

FEDERAL TRUST CORP  
Form 10-K  
March 16, 2006

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**U.S. SECURITIES AND EXCHANGE COMMISSION**  
Washington, D.C. 20549

**FORM 10-K**

(Mark One)

- Annual report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 for the fiscal ended December 31, 2005.**
- Transition report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from \_\_\_\_\_ to \_\_\_\_\_.**

Commission file number: 33-27139.

**FEDERAL TRUST CORPORATION**

*(Exact name of registrant as specified in its charter)*

**Florida**

**59-2935028**

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*(State or other jurisdiction of incorporation or organization)*

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

**312 West 1<sup>st</sup> Street  
Sanford, Florida**

**32771**

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*(Address of principal executive office)*

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*(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**

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*(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

Note - Checking the box above will not relieve any registrant required to file reports pursuant to section 13 or 15(d) of the Exchange Act from their obligations under those Sections.

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

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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 no be contained, to the best of registrant's knowledge, indefinite proxy or information statements incorporated by reference in Part III of the Form 10-K or any amendment to the Form 10-K.

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

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act).

YES  NO

Revenues for the fiscal year ended December 31, 2005: \$36,510,000

The aggregate market value of the common stock of the Registrant held by non-affiliates of the Registrant (7,300,245 shares) on June 30, 2005, was approximately \$81,763,000. The closing price of Registrant's common stock on June 30, 2005 was \$11.20 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 3, 2006 was 8,299,343 shares.

DOCUMENTS INCORPORATED BY REFERENCE:

1. Portions of the Proxy Statement for the 2006 Annual Meeting of Shareholders filed electronically with the Securities and Exchange Commission on or about April 15, 2006. (Part III)
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<sup>(1)</sup> 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-K.

**PART I**

**ITEM 1. 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 essentially has two operating subsidiaries, the Bank and Federal Trust Mortgage Company (the Mortgage Company ) collectively referred to as the Subsidiaries. Federal Trust and its Subsidiaries are collectively referred to herein as the Company. 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 its Subsidiaries. Federal Trust 's corporate headquarters are located at 312 West 9<sup>th</sup> Street, Sanford, Florida 32771, and its telephone number is (407) 323-1833. To date, 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.

**Subsidiaries**

*Federal Trust Bank* is chartered as a Federal-stock savings bank and is primarily engaged in the business of obtaining funds in the form of customer deposits and Federal Home Loan Bank ( FHLB ) advances and investing such funds in permanent loans on residential and commercial real estate and, secondarily in various types of construction, commercial 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.

*Federal Trust Mortgage Company* was formed in May 2005 as a wholly owned subsidiary of Federal Trust. The Mortgage Company commenced operations on January 2, 2006 to provide residential loan products for customers of the Bank, to produce mortgage loans to be sold to third party purchasers, to buy and sell mortgages in the secondary market and to service the residential loan portfolio of the Bank. When the Mortgage Company commenced operations in January 2006, the mortgage origination and servicing staff of the Bank were transferred to the Mortgage Company.

*Federal Trust Statutory Trust I (the Statutory Trust I )* - was formed in September 2003, 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.

**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 sensitive accounting measurement we applied is related to the valuation of the loan portfolio and the adequacy of the allowance for loan losses.

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to; (1) the length of time and the extent to which fair value has been less than cost; (2) the financial condition and near-term prospects of the issuer; and (3) our intent and ability to retain the investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

During 2004, we recorded an other-than-temporary impairment write-down of approximately \$1,055,000. The charge related to our \$9.5 million investment in Freddie Mac and Fannie Mae adjustable rate preferred stock, which is included in our investment securities, available for sale portfolio. These investment grade securities declined in value in 2004 due to the recent events at Freddie Mac and Fannie Mae, coupled with the record low interest rates which caused the dividend payment to decline from the original rates at the time of issuance. During 2005, we sold 42,000 shares of Freddie Mac and Fannie Mae preferred stock with a total book value of \$2.0 million and recognized a net loss on the sales of less than \$6,000. At December 31, 2005, the Bank's carrying value of the remaining Freddie Mac and Fannie Mae preferred stock was \$6.4 million and the market value was \$6.0 million. We believe that the value of these investments will recover in the future, and we determined that no additional other-than-temporary impairment was necessary at December 31, 2005.

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 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.

Large 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 except in the case of delinquencies. 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. 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 the allowance for loan losses is adequate to absorb estimated loan losses associated with the loan portfolio at December 31, 2005. 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, including the risks described in Item 1A of this Form 10-K. 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 identify 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 operating strategy has been and continues to be focused on building a strong community bank branch network serving Central Florida with competitive deposit products, which fund the origination and acquisition of residential mortgage loans, and the expansion of our commercial real estate loan portfolio. Residential loans are typically secured by a first mortgage on a dwelling and commercial loans are secured by real estate located and operated primarily in our market area and where appropriate, the working assets of the borrower (such as accounts receivable, inventory, and equipment). We also provide loans to consumers secured by the equity in their homes.

Our lending activities are funded through core deposit generation fostered by branch expansion, borrowings from the Federal Home Loan Bank, and in the brokered deposit market when rates are favorable. 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 is interest on loans, securities, and overnight deposits, fees on checking and loan accounts and sales of loans and investments held for sale. Our principal expenses are interest paid on deposits and other borrowings, personnel and operating expenses.

### **Market Area and Competition**

We have seven full-service branch offices located in: in Sanford, Winter Park, New Smyrna Beach, Casselberry, Deltona, Orange City and Lake Mary, Florida. Sanford, which is located approximately 20 miles northeast of downtown Orlando, is the second largest city in Seminole County and is the county seat. Winter Park is located 13 miles southeast of Sanford and approximately 7 miles northeast of downtown Orlando. The greater metropolitan Orlando area encompasses Orange, Seminole, Lake, and Osceola Counties in Central Florida. The total population of the four County areas is estimated at 1.9 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. The Casselberry and Lake Mary branches are located in Seminole County between our Sanford and Winter Park Offices. Deltona and Orange City are both located in the Western part of Volusia County along the Interstate 4 corridor between Orlando and Daytona Beach. Our administrative and operation offices are housed 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 makes 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 most recent relocation being The Home Depot Supply, a division of The Home Depot. The Home Depot acquired Hughes Supply, Inc., which is headquartered in Orlando, Florida.

The area is also home to the University of Central Florida with an enrollment of 44,000, 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. In addition, Stetson University, Florida's first private university is located in Volusia County.

We experience substantial competition in attracting and retaining deposits and in lending funds. The primary factors in competing for deposits are customer service, branch locations and 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 loan structure, interest rates and loan origination fees. 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 remained constant over the past several years. As of June 30, 2005, the four largest banking institutions in the state controlled approximately 52% of the bank deposits. In 1995, the four largest controlled less than 29% of the deposits. In the past three years, the three largest financial institutions headquartered in Central Florida have been acquired by institutions headquartered outside of the state. Federal Trust is now one of the largest independent financial institutions with headquarters and all of our branch locations in the Central Florida market place. At the same time that we have seen continued consolidation of the local community banks, and seasoned banking executives spearhead the formation of new community banks with aggressive capital and growth plans.

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 consolidate its interstate subsidiary banks into branches and merge with a bank in another state, depending on state laws.

#### **Lending Activities**

**General.** Our residential lending has traditionally included the origination, purchase and sale of mortgage loans for acquiring or constructing residential real property, primarily secured by first liens on such property. Beginning in January 2006, the residential origination and underwriting functions were transferred to the Mortgage Company. These loans are typically conventional home loans or lot loans which are not insured by the Federal Housing Agency (FHA) or partially secured by the Veterans Administration (VA). Loans with fixed rates beyond five years are generally sold into the secondary market. Loans with fixed rates of five years or less are generally considered for portfolio. Interest rates for construction loans are generally tied to the prime rate and float daily during the construction period and are converted to either fixed or adjustable permanent mortgages upon completion. To a lesser extent, we also make home equity loans which generally float daily with the prime rate. Other consumer related loans are savings loans secured by certificates of deposit at an interest rate above the rate paid on the certificate.

Over the past four years, we have increased our attention toward commercial real estate lending and cross marketing of business accounts. Commercial loans are comprised of loans to small businesses secured by real estate used in the enterprise and, where appropriate, the working assets of the business. We also make commercial real estate loans for the acquisition and development of undeveloped land, and income producing properties. Commercial loans are priced on a floating prime rate basis or fixed at repricing intervals not to exceed five years. As a matter of policy, commercial loans are guaranteed by the borrowers' principals.

**Credit Risk.** Since our primary business is the origination and acquisition of loans, that activity entails potential credit losses which are beyond our control, the magnitude of which depends on a variety of economic factors affecting borrowers. While guidelines have been instituted and credit review procedures have been put into place to protect us from credit losses, some losses may inevitably occur. During 2005, we recognized only \$8,000 in charge-offs, net of recoveries from prior charge-offs.

**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 \$630.8 million at December 31, 2005, representing 86% of total assets at such date. At December 31, 2004, our net loan portfolio was \$521.3 million or 86% of total assets.

Residential mortgage loans, not including construction and lot loans, still comprise the largest group of loans in our loan portfolio, amounting to \$400 million or 63% of the total loan portfolio at December 31, 2005, compared to \$374.6 million or 71% of the total loan portfolio at December 31, 2004. We offer and purchase adjustable rate mortgage ( ARM ) loans with maturities up to 30 years. As of December 31, 2005, approximately 98% of these loans were ARM loans and 2% of our residential loans were fixed-rate. Fixed-rate loans are generally underwritten to secondary market standards to insure liquidity and interest rate risk protection. Residential lot loans amounted to \$40.2 million or 6% of total loans at December 31, 2005. These loans are secured by developed lots ready for construction of single-family homes. Residential construction loans amounted to \$40.4 million or 6% of total loans. These loans are generally on property throughout Central Florida and are underwritten directly to the individual or family for their primary residence or second home.

Commercial real estate secured loans amounted to \$71.3 million or 11% of the total loan portfolio at December 31, 2005. This portfolio includes loans to businesses to finance their office, manufacturing or retail facilities. Commercial land, development and construction loans amounted to \$62.7 million or 10% of total loans. The land loans are generally larger parcels of property held for future development. The development and construction loans include loans for the acquisition and development of both residential and commercial projects. The construction loans are made directly to the builders of single and multi-family homes for pre-sold or speculative units. We also finance the construction of commercial facilities, generally for the owner/operator.

Commercial loans at December 31, 2005, were \$21.3 million or 3% of total loans. These 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.

Consumer loans, consisting of installment loans and savings account loans at December 31, 2005, were \$447,000 or less than 1% of the total loan portfolio.



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The following table sets forth information on our loan portfolio by type (in thousands):

At December 31,

	2005		2004		2003		2002		2001	
	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total
<b>Residential Lending:</b>										
Mortgages	\$ 399,973	62.8%	\$ 374,581	70.8%	\$ 302,083	75.4%	\$ 246,235	79.2%	\$ 203,729	74.2%
Lot Loans	40,203	6.3	41,369	7.8	20,816	5.2	8,742	2.8	5,534	2.0
Construction	40,437	6.4	5,405	1.0	780	0.2	1,822	0.6	8,760	3.2
<b>Total Residential lending</b>	<b>480,613</b>	<b>75.5</b>	<b>421,355</b>	<b>79.6</b>	<b>323,679</b>	<b>80.8</b>	<b>256,799</b>	<b>82.6</b>	<b>218,023</b>	<b>79.4</b>
<b>Commercial Lending:</b>										
<b>Real Estate</b>										
Secured	71,253	11.1	56,267	10.6	47,918	12.0	32,061	10.3	26,782	9.9
<b>Land, Development and Construction</b>										
Commercial loans	21,340	3.4	13,257	2.5	11,639	2.9	6,568	2.1	3,078	1.1
<b>Total Commercial lending</b>	<b>155,302</b>	<b>24.4</b>	<b>107,615</b>	<b>20.3</b>	<b>76,081</b>	<b>19.0</b>	<b>53,227</b>	<b>17.1</b>	<b>53,311</b>	<b>19.5</b>
Consumer Loans	447	0.1	657	0.1	864	0.2	969	0.3	3,111	1.1
<b>Total loans</b>	<b>636,362</b>	<b>100.0%</b>	<b>529,627</b>	<b>100.0%</b>	<b>400,624</b>	<b>100.0%</b>	<b>310,995</b>	<b>100.0%</b>	<b>274,445</b>	<b>100.0%</b>
<b>Add (deduct):</b>										
Allowance for loan losses	(4,477)		(3,835)		(2,779)		(2,110)		(1,765)	
Net premiums, discounts, deferred fees and costs	4,584		3,524		3,346		2,902		2,320	
Loans in process	(5,642)		(7,985)		(2,790)		(3,189)		(10,813)	
<b>Net loans</b>	<b>\$ 630,827</b>		<b>\$ 521,331</b>		<b>\$ 398,401</b>		<b>\$ 308,598</b>		<b>\$ 264,187</b>	

**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 us 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, decreases when rates on existing mortgages are substantially higher than current mortgage loan rates. Residential lot loans generally mature in less than five years and are typically repaid or convert to a construction loan when the owner begins construction of the residence. Construction loans generally mature in one year or less.

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The following table shows the contractual maturities of the Bank's loan portfolio at December 31, 2005. 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 (in thousands):

	<u>Residential</u>	<u>Commercial</u>	<u>Consumer</u>	<u>Total Loans</u>
Amounts due:				
Within 1 year	\$ 11,057	\$ 74,727	\$ 122	\$ 85,906
1 to 3 years	34,895	47,031	294	82,220
3 to 5 years	34,299	25,045	31	59,375
5 to 10 years	44,569	5,229		49,798
10 to 20 years	106,717	3,115		109,832
Over 20 years	249,076	155		249,231
Total due after 1 year	469,556	80,575	325	550,456
Total amounts due	\$ 480,613	\$ 155,302	\$ 447	\$ 636,362

**Loans Due After December 31, 2006.** The following table sets forth at December 31, 2005, the dollar amount of all loans due after December 31, 2006, classified according to whether such loans have fixed or adjustable interest rates (in thousands):

	<u>Due after December 31, 2006</u>		
	<u>Fixed</u>	<u>Adjustable</u>	<u>Total</u>
Residential lending	\$ 12,833	\$ 456,723	\$ 469,556
Commercial lending	17,824	62,751	80,575
Consumer loans	40	285	325
Total	\$ 30,697	\$ 519,759	\$ 550,456

**Purchase, Origination, and Sale of Loans.** Florida has historically experienced a rate of population growth in excess of national averages. The real estate development and construction industries in Florida, however, have been sensitive to cyclical changes in economic conditions and the demand for and supply of residential units. In 2005, the demand for real estate mortgage loans remained strong, but could be affected as real estate values or interest rates continue to rise.

Our loan portfolio consists of purchased and originated loans. When loans are acquired in the secondary market, we generally purchase loan packages of \$2 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 the Bank and the Mortgage Company 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. In addition, if the size of a particular loan request exceeds our legal or internal lending limit, we may sell a participation in that loan to a correspondent bank. From time to time, we also purchase participations from our correspondents.

Commercial and commercial real estate loan originations are primarily attributable to Bank loan officers and referrals from existing customers, while consumer loan originations are attributable largely to depositors and walk-in customers and referrals. All loan applications are evaluated by 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.

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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,

	2005	2004	2003	2002	2001
<b>Originations:</b>					
<b>Mortgage loans:</b>					
Loans on existing property	\$ 51,285	\$ 62,999	\$ 44,416	\$ 97,263	\$ 67,728
Land, Development and Construction loans	64,197	66,719	20,681	27,674	67,678
<b>Total mortgage loans</b>	<b>115,482</b>	<b>129,718</b>	<b>65,097</b>	<b>124,937</b>	<b>135,406</b>
Commercial loans	8,555	7,337	12,373	15,187	5,751
Consumer loans	478	635	701	529	2,469
<b>Total loans originated</b>	<b>124,515</b>	<b>137,690</b>	<b>78,171</b>	<b>140,653</b>	<b>143,626</b>
Purchases	207,136	178,482	176,828	97,897	53,933
<b>Total loans originated and purchased</b>	<b>\$ 331,651</b>	<b>\$ 316,172</b>	<b>\$ 254,999</b>	<b>\$ 238,550</b>	<b>\$ 197,559</b>
<b>Sales and principal repayments:</b>					
Loans sold	(24,407)	(28,632)	(39,560)	(28,072)	(33,764)
Principal repayments	(200,509)	(158,537)	(125,810)	(173,928)	(123,035)
<b>Total loans sold and principal repayments</b>	<b>\$ (224,916)</b>	<b>\$ (187,169)</b>	<b>\$ (165,370)</b>	<b>\$ (202,000)</b>	<b>\$ (156,799)</b>
<b>Increase in total loans (before net items)</b>	<b>\$ 106,735</b>	<b>\$ 129,003</b>	<b>\$ 89,629</b>	<b>\$ 36,550</b>	<b>\$ 40,760</b>

**Loan Underwriting.** Our 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 Loan Committee of the Board of Directors. Loan approvals are made in accordance with delegated authority levels 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 \$4,000,000 require the concurrence of three or more authorized officers. Loans greater than \$4,000,000 require approval of the Board of Directors' 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 loan review process is in place. Additionally, our external auditor and the OTS perform independent testing of the Bank's underwriting and credit quality.

**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.

While our policy is to lend up to 80% of appraised value, we are permitted to lend up to 100% of the appraised value of real property securing a residential 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. Loans that exceed our policy are monitored, reported to the Board and will not exceed our regulatory limits.

The maximum amount that could have been loaned by the Bank to one borrower and the borrower's related entities at December 31, 2005, was approximately \$8.3 million. We have no loans in our portfolio that exceed our loans to one borrower limit.

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.

Federal savings and loan association regulations permit the Bank to invest in loans secured by non-residential or commercial real estate up to four times our regulatory capital. At December 31, 2005, this limit allowed us to invest in non-residential or commercial real estate loans in an aggregate amount up to \$200.1 million. At such date, we had \$71.3 million in loans secured by non-residential or commercial real estate.

The risk of non-payment of loans is inherent in all loans. To address this risk, we carefully evaluate all loan applicants and attempt to minimize our credit risk exposure by use of thorough loan application and approval procedures that we have established for each category of loan. In determining whether to make a loan, we consider the borrower's credit history, analyze the borrower's income and ability to service the loan, and evaluate the need for collateral to secure recovery in the event of default. An allowance for loan losses is maintained based upon assumptions and judgments regarding the ultimate collectability of loans in our portfolio and a percentage of the outstanding balances of specific loans when their ultimate collectability is considered questionable.

**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 other financial institutions. At December 31, 2005, we were servicing \$69.3 million in loans for other institutions, which produces servicing income, net of amortization of mortgage servicing rights. During 2002, we made a strategic decision to have a third party begin servicing our residential mortgage loans. 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, we attempt to collect the payment by contacting the borrower through our in-staff commercial loan officers or through our third party servicer for residential loans. If a payment on a loan has not been received by the end of a grace period, 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.

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If foreclosure is affected, the property is sold at a public auction in which we typically 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, 2005, we had no loans to facilitate the sale of foreclosed assets.

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 as soon as it is determined that repayment of all principal and interest is not likely, however, not later than 90 days past due.

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 loan losses.

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 (in thousands):

	At December 31,				
	2005	2004	2003	2002	2001
Non-accrual loans:					
Mortgage:					
Construction	\$ 158	\$ 5	\$ 229	\$ 293	\$ 418
Residential	1,240	1,862	6,167	5,221	2,629
Commercial					481
Total mortgage	1,398	1,867	6,396	5,514	3,528
Commercial loans	720	720			39
Consumer loans		13		65	22
Total non-accrual	\$ 2,118	\$ 2,600	\$ 6,396	\$ 5,579	\$ 3,589
Total non-accrual loans to total loans	0.3%	0.5%	1.6%	1.8%	1.3%
Total non-accrual loans to total assets	0.3%	0.4%	1.4%	1.5%	1.2%
Total allowance for loss to total non-accrual loans	211.4%	147.5%	43.4%	37.8%	49.2%
Total foreclosed assets	\$ 556	\$ 326	\$ 1,007	\$ 858	\$ 714
Total non-accrual loans and foreclosed assets to total assets	0.4%	0.5%	1.6%	1.7%	1.4%

At December 31, 2005, we 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 \$2.1million and \$2.6 million at December 31, 2005 and 2004, respectively. For the year ended December 31, 2005, interest income that would have been recorded under the original terms of non-accrual loans and interest income actually recognized is summarized below (in thousands):

Interest income that would have been recorded	\$ 208
Interest income recognized	132
Interest income foregone	\$ 76



**Classified Assets Potential Problem Loans.** Federal regulations and the Bank's policies 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.

At December 31, 2005, there were six loans for a total of \$2.4 million that were graded special mention and 28 loans for \$5.4 million classified substandard. There were no loans graded doubtful or loss at December 31, 2005.

#### **Loan Review**

The Bank conducts an internal review of the portfolio on a quarterly basis and requires updated financial statements and income tax returns yearly. Then based on its inspection, the Bank grades its major loans on classifications as outlined above.

#### **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 2005, our gross loans increased by \$106.7 million and management charged \$650,000 to our provision for loan losses. Also during 2005, we recognized \$10,000 in charge-offs against our allowance, but collected \$2,000 in recoveries from prior charge-offs.

While we believe that our allowance for loan losses is adequate as of December 31, 2005, 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, commercial real estate, land and development loans, the composition of our loan portfolio continues to be concentrated primarily in 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 our 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 our primary regulator, the OTS, which will periodically review the loan portfolio and assess the adequacy of the allowance for loan losses.

### **Allowance for Loan Losses**

A number of factors are considered when establishing our allowance for loan losses. 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; land development and construction loans; 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. Provisions for loan losses are debited or credited in order to bring the allowance for loan losses to the required level as determined above.

At December 31, 2005, the allowance for loan losses was \$4.5 million, or 211.3% of non-performing loans and .71% of total loans net of loans in process ( LIP ) compared to \$3.8 million, or 147.5% of non-performing loans and .74% of total loans net of LIP at December 31, 2004. The allowance at December 31, 2005, 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 continues to increase, 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.



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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,				
	2005	2004	2003	2002	2001
Average loans outstanding, net of LIP	\$ 579,811	\$ 447,773	\$ 366,488	\$ 279,934	\$ 245,069
Allowance at beginning of year	3,835	2,779	2,110	1,765	1,634
Charge-offs:					
Residential real estate loans		(106)	(30)	(173)	(211)
Construction loans				(10)	(27)
Commercial real estate loans					
Commercial loans		(48)		(39)	(187)
Consumer loans	(10)		(1)	(36)	
Total loans charged-off	(10)	(154)	(31)	(258)	(425)
Recoveries	2	30	50	158	16
Net recoveries (charge-offs)	(8)	(124)	19	(100)	(409)
Provision for loan losses	650	1,180	650	445	540
Allowance at end of year	\$ 4,477	\$ 3,835	\$ 2,779	\$ 2,110	\$ 1,765
Ratio of net (recoveries) charge-offs to average loans outstanding	.00%	.03%	(.01)%	.04%	.17%
Ratio of allowance to period-end total loans, net of LIP	.71%	.74%	.70%	.69%	.67%
Period-end total loans, net of LIP	\$ 630,720	\$ 521,642	\$ 397,834	\$ 307,806	\$ 263,632

The following table represents information regarding our total allowance for loan losses, as well as the allocation of such amounts to the various categories of loans (\$ in thousands):

	At December 31,									
	2005		2004		2003		2002		2001	
	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 lending	\$ 2,337	75.5%	\$ 2,488	79.6%	\$ 1,886	80.8%	\$ 1,409	82.6%	\$ 1,097	79.4%
Commercial lending	2,130	24.4	1,055	20.3	825	19.0	566	17.1	456	19.5
Consumer loans	10	.1	292	.1	68	.2	135	.3	212	1.1
Total allowance for loan losses	\$ 4,477	100.0%	\$ 3,835	100.0%	\$ 2,779	100.0%	\$ 2,110	100.0%	\$ 1,765	100.0%

## Investment Activities

**Mortgage-Backed Securities.** We purchase mortgage-backed securities and other collateralized mortgage obligations, which are guaranteed as to principal and interest by FNMA and FHLMC, agencies of the Federal government. We also purchased mortgage-backed securities issued by entities that are not Federal Government agencies. The securities are permissible investments for a savings institution and are acquired primarily for their liquidity, yield, and credit characteristics. Such securities may be used as collateral for borrowings. The mortgage-backed securities that are purchased are backed by either fixed-rate or adjustable-rate mortgage loans. At December 31, 2005, these securities totaled \$21.8 million.

**Other Investments.** 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. We also purchase municipal bonds and corporate equity and debt securities. At December 31, 2005, we did not have any securities pledged to the FHLB as collateral under its short-term credit agreement.

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to: (1) the length of time and the extent to which fair value has been less than cost; (2) the financial condition and near-term prospects of the issuer; and (3) our intent and ability to retain the investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

During 2004, we recorded an other-than-temporary impairment write-down of approximately \$1,055,000. The charge related to our \$9.5 million investment in Freddie Mac and Fannie Mae adjustable rate preferred stock, which is included in our investment securities, available for sale portfolio. These investment grade securities declined in value in 2004 due to the events at Freddie Mac and Fannie Mae, coupled with the record low interest rates which caused the dividend payment rate to decline from the original rates at the time of issuance. During 2005, we sold 42,000 shares of Freddie Mac and Fannie Mae preferred stock with a total book value of \$2.0 million and recognized a net loss on the sales of less than \$6,000. At December 31, 2005, the Bank's carrying value of the remaining Freddie Mac and Fannie Mae preferred stock was \$6.4 million and the market value was \$6.0 million. We believe that the value of these investments will recover in the future, and we determined that no additional other-than-temporary impairment was necessary at December 31, 2005.

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

	At December 31,		
	2005	2004	2003
Short-term investments:			
Interest-earning deposits	\$ 6,424	\$ 3,836	\$ 666
Debt securities:			
Government agency	4,798	2,977	1,963
Municipal bonds	12,321	1,056	5,988
Corporate debt	5,068	3,915	
Mortgage-backed securities	21,807	24,152	15,755
Equity securities:			
FHLB stock	10,273	7,385	5,660
Corporate equity	6,086	9,072	9,909
<b>Total investment portfolio</b>	<b>\$ 66,777</b>	<b>\$ 52,393</b>	<b>\$ 39,941</b>

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The following table sets forth the remaining maturity and weighted-average yields as of December 31, 2005 and 2004 (\$ in thousands):

	One Year or less		Over 1 yr to 5 Years		Over 5 Years to 10 Years		More Than 10 Years		Total		
	Carrying Value	Yield	Carrying Value	Yield	Carrying Value	Yield	Carrying Value	Yield	Carrying Value	Yield	
<b>At December 31, 2005:</b>											
Interest-earning deposits	\$ 6,424	4.07%	\$		%\$		%\$		%\$	6,424	4.07%
FHLB stock	10,273	4.60								10,273	4.60
Government agency securities			983	4.00	3,815	4.36				4,798	4.29
Municipal bonds							12,321	4.10		12,321	4.10
Corporate debt			3,213	5.65	1,855	6.31				5,068	5.89
Mortgage-backed securities (*)							21,807	4.82		21,807	4.82
Corporate equity securities (*)							6,086	4.07		6,086	4.07
	<u>\$ 16,697</u>	<u>4.40%</u>	<u>\$ 4,196</u>	<u>5.26%</u>	<u>\$ 5,670</u>	<u>5.00%</u>	<u>\$ 40,214</u>	<u>4.49%</u>	<u>\$ 66,777</u>	<u>4.56%</u>	
<b>At December 31, 2004:</b>											
Interest-earning deposits	\$ 3,836	2.10%	\$		%\$		%\$		%\$	3,836	2.10%
FHLB stock	7,385	3.75								7,385	3.75
Government agency securities					992	5.14	1,985	6.58		2,977	5.68
Municipal bonds							1,056	6.58		1,056	6.58
Corporate debt					3,915	3.95				3,915	3.95
Mortgage-backed securities (*)							24,152	4.09		24,152	4.09
Corporate equity securities (*)							9,072	5.41		9,072	5.41
	<u>\$ 11,221</u>	<u>3.19%</u>	<u>\$</u>	<u>%\$</u>	<u>4,907</u>	<u>4.19%</u>	<u>\$ 36,265</u>	<u>4.63%</u>	<u>\$ 52,393</u>	<u>4.26%</u>	

\* Estimated and scheduled prepayments of principal on Mortgage-backed securities are not allocated in the above table and corporate equity securities are perpetual investments with no maturity date.

**Impact of Interest Rates on the Investment Portfolio.** Starting in June 2004 through the last meeting in January 2006, the Federal Open Market Committee ( FOMC ) of the Federal Reserve has incrementally increased the Federal Funds rate by ¼% from 1.00% to 4.50%. At the same time, longer term Treasury rates driven by market expectations of future inflation, were virtually unchanged. As a result, throughout the period, the Treasury yield curve experienced significant flattening. After the FOMC meeting of January 31, 2006, the short-term Treasury rates were higher than the five through thirty-year bond rates.

Due to the flattening of the yield curve during 2005, and the expectation that the FOMC would reach the end of their rate tightening cycle in 2006, we reduced our mortgage-backed security portfolio to \$21.8 million at December 31, 2005. The reduction was the result of scheduled principal payments and prepayment activity. At the same time, our tax-free municipal bond portfolio was increased from \$1.1 million at December 31, 2004 to \$12.3 million at December 31, 2005.

**Sources of Funds**

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**General.** Deposits are our primary source of funds for use in lending, investments 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. FHLB borrowings are also 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 for the Bank. At December 31, 2005, Federal Trust had approximately \$5.9 million in borrowings which was used as capital for the Bank.

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**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 seven 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.

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,					
	2005		2004		2003	
	Amount	Percent of Deposits	Amount	Percent of Deposits	Amount	Percent of Deposits
Noninterest-bearing checking accounts	\$ 13,628	2.9%	\$ 21,305	5.3%	\$ 6,352	2.0%
Interest-bearing checking accounts	51,682	11.0	48,792	12.1	15,566	4.9
Money-market accounts	78,371	16.6	76,236	18.9	76,047	24.2
Savings accounts	4,062	.8	6,237	1.5	8,714	2.8
<b>Subtotal</b>	<b>147,743</b>	<b>31.3</b>	<b>152,570</b>	<b>37.8</b>	<b>106,679</b>	<b>33.9</b>
<b>Time deposits:</b>						
Less than 1.00%					236	0.1
1.00% to 1.99%	2,160	.5	52,463	13.0	95,193	30.3
2.00% to 2.99%	40,677	8.6	161,975	40.1	84,104	26.7
3.00% to 3.99%	171,712	36.5	29,041	7.2	14,588	4.6
4.00% to 4.99%	108,004	22.9	5,945	1.5	9,174	2.9
5.00% to 5.99%	720	.2	930	.2	2,915	0.9
6.00% to 6.99%	46	.0	677	.1	1,234	0.4
7.00% to 7.99%			515	.1	507	0.2
<b>Total time deposits</b>	<b>323,319</b>	<b>68.7</b>	<b>251,546</b>	<b>62.2</b>	<b>207,951</b>	<b>66.1</b>
<b>Total deposits</b>	<b>\$ 471,062</b>	<b>100.0%</b>	<b>\$ 404,116</b>	<b>100.0%</b>	<b>\$ 314,630</b>	<b>100.0%</b>

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

	Year Ended December 31,					
	2005		2004		2003	
	Average Balance	Average Rate	Average Balance	Average Rate	Average Balance	Average Rate
Noninterest-bearing checking accounts	\$ 14,667		10,076		7,102	
Money market and interest-bearing checking accounts	127,485	2.83	109,654	1.84	92,525	1.91
Savings	5,103	1.37	7,520	1.46	9,446	1.73
Time deposits	282,693	3.16	228,876	2.37	188,975	2.73
<b>Total deposits</b>	<b>\$ 429,948</b>	<b>2.93%</b>	<b>\$ 356,126</b>	<b>2.12%</b>	<b>\$ 298,048</b>	<b>2.38%</b>

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 has 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 \$471.1 million at December 31, 2005, from \$404.1 million at December 31, 2004.

The following table sets forth jumbo certificates of \$100,000 and over at December 31, 2005, maturing as follows (in thousands):

	Amount
Due three months or less	\$ 46,699
Due over three months to six months	50,432
Due over six months to one year	88,073
Due over one year	13,356
	<b>\$ 198,560</b>

At December 31, 2005, the Bank had \$115.6 million in brokered deposits.

**Federal Home Loan Bank Advances.** A source of funds to support our lending activity, are advances from the FHLB. 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, 2005, we had \$201.7 million in borrowings outstanding.

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The following table is a summary of our advances from the Federal Home Loan Bank of Atlanta (\$ in thousands):

Maturing During the Year Ending December 31,	Interest Rate	At December 31,		
		2005	2004	2003
2005	1.15 <sup>(1)</sup>	\$	\$	\$ 25,500
2005	2.00		25,000	25,000
2005	2.44 <sup>(1)</sup>		15,000	
2005	1.70		5,000	
2005	1.56		5,000	
2005	2.84		10,000	
2006	1.24 <sup>(2)</sup>			5,000
2006	0.58 <sup>(1)(2)</sup>			5,000
2006	3.13	5,000	5,000	
2006	4.37	10,000		
2006	4.34	10,000		
2006	4.43	12,500		
2006	3.79	5,000		
2007	5.22	2,200	2,200	2,200
2007	2.01 <sup>(4)</sup>		15,000	
2007	1.26 <sup>(2)</sup>			5,000
2007	3.86	12,500		
2007	4.08	5,000		
2007	4.15	5,000		
2008	1.98 <sup>(2)</sup>		5,000	5,000
2009	2.05 <sup>(3)</sup>	5,000	5,000	
2009	3.11 <sup>(5)</sup>	10,000	10,000	
2010	3.88 <sup>(9)</sup>	15,000		
2011	3.73			25,000
2014	2.93 <sup>(6)</sup>	5,000	5,000	
2014	3.03 <sup>(7)</sup>	11,500	11,500	
2014	3.22 <sup>(8)</sup>	25,000	25,000	
2015	3.19 <sup>(10)</sup>	8,000		
2015	3.51 <sup>(3)</sup>	5,000		
2015	3.29 <sup>(11)</sup>	10,000		
2015	3.77 <sup>(12)</sup>	5,000		
2015	4.00 <sup>(13)</sup>	5,000		
2015	3.77 <sup>(14)</sup>	5,000		
2015	3.89 <sup>(14)</sup>	5,000		
2015	3.99 <sup>(15)</sup>	15,000		
2015	3.77 <sup>(6)</sup>	5,000		
		\$ 201,700	\$ 143,700	\$ 107,700

- (1) Daily advance or adjustable rate.  
(2) FHLB has the option to call every three months.  
(3) FHLB has the option to call every three months beginning in February 2006.  
(4) FHLB has a one-time call option in June 2005.  
(5) FHLB has the option to call every three months beginning in July 2006.  
(6) FHLB has the option to call every three months beginning in December 2006.

(footnotes continued on next page)

- (7) FHLB has the option to call every three months beginning in September 2007.
- (8) FHLB has the option to call every three months beginning in December 2007.
- (9) FHLB has a one time call option in June 2006.
- (10) FHLB has the option to call every three months beginning in January 2007.
- (11) FHLB has the option to call every three months beginning in February 2007.
- (12) FHLB has a one time call option in May 2009.
- (13) FHLB has the option to call every three months beginning in October 2007.
- (14) FHLB has the option to call every three months beginning in November 2006.
- (15) FHLB has the option to call every three months beginning in November 2007.

The security agreement with FHLB includes a blanket floating lien requiring the Bank to maintain qualifying first mortgage loans, discounted at 75% of the unpaid principal balances, as pledged collateral in an amount equal to at least 100% of the total advances outstanding. The FHLB also requires the purchase of FHLB common stock in proportion to the amount of advances outstanding. 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.

**Other Borrowings.** In addition to FHLB advances, another source of funds to support our operations, are borrowings from correspondent banks. During 2003, Federal Trust entered into a loan agreement with a correspondent bank. Under this agreement, we could 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 non-revolving line of credit ( ESOP LOC ) for common stock purchases relating to our Employee Stock Ownership Plan. Both lines were secured by all of the Bank's common stock and had interest rates of prime minus 12.5 basis points as long as we maintain certain loan-to-book value percentages. The loan agreement also has certain covenants that the Company is required to meet. In August 2004, the outstanding balance of the LOC was repaid from a portion of the proceeds of the secondary stock offering.

In 2005 we had a revolving line of credit agreement with a correspondent bank that enabled us to borrow up to \$8,000,000. The interest rate on the line of credit bore interest at the prime lending rate minus 50 basis points as long as we maintain certain loan-to-bank value percentages. The line of credit is secured by all of the Bank's common stock. Federal Trust can draw upon or repay the line of credit in whole or in part for the first 24 months without any prepayment penalties, at which time the remaining principal balance will be scheduled for repayment over eight years. At December 31, 2005, the outstanding balance under the line of credit agreement was approximately \$4.1million, our available balance was \$3.9 million and the interest rate was 6.75% with payments due quarterly.

At December 31, 2004, the balance outstanding on the ESOP LOC was \$885,000. As a result of the reduced interest rate on the new revolving line of credit, the Company elected to repay the ESOP LOC and funded the remaining balance, after the 2005 ESOP allocation, with the new revolving line of credit. At December 31, 2005, \$677,000 of the outstanding balance on the revolving line of credit was to fund the ESOP loan.

Total interest expense on other borrowings for the years ended December 31, 2005, 2004 and 2003, was approximately \$58,000, \$124,000 and \$137,000, 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 (7.45% at December 31, 2005). 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.



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Federal Trust 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, 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 (in thousands):

	<b>At or For the Year Ended December 31,</b>		
	<b>2005</b>	<b>2004</b>	<b>2003</b>
<b>FHLB advances:</b>			
Average balance outstanding	\$ 186,122	\$ 118,729	\$ 95,983
Maximum amount outstanding at any month end during the year	\$ 212,500	\$ 143,700	\$ 123,200
Balance outstanding at end of year	\$ 201,700	\$ 143,700	\$ 107,700
Weighted average interest rate during the year	3.31%	2.34%	2.44%
Weighted average interest rate at end of year	3.67%	2.73%	2.04%
<b>Other borrowings and junior subordinated debentures:</b>			
Average balance outstanding	\$ 9,000	\$ 11,482	\$ 7,091
Maximum amount outstanding at any month end during the year	\$ 12,019	\$ 13,706	\$ 14,011
Balance outstanding at end of year	\$ 12,019	\$ 9,089	\$ 13,706
Weighted average interest rate during the year	5.98%	4.44%	4.63%
Weighted average interest rate at end of year	6.78%	5.22%	3.96%
<b>Total borrowings:</b>			
Average balance outstanding	\$ 195,122	\$ 130,211	\$ 103,074
Maximum amount outstanding at any month end during the year	\$ 224,519	\$ 157,406	\$ 137,211
Balance outstanding at end of year	\$ 213,719	\$ 152,789	\$ 121,406
Weighted average interest rate during the year	3.44%	2.53%	2.59%
Weighted average interest rate at end of year	3.85%	3.02%	2.25%

### Expansion Activities

Since 1998 we have continued to expand our franchise footprint across the Eastern Central Florida corridor as shown in the following table.

Sanford Branch, 420 West First Street, (November 1998)

Winter Park Branch, 655 West Morse Boulevard, (December 2000)

Casselberry Branch, 487 Semoran Boulevard, (December 2002)

New Smyrna Branch, 761 East Third Street, (June 2003)

Deltona Branch, 901 Doyle Road, (Replaced Deltona strip center branch June 2003)

Orange City Branch, 2690 Enterprise Road, (October 2003)

Lake Mary Branch, 791 Rinehart Road, (January 2006)

Port Orange Branch, (Scheduled to open second quarter 2006)

In addition to the above locations, we have three branch locations at various stages of completion. The land for two of the locations, Edgewater (Eastern Volusia County) and Eustis (Lake County) have been purchased. The Palm Coast Office site (Flagler County) will be leased. All three offices are in the pre-construction planning phase with estimated opening in the second half of 2006 through the first quarter of 2007.

All of our branch offices have drive-through windows and ATM facilities.

### Employees

At December 31, 2005, the Company had a total of 87 full-time employees. We consider relations with our employees to be excellent. We currently maintain 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 our market areas. Our employees are not represented by any collective bargaining group.

### 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 only minimal activity over the three years ending in December 2003.

### 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.

### Recent Accounting Pronouncements

In May 2005, the FASB issued FASB Statement No. 154, *Accounting Changes and Error Corrections-a replacement of APB Opinion 20 and FASB Statement 3*. This Statement provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to the newly adopted accounting principle. This statement also provides guidance for determining whether retrospective application of a change is impracticable and for reporting a change when retrospective application is impracticable. This statement shall be effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. Management believes this Statement will not have a material effect on the Company's consolidated financial statements.

In December 2004, the FASB issued FASB Statement No. 153, *Exchanges of Nonmonetary Assets – an Amendment to APB opinion No. 29*. This Statement addresses the measurement of exchanges of nonmonetary assets. The Statement is effective for fiscal periods beginning after June 15, 2005. Management believes this Statement will not have a material effect on the Company's consolidated financial statements.

On December 16, 2004, the FASB issued FASB Statement No. 123(R), Share-Based Payment. Statement 123(R) replaces FASB Statement No. 123, Accounting for Stock-Based Compensation, supersedes APB Opinion No. 25, Accounting for Stock Issued to Employees and amends FASB Statement No. 95, Statement of Cash Flows. Statement 123(R) requires that all share-based payments to employees, including grants of employee stock options, to be recognized in the financial statements based on their fair values. The provisions of Statement 123(R) are effective prospectively as of the first interim or annual reporting period that begins after June 15, 2005. On March 30, 2005, the SEC Staff issued Staff Accounting Bulletin No. 107, *Application of FASB Statement 123R, Share-Based Payment* which amends the effective date to begin the first annual period beginning after June 15, 2005. In anticipation of the adoption of SFAS No. 123(R), the Company accelerated vesting of a number of the outstanding unvested stock options to purchase shares of common stock in December 2005. The decision to accelerate the vesting of stock options, which the Company believes to be in the best interest of its stockholders, was made primarily to reduce non-cash compensation expense that would have been recorded in its statements of operations in future periods upon the adoption of SFAS 123(R) beginning in January 2006. As a result, the implementation of this statement is expected to result in an additional \$31,000 in expense for fiscal year 2006, based on current options outstanding.

In the second quarter of 2004, the Emerging Issues Task Force ( EITF ) released EITF Issue 03-01, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*. The Issue provided guidance for evaluating whether an investment is other-than-temporarily impaired and requires certain disclosures with respect to these investments. On September 30, 2004, the FASB issued FASB Staff position ( FSP ) EITF 3-1-1, *Effective Date of Paragraph 10-20 of EITF Issue 03-1, The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*. This Staff Position delayed certain measurement and recognition provisions of EITF 03-1. Please see *Note 2 Securities of the Notes to Consolidated Financial Statements* for information relating to the required disclosures with respect to these investments.

#### **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 Federal Funds and 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 financial markets, as well as the effect of action by monetary and fiscal authorities, including the Federal Reserve Board, no accurate prediction can be made as to possible future changes in interest rates, deposit levels, loan demand or the business and earnings of the Company.

## REGULATION AND SUPERVISION

### General

Federal Trust is a non-diversified 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. Our 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. As a Florida corporation, Federal Trust is subject to the Florida Business Corporation Act ( FBCA ) and the regulation by the Florida Department of State under its authority to implement the FBCA.

The federal banking agencies have broad discretion in connection with their supervisory and enforcement activities and policies, including policies concerning the classification of assets and the establishment of loan loss reserves for regulatory purposes. Any change in such regulation or banking laws, whether by the OTS, FDIC or the United States Congress, can have a material adverse impact on our operations.

The following summarizes some of the regulatory requirements that are applicable to our operations.

### Regulation of Federal Trust

**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. The OTS considers acquirers to have conclusively gained control of a savings bank if they:

acquire more than 25% of any class of voting stock;

acquire irrevocable proxies representing more than 25% of any class of voting stock;

acquire a combination of shares and irrevocable proxies representing more than 25% of any class of voting stock; or

Control, in any manner, the majority of the directors of the savings bank.

An acquirer must file for approval of control with the OTS or file to rebut the presumptions before acquiring 10% or more of any class of voting stock of the savings bank and again prior to acquiring more than 25% of any class of voting stock of the savings bank and if it has any of the control factors enumerated in 12 C.F.R., Section 574.4(c), which include, but are not limited to:

the acquirer would be one of the two largest shareholders of any class of voting stock;

the acquirer and/or the acquirer's representative or nominees would constitute more than one member of the savings bank's Board of Directors; and

the acquirer, or nominee or management official of the acquirer, 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.

A person or company are presumed to be acting in concert with members of the person's immediate family (which includes a person's spouse, father, mother, children, brothers, sisters and grandchildren, as well as the father, mother, brothers and sisters of the person's spouse, and the spouse of the person's child, brother or sister). Persons will be presumed to be acting in concert with each other where:

both own stock in a savings bank and both are also management officials, controlling shareholders, partners, or trustees of another company; or

one person provides credit to another or is instrumental in obtaining financing for another person to purchase stock of the savings bank.

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A person or company is presumed to be acting in concert with any trust for which such person or company serves as trustee.

**Intra-Company Transactions.** Federal Trust's authority to engage in transactions with related parties or affiliates, or to make loans to certain insiders, are governed by Sections 23A and 23B of the Federal Reserve Act and Regulation W adopted by the Board of Governors of the Federal Reserve System to implement these sections of the Federal Reserve Act. Federal Trust, as the parent-holding company of the Bank, is an affiliate of the Bank.

Sections 23A and 23B generally:

limit the extent to which a bank or its subsidiaries may engage in covered transactions with any one affiliate to an amount equal to 10% of the institution's capital stock and surplus;

contain an aggregate limit on all such transactions with all affiliates to an amount equal to 20% of such capital stock and surplus; and

require that all such transactions be on terms substantially the same, or at least as favorable, to a bank or its subsidiaries as those provided to a non-affiliate.

The term covered transaction includes the making of loans, purchase of assets, issuance of a guarantee and similar other types of transactions. In addition to the restrictions imposed by Sections 23A and 23B, no savings bank may:

loan or otherwise extend credit to an affiliate, except for any affiliate which engages only in activities which are permissible for bank holding companies or loans between affiliates which are 80% or more owned by the same parent company; or

purchase or invest in any stocks, bonds, debentures, notes or similar obligations any affiliate, except for affiliates which are subsidiaries of the bank or savings bank.

The Bank's authority to extend credit to executive officers, directors and 10% shareholders, as well as entities controlled by such persons, is governed by Section 22(g) and 22(h) of the Federal Reserve Act and Regulation O thereunder. Among other things, these regulations require such loans to be made on terms substantially similar to those offered to unaffiliated individuals, place limits on the amount of loans the Bank may make to such persons, based in part, on the Bank's capital position, and require certain approval procedures to be followed. The OTS regulations, with certain minor variances, apply Regulation O to savings banks. At December 31, 2005, the Bank had no outstanding loans or other extensions of credit to the Company's directors and executive officers.

**Support of Subsidiary Depository Banks.** 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.

**Payment of Dividends.** The principal source of cash flow of Federal Trust, including cash flow to pay cash dividends, has been the sale of common stock of Federal Trust, the \$8,000,000 revolving line of credit and 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 paid \$.13 per share in cash dividends to shareholders during 2005 and \$.09 per share in cash dividends during 2004.

**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-K 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-K seventy-five days after the fiscal year end of each year.

Similarly, Form 10-Q must contain information concerning Federal Trust on a quarterly basis. Although Form 10-K requires the inclusion of audited financial statements, unaudited statements are sufficient for inclusion on Form 10-Q. 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-Q. In addition to the annual and quarterly reports, Federal Trust is also required to file report 8-K if any specified reportable events take place. This report is due to be filed with the Securities and Exchange Commission within four days of the occurrence of such event.

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-K's, in addition to our quarterly Form 10-Q's.

**Sarbanes-Oxley Act.** The primary purpose of the Sarbanes-Oxley Act is to protect investors by improving the accuracy and reliability of disclosures made pursuant to the federal securities laws.

The Sarbanes-Oxley Act amends the Securities Exchange Act of 1934 to prohibit a registered public accounting firm from performing specified non-audit services contemporaneously with an audit. The Sarbanes-Oxley Act also vests the audit committee of an issuer with responsibility for the appointment, compensation, and oversight of any registered public accounting firm employed to perform audit services. It requires each audit committee member to be a member of the Board of Directors of the issuer, and to be otherwise independent. The Sarbanes-Oxley Act further requires the Chief Executive Officer and Chief Financial Officer of an issuer to make certain certifications as to each annual and quarterly report.

In addition, the Sarbanes-Oxley Act requires officers to forfeit certain bonuses and profits under certain circumstances. Specifically, if an issuer is required to prepare an accounting restatement due to the material non-compliance of the issuer as a result of misconduct with any financial reporting requirement under the securities laws, the Chief Executive Officer and Chief Financial Officer of the issuer shall be required to reimburse the issuer for: (1) any bonus or other incentive-based or equity-based compensation received by that person from the issuer during the 12-month period following the first public issuance or filing with the Securities and Exchange Commission of the financial document embodying such financial reporting requirement; and (2) any profits realized from the sale of securities of the issuer during that 12-month period.

The Sarbanes-Oxley Act also requires:

Disclosure of all material off-balance sheet transactions and relationships that may have material effect upon the financial status of an issuer; and

The presentation of pro forma financial information in a manner that is not misleading, and which is reconcilable with the financial condition of the issuer under generally accepted accounting principles.

The Sarbanes-Oxley Act also prohibits insider transactions in stock held within pension plans during lock-out periods, and any profits on such insider transactions are to be disgorged. In addition, there is a prohibition of company loans to executives, except in certain circumstances. Further, the Sarbanes-Oxley Act adds a criminal penalty of fines and imprisonment of up to ten years for securities fraud.

**Regulation W.** Regulation W comprehensively implements Sections 23A and 23B of the Federal Reserve Act. Sections 23A and 23B and Regulation W restricts loans by a depository institution to its affiliates, asset purchases by depository institutions from its affiliates, and other transactions between a depository institution and its affiliates. Regulation W unifies in one public document, the Federal Reserve's interpretations of sections 23A and 23B.

**Florida Business Corporation Act.** Federal Trust is subject to the provisions of the FBCA, which authorizes the establishment of Florida corporations and sets forth the corporate governance standards for their operations. Some of the more pertinent provisions include:

- General powers of a corporation;
- Shareholders rights;
- Notice, conduct of meetings and voting rights;
- Director and officer requirements and duties;
- Election of directors;
- Terms of directors;
- Compensation of directors;
- Contract rights of offers;
- Indemnification of directors, officers, employees and agents;
- Business combinations and mergers; and
- Corporate Dissolutions.

The FBCA also permits for super majority voting requirements for shareholders, which may be considered to be anti-takeover provisions. At the 1999 Annual Meeting of Shareholders, the Shareholders approved the Articles of Amendments to our Articles of Incorporation, which require certain super majority voting requirements. Specifically, Article V, *Powers and Governance*, was amended to provide that Special Meetings of Shareholders can be called by 20% or more of all of the outstanding shares; Article VIII, *Amendment*, was amended to provide that any provisions of the Articles of Incorporation can be amended by vote of a majority of all of the outstanding shares of our capital stock; and Article IX, was added to require the vote of not less than 66% of the outstanding shares of common stock for transactions involving *Control Share Acquisition and Business Combinations*.

#### **Regulation of the Bank**

**Capital Requirements.** The OTS and the FDIC have adopted capital regulations, which establish a Tier 1 core capital definition and a minimum 3% leverage capital ratio requirement for the most highly-rated savings banks and holding companies (i.e., those savings banks and holding companies with a composite rating of 1 under the Uniform Financial Institutions Rating System by the Federal Financial Institution Examination Council) that are not anticipating or experiencing significant growth. All other savings banks are required to meet a minimum leverage ratio of at least 4% to 5%. A savings bank that is not in the highest-rated category or that is anticipating or experiencing significant growth will have to meet a minimum leverage ratio of at least 4%.

Under the OTS risk-based regulations, a savings bank must classify its assets and certain off-balance sheet activities into categories and maintain specified levels of capital for each category. The least capital is required for the category deemed by the FDIC to have the least risk, and the most capital is required for the category deemed by the FDIC to have the greatest risk. Under the regulations, certain assets are excluded for purposes of determining risk-based capital. Such assets include intangible assets, unconsolidated subsidiaries, investments in securities subsidiaries, ineligible equity investments and reciprocal holding of capital instruments with other financial institutions.

**Prompt Corrective Action.** Federal banking regulatory agencies have established certain capital and other criteria which define the categories under which a particular financial institution may be classified. Constraints are imposed on operation, management, and capital distributions depending on the category in which a financial institution is classified. Among other things, the regulations define the relevant capital measures for the five capital categories. For example, a savings bank is deemed to be well capitalized if it has a total risk-based capital ratio (total capital to risk-weighted assets) of 10% or greater, a Tier 1 risk-based capital ratio (Tier 1 capital to risk-weighted assets) of 6% or greater, and a Tier 1 leverage capital ratio (Tier 1 capital to adjusted to total assets) of 5% or greater, and is not subject to a regulatory order, agreement or directive to meet and maintain a specific capital level for any capital measure.

A savings bank is deemed to be adequately capitalized if it has a total risk-based capital ratio of 8% or greater, and, generally, a Tier 1 leverage capital ratio of 4% or greater, and the bank does not meet the definition of a well capitalized bank. A savings bank is deemed to be critically undercapitalized if it has a ratio of tangible equity (as defined in the regulations) to total assets that is equal to or less than 2%. In addition, the OTS is authorized to downgrade a savings bank to a lower capital category than the savings bank to a lower capital category than the savings bank's capital ratios would otherwise indicate, based upon safety and soundness considerations (such as when the bank has received a less than satisfactory examination rating for any of the equivalent regulatory rating categories).

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Both the risk-based capital guidelines and the leverage ratio are minimum requirements, applicable only to top-rated savings banks. Savings banks operating at or near these levels are expected to have well-diversified risk, excellent asset quality, high liquidity, good earnings and, in general, have to be considered strong banking organizations and rated composite 1 under the regulatory rating system adopted by the OTS. Savings banks with lower ratings and savings banks with high levels of risk or that are experiencing or anticipating significant growth would be expected to maintain ratios 1% to 2% above the stated minimums.

At December 31, 2005, the Bank exceeded each of its capital requirements. The following table sets forth the regulatory capital calculations of the Bank at December 31, 2005 (\$ in thousands):

	Tier I		Risk-Based	
	Amount	Percent of Assets	Amount	Percent of Assets
Regulatory capital Requirement	\$ 50,628	6.9%	\$ 55,105	11.3%
	29,232	4.0	39,109	8.0
Excess	\$ 21,396	2.9%	\$ 15,996	3.3%

**Standards for Safety and Soundness.** Federal banking agencies have prescribed 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. In addition, the federal banking regulatory agencies have prescribed by regulation standards specifying:

- Maximum classified assets to capital ratios;
- Minimum earnings sufficient to absorb losses without impairing capital;
- To the extent feasible, a minimum ratio of market value to book value for publicly traded shares of depository banks or the depository bank holding companies; and
- Such other standards relating to asset quality, earnings and valuation as the agency deems appropriate.

If the OTS determines that a savings bank 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 bank 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 savings bank 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.

The current regular semi-annual SAIF assessments range between 0% (for well capitalized and financially sound savings banks with a few minor weaknesses) to 0.27% of deposits for a savings bank in the lowest category (i.e., undercapitalized and posing a substantial probability of loss to the FDIC, unless effective corrective action is taken). The Bank's assessment at December 31, 2005 was .0132% on deposits and the Bank paid approximately \$55,000 in SAIF assessments during the year ended December 31, 2005.



**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, 2005, the Bank exceeded the QTL test, maintaining 78% of its portfolio assets in qualified thrift investments.

**Brokered Deposits.** In accordance with the Federal Deposit Insurance Corporation Improvement Act of 1991, the FDIC has implemented restrictions on the acceptance of brokered deposits. In general, only well capitalized financial institutions may accept brokered deposits. As a well capitalized savings bank, the Bank is able to accept some brokered deposits to fund its liquidity and loan demand needs. At December 31, 2005, the Bank had \$115.6 million in brokered deposits.

**Gramm-Leach-Bliley Act.** The Gramm-Leach-Bliley Act of 1999, amongst other items, established a minimum federal standard of financial privacy. Financial institutions are required to have written privacy policies that must be disclosed to customers. The disclosure of a financial institution's privacy policy must take place at the time a customer relationship is established and not less than annually during the continuation of the relationship. The act also limits when and how financial institutions may share their customers' personal information with both affiliated and nonaffiliated entities.

**USA Patriot Act.** The terrorist attacks in September 2001, have led to the adoption of the Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, commonly known as the USA Patriot Act. Part of the USA Patriot Act is the International Money Laundering Abatement and Financial Anti-Terrorism Act of 2001. This act requires the Secretary of the Treasury, in consultation with the heads of other government agencies, to adopt special measures applicable to financial institutions. These measures include enhanced recordkeeping and reporting requirements for certain financial transactions that are of primary money laundering concern, due diligence requirements concerning the beneficial ownership of 22 certain types of accounts, and restrictions or prohibitions on certain types of accounts with foreign financial institutions. Among its other provisions, this law requires each financial institution to: (i) establish an anti-laundering program; (ii) establish due diligence policies, procedures and controls with respect to private banking accounts and correspondent banking accounts involving foreign individuals and certain foreign banks; and (iii) avoid establishing, maintaining, administering, or managing correspondent accounts in the United States for, or on behalf of, a foreign bank that does not have a physical presence in this country. In addition, the law contains a provision encouraging cooperation among financial institutions, regulatory authorities and law enforcement authorities with respect to individuals, entities and organizations engaged in, or reasonably suspected of engaging in, terrorist acts or money laundering activities. The law expands the circumstances under which funds in a bank account may be forfeited and requires covered financial institutions to respond under certain circumstances to requests for information from federal banking agencies within 120 hours.

**Interstate Banking.** Federally chartered savings banks are allowed to branch nationwide to the extent allowed by federal statute. This ability permits savings banks 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 banks. Prior approval of the OTS is required for a savings bank 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 bank 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 banks 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 bank's total assets, including consolidated subsidiaries, as reported in the savings bank's latest quarterly thrift financial report. The Bank paid approximately \$129,000 in OTS assessments for the year-ended December 31, 2005.

### **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 the lesser of 0.20% of total assets or \$25 million plus 4.5% of outstanding advances. The Bank is in compliance with this requirement and at December 31, 2005, the Bank held \$10.3 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 programs. These requirements could reduce the amount of dividends that the FHLBs pay to their members and could also result in the FHLBs imposing a higher rate of interest on advances to members. For the year ended December 31, 2005, dividends paid by the FHLB-Atlanta to the Bank amounted to approximately \$394,000 for a yield of approximately 4.14%. Should dividends be reduced, or interest on FHLB advances increased, the consolidated net interest income might also be reduced for the Bank. Furthermore, there can be no assurance that the value of the FHLB-Atlanta stock held by the Bank will not decrease as a result of any new legislation.

### **Federal Reserve System**

The Federal Reserve regulations require depository institutions to maintain non-interest-earning reserves against their transaction accounts (primarily NOW and regular checking accounts). The Federal Reserve regulations generally require that reserves of 3% must be maintained against aggregate transaction accounts of \$40.5 million or less (subject to adjustment by the Federal Reserve) plus 10% of accounts in excess of \$40.5 million. The first \$7.8 million of otherwise reservable balances (subject to adjustments by the Federal Reserve) are exempted from the reserve requirements. The Bank is in compliance with the foregoing requirements. The balances maintained to meet the reserve requirements imposed by the Federal Reserve may be used to satisfy liquidity requirements imposed by the OTS. Because required reserves must be maintained in the form of either vault cash, a non-interest-bearing account at a Federal Reserve or a pass-through account as defined by the Federal Reserve, the effect of this reserve requirement is to reduce the Bank's interest-earning assets. FHLB System members are also authorized to borrow from the Federal Reserve discount window, however, Federal Reserve regulations require institutions to exhaust all FHLB sources before borrowing from a Federal Reserve.

### **Item 1A. Risk Factors**

Investing in our common stock involves risk. In addition to the other information set forth elsewhere in this Report, the following factors relating to us and our common stock should be carefully considered in deciding whether to invest in our common stock.

#### ***Our growth strategy may not be successful***

As a strategy, we have sought to increase the size of our franchise through branch expansion and rapid growth, aggressively pursuing business development opportunities. No assurance can be provided that we will continue to be successful in increasing the volume of loans and deposits at acceptable risk levels and upon acceptable terms and expanding our asset base, while managing the costs and implementation risks associated with this growth strategy. There also can be no assurance that any further expansion will be profitable or that we will continue to be able to sustain our rate of growth, either through internal growth or through other successful expansions of our banking markets, or that we will be able to maintain capital sufficient to support our continued growth.

#### ***Losses from loan defaults may exceed the allowance we establish for that purpose, which will have a material adverse effect on our business***

If a significant number of loans are not repaid, it would have an adverse effect on our earnings and overall financial condition. Like all financial institutions, we maintain an allowance for loan losses to provide for losses inherent in the loan portfolio. The allowance for loan losses reflects our best estimate of probable losses in the loan portfolio at the relevant balance sheet date. This evaluation is primarily based upon a review of our and the banking industry's historical loan loss experience, known risks contained in the loan portfolio, composition and growth of the loan portfolio, and economic factors. However, the determination of an appropriate level of loan loss allowance is an inherently difficult process and is based on numerous assumptions. As a result, our allowance for loan losses may not be adequate to cover actual losses, and future increased provisions for loan losses may have a material adverse affect our earnings.

***If real estate values in our target markets decline, our loan portfolio would be impaired***

A significant portion of our loan portfolio consists of mortgages secured by real estate located in our primary market area of Orange, Seminole and Volusia Counties. Real estate values and real estate markets are generally affected by, among other things, changes in national, regional or local economic conditions; fluctuations in interest rates and the availability of loans to potential purchasers; changes in the tax laws and other governmental statutes, regulations and policies; and acts of nature. If real estate prices decline in any of these markets, the value of the real estate collateral securing our loans could be reduced. Such a reduction in the value of our collateral could increase the number of non-performing loans and adversely affect our financial performance.

***If we lose key employees, our business may suffer***

Our success is largely dependent on the personal contacts of our officers and employees in our market areas. If we lose key employees, temporarily or permanently, our business could be negatively impacted. We could be particularly hurt if our key employees went to work for our competitors. Our future success depends on the continued contributions of our existing senior management personnel, including our Chief Executive Officer and President James V. Suskiewich, Chief Financial Officer Gregory E. Smith, and our subsidiary Presidents, Stephen C. Green and Thomas P. Spatola. We have entered into an employment agreement with Chief Executive Officer and President Suskiewich and Severance Agreements with five of our key executive officers, which contain standard non-competition provisions to help alleviate some of this risk.

***Our subsidiaries face strong competition, which may limit their asset growth and profitability***

Our primary market area is the urban areas of Orange, Seminole and Volusia Counties, and to a lesser extent Lake and Osceola Counties. The banking business in these areas is extremely competitive, and the level of competition facing us following our expansion plans may increase further, which may limit our asset growth and profitability. Our subsidiary bank and mortgage company experience competition in both lending and attracting funds from other banks, savings institutions, and non-bank financial institutions located within our market area, many of which are significantly larger institutions. Non-bank institutions competing for deposits and deposit type accounts include mortgage bankers and brokers, finance companies, credit unions, securities firms, money market funds, life insurance companies and the mutual funds industry. For loans, we encounter competition from other banks, savings associations, finance companies, mortgage bankers and brokers, insurance companies, small loan and credit card companies, credit unions, pension trusts and securities firms.

***If adverse economic conditions in our target markets exist for a prolonged period, our financial results could be adversely affected***

Our success will depend in large part on economic conditions in Central Florida. A prolonged economic downturn or recession in this market could increase our nonperforming assets, which would result in operating losses, impaired liquidity and the erosion of capital. A variety of factors could cause such an economic dislocation or recession, including adverse developments in the industries in these areas such as tourism, or natural disasters such as hurricanes, floods or tornadoes, or additional terrorist activities such as those our country experienced in September 2001.

***Federal Trust and its subsidiaries operate in an environment highly regulated by state and federal government; changes in banking laws and regulations could have a negative impact on our business.***

As a unitary holding company, Federal Trust is regulated primarily by the Office of Thrift Supervision. Our current Subsidiaries are regulated primarily by the Office of Thrift Supervision, the Federal Deposit Insurance Corporation and the Florida Office of Finance Regulation. Federal and various state laws and regulations govern numerous aspects of our operations and the operations of our Subsidiaries, including:

- Adequate capital and financial condition;
- Permissible types and amounts of extensions of credit and investments;
- Permissible non-banking activities; and
- Restrictions on dividend payments.

Federal and state regulatory agencies have extensive discretion and power to prevent or remedy unsafe or unsound practices or violations of law by our holding company, our subsidiary bank and mortgage company. Following such examinations, Federal Trust may be required, among other things, to change its asset valuations or the amounts of required loan loss allowances or to restrict its operations, based on information available to them at the time of their respective examination.

***Regulatory action could severely limit future expansion plans***

To carry out some of our expansion plans, we are required to obtain permission from the OTS. Application for the acquisition of existing thrifts and banks are submitted to the federal and state bank regulatory agencies for their approval. The future climate for regulatory approval is impossible to predict. Regulatory agencies could prohibit or otherwise significantly restrict our expansion plans, as well as those of our Subsidiaries, which could limit our ability to increase revenue.

***Investors may face dilution resulting from the issuance of common stock in the future***

We have the power to issue common stock without shareholder approval, up to the number of authorized shares set forth in our Articles of Incorporation. Our Board of Directors may determine from time to time a need to obtain additional capital through the issuance of additional shares of common stock or other securities, subject to limitations imposed by the American Stock Exchange and the OTS. There can be no assurance that such shares can be issued at prices or on terms better than or equal to the terms obtained by our current shareholders. The issuance of any additional shares of common stock by us in the future may result in a reduction of the book value or market price, if any, of the then-outstanding common stock. Issuance of additional shares of common stock will reduce the proportionate ownership and voting power of our existing shareholders.

***Shares of preferred stock may be issued in the future which could materially adversely affect the rights of the holders of our common stock***

Pursuant to our Articles of Incorporation, we have the authority to issue preferred stock and to determine the designations, preferences, rights and qualifications or restrictions of those shares without any further vote or action of the shareholders. The rights of the holders of our common stock will be subject to, and may be materially adversely affected by, the rights of the holders of any preferred stock that may be issued by us in the future.

***Our common stock is not an insured bank deposit and is subject to market risk***

Our shares of common stock are not deposits, savings accounts or other obligations of us, our subsidiaries or any other depository institution, are not guaranteed by us or any other entity, and are not insured by the Federal Deposit Insurance Corporation or any other governmental agency.

***We may need additional capital in the future and this capital may not be available when needed or at all***

We may need to incur additional debt or equity financing in the near future to fund future growth and meet our capital needs. We cannot assure you that such financing will be available to us on acceptable terms or at all. If we are unable to obtain future financing, we may not have the resources available to fund our planned growth.

***Future sales of our common stock could depress the price of the common stock***

Sales of a substantial number of shares of our common stock in the public market by our shareholders, or the perception that such sales are likely to occur, could cause the market price of our common stock to decline.

***There are substantial regulatory limitations on ownership of our common stock and changes of control***

With certain limited exceptions, federal regulations prohibit a person or company or a group of persons deemed to be acting in concert from, directly or indirectly, acquiring 10% or more (5% if the acquirer is a bank holding company) of any class of our voting stock or obtaining the ability to control in any manner the election of a majority of our directors or otherwise direct our management or our policies without prior notice or application to and the approval of the OTS.

***Although publicly traded, our common stock has substantially less liquidity than the average trading market for a stock quoted on the American Stock Exchange, and our price may fluctuate in the future***

Although our common stock is listed for trading on the American Stock Exchange, the trading market in our common stock has substantially less liquidity than the average trading market for companies quoted on the American Stock Exchange. A public trading market having the desired characteristics of depth, liquidity and orderliness depends on the presence in the marketplace of willing buyers and sellers of our common stock at any given time. This presence depends on the individual decisions of investors and general economic and market conditions over which we have no control.



The market price of our common stock may fluctuate in the future, and these fluctuations may be unrelated to our performance. General market price declines or overall market volatility in the future could materially adversely affect the price of our common stock, and the current market price may not be indicative of future market prices.

***All of Federal Trust Bank's stock is pledged under a line of credit agreement***

Federal Trust, as the sole holder of the Bank's outstanding stock, has pledged the Bank's stock in its entirety as security for the extension of a line of credit. This credit arrangement could impair our ability to borrow other funds which could inhibit our ability to fund future growth. The Bank's stock constitutes a significant portion of Federal Trust's assets, therefore, in the unlikely event that Federal Trust defaults on the payments of this line of credit, we may be forced to transfer some or all of the Bank's stock to satisfy the debt on the line credit, which would result in the Bank no longer being a subsidiary of Federal Trust.

***Changes in interest rates can have an adverse effect on our profitability***

Federal Trust's earnings and cash flows are largely dependent upon its net interest income. Net interest income is the difference between interest income earned on interest earning assets such as loans and investment securities and interest expense paid on interest bearing liabilities such as deposits and borrowed funds. Interest rates are highly sensitive to many factors that are beyond our control, including general economic conditions, competition, and policies of various governmental and regulatory agencies and, in particular, the Board of Governors of the Federal Reserve System. Changes in monetary policy, including changes in interest rates, could influence not only the interest we receive on loans and investment securities and the amount of interest it pays on deposits and borrowings, but such changes could also affect (i) our ability to originate loans and obtain deposits, (ii) the fair value of our financial assets and liabilities, and (iii) the average duration of our assets and liabilities. If the interest rates paid on deposits and other borrowings increase at a faster rate than the interest rates received on loans and other investments, our net interest income, and therefore earnings, could be adversely affected. Earnings could also be adversely affected if the interest rates received on loans and other investments fall more quickly than the interest rates paid on deposits and other borrowings.

Although management believes it has implemented effective asset and liability management strategies to reduce the potential effects of changes in interest rates on our results of operations, any substantial unexpected, prolonged change in market interest rates could have a material adverse effect on our financial condition and results of operations.

**Item 1B. Unresolved Staff Comments.**

Not applicable.

**ITEM 2. PROPERTIES**

The following table sets forth certain information on the Company's principal offices, net carrying value and the expiration of leases when applicable at December 31, 2005 (\$ in thousands):

	Net Carrying Value of Real Property			Lease Expiration
	Owned	Leased		
Sanford Branch Branch 420 West First Street Sanford, Florida 32771	\$ 1,144	N/A		N/A
Winter Park Branch 655 West Morse Blvd. Winter Park, Florida 32789	N/A	\$ 260		12/31/10
Casselberry Branch 487 Semoran Boulevard Casselberry, Florida 32707	\$ 1,329	N/A		N/A
New Smyrna Beach Branch 761 East Third Avenue New Smyrna Beach, Florida 32169	N/A	\$ 0		08/31/06
Orange City Branch 2690 Enterprise Road Orange City, Florida 32763	\$ 1,341	N/A		N/A
Deltona Branch 901 Doyle Road Deltona, Florida 32725	\$ 928	N/A		N/A
Lake Mary Branch (2) 791 Rinehart Road Lake Mary, Florida 32746	\$ 852	N/A		3/31/25
Corporate Headquarters (1) 312 West First Street Sanford, Florida 32771	N/A	\$ 5,545		8/31/16
Future Branch locations (3)	\$ 1,551	N/A		N/A

The Company also had net furniture, fixtures, and equipment of approximately \$1,072,000.

Note (1): In October 2001, Federal Trust completed a transaction in which it entered into a 15 year, fixed-rate lease on the office building in Sanford, Florida, which houses the Executive, Administrative, Lending and Operations Departments. The lease provides for a fixed annual rental over the 15 year term. In addition, the agreement provides for the purchase of the office building at the end of the lease term for \$1, with an option to purchase the building at any time during the 15 year term at a pre-determined amount. The building has a total of 46,586 rentable square feet of which the Company occupies 24,177 square feet. The remaining 22,409 square feet is rented to various non-affiliated tenants.

Note (2): The Bank has a ground lease on the Lake Mary branch site. The lease has a 20 year term with optional renewal periods. The building and improvements for the branch is owned by the Bank.

Note (3): The Bank owns three parcels of land in Port Orange and Edgewater, in Volusia County and Eustis in Lake County, Florida and has a letter of intent for a ground lease on a parcel of land in Flagler County, Florida, with lease payments commencing in the second quarter of 2006. Construction of the Port Orange branch commenced in December 2005 and construction is expected to commence on the Eustis branch in the second quarter of 2006 and on Palm Coast and Edgewater branches in the third or fourth quarter of 2006.

**ITEM 3. 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.

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

During the fourth quarter of the fiscal year ended December 31, 2005, no matters were submitted to a vote of the security holders through a solicitation or otherwise.

**PART II**

**ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCK HOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

(a) In June 2003, Federal Trust's stock began trading on the American Stock Exchange under the symbol "FDT". Prior to that, Federal Trust's common stock traded on the NASDAQ Small Cap Market under the symbol "FDTR". As of March 3, 2006, there were 394 registered holders of common stock of Federal Trust, some of which are street name holders. Federal Trust paid cash dividends of \$.13 per share during 2005 (\$.03 per share for the first three quarters of 2005 and \$.04 per share for the fourth quarter.) and \$.09 per share during 2004. The following table lists the low and high closing stock prices for the periods indicated.

	Calendar Year 2005		Calendar Year 2004	
	Low \$	High \$	Low \$	High \$
First Quarter	\$ 9.90	\$ 10.60	\$ 7.20	\$ 7.89
Second Quarter	9.92	11.25	7.46	8.13
Third Quarter	11.00	12.32	7.36	8.56
Fourth Quarter	10.00	12.63	8.13	10.47

(b) Not Applicable

(c) There were no stock repurchases during the quarter ended December 31, 2005.



**ITEM 6. SELECTED FINANCIAL DATA**  
**CONSOLIDATED FINANCIAL HIGHLIGHTS**

(\$ in thousands, except per share amounts)

	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>	<u>2001</u>
<b>AT YEAR END:</b>					
Total assets	\$ 735,416	\$ 603,131	\$ 468,198	\$ 368,054	\$ 306,481
Loans, net	630,827	521,331	398,401	308,598	264,187
Investment Securities	50,080	41,172	33,615	21,520	13,948
Deposits	471,062	404,116	314,630	278,531	225,400
Stockholders' Equity	44,141	39,387	26,457	25,039	18,531
Book value per share	5.33	4.97	4.05	3.80	3.43
Shares outstanding (*)	8,277,554	7,942,438	6,526,215	6,591,338	5,409,449
Equity-to-assets ratio	6.00%	6.53%	5.65%	6.80%	6.05%
<b>FOR THE YEAR:</b>					
Interest income	\$ 33,977	\$ 24,609	\$ 20,921	\$ 19,452	\$ 19,950
Interest expense	19,336	10,851	9,750	10,971	13,272
Net interest income	14,641	13,758	11,171	8,481	6,678
Provision for loan losses	650	1,180	650	445	540
Net interest income after provision for loan losses	13,991	12,578	10,521	8,036	6,138
Other income	2,533	2,391	2,358	2,400	2,383
Other-than-temporary impairment		1,055			
Other expenses	9,791	9,334	8,826	7,339	6,538
Net earnings	4,436	3,089	2,777	2,059	1,267
Basic earnings per share	.55	.44	.42	.34	.25
Diluted earnings per share	.54	.43	.42	.34	.25
Average common shares outstanding	8,107,277	7,082,421	6,548,957	5,991,155	5,060,450
Return on average assets	.66%	.59%	.64%	.63%	.47%
Return on average equity	10.70%	9.80%	10.79%	9.45%	7.40%
Net interest margin	2.30%	2.80%	2.73%	2.71%	2.58%
Average equity to average assets ratio	6.16%	6.02%	5.95%	6.68%	6.30%
Dividend payout ratio	24.03%	20.36%	11.81%		
Allowance for loan losses as a percent of loans, net	.71%	.74%	.70%	.68%	.67%

\* Net of unallocated ESOP shares of 21,789, 119,375 and 135,592 as of December 31, 2005, 2004 and 2003, respectively.

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
RESULTS OF OPERATIONS**

**Overview**

For the year ended December 31, 2005, we had net earnings of \$4.4 million, compared to \$3.1 million for 2004. On a per share basis, basic earnings for 2005 were \$.55 and diluted earnings were \$.54 compared to \$.44 for basic and \$.43 diluted earnings per share for 2004.

During the fourth quarter of 2004, we recorded an other-than-temporary impairment charge of approximately \$659,000 after tax, or \$.09 per share. Excluding the effect of the other-than-temporary impairment charge, net earnings for 2004 would have been \$3.7 million or \$.53 per share. The charge related to a \$9.5 million investment in Freddie Mac and Fannie Mae adjustable rate preferred stock. These investment grade securities declined in value in 2004 due to the events at Freddie Mac and Fannie Mae coupled with the record low interest rates which caused the dividend payment rate to decline from the original rates at the time of issuance. While we believe that the value of these investments will recover in the future as the dividend rates adjust, we are unable to determine at this time when and how much the prices will recover.

Total assets at the end of 2005 were \$735.4 million, an increase of \$132.3 million, or 22% from December 31, 2004. Net loans grew to \$630.8 million during 2005, up \$109.5 million or 21% from the end of 2004. Funding for our growth in 2005 came from a \$66.9 million, or 17% increase in total deposits and a \$58 million, or 40% increase in FHLB advances. Total deposits and FHLB advances at December 31, 2005, were \$471.1 million and \$201.7 million, respectively, compared to \$404.1 million and \$143.7 million, respectively at the end of 2004.

At the end of 2005, stockholders' equity was \$44.1 million, compared to \$39.4 million at December 31, 2004. The book value per share grew to \$5.33 at December 31, 2005, from \$4.97 at December 31, 2004. We paid cash dividends of \$.13 per share in 2005, compared to \$.09 per share in 2004.

**General**

Federal Trust was organized in February 1989 for the purpose of becoming the unitary savings and loan holding company of the Bank, a federally-chartered stock savings bank. Our corporate headquarters are located at 312 West First Street, Sanford, Florida 32771 and our telephone number is (407) 323-1833. To date, the principal source of our 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 us or our affiliates. See Regulation and Supervision. In January 2006, the Mortgage Company, a newly created subsidiary of Federal Trust, commenced operations. Residential mortgage originations will now be done by the Mortgage Company.

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**Average Balance Sheet**

The following table sets forth, for the periods indicated, information regarding: (i) the total dollar amount of interest income from interest-earning assets and the resultant average yields; (ii) the total dollar amount of interest expense on interest-bearing liabilities and the resultant average cost; (iii) net interest income; (iv) interest rate spread; (v) net interest margin; and (vi) weighted average yields and rates. Average balances are based on average daily balances (\$ in thousands):

	For The Year Ended December 31,								
	2005			2004			2003		
	Average Balance	Interest	Average Yield/ Cost	Average Balance	Interest	Average Yield/ Cost	Average Balance	Interest	Average Yield/ Cost
<b>Interest-earning assets:</b>									
Loans (1)	\$ 579,811	\$ 31,484	5.43	\$ 447,773	\$ 23,034	5.14%	\$ 366,488	\$ 19,591	5.35%
Securities	45,700	2,001	4.38	35,516	1,290	3.63	34,755	1,112	3.20
Other interest-earning assets (2)	11,352	492	4.33	7,521	285	3.79	7,626	218	2.86
<b>Total interest-earning assets</b>	<b>636,863</b>	<b>33,977</b>	<b>5.34</b>	<b>490,810</b>	<b>24,609</b>	<b>5.01</b>	<b>408,869</b>	<b>20,921</b>	<b>5.12</b>
Non-interest earning assets	35,953			32,883			23,942		
<b>Total assets</b>	<b>\$ 672,816</b>			<b>\$ 523,693</b>			<b>\$ 432,811</b>		
<b>Interest-bearing liabilities:</b>									
Non-interest bearing demand deposits	\$ 14,667			\$ 10,076			\$ 7,102		
Interest-bearing demand and money- market deposits	127,485	3,606	2.83	109,654	2,019	1.84	92,525	1,764	1.91
Savings deposits	5,103	70	1.37	7,520	110	1.46	9,446	163	1.73
Time deposits	282,693	8,928	3.16	228,876	5,430	2.37	188,975	5,156	2.73
<b>Total deposit accounts</b>	<b>429,948</b>	<b>12,604</b>	<b>2.93</b>	<b>356,126</b>	<b>7,559</b>	<b>2.12</b>	<b>298,048</b>	<b>7,083</b>	<b>2.38</b>
Borrowings (3)	195,122	6,732	3.45	130,211	3,292	2.52	103,074	2,667	2.59
<b>Total interest bearing liabilities</b>	<b>625,070</b>	<b>19,336</b>	<b>3.09</b>	<b>486,337</b>	<b>10,851</b>	<b>2.23</b>	<b>401,122</b>	<b>9,750</b>	<b>2.43</b>
Non-interest bearing liabilities	6,283			5,842			5,941		
Stockholders equity	41,463			31,514			25,748		
<b>Total liabilities and stockholders equity</b>	<b>\$ 672,816</b>			<b>\$ 523,693</b>			<b>\$ 432,811</b>		
Net interest/dividend income		\$ 14,641			\$ 13,758			\$ 11,171	
Interest rate spread (4)			2.25%			2.78%			2.69%
Net interest margin (5)			2.30%			2.80%			2.73%
Ratio of average interest-earning assets to average interest-bearing liabilities	1.03			1.01			1.02		

- 
- (1) Includes non-accrual loans.
  - (2) Includes interest-earning deposits and FHLB stock.
  - (3) Includes FHLB advances, other borrowings, junior subordinated debentures and capital lease obligation.
  - (4) Interest rate spread represents the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities.
  - (5) Net interest margin is net interest income divided by average interest-earning assets.

**Rate/Volume Analysis**

The following table sets forth certain information regarding changes in interest income and interest expense for the periods indicated. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to: (i) changes in rate (change in rate multiplied by prior volume); (ii) changes in volume (changes in volume multiplied by prior rate); and (iii) changes in rate-volume (change in rate multiplied by change in volume) (in thousands):

	<b>Year Ended December 31, 2005 vs. 2004</b>			
	<b>Increase (Decrease) Due to Changes in</b>			
	<b>Rate</b>	<b>Volume</b>	<b>Rate/ Volume</b>	<b>Total</b>
<b>Interest-earning assets:</b>				
Loans	\$ 1,280	\$ 6,792	\$ 378	\$ 8,450
Securities	265	370	76	711
Other interest-earning assets	41	145	21	207
<b>Total</b>	<b>1,586</b>	<b>7,307</b>	<b>475</b>	<b>9,368</b>
<b>Interest-bearing liabilities:</b>				
Deposit accounts	2,881	1,567	597	5,045
FHLB advances and other borrowings	1,201	1,641	598	3,440
<b>Total</b>	<b>4,082</b>	<b>3,208</b>	<b>1,195</b>	<b>8,485</b>
<b>Net change in net interest income before provision for loan losses</b>	<b>\$ (2,496)</b>	<b>\$ 4,099</b>	<b>\$ (720)</b>	<b>\$ 883</b>

	<b>Year Ended December 31, 2004 vs. 2003</b>			
	<b>Increase (Decrease) Due to Changes in</b>			
	<b>Rate</b>	<b>Volume</b>	<b>Rate/ Volume</b>	<b>Total</b>
<b>Interest-earning assets:</b>				
Loans	\$ (770)	\$ 4,349	\$ (154)	\$ 3,425
Securities	149	24	5	178
Other interest-earning assets	71	(3)	(1)	67
<b>Total</b>	<b>(550)</b>	<b>4,370</b>	<b>(150)</b>	<b>3,670</b>
<b>Interest-bearing liabilities:</b>				
Deposit accounts	(775)	1,382	(131)	476
FHLB advances and other borrowings	(62)	703	(16)	625
<b>Total</b>	<b>(837)</b>	<b>2,085</b>	<b>(147)</b>	<b>1,101</b>
<b>Net change in net interest income before provision for loan losses</b>	<b>\$ 287</b>	<b>\$ 2,285</b>	<b>\$ (3)</b>	<b>\$ 2,569</b>

**Liquidity and Capital Resources at December 31, 2005**

**General.** Like other financial institutions, we must ensure that sufficient funds are available to meet deposit withdrawals, loan commitments, investment needs and expenses. Control of our cash flow requires the anticipation of deposit flows and loan payments. Our primary sources of funds are deposit accounts, FHLB advances and principal and interest payments on loans and investments.

We require funds in the short term to finance ongoing operating expenses, pay liquidating deposits, purchase investments in securities and invest in loans. We fund short-term requirements through advances from the FHLB, deposit growth, the sale of investments, and loan principal payments. Management has no plans to significantly change long-term funding requirements. Long-term funds are required to invest in loans for our portfolio, purchase fixed assets and provide for the liquidation of deposits maturing in the future. Long-term funding requirements are obtained from principal payments from maturing loans, the sale of loans and the sale of investments.

The following summarizes the Company's contractual obligations, including certain on-balance-sheet and off-balance-sheet obligations, at December 31, 2005 (in thousands):

	Payments Due by Period				
	Total	Less Than 1 Year	Greater Than 1 Year, Up To 3 Years	Greater Than 3 Years, Up To 5 Years	More than 5 Years
FHLB advances assumed final maturity	\$ 201,700	\$ 42,500	\$ 24,700	\$ 30,000	\$ 104,500
Time deposit maturities	323,319	295,534	27,155	630	
Junior subordinated debentures assumed final maturity	5,155				5,155
Accrued Interest Payable	1,208	1,208			
Other borrowings	4,100		769	1,025	2,306
Capital Lease Obligation	4,688	439	878	878	2,493
Operating Leases	2,908	324	646	697	1,241
Loan Commitments	14,518	14,518			
Standby Letters of Credit	7,962	7,962			
Undisbursed construction and line of credit loans	57,294	57,294			
<b>Total</b>	<b>\$ 622,852</b>	<b>\$ 419,779</b>	<b>\$ 54,148</b>	<b>\$ 33,230</b>	<b>\$ 115,695</b>

During the year ended December 31, 2005, our sources of funds came primarily from sale of loans of \$24.8 million; net principal repayment of loans of \$70.5 million; proceeds from the increase in deposits of \$66.9 million; increased FHLB advances of \$58.0 million; and the proceeds from the sale and repayments of securities of \$14.9 million. We used cash to fund \$207.1 million in loan purchases; \$2.2 million in loans originated for sale; the purchase of securities for \$22.7 million; the purchase of FHLB stock of \$2.9 million; and the purchase of premises and equipment of \$2.6 million. Management believes that in the future, funds will continue to be obtained from the above sources.

At December 31, 2005, loans-in-process, or closed loans scheduled to be funded over a future period of time, totaled \$46.8 million. Loans committed, but not closed, totaled \$14.5 million, available lines of credit totaled \$10.5 million and standby letters of credit totaled \$8.0 million. Funding for these amounts is expected to be provided by the sources described above.

In December 2005, the Bank's average liquidity was 10%. The Bank's seven Central Florida branches, plus the four additional planned branches, are expected to generate deposits to provide liquidity for expected loan originations and other investments. The Asset/Liability Management Committee meets regularly and, reviews liquidity levels to ensure that funds are available as needed.

We paid cash dividends per share of \$.13 in 2005 and \$.09 in 2004. The payment of future dividends will depend on general economic conditions, as well as our overall performance, capital need and regulatory restrictions.

At December 31, 2005, Federal Trust had \$192,000 in cash in its account, which will be used primarily for cash dividend payments and operating expenses.

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The following table is a reconciliation of the Bank's stockholders' equity calculated in accordance with accounting principles generally accepted in the United States of America (GAAP) to regulatory capital (in thousands):

	At December 31, 2005	
	Tier I	Total Risk-Based
Bank's stockholders' equity in accordance with GAAP	\$ 50,029	\$ 50,029
Add (deduct):		
Unrealized losses on investments	668	668
Excess mortgage servicing rights and Excess net deferred tax assets	(69)	(69)
General valuation allowances		4,477
	\$ 50,628	\$ 55,105

At December 31, 2005, the Bank exceeded each of its minimum capital requirements.

### Results of Operations

#### Comparison of the Years Ended December 31, 2005 and 2004

**General.** The Company had net earnings for 2005 of \$4.4 million or \$.55 per basic share and \$.54 per diluted share compared to net earnings of \$3.1 million or \$.44 per basic and \$.43 per diluted share for 2004. The improvement in the net earnings in 2005 was due to the non-cash, other-than-temporary impairment charge of approximately \$1,055,000 recorded in December 2004, together with the increases in net interest income and other income in 2005, partially offset by an increase in other expenses.

The other-than-temporary impairment charge related to the Bank's \$9.5 million investment in Freddie Mac and Fannie Mae adjustable rate preferred stock. These investment grade securities declined in value in 2004 due to the recent events at the Government Sponsored Enterprises (GSEs) coupled with the record low interest rates, which caused the dividend payment rate to decline from the original rates at the time of issuance. The other-than-temporary impairment charge was recorded in 2004 since we were unable to determine at that time when and how much the preferred stock prices will recover. Excluding the \$659,000 after-tax effect of the charge, net earnings for 2004 would have been \$3.7 million, or \$.53 and \$.52 per basic and fully diluted share, respectively.

**Interest Income.** Interest income was \$34.0 million in 2005 compared to \$24.6 million in 2004. Interest income on loans increased to \$31.5 million in 2005 from \$23.0 million in 2004. The increase in interest income on loans in 2005 is attributable primarily to an increase in the average amount of loans outstanding during the year and to a lesser extent by an increase in yield earned on loans. Interest income on securities increased to \$2.0 million in 2005 from \$1.3 million in 2004 as a result of an increase in the average balance of securities held by the Company and an increase in the yield earned on the securities. Other interest income increased from \$285,000 in 2004 to \$492,000 during 2005. Management expects the yield earned on the portfolios to fluctuate with general market interest rate movements.

**Interest Expense.** Interest expense increased during 2005 to \$19.3 million compared to \$10.9 million in 2004, due to an increase in the average amount of deposit accounts and borrowings outstanding and an increase in the average rate paid. Interest expense on deposits increased by \$5.0 million in 2005 as a result of an increase in the average amount of deposits and an increase in average rate paid on deposits. Interest expense on these accounts will increase or decrease according to the general level of interest rates. Interest on borrowings increased to \$6.7 million in 2005 from \$3.3 million in 2004 due to an increase in the average amount of borrowings outstanding, and an increase in the average rate paid for borrowings. Management expects to continue to use FHLB advances and other borrowings when the rates offered on such funds is favorable when compared to the rates paid on deposits in the local market.

**Provisions for Loan Losses.** A provision for loan losses is charged to earnings based upon our evaluation of the inherent losses in the loan portfolio. Our provisions for loan losses for 2005, were \$650,000 compared to \$1,180,000 in 2004 based on our evaluation of the loan portfolio. The total loan grew by \$106.7 million, or 20% in 2005. Of this amount, \$25.4 million were residential mortgage loans, \$35.0 million in residential construction loans, \$15.0 million in non-residential real estate loans and \$24.6 million in land development and construction loans. As of December 31, 2005, 63% of our loan portfolio was in residential mortgage loans, which historically have had the lowest risk of loss in the overall portfolio, and as a result have had a lower reserve percentage applied to them based on historical loss percentages.

Total charge-offs were \$10,000 in 2005 compared to recoveries of \$2,000 on loans previously charged-off. For 2004, total charge-offs and recoveries were \$154,000 and \$30,000, respectively. At December 31, 2005, the allowance for loan losses was \$4.5 million, or .71% of year-end loans net, compared to \$3.8 million, or .74% of net loans at December 31, 2004. Total non-accrual loans at December 31, 2005, decreased to \$2.1 million compared to \$2.6 million at December 31, 2004. The amount needed in the allowance for loan losses for nonaccrual loans is based on the particular circumstances of the individual loans, including the type, amount, and value of the collateral, if any, and the overall composition and amount of the performing loans in the portfolio at the time of evaluation, and, as a result, will vary over time.

**Other Income.** Other income increased \$218,000 to \$2.5 million for the year ended December 31, 2005. Included in other income for 2005, are \$94,000 in net gains on disposition of foreclosed assets.

**Other Expense.** Other expense increased to \$9.8 million in 2005 or 5.0%, from \$9.3 million in 2004. The increase was the result of increased salary and employee benefits expense, occupancy expenses and professional services. The increase in salary and employee benefits of \$311,000 was the result of additions to staff, as a result of the continued growth of the Company and the formation of the Mortgage Company, together with the manpower and professional services associated with Sarbanes-Oxley Section 404, which required additional documentation and testing of our internal controls over financial reporting.

**Income Taxes.** Income taxes increased from \$1.5 million (an effective tax rate of 32.6%) in 2004 to \$2.3 million (an effective tax rate of 34.1%) in 2005.

#### **Comparison of the Years Ended December 31, 2004 and 2003**

**General.** The Company had net earnings for 2004 of \$3.1 million or \$.44 per basic share and \$.43 per diluted share compared to net earnings of \$2.8 million or \$.42 per basic and diluted share for 2003. The improvement in the net earnings in 2004 was due to increases in net interest income, partially offset by an increase in other expenses and a non-cash, other-than-temporary impairment charge of approximately \$1,055,000.

The charge related to the Bank's \$9.5 million investment in Freddie Mac and Fannie Mae adjustable rate preferred stock. These investment grade securities declined in value in 2004 due to the events at the Government Sponsored Enterprises (GSEs) coupled with record low interest rates, which caused the dividend payment rate to decline from the original rates at the time of issuance. The other-than-temporary impairment charge was recorded in 2004 since we were unable to determine at that time when and how much the preferred stock prices would recover. Excluding the \$659,000 after-tax effect of the charge, net earnings for 2004 would have been \$3.7 million, or 35% higher than the net earnings for 2003. On a per share basis, excluding the impairment charge, basic and fully diluted earnings were \$.53 and \$.52, respectively, for 2004 compared to \$.42 for both basic and fully diluted earnings in 2003.

**Interest Income.** Interest income was \$24.6 million in 2004 compared to \$20.9 million in 2003. Interest income on loans increased to \$23.0 million in 2004 from \$19.6 million in 2003. The increase in interest income on loans in 2004 was primarily attributable to an increase in the average amount of loans outstanding during the year offset partially by a decrease in yield earned on loans. Interest income on securities increased to \$1.3 million in 2004 from \$1.1 million in 2003 as a result of an increase in the average balance of securities held by the Company and an increase in the yield earned on the securities. Other interest income increased from \$218,000 in 2003 to \$285,000 during 2004. Management expects the yield earned on the portfolios to fluctuate with general market interest rate movements.



**Interest Expense.** Interest expense increased during 2004 to \$10.9 million compared to \$9.8 million in 2003 primarily due to a decrease in the average cost paid partially offset by an increase in the average amount of deposit accounts and borrowings outstanding. Interest expense on deposits increased by \$476,000 in 2004 as a result of an increase in the average amount of deposits partially offset by a decrease in average cost paid on deposits. Interest expense on these accounts will increase or decrease according to the general level of interest rates. Interest on borrowings increased to \$3.3 million in 2004 from \$2.7 million in 2003 due to an increase in the amount of borrowings outstanding, partially offset by a slight decrease in the average cost paid for borrowings. Management expects to continue to use FHLB advances and other borrowings when the rates offered on such funds is favorable when compared to the rates paid on deposits in the local market.

**Provisions for Loan Losses.** A provision for loan losses is charged to earnings based upon our evaluation of the inherent losses in the loan portfolio. Our provisions for loan losses for 2004 were \$1,180,000 compared to \$650,000 in 2003 based on our evaluation of the loan portfolio. The total loan portfolio grew by \$129.0 million, or 32% in 2004. Of this amount, \$72.5 million were residential mortgage loans. As of December 31, 2004, 70.8% of our loan portfolio was in residential mortgage loans, which historically have had the lowest risk of loss in the overall portfolio, and as a result have had a lower reserve percentage applied to them based on historical loss percentages.

Total charge-offs were \$154,000 in 2004 compared to recoveries of \$30,000 on loans previously charged-off. For 2003, total charge-offs and recoveries were \$31,000 and \$50,000, respectively. At December 31, 2004, the allowance for loan losses was \$3.8 million, or .74% of year-end loans, compared to \$2.8 million, or .70% of loans at December 31, 2003. Total non-accrual loans at December 31, 2004, were \$2.6 million compared to \$6.4 million at December 31, 2003. The amount needed in the allowance for loan losses for nonaccrual loans is based on the particular circumstances of the individual loans, including the type, amount, and value of the collateral, if any, and the overall composition and amount of the performing loans in the portfolio at the time of evaluation, and, as a result, will vary over time.

**Other Income.** Other income increased slightly to \$2.4 million for the year ended December 31, 2004.

**Other Expense.** Other expense increased to \$9.3 million in 2004, or 5.8% from \$8.8 million in 2003. The increase was the result of increased salary and employee benefits expense, occupancy expenses, professional services and data processing expense. The increase in salary and employee benefits of \$361,000 was the result of additions to staff, due to the continued growth of the Company and the opening of the new branches in June 2003 and October 2003 and the relocation to our permanent Deltona branch in 2004, which also caused occupancy expense to increase. In addition, staff was added in the commercial and residential loan departments as part of our strategy to increase loan production. Data processing expense increased as a result of an increase in the number of accounts and the opening of the new branches.

**Income Taxes.** Income taxes increased from \$1.3 million (an effective tax rate of 31.5%) in 2003 to \$1.5 million (an effective tax rate of 32.6%) in 2004.

## **ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.**

### **Asset /Liability Management**

It is the objective of the Company to manage assets and liabilities to provide a satisfactory, consistent level of profitability within the framework of established cash, loan, investment, borrowing and capital policies. The Bank's management is responsible for monitoring policies and procedures that are designed to ensure acceptable composition of the asset/liability mix, stability and leverage of all sources of funds while adhering to prudent banking practices. It is the overall philosophy of management to support asset growth through FHLB advances, borrowings, and most importantly, core deposits, which include deposits of all categories made by individuals, partnerships and corporations. Management of the Company seeks to invest the largest portion of its assets in residential, commercial, and consumer loans.

The asset/liability mix is monitored on a monthly basis and a monthly report reflecting interest-sensitive assets and interest-sensitive liabilities is prepared and presented to the Bank's Board of Directors. The objective of this policy is to control interest-sensitive assets and liabilities to minimize the impact of substantial movements in interest rates on the Bank's earnings.

Our profitability, like that of most bank holding companies and financial institutions, is dependent to a large extent upon its net interest income, which is the difference between our interest income on interest-earning assets, such as loans, mortgage-backed securities and investment securities, and our interest expense on interest-bearing liabilities, such as deposits and other borrowings. Financial institutions are affected by general changes in levels of interest rates and other economic factors beyond their control. At December 31, 2005, our cumulative, one-year interest sensitivity gap (the difference between the amount of interest-earning assets anticipated to mature or reprice within one year and the amount of interest-bearing liabilities anticipated to mature or reprice within one year) as a percentage of total assets was a negative 22.8%, while our three-month gap was virtually matched with \$277.5 million assets and \$274.8 million in liabilities scheduled or eligible for repricing. Generally, an institution with a negative gap would experience a decrease in net interest income in a period of rising interest rates or an increase in net interest income in a period of declining interest rates since there will be more liabilities than assets that will either mature or be subject to repricing within the one-year period. However, certain shortcomings are inherent in this rate sensitivity analysis. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different manners to changes in market interest rates. Therefore, no assurance can be given that we will be able to maintain our net interest-rate spread as market interest rates fluctuate.

We monitor our interest-rate risk through the Asset/Liability Committee which meets regularly and reports the results of the meetings to the Board of Directors. Our policy is to seek to maintain a balance between interest-earning assets and interest-bearing liabilities so that the cumulative one-year gap is within a range established by the Board of Directors and which we believe is conducive to maintaining profitability without incurring undue risk. During 2005, we increased our investment in adjustable-rate and shorter average-life loans and as noted above, our matched three-month gap position will help reduce the negative impact of the anticipated further increases in short-term interest rates in the first half of 2006.

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The following table sets forth the amounts of interest-earning assets and interest-bearing liabilities outstanding at December 31, 2005, that are expected to reprice, based upon certain assumptions and contractual maturities, in each of the future periods shown. Adjustable-rate mortgage-backed securities are scheduled according to their next adjustment date and fixed-rate mortgage-backed securities are scheduled according to their maturity date (in thousands):

	Three Months or Less	More than Three Months to Six Months	More than Six Months to 12 Months	More than One Year to 3 Years	More than Three Years to 5 Years	More than Five Years to 10 Years	More than Ten Years	Total
<b>Rate-sensitive assets:</b>								
Residential lending	\$ 122,568	\$ 41,587	\$ 39,871	\$ 193,773	\$ 67,893	\$ 4,952	\$ 9,969	\$ 480,613
Commercial and consumer lending	128,820	3,550	5,197	5,973	8,932	1,680	1,597	155,749
Mortgage-backed securities	2,918	242	719	8,141	3,275	4,470	2,563	22,328
Debt securities	6,541	42	86	465	605	12,302	2,696	22,737
Corporate equity securities			2,750		3,668		76	6,494
FHLB stock	10,273							10,273
Interest-earning deposits	6,424							6,424
<b>Total interest-earning assets</b>	<b>277,544</b>	<b>45,421</b>	<b>48,623</b>	<b>208,352</b>	<b>84,373</b>	<b>23,404</b>	<b>16,901</b>	<b>704,618</b>
<b>Rate-sensitive liabilities:</b>								
<b>Deposits:</b>								
Demand, money-market and savings accounts	134,115							134,115
Time deposits	73,880	76,533	145,120	27,155	630	1		323,319
FHLB advances	57,500	10,000	30,000	99,200	5,000			201,700
Other borrowings	9,255		2,764					12,019
<b>Total interest-bearing liabilities</b>	<b>274,750</b>	<b>86,533</b>	<b>177,884</b>	<b>126,355</b>	<b>5,630</b>	<b>1</b>		<b>671,153</b>
<b>Interest-sensitivity gap</b>	<b>\$ 2,794</b>	<b>\$ (41,112)</b>	<b>\$ (129,261)</b>	<b>\$ 81,997</b>	<b>\$ 78,743</b>	<b>\$ 23,403</b>	<b>\$ 16,901</b>	<b>\$ 33,465</b>
<b>Cumulative interest-sensitivity gap</b>	<b>\$ 2,794</b>	<b>\$ (38,318)</b>	<b>\$ (167,579)</b>	<b>\$ (85,582)</b>	<b>\$ (6,839)</b>	<b>\$ 16,564</b>	<b>\$ 33,465</b>	
<b>Cumulative interest-earning assets</b>	<b>\$ 277,544</b>	<b>\$ 322,965</b>	<b>\$ 371,588</b>	<b>\$ 579,940</b>	<b>\$ 664,313</b>	<b>\$ 687,717</b>	<b>\$ 704,618</b>	
<b>Cumulative interest-bearing liabilities</b>	<b>\$ 274,750</b>	<b>\$ 361,283</b>	<b>\$ 539,167</b>	<b>\$ 665,522</b>	<b>\$ 671,152</b>	<b>\$ 671,153</b>	<b>\$ 671,153</b>	
<b>Cumulative interest-sensitivity gap as a percentage of total assets</b>	<b>0.4%</b>	<b>-5.2%</b>	<b>-22.8%</b>	<b>-11.6%</b>	<b>-0.9%</b>	<b>2.3%</b>	<b>4.6%</b>	
<b>Cumulative interest-earning assets as a percentage of cumulative interest-bearing liabilities</b>	<b>101.0%</b>	<b>89.4%</b>	<b>68.9%</b>	<b>87.1%</b>	<b>99.0%</b>	<b>102.5%</b>	<b>105.0%</b>	



**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

Certain information required by this Item is included in Item 6 of Part II of this report under the heading "Selected Quarterly Financial Data" and is incorporated by reference. All other information required by this Item is included in Item 15 of Part IV of this Form 10-K and is incorporated into this Item by reference.

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## FEDERAL TRUST CORPORATION AND SUBSIDIARIES

Consolidated Balance Sheets  
(\$ in thousands, except per share amounts)

	At December 31,	
	2005	2004
<b>Assets</b>		
Cash and due from banks	\$ 6,572	3,645
Interest-earning deposits	6,424	3,836
Cash and cash equivalents	12,996	7,481
Securities available for sale	50,080	41,172
Loans, less allowance for loan losses of \$4,477 in 2005 and \$3,835 in 2004	630,827	521,331
Accrued interest receivable	4,138	3,254
Premises and equipment, net	14,376	12,499
Foreclosed assets	556	326
Federal Home Loan Bank stock	10,273	7,385
Mortgage servicing rights, net	804	868
Bank-owned life insurance	6,964	6,717
Deferred tax asset	2,476	1,119
Other assets	1,926	979
<b>Total assets</b>	<b>\$ 735,416</b>	<b>603,131</b>
<b>Liabilities and Stockholders Equity</b>		
Liabilities:		
Noninterest-bearing demand deposits	\$ 13,628	21,305
Interest-bearing demand deposits	51,682	48,792
Money-market deposits	78,371	76,236
Savings deposits	4,062	6,237
Time deposits	323,319	251,546
<b>Total deposits</b>	<b>471,062</b>	<b>404,116</b>
Federal Home Loan Bank advances	201,700	143,700
Other borrowings	4,100	885
Junior subordinated debentures	5,155	5,155
Capital lease obligation	2,764	3,049
Accrued interest payable	1,208	811
Official checks	1,589	1,045
Other liabilities	3,697	4,983
<b>Total liabilities</b>	<b>691,275</b>	<b>563,744</b>
Commitments and contingencies (Notes 5, 11 and 17)		
Stockholders equity:		
Common stock, \$.01 par value, 15,000,000 shares authorized; 8,299,343 and 8,061,813 shares issued in 2005 and 2004, respectively	83	81
Additional paid-in capital	33,679	32,059
Retained earnings	11,459	8,089
Unallocated ESOP shares (21,789 and 119,375 shares)	(157)	(862)
Accumulated other comprehensive income (loss)	(923)	20
<b>Total stockholders equity</b>	<b>44,141</b>	<b>39,387</b>
<b>Total liabilities and stockholders equity</b>	<b>\$ 735,416</b>	<b>603,131</b>

See Accompanying Notes to Consolidated Financial Statements.



## FEDERAL TRUST CORPORATION AND SUBSIDIARIES

Consolidated Statements of Earnings  
(\$ in thousands, except per share amounts)

	Year Ended December 31,		
	2005	2004	2003
Interest income:			
Loans	\$ 31,484	23,034	19,591
Securities	2,001	1,290	1,112
Other	492	285	218
Total interest income	33,977	24,609	20,921
Interest expense:			
Deposits	12,604	7,559	7,083
Other	6,732	3,292	2,667
Total interest expense	19,336	10,851	9,750
Net interest income	14,641	13,758	11,171
Provision for loan losses	650	1,180	650
Net interest income after provision for loan losses	13,991	12,578	10,521
Other income:			
Service charges and fees	304	388	348
Gain on sale of loans held for sale	368	519	604
Gain on sale of securities available for sale	208	64	363
Rental income	304	262	408
Increase in cash surrender value of life insurance policies	247	262	206
Other	1,102	896	429
Total other income	2,533	2,391	2,358
Other-than-temporary impairment		(1,055)	
Other expense:			
Salary and employee benefits	5,203	4,892	4,531
Occupancy expense	1,623	1,502	1,483
Professional services	665	575	466
Data processing	656	637	572
Marketing and advertising	214	314	209
Other	1,430	1,414	1,565
Total other expense	9,791	9,334	8,826
Earnings before income taxes	6,733	4,580	4,053
Income taxes	2,297	1,491	1,276
Net earnings	\$ 4,436	3,089	2,777
Earnings per share:			
Basic	\$ 0.55	0.44	0.42
Diluted	\$ 0.54	0.43	0.42



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See Accompanying Notes to Consolidated Financial Statements

## FEDERAL TRUST CORPORATION AND SUBSIDIARIES

## Consolidated Statements of Stockholders' Equity

Years Ended December 31, 2005, 2004 and 2003

(\$ in thousands)

	Common Stock		Additional Paid-In Capital	Retained Earnings	Unallocated ESOP Shares	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
	Shares	Amount					
Balance at December 31, 2002	6,591,338	\$ 66	21,778	3,180		15	25,039
Comprehensive income:							
Net earnings				2,777			2,777
Change in net unrealized loss on securities available for sale, net of tax of \$87						(344)	(344)
Comprehensive income							2,433
Issuance of common stock, net of issuance cost of \$39	70,469	1	281				282
Purchase of common shares for the ESOP (135,592 shares)					(979)		(979)
Dividends paid, \$.05 per share				(328)			(328)
Accretion of stock options for stock compensation programs			10				10
Balance at December 31, 2003	6,661,807	\$ 67	22,069	5,629	(979)	(329)	26,457
Comprehensive income:							
Net earnings				3,089			3,089
Change in net unrealized gain on securities available for sale, net of tax benefit of \$195						349	349
Comprehensive income							3,438
Proceeds from sale of common stock, net of offering costs of \$531	1,400,000	14	9,955				9,969
Issuance of common stock, stock options exercised	6						
ESOP shares allocated (16,217 shares)			35		117		152
Dividends paid, \$.09 per share				(629)			(629)
Balance at December 31, 2004	8,061,813	\$ 81	32,059	8,089	(862)	20	39,387

(Continued)

## FEDERAL TRUST CORPORATION AND SUBSIDIARIES

## Consolidated Statements of Stockholders Equity, Continued

Years Ended December 31, 2005, 2004 and 2003  
(\$ in thousands)

	Common Stock		Additional Paid-In Capital	Retained Earnings	Unallocated ESOP Shares	Accumulated Other Comprehensive Income (Loss)	Total Stockholders Equity
	Shares	Amount					
Balance at December 31, 2004	8,061,813	\$ 81	32,059	8,089	(862)	20	39,387
Comprehensive income:							
Net earnings				4,436			4,436
Change in net unrealized loss on securities available for sale, net of tax of \$569						(943)	(943)
Comprehensive income							3,493
Tax benefit related to exercise stock options			169				169
Issuance of common stock, stock options exercised	237,530	2	989				991
ESOP shares allocated (27,586 shares)			131		199		330
ESOP shares sold (70,000 shares)			331		506		837
Dividends paid, \$.13 per share				(1,066)			(1,066)
Balance at December 31, 2005	8,299,343	\$ 83	33,679	11,459	(157)	(923)	44,141

See Accompanying Notes to Consolidated Financial Statements.

## FEDERAL TRUST CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows  
(In thousands)

	Year Ended December 31,		
	2005	2004	2003
Cash flows from operating activities:			
Net earnings	\$ 4,436	3,089	2,777
Adjustments to reconcile net earnings to net cash provided by operating activities:			
Depreciation and amortization	690	664	577
Net amortization of premiums and discounts on securities	81	347	326
Amortization of mortgage servicing rights	403	385	542
Valuation allowance on mortgage servicing rights	(100)	30	70
Net amortization of loan origination fees, costs, premiums and discounts	982	1,108	1,770
Provision for loan losses	650	1,180	650
Other-than-temporary impairment		1,055	
Loans originated for resale	(11,762)	(10,036)	(20,337)
Proceeds from sales of loans held for sale	24,776	29,151	40,164
Gain on sale of loans held for sale	(368)	(519)	(604)
Deferred income tax benefit	(788)	(673)	(338)
Gain on sale of securities available for sale	(208)	(64)	(363)
Loss on sale of foreclosed assets			41
Increase in cash surrender value of life insurance policies	(247)	(262)	(206)
Accretion of stock option expense			10
Allocate ESOP shares		152	
Tax benefit from options	169		
Cash provided by (used in) resulting from changes in:			
Accrued interest receivable	(884)	(920)	(148)
Other assets	(947)	497	(920)
Accrued interest payable	397	284	78
Official checks	544	(567)	(166)
Other liabilities	(853)	1,233	(1,320)
Net cash provided by operating activities	16,971	26,134	22,603
Cash flows from investing activities:			
Principal repayments, net of loans originated	80,031	33,291	63,991
Purchase of loans	(207,136)	(178,482)	(176,828)
Purchase of securities available for sale	(22,671)	(24,404)	(36,607)
Proceeds from principal repayments, calls and sales of securities available for sale	14,916	16,053	24,014
Net proceeds from the sale of foreclosed assets	324	1,748	941
Purchase of Federal Home Loan Bank stock	(2,888)	(1,725)	(2,800)
Purchase of premises and equipment	(2,567)	(1,260)	(2,623)
Purchase of bank-owned life insurance			(3,400)
Net cash used in investing activities	(139,991)	(154,779)	(133,312)
Cash flows from financing activities:			
Net increase in deposits	66,946	89,486	36,099
Net increase in Federal Home Loan Bank advances	58,000	36,000	53,500
Net increase (decrease) in other borrowings	3,215	(4,332)	4,302
Principal repayments under capital lease obligation	(285)	(285)	(305)
Proceeds from issuance of junior subordinated debentures			5,155
Net increase (decrease) in advance payments by borrowers for taxes and insurance	(103)	184	(117)
Dividends paid	(1,066)	(629)	(328)
Purchase of common shares for the ESOP			(979)
Net proceeds from the sale of common stock	1,828	9,969	282
Net cash provided by financing activities	128,535	130,393	97,609

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Net increase (decrease) in cash and cash equivalents	5,515	1,748	(13,100)
Cash and cash equivalents at beginning of year	7,481	5,733	18,833
Cash and cash equivalents at end of year	\$ 12,996	7,481	5,733

(Continued)

## FEDERAL TRUST CORPORATION AND SUBSIDIARIES

Consolidated Statements of Cash Flows, Continued  
(In thousands)

	Year Ended December 31,		
	2005	2004	2003
Supplemental disclosure of cash flow information:			
Cash paid during the year for:			
Interest	\$ 18,939	10,567	9,672
Income taxes	\$ 2,521	2,115	1,914
Noncash transactions:			
Foreclosed assets acquired in settlement of loans	\$ 554	1,067	1,131
Other comprehensive income (loss), net change in unrealized gain (loss) on securities available for sale, net of tax	\$ (943)	349	(344)
Other-than-temporary impairment on securities available for sale	\$	1,055	
Premises and equipment under capital lease obligation	\$		1,500
Securitization of loans held for sale	\$ 2,538		
Transfer of loans in portfolio to loans held for sale	\$ 14,850	19,855	18,361
Mortgage servicing rights recognized upon sale of loans held for sale	\$ 239	310	260

See Accompanying Notes to Consolidated Financial Statements.

**FEDERAL TRUST CORPORATION AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements**

**At December 31, 2005 and 2004 and for Each of the Years  
in the Three-Year Period Ended December 31, 2005**

**(1) Organization and Summary of Significant Accounting Policies**

**Organization.** Federal Trust Corporation ( Federal Trust ) is the sole shareholder of Federal Trust Bank (the Bank ) and Federal Trust Mortgage Company ( Mortgage Company ). Federal Trust operates as a unitary savings and loan holding company. Federal Trust's business activities primarily include the operation of the Bank and the Mortgage Company. The Bank is federally-chartered as a stock savings bank. The Bank's deposits are insured up to the applicable limits by the Federal Deposit Insurance Corporation. The Bank provides a wide range of banking services to individual and corporate customers through its seven offices located in Orange, Seminole and Volusia Counties, Florida. The Mortgage Company was established in May 2005 and commenced operations in January 2006 to provide residential loan products for customers of the Bank, to close mortgage loans on behalf of certain third party purchasers, and to sell mortgage loans in the secondary market.

FTB Financial, Inc., a wholly-owned subsidiary of the Bank, provided investment services to customers of the Bank. FTB Financial, Inc. ceased operations in September 2003 and is currently inactive.

**Basis of Financial Statement Presentation.** The consolidated financial statements include the accounts of Federal Trust, the Bank and the Bank's subsidiary (together, the Company ). All significant intercompany accounts and transactions have been eliminated in consolidation.

The accounting and reporting policies of the Company conform to U.S. generally accepted accounting principles and prevailing practices within the banking industry. The following summarizes the more significant of these policies and practices.

**Use of Estimates.** The preparation of consolidated financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amount of revenues and expenses during the reporting period. The most significant estimates made by management that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and foreclosed assets and the valuation of deferred tax assets. Actual results could differ from these estimates.

**Cash and Cash Equivalents.** For the purposes of reporting cash flows, cash and cash equivalents includes cash and due from banks and interest-earning deposits with maturities of three months or less.

The Bank is required by law or regulation to maintain cash reserves in the form of vault cash or in a noninterest-earning account with the Federal Reserve Bank or other qualified banks, based on its transaction deposit accounts. These reserve balances at December 31, 2005 and 2004 were approximately \$2,849,000 and \$1,449,000, respectively.

(Continued)

**FEDERAL TRUST CORPORATION AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements, Continued**

**(1) Organization and Summary of Significant Accounting Policies, Continued**

**Securities.** The Company may classify its securities as either trading, held to maturity or available for sale. Trading securities are held principally for resale and recorded at their fair values. Unrealized gains and losses on trading securities are included immediately in earnings. Held-to-maturity securities are those which the Company has the positive intent and ability to hold to maturity and are reported at amortized cost. Available-for-sale securities consist of securities not classified as trading securities nor as held-to-maturity securities. Unrealized holding gains and losses, net of tax, on available-for-sale securities are excluded from earnings and reported in accumulated other comprehensive income (loss). A security is considered impaired if its fair value is less than its accumulated cost. If the impairment is considered to be other-than-temporary, an impairment loss is recognized in earnings equal to the difference between the security's cost and its fair value. During the year ended December 31, 2004, the Company recorded an other-than-temporary loss of approximately \$1,055,000 (see note 2). Gains and losses on the sale of available-for-sale securities are recorded on the trade date and determined using the specific-identification method. Premiums and discounts on securities available for sale are recognized in interest income using the interest method over the period to maturity.

**Loans.** Loans that management has the intent and the Company has the ability to hold until maturity or payoff, are reported at their outstanding unpaid principal balance, adjusted for premiums or discounts on loans purchased, charge-offs and recoveries, the allowance for loan losses and deferred fees and costs on originated loans.

Loan origination fees are deferred and certain direct loan origination costs are capitalized. Both are recognized in earnings over the contractual life of the loans, adjusted for estimated prepayments based on the Company's historical prepayment experience. If the loan is prepaid, the remaining unamortized fees and costs are charged to earnings. Amortization is ceased on nonaccrual loans.

Loans are placed on nonaccrual status when the loan becomes more than 90 days past due as to interest or principal, unless the loan is both well collateralized and in the process of collection, or when the full, timely collection of interest or principal becomes uncertain. When a loan is placed on nonaccrual status, the accrued and unpaid interest receivable is written off and the loan is accounted for on the cash or cost recovery method thereafter, until qualifying for return to accrual status.

The Company considers a loan to be impaired when it is probable that the Company will be unable to collect all amounts due, both principal and interest, according to the contractual terms of the loan agreement. When a loan is impaired, the Company may measure impairment based on (a) the present value of the expected future cash flows of the impaired loan discounted at the loan's original effective interest rate, (b) the observable market price of the impaired loan, or (c) the fair value of the collateral of a collateral-dependent loan. The Company selects the measurement method on a loan-by-loan basis, except for collateral-dependent loans for which foreclosure is probable, are measured at the fair value of the collateral. In a troubled debt restructuring involving a restructured loan, the Company measures impairment by discounting the total expected future cash flows at the loan's original effective rate of interest.

(Continued)



**FEDERAL TRUST CORPORATION AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements, Continued**

**(1) Organization and Summary of Significant Accounting Policies, Continued**

**Loans Held for Sale.** Loans originated that are intended to be sold in the secondary market are carried at the lower of cost or estimated fair value in the aggregate. Net unrealized losses are recognized through a valuation allowance by charges to earnings. The Company had approximately \$1,055,000 and \$1,628,000 of loans held for sale at December 31, 2005 and 2004, respectively, which are included in loans on the accompanying consolidated balance sheets and the fair value of these loans exceeded book value in the aggregate. Loan origination fees are deferred and direct loan origination costs are capitalized until the related loan is sold, at which time the net fees are included in the gain on sale of loans held for sale in the consolidated statements of earnings.

**Allowance for Loan Losses.** The Company follows a consistent procedural discipline and accounts for loan loss contingencies in accordance with Statement of Financial Accounting Standards No.5, *Accounting for Contingencies* (Statement 5). The following is a description of how each portion of the allowance for loan losses is determined.

The Company segregates the loan portfolio for loan loss purposes into the following broad segments: commercial real estate; residential real estate; commercial business; and consumer loans. The Company provides for a general allowance for losses inherent in the portfolio by the above categories, which consists of two components. First, general loss percentages are calculated based upon historical analyses. Second, 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 supplemental 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; changes in the outlook for local, regional and national economic conditions and concentrations of credit risk.

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 state the allowance for loan losses to the required level.

Regulatory examiners may require the Company to recognize additions to the allowance based upon their judgments about the information available to them at the time of their examination. Management believes that the allowance for loan losses is adequate at December 31, 2005.

**Mortgage Servicing Rights.** Mortgage servicing rights are recognized as separate assets when rights are acquired through sale of financial assets. For sales of mortgage loans, a portion of the cost of originating the loan is allocated to the servicing right based on relative fair value. Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively, is based on a valuation model that calculates the net present value of estimated future net servicing income.

(Continued)

FEDERAL TRUST CORPORATION AND SUBSIDIARIES

Notes to Consolidated Financial Statements, Continued

(1) Organization and Summary of Significant Accounting Policies, Continued

**Mortgage Servicing Rights, Continued.** The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earning rate, an inflation rate, ancillary income, prepayment speeds and default rates and losses. Capitalized servicing rights are reported as an asset and are amortized into non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets.

Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to amortized costs. Impairment is determined by stratifying rights into tranches based on predominant risk characteristics, such as interest rate, loan type and investor type. Impairment is recognized through a valuation allowance account, to the extent that all or a portion of the impairment no longer exists based on the fair value, a reduction of the allowance may be recorded as an increase to income. There was no valuation allowance at December 31, 2005 and at December 31, 2004 the Company had a valuation allowance of \$100,000.

Servicing fee income is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal; or a fixed amount per loan and are recorded as income when earned. The amortization of mortgage servicing rights is netted against loan servicing fee income.

**Foreclosed Assets.** Assets acquired in the settlement of loans are initially recorded at the lower of cost (principal balance of the former loan plus costs of obtaining title and possession) or estimated fair value at the date of acquisition. Subsequently, such assets acquired are carried at the lower of cost or fair value less estimated costs to sell. Costs relating to development and improvement of foreclosed assets are capitalized, whereas costs relating to holding the foreclosed assets are charged to earnings.

**Premises and Equipment.** Land is stated at cost. Premises and equipment and leasehold improvements are stated at cost less accumulated depreciation and amortization. Depreciation is computed using the straight-line method over the estimated useful lives of the related assets. Amortization of leasehold improvements is computed using the straight-line method over the lesser of the estimated useful lives or the respective lease terms, including renewal options expected to be exercised. Major renovations and betterments of property are capitalized; maintenance, repairs, and minor renovations and betterments are expensed in the period incurred. Upon retirement or other disposition of the assets, the asset cost and related accumulated depreciation or amortization are removed from the accounts, and gains or losses are included in earnings.

**Stock Compensation Plans.** Statement of Financial Accounting Standards (SFAS) No. 123R, *Accounting for Stock-Based Compensation*, requires all entities to adopt a fair value based method of accounting for employee stock compensation plans effective January 1, 2006, whereby compensation cost is measured at the grant date based on the value of the award and is recognized over the service period, which is usually the vesting period. However, for year ending December 31, 2005, it also allows an entity to continue to measure compensation cost for those plans using the intrinsic value based method of accounting prescribed by Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* ( APB No. 25 ), whereby compensation cost is the excess, if any, of the quoted market price of the stock at the grant date (or other measurement date) over the amount an employee must pay to acquire the stock. The Company accounts for their stock option plans under the recognition and measurement principles of APB No. 25.

(Continued)

## FEDERAL TRUST CORPORATION AND SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

## (1) Organization and Summary of Significant Accounting Policies, Continued

**Stock Compensation Plans, Continued.** In December 2005, the Board of Directors of the Company approved the acceleration of vesting of 196,309 stock options. The expense that would have been recorded in 2006 through 2010 under the provision of SFAS 123R if the vesting of the options had not been accelerated, would have been \$238,000. The implementation of this statement is expected to result in an additional \$31,000 in expense for the year ended December 31, 2006, based on current options outstanding.

The following table illustrates the assumptions used in calculating the grant-date fair value and the effect on net earnings and basic and diluted earnings per share as if the Company had applied the fair value recognition provisions of SFAS No. 123R to stock-based employee compensation. For purposes of proforma disclosure, the estimated fair value is included in expense in the period vesting occurs (\$in thousands, except per share amounts):

	Year Ended December 31,		
	2005	2004	2003
<b>Assumptions:</b>			
Weighted-average risk-free rate of return	4.27%	4.68%	4.42%
Annualized dividend yield	1.35%	1.05%	.80%
Expected life of options granted	3 years	10 years	10 years
Expected stock volatility	20%	20%	30%
<b>Year Ended December 31,</b>			
	2005	2004	2003
Grant-date fair value of options issued during the year	\$ 482	8	495
Weighted-average grant-date fair value per option of options issued during the year	\$ 2.22	2.68	3.01
Net earnings, as reported	\$ 4,436	3,089	2,777
Deduct: Total stock-based employee compensation determined under the fair value based method for all awards, net of related tax benefit	(658)	(181)	(159)
Proforma net earnings	\$ 3,778	2,908	2,618
<b>Basic earnings per share:</b>			
As reported	\$ .55	.44	.42
Proforma	\$ .47	.41	.40
<b>Diluted earnings per share:</b>			
As reported	\$ .54	.43	.42
Proforma	\$ .46	.40	.39

(Continued)

## FEDERAL TRUST CORPORATION AND SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

## (1) Organization and Summary of Significant Accounting Policies, Continued

**Comprehensive Income.** Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net earnings. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the equity section of the consolidated balance sheets, such items, along with net earnings, are components of comprehensive income.

The components of other comprehensive income (loss) and related tax effects are as follows (in thousands):

	Year Ended December 31,		
	2005	2004	2003
Unrealized holding losses on securities available for sale	\$ (1,304)	(447)	(172)
Reclassification adjustment for gains realized in earnings	(208)	(64)	(363)
Reclassification adjustment for other than temporary impairment realized		1,055	
Net change in unrealized amount	(1,512)	544	(535)
Income taxes (benefit)	(569)	195	(191)
Net amount	\$ (943)	349	(344)

(Continued)

## FEDERAL TRUST CORPORATION AND SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

## (1) Organization and Summary of Significant Accounting Policies, Continued

**Earnings Per Share of Common Stock.** The Company follows the provisions of Statement of Financial Accounting Standards No. 128, *Earnings Per Share* ( SFAS No. 128 ). SFAS No. 128 provides accounting and reporting standards for calculating earnings per share. Basic earnings per share of common stock have been computed by dividing the net earnings for the year by the weighted-average number of shares outstanding. Shares of common stock purchased by the Company's Employee Stock Ownership Plan ( ESOP ) are considered outstanding when the shares are allocated to participants. Diluted earnings per share is computed by dividing net earnings by the weighted-average number of shares outstanding including the dilutive effect of stock options computed using the treasury stock method. The following table presents the calculation of basic and diluted earnings per share of common stock (in thousands, except per share amounts):

	Year Ended December 31,		
	2005	2004	2003
Weighted-average shares outstanding before adjustment for unallocated ESOP shares	8,197	7,213	6,592
Adjustment to reflect the effect of unallocated ESOP shares	(90)	(131)	(43)
Weighted-average shares outstanding for basic earnings per share	8,107	7,082	6,549
Basic earnings per share	\$ .55	.44	.42
Total weighted-average shares outstanding for basic earnings per share computation	8,107	7,082	6,549
Additional dilutive shares using the average market value for the period utilizing the treasury stock method regarding stock options	125	180	113
Weighted-average shares and equivalents outstanding for diluted earnings per share	8,232	7,262	6,662
Diluted earnings per share	\$ .54	.43	.42

**Income Taxes.** Federal Trust and the Bank file a consolidated income tax return. Income taxes are allocated between Federal Trust and the Bank as though separate income tax returns were filed.

The Company accounts for income taxes under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be realized or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in earnings in the period that includes the enactment date. Valuation allowances are provided against assets which are not likely to be realized.

(Continued)

**FEDERAL TRUST CORPORATION AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements, Continued**

**(1) Organization and Summary of Significant Accounting Policies, Continued**

**Off-Balance Sheet Financial Instruments.** In the ordinary course of business, the Company has entered into off-balance-sheet financial instruments consisting of commitments to extend credit, unused lines of credit, standby letters of credit and undisbursed construction loans in process. Such financial instruments are recorded in the consolidated financial statements when they are funded.

**Recent Accounting Pronouncements**

In May 2005, the FASB issued FASB Statement No. 154, *Accounting Changes and Error Corrections—a replacement of APB Opinion 20 and FASB Statement 3*. This Statement provides guidance on the accounting for and reporting of accounting changes and error corrections. It establishes, unless impracticable, retrospective application as the required method for reporting a change in accounting principle in the absence of explicit transition requirements specific to the newly adopted accounting principle. This statement also provides guidance for determining whether retrospective application of a change is impracticable and for reporting a change when retrospective application is impracticable. This statement shall be effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. Management believes this Statement will not have a material effect on the Company's consolidated financial statements.

In December 2004, the FASB issued FASB Statement No. 153, *Exchanges of Nonmonetary Assets — an Amendment to APB opinion No. 29*. This Statement addresses the measurement of exchanges of nonmonetary assets. The Statement is effective for fiscal periods beginning after June 15, 2005. Management believes this Statement will not have a material effect on the Company's consolidated financial statements.

On December 16, 2004, the FASB issued FASB Statement No. 123(R), *Share-Based Payment*. Statement 123(R) replaces FASB Statement No. 123, *Accounting for Stock-Based Compensation*, supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees* and amends FASB Statement No. 95, *Statement of Cash Flows*. Statement 123(R) requires that all share-based payments to employees, including grants of employee stock options, be recognized in the financial statements based on their fair values. The provisions of Statement 123(R) are effective prospectively as of the first interim or annual reporting period that begins after June 15, 2005. On March 30, 2005, the SEC Staff issued Staff Accounting Bulletin No. 107, *Application of FASB Statement 123R, Share-Based Payment* which amends the effective date to begin the first *annual* period beginning after June 15, 2005. In anticipation of the adoption of SFAS No. 123(R), the Company accelerated vesting of a number of the outstanding unvested stock options to purchase shares of common stock in December 2005. The decision to accelerate the vesting of stock options, which the Company believes to be in the best interest of its stockholders, was made primarily to reduce non-cash compensation expense that would have been recorded in its statements of earnings in future periods upon the adoption of SFAS 123(R) beginning in January 2006. The implementation of this statement is expected to result in an additional \$31,000 in compensation expense for fiscal year 2006, based on current unvested options outstanding.

(Continued)

**FEDERAL TRUST CORPORATION AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements, Continued**

**(1) Organization and Summary of Significant Accounting Policies, Continued**

In the second quarter of 2004, the Emerging Issues Task Force ( EITF ) released EITF Issue 03-01, *The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*. The Issue provided guidance for evaluating whether an investment is other-than-temporarily impaired and requires certain disclosures with respect to these investments. On September 30, 2004, the FASB issued FASB Staff position ( FSP ) EITF 3-1-1, *Effective Date of Paragraph 10-20 of EITF Issue 03-1, The Meaning of Other-Than-Temporary Impairment and its Application to Certain Investments*. This Staff Position delayed certain measurement and recognition provisions of EITF 03-1. Please see *Note 2 Securities of the Notes to Consolidated Financial Statements* for information relating to the required disclosures with respect to these investments.

**Reclassification.** Certain amounts in the 2004 and 2003 consolidated financial statements have been reclassified to conform with the 2005 presentation.

(Continued)

## FEDERAL TRUST CORPORATION AND SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

## (2) Securities Available for Sale

All securities have been classified as available for sale by management. The amortized cost and estimated fair values of securities available for sale are as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>At December 31, 2005:</b>				
Mortgage-backed securities	\$ 22,328	6	(527)	21,807
Municipal bonds	12,434	45	(158)	12,321
Corporate equity securities	6,494		(408)	6,086
U.S. government agency securities	4,842		(44)	4,798
Corporate bonds	5,461		(393)	5,068
	<u>\$ 51,559</u>	<u>51</u>	<u>(1,530)</u>	<u>50,080</u>
<b>At December 31, 2004:</b>				
Mortgage-backed securities	24,118	95	(61)	24,152
Municipal bonds	1,046	15	(5)	1,056
Corporate equity securities	8,988	98	(14)	9,072
U.S. government agency securities	2,992		(15)	2,977
Corporate Bonds	3,995		(80)	3,915
	<u>\$ 41,139</u>	<u>208</u>	<u>(175)</u>	<u>41,172</u>

The amortized cost and estimated fair values of securities available for sale at December 31, 2005, by contractual maturity are below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties (in thousands):

	Amortized Cost	Fair Value
Due after one year up to five years	\$ 4,455	4,196
Due after five years up to ten years	5,848	5,670
Due after ten years	12,434	12,321
Mortgage-backed securities	22,328	21,807
Corporate equity securities	6,494	6,086
	<u>\$ 51,599</u>	<u>50,080</u>

(Continued)



## FEDERAL TRUST CORPORATION AND SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

## (2) Securities Available for Sale, Continued

The following summarizes sales of securities (in thousands):

	Year Ended December 31,		
	2005	2004	2003
Proceeds from sales	\$ 5,315	9,352	13,753
Gross gains from sales	\$ 215	114	363
Gross losses from sales	(7)	(50)	
Net gain	\$ 208	64	363

Information pertaining to securities with gross unrealized losses at December 31, 2005, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows (in thousands):

	Less Than Twelve Months		Over Twelve Months	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
<b>At December 31, 2005:</b>				
Mortgage-backed securities	\$ (330)	12,557	(197)	8,190
Municipal bonds	(158)	8,346		101
Corporate equity securities	(371)	3,296	(37)	2,789
U.S. government agency securities	(10)	983	(34)	1,967
Corporate Bonds	(88)	1,377	(305)	3,692
	\$ (957)	26,559	(573)	16,739
<b>At December 31, 2004:</b>				
Mortgage-backed securities	\$ (60)	9,107	(1)	268
Municipal bonds			(5)	318
Corporate equity securities	(11)	3,489	(3)	997
U.S. government agency securities	(15)	2,977		
Corporate Bonds	(80)	3,915		
	\$ (166)	19,488	(9)	1,583

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

During 2004, the Company recorded an other-than-temporary impairment write-down of approximately \$1,055,000. The charge related to the Company's \$9.5 million investment in Freddie Mac and Fannie Mae adjustable rate preferred stock. These investment grade securities declined in value in 2004 due to the recent events at Freddie Mac and Fannie Mae coupled with the record low interest rates which caused the dividend payment rate to decline from the original rates at the time of issuance.



## FEDERAL TRUST CORPORATION AND SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

(2) **Securities Available for Sale, Continued**

At December 31, 2005, the Company has nine mortgage-backed securities, fourteen municipal bonds, three corporate equity securities, two U.S. government agency securities and two corporate bonds with unrealized losses. Management believes these unrealized losses relate to changes in interest rates and not credit quality. Management also believes the Company has the ability to hold these securities until maturity or for the foreseeable future and therefore no declines are deemed to be other-than-temporary.

(3) **Loans**

The components of loans are summarized as follows (in thousands):

	At December 31,	
	2005	2004
Residential lending:		
Mortgages (*)	\$ 399,973	374,581
Lot loans	40,203	41,369
Construction	40,437	5,405
<b>Total Residential lending</b>	<b>480,613</b>	<b>421,355</b>
Commercial lending:		
Real Estate Secured	71,253	56,267
Land, Development and Construction	62,709	38,091
Commercial loans	21,340	13,257
<b>Total Commercial lending</b>	<b>155,302</b>	<b>107,615</b>
Consumer loans	447	657
<b>Total loans</b>	<b>636,362</b>	<b>529,627</b>
Add (deduct):		
Allowance for loan losses	(4,477)	(3,835)
Net premiums, discounts, deferred fees and costs	4,584	3,524
Undisbursed portion of loans in process	(5,642)	(7,985)
<b>Loans, net</b>	<b>\$ 630,827</b>	<b>521,331</b>

(\*) Includes approximately \$1,055,000 and \$1,628,000 of loans held for sale at December 31, 2005 and 2004, respectively.

(Continued)

## FEDERAL TRUST CORPORATION AND SUBSIDIARIES

## Notes to Consolidated Financial Statements, Continued

## (3) Loans, Continued

The following is a summary of information regarding nonaccrual and impaired loans (in thousands):

	At December 31,	
	2005	2004
Nonaccrual loans	\$ 2,118	2,600
Accruing loans past due ninety days or more	\$	
Recorded investment in impaired loans for which there is a related allowance for loan losses	\$ 2,118	2,648
Recorded investment in impaired loans for which there is no related allowance for loan losses	\$	
Allowance for loan losses related to impaired loans	\$ 318	290
	<b>Interest Income Recognized and Received on Impaired Loans</b>	<b>Average Net Recorded Investment in Impaired Loans</b>
<b>For the Year Ended December 31:</b>		
2005	\$ 132	2,298
2004	\$ 122	4,181
2003	\$ 111	6,343

The activity in the allowance for loan losses is as follows (in thousands):

	For the Year Ended December 31,		
	2005	2004	2003
Balance at beginning of year	\$ 3,835	2,779	2,110
Provision for loan losses	650	1,180	650
Charge-offs	(10)	(154)	(31)
Recoveries	2	30	50
Balance at end of year	\$ 4,477	3,835	2,779

## (4) Loan Servicing

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Loans serviced for other entities are not included in the accompanying consolidated balance sheets. The unpaid principal balances of these loans were approximately \$69.3 million and \$80.8 million at December 31, 2005 and 2004, respectively.

(Continued)

**FEDERAL TRUST CORPORATION AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements, Continued**

**(4) Loan Servicing, Continued**