert to permanent mortgage loans. Construction loans generally can be made with a maximum loan to value ratio of 80% of the appraised value with maximum terms of 30 years. The largest outstanding residential construction loan at December 31, 2013 was $990,000, of which $237,000 was disbursed. We also require periodic inspections of the property during the term of the construction.

We generally do not make conventional loans with loan-to-value ratios exceeding 80%. Loans with loan-to-value ratios in excess of 80% generally require private mortgage insurance, government guarantee or additional collateral. We require all properties securing mortgage loans to be appraised by an independent appraiser approved by our Board of Directors and licensed by the State of Illinois. We require title insurance on all first mortgage loans. Borrowers must obtain hazard insurance, or flood insurance for loans on property located in a flood zone, before closing the loan.

We participate with the USDA Rural Development Company to offer loans to qualifying customers. Loans are granted up to 100% of appraised value and the USDA guarantees up to 80% of the loan. These loans require no down payment but are subject to maximum income limitations.

*Lines of Credit*. We offer lines of credit, principally home equity lines of credit, which have adjustable rates of interest that are indexed to the prime rate as published in *The Wall Street Journal* for terms of up to 20 years. These loans are originated with maximum loan-to-value ratios of 80% of the appraised value of the property, and we require that we have a second lien position on the property. We also offer secured and unsecured lines of credit for well-qualified individuals and small businesses. Management includes these loans based on the collateral supporting the line of credit in either the non-residential, multi-family, commercial or one-to-four family categories for the purposes of monitoring and evaluating the portfolio.

*Multi-Family and Non-Residential Real Estate Loans*. We offer fixed rate balloon and adjustable-rate mortgage loans secured by multi-family and non-residential real estate. Our multi-family and non-residential real estate loans are generally secured by condominiums, apartment buildings, single-family subdivisions and owner-occupied properties used for businesses.

We originate and purchase multi-family and non-residential real estate loans with terms generally up to 25 years. Interest rates and payments on adjustable-rate loans adjust every one, three and five years. Interest rates and payments on our adjustable rate loans generally are adjusted to a rate typically equal to the interest rate used for one- to- four family loan products, plus 50 basis points to 100 basis points based on credit-worthiness and risk. The adjustment per period is 1% to 2% based on the loan contract, to a lifetime cap of 5%. Loan amounts generally do not exceed 70% of the appraised value for well-qualified borrowers.

We originate and purchase land loans to individuals on approved residential building lots for personal use for terms of up to 15 years and to a maximum loan to value ratio of 80% of the appraisal value. Our land loans are adjustable loans with adjustments occurring every one, three and five years, based on the original contract. Interest rate adjustments are based on the CMT plus a spread. For adjustable loans in this class, the loans generally have a floor ranging from the initial rate up to 4.875%.

We also make non-residential loans for commercial development projects including condominiums, apartment buildings, single-family subdivisions, single-family speculation loans, as well as owner-occupied properties used for business. These loans provide for payment of interest only during the construction phase and may, in the case of an apartment or commercial building, convert to a permanent mortgage loan. In the case of a single family subdivision or construction or builder loan, as individual lots are sold, the principal balance is reduced by a minimum of 80% of the net lot sales price. In the case of a commercial construction loan, the construction period may be from nine months to two years. Loans are generally made to a maximum of 70% of the appraised value as determined by an appraisal of the property made by an independent licensed appraiser. We also require periodic inspections of the property during the term of the construction loan. The largest non-residential loan at December 31, 2013 was a troubled debt restructured loan from 2012 with a restructured balance of $1.8 million, of which $1.7 million is outstanding. This loan has been performing in accordance with its modified terms since it was restructured in December 2012 and will be returned to a performing status once scheduled principal payments begin. For adjustable loans in this category, there generally is an interest rate floor ranging from 3.75% to 6.00%.

Loans secured by multi-family and non-residential real estate generally have larger balances and involve a greater degree of risk than one-to-four family residential mortgage loans. Of primary concern in multi-family and non-residential real estate lending is the borrower’s credit-worthiness and the feasibility and cash flow potential of the project. Payments on loans secured by income producing properties often depend on successful operation and management of the properties. As a result, repayment of such loans may be subject, to a greater extent than residential real estate loans, to adverse conditions in the real estate market or the economy. In reaching a decision on whether to make a multi-family or non-residential real estate loan, we consider the net operating income of the property, the borrower’s expertise, credit history and profitability, and the value of the underlying property.

*Commercial Loans.* These loans consist of operating lines of credit secured by general business assets and equipment. We loan primarily to businesses with less than $5,000,000 in annual revenues. The operating lines of credit are generally short term in nature with interest rates tied to short term rates and adjustments occurring daily, monthly, or quarterly based on the original contract. For adjustable loans, there is an interest rate floor built in to them ranging from 3.75% to 6.00%. The equipment loans are typically made with maturities of less than five years and are priced with a fixed interest rate. The Bank has originated commercial loans from Bankers Healthcare Group in prior years. Bankers Healthcare Group specializes in loans to healthcare professionals of all specialties throughout the United States. These loans are primarily comprised of working capital and equipment loans. We underwrite these loans based on our criteria and service the loans in-house.

*Consumer Loans.* We offer a variety of consumer loans, which include auto, share loans and personal unsecured loans to our customer base and related individuals. Unsecured loans generally have a maximum borrowing limit of $25,000 and a maximum term of four years.

The procedures for underwriting consumer loans include an assessment of the applicant’s payment history on other debts and ability to meet existing obligations and payments on the proposed loans. Although the applicant’s credit-worthiness is a primary consideration, the underwriting process also includes a comparison of the value of the collateral, if any, to the proposed loan amount.

Consumer loans may entail greater risk than do residential mortgage loans, particularly in the case of consumer loans that are unsecured or secured by assets that depreciate rapidly. In such cases, repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment for the outstanding loan and the remaining deficiency often does not warrant further substantial collection efforts against the borrower. In addition, consumer loan collections depend on the borrower’s continuing financial stability, and therefore are more likely to be adversely affected by job loss, divorce, illness, or personal bankruptcy. Furthermore, the application of various federal and state laws, including federal and state bankruptcy and insolvency laws may limit the amount which can be recovered on such loans.

*Purchased Auto Loans*. The Bank purchases auto loans from regulated financial institutions. At December 31, 2013 and 2012, we had $8.2 million and $7.8 million of loans outstanding, respectively. These types of loans are primarily low balance individual auto loans. We have the opportunity to review the loans at least three days prior to our purchase and we have a right to refuse any specific loan within thirty days of the purchase of any given loan pool. During 2013, we purchased $4.0 million of auto loans.

*Loan Origination, Purchases and Sales*. Loan originations come from a number of sources. The primary source of loan originations are our in-house loan originators, and to a lesser extent, advertising and referrals from customers. We occasionally purchase loans or participation interests in loans. As of December 31, 2013, we had an aggregate of $10.1 million in purchased loan participations outstanding, including the auto loans purchased as discussed in the previous paragraph. The largest outstanding loan participation as of December 31, 2013 was a non-residential real estate loan for $0.7 million. This loan is performing in accordance with its terms.

We sell some of the longer-term fixed-rate one-to-four family mortgage loans that we originate in the secondary market based on prevailing market interest rate conditions, an analysis of the composition and risk of the loan portfolio, liquidity needs and interest rate risk management goals. Generally, loans are sold without recourse and with servicing retained. We sold $5.4 million and $8.4 million of loans in the years ended December 31, 2013 and 2012, respectively. We occasionally sell participation interests in loans and may sell loan participations in the future.

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The following table shows our loan originations, purchases, sales and repayment activities for the periods indicated.

| | For The Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| | **2013** | **2012** | **2011** | **2010** | **2009** |
| | **(In Thousands)** | | | | |
| Beginning balance, net | $121,995 | $127,972 | $135,351 | $148,700 | $156,444 |
| Loans originated | | | | | |
| One-to-four family | 9,686 | 12,924 | 5,666 | 19,872 | 25,587 |
| Multi-family | 19 | 77 | 129 | 562 | 2,245 |
| Lines of credit | 987 | 381 | 1,799 | 530 | 5,315 |
| Non-residential real estate | 3,182 | 3,888 | 4,015 | 1,085 | 2,196 |
| Commercial | 458 | 285 | 335 | 8,287 | 7,738 |
| Construction | 2,111 | 105 | 982 | 668 | 710 |
| Consumer | 248 | 265 | 190 | 481 | 961 |
| Total loans originated | 16,691 | 17,925 | 13,116 | 31,485 | 44,752 |
| Loans purchased | | | | | |
| One-to-four family | - | - | - | - | - |
| Multi-family | - | - | - | - | 4 |
| Non-residential real estate | - | - | - | - | 895 |
| Commercial | - | - | - | - | - |
| Consumer | 4,048 | 5,847 | 3,050 | 2,003 | - |
| Total loans purchased | 4,048 | 5,847 | 3,050 | 2,003 | 899 |
| Loan sales(1) | (5,324) | (8,333) | (598) | (8,713) | (14,772) |
| Principal payments | (25,590) | (22,890) | (22,927) | (36,912) | (37,658) |
| Change in allowance for loan losses | 471 | 1,366 | (44) | (1,188) | (1,910) |
| Change in undisbursed loan funds | (1,640) | 115 | 7 | (26) | 962 |
| Change in deferred loan costs (fees), net | 22 | (7) | 17 | 2 | (17) |
| Ending balance, net | $110,673 | $121,995 | $127,972 | $135,351 | $148,700 |

(1) All loan sales were one-to-four family loans.

*Loan Approval Procedures and Authority*. Our lending activities follow written, non-discriminatory underwriting standards and loan origination procedures established by our Board of Directors and management.

For one-to-four family loans and owner occupied residential loans, our President may approve loans up to $400,000 and two members of our Board of Directors must approve loans over $400,000. Residential loans and all commercial loans above $400,000 up to $1 million in the aggregate to any borrower(s) must be approved by a majority of our inside loan committee. This committee consists of our President, Vice President and our Commercial Banking Officer. For loans to any borrower(s) in the aggregate of more than $1 million up to $2 million, approval is required by a majority of our level two loan committee, which consists of the inside loan committee, one designated outside director and our Chairman of the Board. For loan requests above $2 million in the aggregate to any borrower(s), approval is required by a majority of the Board of Directors level loan committee, which consists of the inside loan committee and the Bank's Board of Directors as a whole.

*Loans to One Borrower*. The maximum amount that we may lend to one borrower and the borrower's related entities is limited by regulation to generally 15% of our stated capital and reserves. At December 31, 2013, our regulatory maximum was $3.3 million.

*Loan Commitments*. We issue commitments for fixed-rate and adjustable-rate mortgage loans conditioned upon the occurrence of certain events. Commitments to originate mortgage loans are legally binding agreements to lend to our customers and generally expire in 45 days.

*Delinquencies*. When a borrower fails to make a required loan payment, we take a number of steps to have the borrower cure the delinquency and restore the loan to current status. We make initial contact with the borrower when the loan becomes 10 days past due. If payment is not then received by the 30$^{th}$ day of delinquency, additional letters are sent and phone calls generally are made to the customer by the Vice President or President. When the loan becomes 60 days past due, we generally commence foreclosure proceedings against any real property that secures the loan or attempt to repossess any personal property that secures a consumer loan. If a foreclosure action is instituted and the loan is not brought current, paid in full, or refinanced before the foreclosure sale, the real property securing the loan generally is sold at foreclosure. We may consider loan workout arrangements with certain borrowers under certain circumstances.

Management informs the Board of Directors on a monthly basis of the amount of loans delinquent more than 60 days, all loans in foreclosure and all foreclosed and repossessed property that we own.

**Delinquent Loans**

The following table presents information with respect to the delinquent loans at the dates indicated.

| | **December 31, 2013** | | | | | |
|---|---|---|---|---|---|---|
| | **60-89 Days** | | **90 Days or More** | | **Total** | |
| | **(Dollars in Thousands)** | | | | | |
| | **Number of Loans** | **Principal Balance** | **Number of Loans** | **Principal Balance** | **Number of Loans** | **Principal Balance** |
| One-to-four family | 5 | $ 429 | 10 | $ 1,451 | 15 | $ 1,880 |
| Multi-family | - | - | - | - | - | - |
| Lines of credit | 2 | 64 | 2 | 162 | 4 | 226 |
| Non-residential real estate | 2 | 428 | 2 | 319 | 4 | 747 |
| Construction | - | - | - | - | - | - |
| Consumer | - | - | - | - | - | - |
| Total | 9 | $ 921 | 14 | $ 1,932 | 23 | $ 2,853 |

| | **December 31, 2012** | | | | | |
|---|---|---|---|---|---|---|
| | **60-89 Days** | | **90 Days or More** | | **Total** | |
| | **(Dollars in Thousands)** | | | | | |
| | **Number of Loans** | **Principal Balance** | **Number of Loans** | **Principal Balance** | **Number of Loans** | **Principal Balance** |
| One-to-four family | 5 | $ 616 | 8 | $ 613 | 13 | $ 1,229 |
| Multi-family | - | - | - | - | - | - |
| Lines of credit | - | - | 3 | 1,009 | 3 | 1,009 |
| Non-residential real estate | 1 | 335 | 3 | 516 | 4 | 851 |
| Construction | - | - | - | - | - | - |
| Commercial | - | - | - | - | - | - |
| Consumer | 1 | 19 | - | - | 1 | 19 |

| | | | | | | |
|---|---|---|---|---|---|---|
| Total | 7 | $ 970 | 14 | $ 2,138 | 21 | $ 3,108 |

| | **December 31, 2011** | | | | | |
|---|---|---|---|---|---|---|
| | **60-89 Days** | | **90 Days or More** | | **Total** | |
| | **(Dollars in Thousands)** | | | | | |
| | **Number of Loans** | **Principal Balance** | **Number of Loans** | **Principal Balance** | **Number of Loans** | **Principal Balance** |
| One-to-four family | 3 | $ 849 | 25 | $ 2,459 | 28 | $ 3,308 |
| Multi-family | - | - | 1 | 305 | 1 | 305 |
| Lines of credit | - | - | 7 | 1,980 | 7 | 1,980 |
| Non-residential real estate | 1 | 57 | 5 | 709 | 6 | 766 |
| Construction | - | - | - | - | - | - |
| Commercial | - | - | 1 | 7 | 1 | 7 |
| Consumer | 2 | 43 | 2 | 5 | 4 | 48 |
| Total | 6 | $ 949 | 41 | $ 5,465 | 47 | $ 6,414 |

| | December 31, 2010 | | | | | |
|---|---|---|---|---|---|---|
| | 60-89 Days | | 90 Days or More | | Total | |
| | (Dollars in Thousands) | | | | | |
| | Number of Loans | Principal Balance | Number of Loans | Principal Balance | Number of Loans | Principal Balance |
| One-to-four family | 9 | $ 1,948 | 31 | $ 3,622 | 40 | $ 5,570 |
| Multi-family | - | - | - | - | - | - |
| Lines of credit | 4 | 228 | 6 | 401 | 10 | 629 |
| Non-residential real estate | 2 | 184 | 8 | 1,248 | 10 | 1,432 |
| Construction | - | - | - | - | - | - |
| Commercial | - | - | 1 | 20 | 1 | 20 |
| Consumer | 3 | 23 | - | - | 3 | 23 |
| Total | 18 | $ 2,383 | 46 | $ 5,291 | 64 | $ 7,674 |

| | December 31, 2009 | | | | | |
|---|---|---|---|---|---|---|
| | 60-89 Days | | 90 Days or More | | Total | |
| | (Dollars in Thousands) | | | | | |
| | Number of Loans | Principal Balance | Number of Loans | Principal Balance | Number of Loans | Principal Balance |
| One-to-four family | 11 | $ 777 | 26 | $ 3,856 | 37 | $ 4,633 |
| Multi-family | - | - | - | - | - | - |
| Lines of credit | 2 | 139 | 6 | 248 | 8 | 387 |
| Non-residential real estate | 2 | 153 | 7 | 2,020 | 9 | 2,173 |
| Construction | - | - | - | - | - | - |
| Consumer | 2 | 1 | 3 | 25 | 5 | 26 |
| Total | 17 | $ 1,070 | 42 | $ 6,149 | 59 | $ 7,219 |

*Classified Assets*. Federal Deposit Insurance Corporation regulations and our Asset Classification Policy provide that loans and other assets considered to be of lesser quality be classified 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. We classify an asset as “special mention” if the asset has a potential weakness that warrants management's close attention. While such assets are not impaired, management has concluded that if the potential weakness in the asset is not addressed, the value of the asset may deteriorate, adversely affecting the repayment of the asset. Loans classified as impaired for financial reporting purposes are generally those loans classified as substandard or doubtful for regulatory reporting purposes.

An insured institution is required to establish allowances for loan losses in an amount deemed prudent by management for loans classified substandard or doubtful, as well as for other problem loans. General allowances represent loss allowances which have been established to recognize the inherent losses associated with lending activities, but which, unlike specific allowances, have not been allocated to particular problem assets. When an insured institution classifies problem assets as "loss," it is required to charge off such amounts. An institution's determination as to the classification of its assets and the amount of its valuation allowances is subject to review by the Office of the Comptroller of the Currency ("OCC").

On the basis of management's review of its assets, at December 31, 2013 and 2012, we had classified $3.4 million and $4.4 million, respectively, of our assets as special mention and $5.8 million and $5.6 million, respectively, of our assets as substandard. We had classified none of our assets as doubtful at December 31, 2013 and December 31, 2012. There were no assets classified as loss for the years ended December 31, 2013 or 2012. The loan portfolio is reviewed on a regular basis to determine whether any loans require classification in accordance with applicable regulations. Not all classified assets constitute non-performing assets.

As the economic downturn continued in our market during 2013 and foreclosures and liquidations as a manner of reducing non-performing assets proved costly, the Company continued its restructuring process with respect to certain non-performing loans that provided for restructuring of the terms of the loan due to economic or legal reasons