

Bancorp, Inc.
Form 10-K
March 13, 2012

UNITED STATES
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 year ended December 31, 2011

OR

☐ 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 51018

The Bancorp, Inc.
(exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

23-3016517
(IRS Employer
Identification No.)

409 Silverside Road, Wilmington, DE
(Address of principal executive offices)

19809
(Zip Code)

Registrant's telephone number, including area code: (302) 385-5000

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

Title of each Class

Name of each Exchange
on which Registered

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Common Stock, par value \$1.00 per share

NASDAQ Global Select

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

Title of each Class	Name of each Exchange on which Registered
None	None

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(a) of the Act.

Yes ☐ No ☒

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes ☒ No ☐

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

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

Large accelerated filer ☐

Accelerated filer ☒

Non-accelerated filer ☐

Smaller Reporting Company ☐

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

The aggregate market value of the common shares of the registrant held by non-affiliates of the registrant, based upon the closing price of such shares on June 30, 2011 of \$10.45, was approximately \$319.7 million.

As of February 15, 2012, 33,096,281 shares of common stock, par value \$1.00 per share, of the registrant were outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the proxy statement for registrant's 2012 Annual Meeting of Shareholders are incorporated by reference in Part III of this Form 10-K.

THE BANCORP, INC.
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SIGNATURES

FORWARD-LOOKING STATEMENTS

The Securities and Exchange Commission, or SEC, encourages companies to disclose forward-looking information so that investors can better understand a company's future prospects and make informed investment decisions. This report contains such "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, or Securities Act, and Section 21E of the Securities Exchange Act of 1934, as amended, or Exchange Act.

Words such as "anticipates," "estimates," "expects," "projects," "intends," "plans," "believes," "should" and words and terms of similar substance used in connection with any discussion of future operating and financial performance identify forward-looking statements. Unless we have indicated otherwise, or the context otherwise requires, references in this report to "we," "us," and "our" or similar terms, are to The Bancorp, Inc. and its subsidiaries.

We claim the protection of safe harbor for forward-looking statements provided in the Private Securities Litigation Reform Act of 1995. These statements may be made directly in this report and they may also be incorporated by reference in this report to other documents filed with the SEC, and include, but are not limited to, statements about future financial and operating results and performance, statements about our plans, objectives, expectations and intentions with respect to future operations, products and services, and other statements that are not historical facts. These forward-looking statements are based upon the current beliefs and expectations of our management and are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are difficult to predict and generally beyond our control. In addition, these forward-looking statements are subject to assumptions with respect to future business strategies and decisions that are subject to change. Actual results may differ materially from the anticipated results discussed in these forward-looking statements.

The following factors, among others, could cause actual results to differ materially from the anticipated results or other expectations expressed in the forward-looking statements:

- the risk factors discussed and identified in Item 1A of this report and in other of our public filings with the SEC;
- recessionary conditions in the U.S. economy and significant dislocations in the credit markets have had, and may continue to have, significant adverse effects on our assets and operating results, including increases in payment defaults and other credit risks, decreases in the fair value of some assets and increases in our provision for loan losses;
- current economic and credit market conditions, if they continue, may result in a reduction in our capital base, reducing our ability to maintain deposits at current levels;
- - operating costs may increase;
 - adverse governmental or regulatory policies may be enacted;
 - management and other key personnel may be lost;
 - competition may increase;
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the costs of our interest-bearing liabilities, principally deposits, may increase relative to the interest received on our interest-bearing assets, principally loans, thereby decreasing our net interest income;

the geographic concentration of our loans could result in our loan portfolio being adversely affected by economic factors unique to the geographic area and not reflected in other regions of the country;

the market value of real estate that secures our loans has been, and may continue to be, adversely affected by current economic and market conditions, and may be affected by other conditions outside of our control such as lack of demand for real estate of the type securing our loans, natural disasters, changes in neighborhood values, competitive overbuilding, weather, casualty losses, occupancy rates and other similar factors.

We caution you not to place undue reliance on these forward-looking statements, which speak only as of the date of this report. All subsequent written and oral forward-looking statements attributable to us or any person acting on our behalf are expressly qualified in their entirety by the cautionary statements contained or referred to in this section. Except to the extent required by applicable law or regulation, we undertake no obligation to update these forward-looking statements to reflect events or circumstances after the date of this filing or to reflect the occurrence of unanticipated events.

PART I

Item 1. Business.

Overview

We are a Delaware financial holding company with a wholly owned subsidiary, The Bancorp Bank, which we refer to as the Bank. All revenue and income is currently generated through the Bank. Interest earning assets consist primarily of commercial loans in the Philadelphia metropolitan area. Additionally, loans collateralized by securities are generated through wealth management affinity groups and are typically offered in conjunction with brokerage accounts. Automobile fleet leases are generated in a number of Atlantic Coast and other states. At December 31, 2011, commercial loans, security backed loans and leases amounted to \$1.3 billion, \$144.7 million and \$129.7 million, respectively. Accordingly, the categories comprised 75%, 8% and 7% of the loan portfolio, respectively. Deposits are generated primarily through accounts generated through affinity groups. Through the Bank, we provide a wide range of commercial and retail and related banking services, which include private label banking, healthcare accounts, prepaid and debit cards and merchant card processing to both regional and national markets.

Regionally, we focus on providing our banking services directly to retail and commercial customers in the Philadelphia-Wilmington metropolitan area, consisting of the 12 counties surrounding Philadelphia, Pennsylvania and Wilmington, Delaware including Philadelphia, Delaware, Chester, Montgomery, Bucks and Lehigh Counties in Pennsylvania, New Castle County in Delaware and Mercer, Burlington, Camden, Ocean and Cape May Counties in New Jersey. We believe that changes in recent years in this market have created an underserved base of small and middle-market businesses and high net worth individuals that are interested in banking with a company headquartered in and with decision-making authority based in, the Philadelphia-Wilmington area. We believe that our presence in the area provides us with insights as to the local market and, as a result, with the ability to tailor our products and services, and particularly the structure of our loans, more closely to the needs of our targeted customers. We seek to develop overall banking relationships with our targeted customers so that our lending operations serve as a generator of deposits and our deposit relationships serve as a source of loans. We believe that our regional presence also allows us to oversee and further develop our existing customer relationships.

Nationally, we focus on providing our services to organizations with a pre-existing customer base who can use one or more selected banking services tailored to support or complement the services provided by these organizations to their customers. These services include private label banking; credit and debit card processing for merchants affiliated with independent service organizations; healthcare savings accounts for healthcare providers and third-party plan administrators; and prepaid cards, also known as stored value cards, for insurers, incentive plans, large retail chains and consumer service organizations. We typically provide these services under the name and through the facilities of each organization with whom we develop a relationship. We refer to this, generally, as affinity group banking. Our

private label banking, merchant processing, healthcare accounts and prepaid card programs are a source of fee income and low-cost deposits.

Our main office is located at 409 Silverside Road, Wilmington, Delaware 19809 and our telephone number is (302) 385-5000. Our web address is www.thebancorp.com. We make available free of charge on our website our Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and amendments to those reports as soon as reasonably practicable after we file them with the SEC. Investors are encouraged to access these reports and other information about our business on our website. Information found on our website is not part of this Annual Report on Form 10-K. We also will provide copies of our Annual Report on Form 10-K, free of charge, upon written request of Investor Relations Department at the Company's address for its principal executive officers, 409 Silverside Road, Wilmington, Delaware 19809. Also posted on our website, and available in print upon request of any shareholder to our Investor Relations Department, are the charters of standing committees of our Board of Directors and standards of conduct governing our directors, officers and employees.

Our Strategies

Our principal strategies are to:

Fund loan portfolio growth through low-cost deposits generated by our prepaid card, wealth management, healthcare accounts, community banking and merchant processing operations and generate noninterest income from prepaid cards and other areas. Our principal focus is to grow our loan portfolio, primarily commercial loans in the greater Philadelphia metropolitan area, and fund these loans using deposits generated through a variety of sources that provide low cost and stable deposits. Funding sources include prepaid cards, wealth management, healthcare accounts, community banking operations in the Philadelphia area and merchant processing. Our funding growth reflects the prepaid card, wealth management and healthcare strategies noted above and growth in related affinity groups through which we acquire the majority of our deposits. The majority of our noninterest income is derived from prepaid cards.

Build upon the Network of Relationships Developed by our Senior Management. We seek to build upon our senior managers' network of relationships through the regional division of the Bank that targets individuals and businesses in the greater Philadelphia-Wilmington metropolitan area. This division seeks to offer these customers products and services that meet their banking and financing needs, and to provide them with the attention of senior management which we believe is often lacking at larger financial institutions. The division offers a staff experienced in servicing the banking and financing needs of small to mid-size businesses.

Develop Relationships with Affinity Groups to Gain Sponsored Access to their Membership, Client or Customer Bases to Market our Services. We seek to develop relationships with organizations with established membership, client or customer bases. Through these affinity group relationships, we gain access to an organization's members, clients and customers under the organization's sponsorship. We believe that by marketing targeted products and services to these constituencies through their pre-existing relationships with the organizations, we will continue to generate lower cost deposits, generate fee income and, with respect to private label banking, lower our customer acquisition costs and build close customer relationships.

Develop Relationships with Small to Mid-Size Businesses and their Principals. Our target market regionally is small to mid-size businesses and their principals. We believe that satisfactory attention to this market requires a combination of the ability to provide a high level of service, including customized financing to meet a customer's needs, and the personal attention of senior management. Because of the significant consolidation of banking institutions in the Philadelphia-Wilmington metropolitan area, we believe that many of the financial institutions with which we compete may have become too large to provide those services efficiently and cost-effectively.

Use Our Existing Infrastructure as a Platform for Growth. We have made significant investments in our banking infrastructure to support our growth. We believe that this infrastructure can accommodate significant additional growth without proportionate increases in expense. We believe that this infrastructure enables us to maximize efficiencies in both our regional market and our national affinity group market through economies of scale as we grow without adversely affecting our relationships with our customers.

Commercial Banking Operations

Deposit Products and Services. We offer our depositors a wide range of products and services, including:

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checking accounts, featuring no required minimum balance, no monthly maintenance fees, competitive interest rates, rebates on automated teller machine fees, free debit Visa check card and overdraft protection plans; and premium checking accounts with free online bill paying, an enhanced debit Visa check card or an automated teller machine (ATM) card;

- savings accounts;
- healthcare interest bearing accounts;
- money market accounts;

commercial accounts, including general commercial checking, small business checking, business savings and business money market accounts;

- certificates of deposit; and
- prepaid and payroll cards.

Lending Activities. At December 31, 2011, we had a net loan portfolio of \$1.74 billion, representing 58.0% of our total assets at that date. We originate substantially all of our portfolio loans, although from time to time we purchase residential mortgages and leases. Where a proposed loan exceeds our lending limit, we typically sell a participation in the loan to another financial institution. We generally separate our lending function into commercial term loans, commercial mortgage loans, commercial lines of credit, construction loans, direct lease financing and personal (consumer) loans. We focus primarily on lending to small to mid-size businesses and their principals. As a result, commercial, construction and commercial mortgage loans have comprised a majority of our loan portfolio since we commenced operations. At December 31, 2011, commercial, construction and commercial mortgage loans comprised \$1.31 billion, or 75.0%, of our total loan portfolio. These types of loans are generally viewed as having more risk of default than residential real estate loans or consumer loans and are typically larger than residential real estate and consumer loans.

While originating loans, we rely upon our evaluation of the creditworthiness and debt-servicing capability of a borrower. We typically require that our loans be secured by tangible collateral, usually residential or commercial real property. We do not typically engage in non-recourse lending (that is, lending as to which the lender only looks to the asset securing the loan for repayment) and will typically require the principals of any commercial borrower to personally guarantee the loan. We analyze credit risk prior to making commercial loans on an individual loan basis. We consider relevant aspects of the borrower's financial position and cash flows, past borrower performance, our knowledge of local market conditions, side collateral and the ratio of the loan amount to estimated property value, which can vary depending on those factors. The maturity dates on our loans are generally short to mid-term. We typically seek to structure our loans with variable rates of interest based upon either a stated prime rate or the London Inter-Bank Offered Rate, or LIBOR, although we do lend at fixed rates when appropriate for a particular customer.

Commercial Term Lending. We make loans to businesses to finance fixed assets, acquisitions and other long-term needs of our business customers. While the loans are generally secured, the loans are underwritten with an emphasis upon our evaluation of the future cash flows of the borrower. Maturities of these loans are typically five years or less and have amortization schedules that do not exceed the useful life of the asset to be acquired with the financing. As of December 31, 2011, commercial term loans amounted to \$377.0 million or 21.6% of our total loan portfolio.

Commercial Mortgage Lending. We make loans to businesses to finance the acquisition of, or to refinance, income-producing real property. The principal repayment source for these loans is the property and the income it produces, which depends upon the operation of the property and its market value, although we also evaluate the creditworthiness of the borrower and guarantors as a second repayment source. These loans typically are secured by real estate which is either for rent or sale. Maturities on these loans generally do not exceed 10 years, although they may have an extended amortization schedule resulting in a balloon payment due at maturity. As of December 31, 2011, commercial mortgages amounted to \$609.6 million or 35.0% of our total loan portfolio.

Commercial Lines of Credit. We offer lines of credit to businesses which are typically short-term facilities intended to support seasonal cash needs. They may be secured or unsecured, depending on the purpose, anticipated repayment

source and financial condition of the borrower. This form of financing is typically self-liquidating as repayment comes from the conversion of the financed assets to cash. Lines of credit are payable on demand and the availability of the line of credit is subject to a periodic review of the borrower's financial information. Generally, lines of credit terminate between one year and 18 months after they have been established. Lines of credit that have termination dates in excess of one year typically must be paid out at least annually. As of December 31, 2011, loans drawn from our outstanding commercial lines of credit amounted to \$73.4 million or 4.2% of our total loan portfolio.

1-4 Family Construction Loans. We make loans to residential developers for acquisition of land, site improvements and construction of single and multi-family residential units for sale. Terms of the loans are generally for no longer than two years. Repayment of these loans typically depends on the sale of the residential units to consumers or sale of the property to another developer. As of December 31, 2011, construction loans amounted to \$85.2 million or 4.9% of our total loan portfolio.

Commercial Construction, Acquisition and Development. We make construction loans on commercial and industrial properties that later require permanent financing. As of December 31, 2011, acquisition and development loans amounted to \$69.7 million or 4.0% and commercial construction loans amounted to \$91.7 million or 5.3% of our total loan portfolio, respectively.

Direct Lease Financing. We make leases for commercial and municipal automobile fleets and additionally make equipment leases. As of December 31, 2011, direct lease financing amounted to \$129.7 million or 7.4% of our total loan portfolio.

Consumer Loans. We provide loans to consumers to finance personal residences, automobiles, home improvements and for other purposes. The majority of our consumer loans are secured by either the borrower's securities portfolio or residence, typically in a first or second lien position. As of December 31, 2011, consumer loans amounted to \$305.2 million or 17.5% of our total loan portfolio.

Affinity Banking

Private Label Banking. For our private label banking, we create unique banking websites for each affinity group, enabling the affinity group to provide its members with the banking services and products we offer or just those banking services and products it believes will be of interest to its members. We design each website to carry the brand of the affinity group and carry the "look and feel" of the affinity group's own website. Each such website, however, indicates that we provide all banking services. To facilitate the creation of these individualized banking websites, we have packaged our products and services into a series of modules, with each module providing a specific service, such as basic banking, electronic payment systems and loan centers. Each affinity group selects from our menu of service modules those services that it wants to offer its members or customers. We and the affinity group also may create products and services, or modify products and services already on our menu, that specifically relate to the needs and interests of the affinity group's members or customers. We pay fees to certain affinity groups based upon deposits and loans they generate. These fees vary, and certain fees increase as market interest rates increase, while other fee rates are fixed. We include these fees as a component of interest expense in calculating our net interest margin. These fees totaled \$3.1 million, \$2.3 million and \$2.3 million for the years ended December 31, 2011, 2010 and 2009, respectively. These amounts include fees paid related to prepaid cards, healthcare accounts and merchant card processing which are described below.

Prepaid Cards. We have developed prepaid card programs for insurance indemnity payments, flexible spending account funds, corporate and incentive rewards, payroll cards, consumer gift cards and general purpose re-loadable cards. Our cards are offered to end users through our relationships with insurers, benefits administrators, third-party administrators, corporate incentive companies, rebate fulfillment organizations, payroll administrators, large retail chains and consumer service organizations. We also provide consumer use cards branded with network or association logos such as Visa, MasterCard, and Discover. The majority of fees the Company earns results from contractual fees paid by third party sponsors, computed on a per transaction basis and paid monthly. Additionally, the Company earns interchange fees paid through settlement associations such as Visa, which are also determined on a per transaction basis. Prepaid cards also provide us with low cost deposits from the amounts delivered to us to fund the cards.

Healthcare Accounts. We have developed relationships with healthcare providers and third-party benefit administrators who facilitate the enrollment of both groups and individuals in high deductible health plans and health savings accounts. Our healthcare account program provides these organizations with a turnkey, low-cost benefit for their members. Under these programs, we provide private label interest bearing healthcare accounts, which enable affinity group members to access account information, conduct transactions and process payments to healthcare

providers. The healthcare accounts provide us with a source of interest checking deposits.

Merchant Card Processing. We act as the depository institution for the processing of credit and debit card payments made to various businesses. We also act as the bank sponsor and depository institution for independent service organizations that process such payments. We have designed products that enable those organizations to more easily process electronic payments and to better manage their risk of loss. Our services also enable independent service organizations to provide their members with access to their account balances through the Internet. These relationships are a source of demand deposits and fee income.

Wealth Management. We have developed strategic relationships with limited-purpose trust companies, registered investment advisers, broker-dealers and other firms offering wealth management services. We provide customized, private label demand, money market and security-backed loan products to the client base, of these groups.

Other Operations

Account Services. Account holders may access our products through the website of their affinity group or other organizational affiliate, or through our website, from any personal computer with a secure web browser, regardless of its location. This access allows account holders to apply for loans, review account activity, enter transactions into an online account register, pay bills electronically, receive statements electronically and print bank statements. To open a new account, a customer completes a simple online enrollment form. Customers can make deposits into an account via direct deposit, by funds transfer between existing accounts, by wire transfer, by mail, at any deposit-taking automated teller machine, at any of the more than 3,400 UPS Stores throughout the United States or in person at our Delaware offices (although we do not maintain a teller line). Customers may also make withdrawals and have access to their accounts at automated teller machines.

Call Center. We have a call center that operates as an inbound customer support center. The call center provides account holders or potential account holders with assistance in opening accounts, applying for loans or otherwise accessing the Bank's products and services, and in resolving any problems that may arise in the servicing of accounts, loans or other banking products. The call center operates from 8:00 a.m. to 10:00 p.m. EST Monday through Friday, and 9:00 a.m. to 5:00 p.m. on Saturday. Outside these hours we outsource call center operations to M&I Direct, a third-party service provider.

Third-Party Service Providers. To reduce operating costs and to capitalize on the technical capabilities of selected vendors, we arrange for the outsourcing of specific bank operations and systems to third-party service providers, principally the following:

• fulfillment functions and similar operating services, including check processing, check imaging, electronic bill payment and statement rendering;

- fulfillment and servicing of prepaid cards;
- compliance and internal audit;
- call center customer support;
- access to automated teller machine networks;
- processing and temporarily funding residential mortgage loans we will not hold in our portfolio;
- bank accounting and general ledger system;
- data warehousing services; and
- certain software development

Because we outsource these operational functions to experienced third-party service providers that have the capacity to process a high volume of transactions, we believe we can more readily and cost-effectively respond to growth than if we sought to develop these capabilities internally. Should any of our current relationships terminate, we believe we could secure the required services from an alternative source without material interruption of our operations.

Sales and Marketing

Commercial Banking. Our regional banking operation targets a customer base of professionals and business owners in the Philadelphia-Wilmington area and uses a personal contact/targeted media advertising approach. This program consists of:

- direct e-mail and letter introductions to senior management's contacts;
- invitation-only, private receptions with prominent business leaders in the Philadelphia community;

- advertisements in local media outlets, principally newspapers and radio stations; and
- charitable sponsorships.

Affinity Group Banking. Because of the national scope of our affinity group banking operation, we use a personal sales/targeted media advertising approach. This program consists of:

- print advertising;
- attending and making presentations at trade shows and other events for targeted affinity organizations;
- direct mail; and

• direct contact with potential affinity organizations by our marketing staff, with relationship managers focusing on particular regional markets.

Loan Production Offices. We maintain three loan production offices in the Philadelphia metropolitan area. We established these offices to serve suburban areas south (our Exton, Pennsylvania office) and north (our Warminster, Pennsylvania office) of center city Philadelphia. In addition, we maintain two offices to market and administer our leasing programs, one in Maryland and one in Florida.

Marketing Staff. Our marketing staff focuses on marketing to particular affinity groups and the targeted audience of our Philadelphia regional banking operations.

Technology

Core and Internet Banking Systems. We obtain a significant portion of our core and internet banking systems and operations under non-exclusive licenses between us and Fidelity National Information Services, Inc.. These systems principally include those for general ledger and deposit, loan and check processing, consumer electronic banking and business electronic banking.

Software. We have internally-developed software to provide our online and traditional banking products and services. We have developed a series of financial service modules that are easy to deploy and that we can readily adapt to serve our customers' needs. We developed these modules using an open architecture and object-oriented technologies. We use the modules to extend the functionality of our core and Internet banking systems and to personalize financial services to the constituencies we serve.

System Architecture. We provide financial products and services through a highly-secured four-tiered architecture using the Microsoft Windows Server 2003 and 2008 operating system, Microsoft Internet Information Server web server software, Microsoft SQL 2008 R2, Microsoft .NET Framework, CheckPoint Systems and Cisco Systems firewalls, and our licensed and proprietary financial services software. User activity is distributed and load-balanced across multiple servers on each tier through our proprietary software and third-party equipment, which maintain replicated, local storage of underlying software and data, resulting in minimal interdependencies among servers. Each server is backed up to a storage area network that replicates across locations. The system's flexible architecture is designed to have the capacity, or to be easily expanded to add capacity, to meet future demand. In addition to built-in redundancies, we continuously operate automated internal monitoring tools and independent third parties continuously monitor our websites.

Our primary website hosting facility is in Wilmington, Delaware and connects to the Internet by Cisco routers through Internap Technology's New York network operating center and Paetec, located in Bethlehem, Pennsylvania network operating center. We also maintain a completely redundant standby hosting facility at our Sioux Falls, South Dakota office. Internap's Denver network operating center provides internet connectivity to the Sioux Falls offices.

Intellectual Property and Other Proprietary Rights

Since a significant portion of the core and Internet banking systems and operations we use come from third-party providers, our primary proprietary intellectual property is the software for creating affinity group bank websites. We rely principally upon trade secret and trademark law to protect our intellectual property. We do not typically enter into intellectual property-related confidentiality agreements with our employees or our affinity group customers because we maintain control over the software used to create the sites and their banking functions rather than licensing them for customers to use. Moreover, we believe that factors such as the relationships we develop with our affinity group and banking customers, the quality of our banking products, the level and reliability of the service we provide, and the customization of our products and services to meet the need of our affinity group and other customers are substantially more significant to our ability to succeed.

Competition

We believe that our principal competitors for loans and regional deposits are mid-Atlantic regional banks such as Citizens Bank, Sovereign Bank, TD Bank, M&T Bank and Republic Bank. We also face competition from Internet-based banks, and from banks, such as ING Direct and E-Trade Bank, that provide Internet banking services as part of their overall banking environment. We also directly compete with Virtual Bank, an Internet-based bank that also provides private labeled financial services to affinity groups and communities. We compete more generally with numerous other banks and thrift institutions, mortgage brokers and other financial institutions such as finance companies, credit unions, insurance companies, money market funds, investment firms and private lenders, as well as on-line computerized services and other non-traditional competitors. We believe that our ability to compete successfully depends on a number of factors, including:

- our ability to build upon the customer relationships developed by our senior management and through our marketing programs;

- our ability to expand our affinity group banking program;

- competitors' interest rates and service fees;

- the scope of our products and services;

- the relevance of our products and services to customer needs and demands and the rate at which we and our competitors introduce them;

- satisfaction of our customers with our customer service;

- our perceived safety as a depository institution, including our size, credit rating, capital strength and earnings strength;

- our perceived ability to withstand current turbulent economic conditions;

- ease of use of our banking website; and

- the capacity, reliability and security of our network infrastructure.

If we experience difficulty in any of these areas, our competitive position could be materially adversely affected, which would affect our growth, our profitability and, possibly, our ability to continue operations. While the banking industry is highly competitive, we believe we can compete effectively as a result of our focus on small to mid-size businesses and their principals, a market segment we believe is under-served in our region and, with respect to our affinity group operations, as a result of our ability to customize our product offerings to the affinity group's needs. We believe that the costs of entry to offering deposit accounts and prepaid cards through affinity groups is relatively high and somewhat prohibitive to new competitors. We have competed successfully with institutions much larger than ourselves; however, many of our competitors have larger customer bases, greater name recognition, greater financial and other resources and longer operating histories which may impact our ability to compete. Our future success will depend on our ability to compete effectively in a highly competitive market and geographic area.

Regulation Under Banking Law

We are extensively regulated under both federal and state banking law. We are a Delaware corporation and a financial holding company registered with the Board of Governors of the Federal Reserve System, or the Federal Reserve. We are subject to supervision and regulation by the Federal Reserve and the Delaware Office of the State Bank Commissioner. The Bank, as a state-chartered, nonmember depository institution, is supervised by the Delaware Office of the State Bank Commissioner, as well as the Federal Deposit Insurance Corporation, or FDIC.

The Bank is subject to requirements and restrictions under federal and state law, including requirements to maintain reserves against deposits, restrictions on the types and amount of loans that may be made and the interest that may be charged, and limitations on the types of investments that may be made and the types of services that may be offered. Various consumer laws and regulations also affect the Bank's operations.

Federal Regulation

As a financial holding company, we are subject to regular examination by the Federal Reserve and must file annual reports and provide any additional information that the Federal Reserve may request. Under the Bank Holding Company Act of 1956, as amended, which we refer to as the BHCA, a financial holding company may not directly or indirectly acquire ownership or control of more than 5% of the voting shares or substantially all of the assets of any bank, or merge or consolidate with another financial holding company, without the prior approval of the Federal Reserve.

Permitted Activities. The BHCA generally limits the activities of a financial holding company and its subsidiaries to that of banking, managing or controlling banks, or any other activity that is determined to be so closely related to banking or to managing or controlling banks that an exception is allowed for those activities. These activities include, among other things, and subject to limitations, operating a mortgage company, finance company, credit card company or factoring company; performing data processing operations; provide investment and financial advice; acting as an insurance agent for particular types of credit related insurance and providing specified securities brokerage services for customers. We have no present plans to engage in any of these activities other than through the Bank.

Change in Control. The BHCA prohibits a company from acquiring control of a financial holding company without prior Federal Reserve approval of an application. Similarly, the Change in Bank Control Act, which we refer to as the CBCA, prohibits a person or group of persons from acquiring "control" of a financial holding company unless the Federal Reserve has been notified and has not objected to the transaction. In general, under a rebuttable presumption established by the Federal Reserve, the acquisition of 10% or more of any class of voting securities of a financial holding company is presumed to be an acquisition of control of the holding company if:

- the financial holding company has a class of securities registered under Section 12 of the Securities Exchange Act of 1934; or

- no other person will own or control a greater percentage of that class of voting securities immediately after the transaction.

An acquisition of 25% or more of the outstanding shares of any class of voting securities of a financial holding company is conclusively deemed to be the acquisition of control. In determining percentage ownership for a person, Federal Reserve policy is to count securities obtainable by that person through the exercise of options or warrants, even if the options or warrants have not then vested.

The Federal Reserve has revised its minority investment policy statement, under which, subject to the filing of certain commitments with the Federal Reserve, an investor can acquire up to one-third of our equity without being deemed to have engaged in a change in control, provided that no more than 15% of the investor's equity is voting stock. This revised policy statement also permits non-controlling passive investors to engage in interactions with our management without being considered as controlling our operations.

Regulatory Restrictions on Dividends. It is the policy of the Federal Reserve that financial holding companies should pay cash dividends on common stock only out of income available over the past year and only if prospective earnings

retention is consistent with the organization's expected future needs and financial condition. The policy provides that financial holding companies should not maintain a level of cash dividends that undermines the financial holding company's ability to serve as a source of strength to its banking subsidiaries. See "Holding Company Liability," below. Federal Reserve policies also affect the ability of a financial holding company to pay in-kind dividends.

Various federal and state statutory provisions limit the amount of dividends that subsidiary banks can pay to their holding companies without regulatory approval. The Bank is also subject to limitations under state law regarding the payment of dividends, including the requirement that dividends may be paid only out of net profits. See “Delaware Regulation” below. In addition to these explicit limitations, federal and state regulatory agencies are authorized to prohibit a banking subsidiary or financial holding company from engaging in unsafe or unsound banking practices. Depending upon the circumstances, the agencies could take the position that paying a dividend would constitute an unsafe or unsound banking practice.

Because we are a legal entity separate and distinct from the Bank, our right to participate in the distribution of assets of the Bank, or any other subsidiary, upon the Bank’s or the subsidiary’s liquidation or reorganization will be subject to the prior claims of the Bank’s or subsidiary’s creditors. In the event of liquidation or other resolution of an insured depository institution, the claims of depositors and other general or subordinated creditors have priority of payment over the claims of holders of any obligation of the institution’s holding company or any of the holding company’s shareholders or creditors.

Holding Company Liability. Under Federal Reserve policy a financial holding company is expected to act as a source of financial strength to each of its banking subsidiaries and commit resources to their support. The Dodd-Frank Act codified this policy as a statutory requirement. Under this requirement, we are expected to commit resources to support the Bank, including at times when we may not be in a financial position to provide such resources. As discussed below under “Prompt Corrective Action,” a financial holding company in certain circumstances could be required to guarantee the capital plan of an undercapitalized banking subsidiary.

In the event of a financial holding company’s bankruptcy under Chapter 11 of the U.S. Bankruptcy Code, the trustee will be deemed to have assumed, and is required to cure immediately, any deficit under any commitment by the debtor holding company to any of the federal banking agencies to maintain the capital of an insured depository institution, and any claim for breach of such obligation will generally have priority over most other unsecured claims.

Capital Adequacy. The Federal Reserve and the FDIC have issued standards for measuring capital adequacy for financial holding companies and banks. These standards are designed to provide risk-based capital guidelines and to incorporate a consistent framework. The risk-based guidelines are used by the agencies in their examination and supervisory process, as well as in the analysis of any applications. As discussed below under “Prompt Corrective Action,” a failure to meet minimum capital requirements could subject us or the Bank to a variety of enforcement remedies available to federal regulatory authorities, including, in the most severe cases, termination of deposit insurance by the FDIC and placing the Bank into conservatorship or receivership.

In general, these risk-related standards require banks and financial holding companies to maintain capital based on “risk-adjusted” assets so that the categories of assets with potentially higher credit risk will require more capital backing than categories with lower credit risk. In addition, banks and financial holding companies are required to maintain capital to support off-balance sheet activities such as loan commitments.

As a result of the Dodd-Frank Act our financial holding company status depends upon our maintaining our status as “well capitalized” and “well managed” under applicable Federal Reserve regulations. If a financial holding company ceases to meet these requirements, the Federal Reserve may impose corrective capital and/or managerial requirements on the financial holding company and place limitations on its ability to conduct the broader financial activities permissible for financial holding companies. In addition, the Federal Reserve may require divestiture of the holding company’s depository institution if the deficiencies persist.

The standards classify total capital for this risk-based measure into two tiers, referred to as Tier 1 and Tier 2. Tier 1 capital consists of common shareholders' equity, certain non-cumulative perpetual preferred stock, and minority interests in equity accounts of consolidated subsidiaries, less certain adjustments. Tier 2 capital consists of the allowance for loan and lease losses (within certain limits), perpetual preferred stock not included in Tier 1, hybrid capital instruments, term subordinate debt, and intermediate-term preferred stock, less certain adjustments. Together, these two categories of capital comprise a bank's or financial holding company's "qualifying total capital." However, capital that qualifies as Tier 2 capital is limited in amount to 100% of Tier 1 capital in testing compliance with the total risk-based capital minimum standards. Banks and financial holding companies must have a minimum ratio of 8% of qualifying total capital to risk-weighted assets, and a minimum ratio of 4% of qualifying Tier 1 capital to risk-weighted assets. At December 31, 2011, we and the Bank had total capital to risk-adjusted assets ratios of 15.89% and 11.60%, respectively, and Tier 1 capital to risk-adjusted assets ratios of 14.64% and 10.34%, respectively.

In addition, the Federal Reserve and the FDIC have established minimum leverage ratio guidelines. The principal objective of these guidelines is to constrain the maximum degree to which a financial institution can leverage its equity capital base. It is intended to be used as a supplement to the risk-based capital guidelines. These guidelines provide for a minimum ratio of Tier 1 capital to adjusted average total assets of 3% for financial holding companies that meet certain specified criteria, including those having the highest regulatory rating. Other financial institutions generally must maintain a leverage ratio of at least 3% plus 100 to 200 basis points. The guidelines also provide that financial institutions experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets. Furthermore, the banking agencies have indicated that they may consider other indicia of capital strength in evaluating proposals for expansion or new activities. At December 31, 2011, we and the Bank had leverage ratios of 8.69% and 6.13%, respectively.

The federal banking agencies' standards provide that concentration of credit risk and certain risks arising from nontraditional activities, as well as an institution's ability to manage these risks, are important factors to be taken into account by them in assessing a financial institution's overall capital adequacy. The risk-based capital standards also provide for the consideration of interest rate risk in the agency's determination of a financial institution's capital adequacy. The standards require financial institutions to effectively measure and monitor their interest rate risk and to maintain capital adequate for that risk. These standards can be expected to be amended from time to time.

The Dodd-Frank Act includes certain related provisions which are often referred to as the "Collins Amendment." These provisions are intended to subject bank holding companies to the same capital requirements as their bank subsidiaries and to eliminate or significantly reduce the use of hybrid capital instruments, especially trust preferred securities, as regulatory capital. Under the Collins Amendment, trust preferred securities issued by a company, such as our company, with total consolidated assets of less than \$15 billion before May 19, 2010 and treated as regulatory capital are grandfathered, but any such securities issued later are not eligible as regulatory capital. The banking regulators must develop regulations setting minimum risk-based and leverage capital requirements for holding companies and banks on a consolidated basis that are no less stringent than the generally applicable requirements in effect for depository institutions under the prompt corrective action regulations discussed below. The banking regulators also must seek to make capital standards countercyclical so that the required levels of capital increase in times of economic expansion and decrease in times of economic contraction. The Act requires these new capital regulations to be adopted by the Federal Reserve in final form 18 months after the date of enactment of the Dodd-Frank Act (July 21, 2010).

Prompt Corrective Action. Federal banking agencies must take prompt supervisory and regulatory actions against undercapitalized depository institutions pursuant to the Prompt Corrective Action provisions of the Federal Deposit Insurance Act. Depository institutions are assigned one of five capital categories—"well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized"—and are subjected to differential regulation corresponding to the capital category within which the institution falls. Under certain circumstances, a well capitalized, adequately capitalized or undercapitalized institution may be treated as if the institution were in the next lower capital category. As we describe in Item 7, "Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources," an institution is deemed to be well capitalized if it has a total risk-based capital ratio of at least 10%, a Tier 1 risk-based capital ratio of at least 6.0% and a leverage ratio of at least 5%. An institution is adequately capitalized if it has a total risk-based capital ratio of at least 8%, a Tier 1 risk-based capital ratio of at least 4% and a leverage ratio of at least 4%. At December 31, 2011, our total risk-based capital ratio was 15.89%, our Tier 1 risk-based capital ratio was 14.64% and our leverage ratio was 8.69%, while the Bank's ratios were 11.60%, 10.34% and 6.13%, respectively and, accordingly, both we and the Bank were "well capitalized" within the meaning of the regulations. A depository institution is generally prohibited from making capital distributions (including paying dividends) or paying management fees to a holding company if the institution

would thereafter be undercapitalized. Adequately capitalized institutions cannot accept, renew or roll over brokered deposits except with a waiver from the FDIC, and are subject to restrictions on the interest rates that can be paid on such deposits. Undercapitalized institutions may not accept, renew, or roll over brokered deposits.

Bank regulatory agencies are permitted or, in certain cases, required to take action with respect to institutions falling within one of the three undercapitalized categories. Depending on the level of an institution's capital, the agency's corrective powers include, among other things:

- prohibiting the payment of principal and interest on subordinated debt;
- prohibiting the holding company from making distributions without prior regulatory approval;
 - placing limits on asset growth and restrictions on activities;

- placing additional restrictions on transactions with affiliates;
- restricting the interest rate the institution may pay on deposits;
- prohibiting the institution from accepting deposits from correspondent banks; and
- in the most severe cases, appointing a conservator or receiver for the institution.

A banking institution that is undercapitalized must submit a capital restoration plan. This plan will not be accepted unless, among other things, the banking institution's holding company guarantees the plan up to an agreed-upon amount. Any guarantee by a depository institution's holding company is entitled to a priority of payment in bankruptcy. Failure to implement a capital plan, or failure to have a capital restoration plan accepted, may result in a conservatorship or receivership.

Insurance of Deposit Accounts. The Bank's deposits are insured to the maximum extent permitted by the Deposit Insurance Fund ("DIF"). Upon enactment of the Emergency Economic Stabilization Act of 2008 on October 3, 2008, federal deposit insurance coverage levels under the DIF temporarily increased from \$100,000 to \$250,000 per deposit category, per depositor, per institution, through December 31, 2009. On May 20, 2009, the Helping Families Save Their Homes Act extended the temporary increase through December 31, 2013. The Dodd-Frank Act permanently increases the maximum amount of deposit insurance to \$250,000 per deposit category, per depositor, per institution retroactive to January 1, 2008, and noninterest-bearing transaction accounts have unlimited deposit insurance through December 31, 2013.

As the insurer, the FDIC is authorized to conduct examinations of, and to require reporting by, FDIC-insured institutions. The FDIC also may prohibit any FDIC-insured institution from engaging in any activity the FDIC determines by regulation or order to pose a serious threat to the DIF. The FDIC also has the authority to initiate enforcement actions against banks.

The FDIC has implemented a risk-based assessment system under which FDIC-insured depository institutions pay annual premiums at rates based on their risk classification. A bank's risk classification is based on its capital levels and the level of supervisory concern the bank poses to the regulators. Institutions assigned to higher risk classifications (that is, institutions that pose a greater risk of loss to the DIF) pay assessments at higher rates than institutions that pose a lower risk. A decrease in a bank's capital ratios or the occurrence of events that have an adverse effect on a bank's asset quality, management, earnings or liquidity could result in a substantial increase in deposit insurance premiums paid by a bank, which would adversely affect earnings. In addition, the FDIC can impose special assessments in certain instances. The range of assessments in the risk-based system is a function of the reserve ratio in the DIF. Each insured institution is assigned to one of four risk categories based on supervisory evaluations, regulatory capital levels and certain other factors. An institution's assessment rate depends upon the category to which it is assigned. Unlike the other categories, Risk Category I contains further risk differentiation based on the FDIC's analysis of financial ratios, examination component ratings and other information. Assessment rates are determined by the FDIC and, including potential adjustments to reflect an institution's risk profile, currently range from five to nine basis points for the healthiest institutions (Risk Category I) to 35 basis points of assessable liabilities for the riskiest (Risk Category IV). Rates may be increased an additional ten basis points depending on the amount of brokered deposits utilized. The above rates apply to institutions with assets under \$10 billion. Other rates apply for larger, or "highly complex" institutions. The FDIC may adjust rates uniformly from one quarter to the next, except that no single adjustment can exceed three basis points. At December 31, 2011, the Bank's DIF assessment rate was 9.04 basis points.

On February 27, 2009, the FDIC announced an interim rule pursuant to which it would impose an emergency special assessment of \$0.20 per \$100 of domestic deposits for all banks to be collected on September 30, 2009. The assessment base for the emergency special assessment would be the same as the assessment base for the second quarter risk-based assessment. In addition, the FDIC's interim rule provided the FDIC with authority to impose an additional emergency special assessment of up to 10 basis points if at the end of any quarter the FDIC determines that the DIF's reserve ratio has fallen close to zero or negative. In May 2009, the FDIC adopted the final rule, effective June 30, 2009, that imposed a special assessment of five cents for every \$100 on each insured depository institution's assets minus its Tier 1 capital as of June 30, 2009, subject to a cap equal to \$0.10 per \$100 of assessable deposits for the second quarter.

On November 12, 2009, in order to strengthen the cash position of the FDIC's DIF immediately, the FDIC required banks to prepay their estimated quarterly risk-based assessments for the fourth quarter of 2009 and for all of 2010, 2011 and 2012. In addition, the FDIC adopted a three-basis point increase in assessment rates effective on January 1, 2011. Under the rule each institution's deposit assessment base would be calculated using its third quarter 2009 deposit assessment base, adjusted quarterly for an estimated 5 percent annual growth rate in the deposit assessment base through the end of 2012. The prepaid assessment was collected on December 30, 2009 and was mandatory for all institutions (subject to the exercise of the FDIC's discretion to exempt an institution if the FDIC determines that the prepayment would affect the safety and soundness of the institution). We recorded a prepaid assessment of approximately \$10.0 million, which according to the rule was recorded as a prepaid expense (asset) as of December 30, 2009 and is being amortized over a three year period; as of December 31, 2011, \$2.8 million of the prepaid assessment remained.

In November 2010, the FDIC issued a notice of proposed rulemaking to change the deposit insurance assessment base from total domestic deposits to average total assets minus average tangible equity, as required by the Dodd-Frank Act, with a proposed effective date of April 1, 2011. The FDIC also issued a notice of proposed rulemaking to revise the deposit insurance assessment system for large institutions. The FDIC proposed to create a two tier system—one for most large institutions that have more than \$10 billion in assets, and another for “highly complex” institutions that have over \$50 billion in assets and are fully owned by a parent with over \$500 billion in assets. These proposals did not apply to us or the Bank.

On February 9, 2011, the FDIC adopted a final rule which redefines the deposit insurance assessment base as required by the Dodd-Frank Act. The final rule sets the deposit insurance assessment base as average consolidated total assets minus average tangible equity. It also sets a new assessment rate schedule which reflects assessment rate adjustments including potentially reduced rates tied to unsecured debt and potentially increased rates for brokered deposits. The final rule generally became effective on April 1, 2011.

Loans-to-One Borrower. Generally, a bank may not make a loan or extend credit to a single or related group of borrowers in excess of 15% of its unimpaired capital and surplus. An additional amount may be lent, equal to 10% of unimpaired capital and surplus, if such loan is secured by specified collateral, generally readily marketable collateral (which is defined to include certain financial instruments and bullion) and real estate. At December 31, 2011, the Bank's limit on loans-to-one borrower was \$32.3 million (\$53.8 million for secured loans). At December 31, 2011, the Bank's largest aggregate outstanding balance of loans-to-one borrower was \$45.0 million, which was secured by real estate.

Transactions with Affiliates and other Related Parties. There are various legal restrictions on the extent to which a financial holding company and its nonbank subsidiaries can borrow or otherwise obtain credit from banking subsidiaries or engage in other transactions with or involving those banking subsidiaries. The Bank's authority to engage in transactions with related parties or “affiliates” (that is, any company that controls or is under common control with an institution, including us and our non-bank subsidiaries) is limited by Sections 23A and 23B of the Federal Reserve Act and Regulation W promulgated thereunder. Section 23A restricts the aggregate amount of covered transactions with any individual affiliate to 10% of the Bank's capital and surplus. At December 31, 2011, we were not indebted to the Bank. The aggregate amount of covered transactions with all affiliates is limited to 20% of the Bank's capital and surplus. Certain transactions with affiliates are required to be secured by collateral in an amount and of a type described in Section 23A and the purchase of low quality assets from affiliates is generally prohibited. Section 23B generally provides that certain transactions with affiliates, including loans and asset purchases, must be on terms and under circumstances, including credit standards, that are substantially the same or at least as favorable to the institution as those prevailing at the time for comparable transactions with non-affiliated companies.

The Dodd-Frank Act generally enhances the restrictions on transactions with affiliates under Section 23A and 23B of the Federal Reserve Act, including an expansion of the definition of “covered transactions” and an increase in the amount of time for which collateral requirements regarding covered credit transactions must be satisfied. Insider transaction limitations are expanded through the strengthening of loan restrictions to insiders and the expansion of the types of transactions subject to the various limits, including derivatives transactions, repurchase agreements, reverse repurchase agreements and securities lending or borrowing transactions. Restrictions are also placed on certain assets sales to and from an insider to an institution including requirements that such sales be on market terms and, in certain circumstances, approved by the institution’s board of directors.

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

Standards for Safety and Soundness. The Federal Deposit Insurance Act requires each federal banking agency to prescribe for all insured depository institutions standards relating to, among other things, internal controls, information and audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, compensation, fees, benefits and such other operational and managerial standards as the agency deems appropriate. The federal banking agencies have adopted final regulations and Interagency Guidelines Prescribing Standards for Safety and Soundness to implement these safety and soundness standards. The guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. If the appropriate federal banking agency determines that an institution fails to meet any standard prescribed by the guidelines, the agency may require the institution to submit to the agency an acceptable plan to achieve compliance with the standard.

Privacy. Financial institutions are required to disclose their policies for collecting and protecting confidential information. Customers generally may prevent financial institutions from sharing nonpublic personal financial information with nonaffiliated third parties except under narrow circumstances, such as the processing of transactions requested by the consumer or when the financial institution is jointly sponsoring a product or service with a nonaffiliated third party. Additionally, financial institutions generally may not disclose consumer account numbers to any nonaffiliated third party for use in telemarketing, direct mail marketing or other marketing to consumers. The federal banking agencies have issued a model privacy notice for use by financial institutions in 2011. These model notices have been adopted for use by the Bank and are being implemented in accordance with Bank policy.

The Fair and Accurate Credit Transactions Act of 2003, known as the FACT Act, provides consumers with the ability to restrict companies from using certain information obtained from affiliates to make marketing solicitations. In general, a person is prohibited from using information received from an affiliate to make a solicitation for marketing purposes to a consumer, unless the consumer is given notice and had a reasonable opportunity to opt out of such solicitations. The rule permits opt-out notices to be given by any affiliate that has a pre-existing business relationship with the consumer and permits a joint notice from two or more affiliates. Moreover, such notice would not be applicable if the company using the information has a pre-existing business relationship with the consumer. This notice may be combined with other required disclosures to be provided under other provisions of law, including notices required under other applicable privacy provisions.

Section 315 of the FACT Act requires each financial institution or creditor to develop and implement a written Identity Theft Prevention Program to detect, prevent and mitigate identity theft in connection with the opening of certain accounts or certain existing accounts. In accordance with this rule, the Bank was required to adopt “reasonable policies and procedures” to:

- identify relevant red flags for covered accounts and incorporate those red flags into the program;
- detect red flags that have been incorporated into the program;
- respond appropriately to any red flags that are detected to prevent and mitigate identity theft; and

• ensure the program is updated periodically, to reflect changes in risks to customers or to the safety and soundness of the financial institution or creditor from identity theft.

Bank Secrecy Act- Anti-Money Laundering and Related Regulations. The Bank Secrecy Act, which we refer to as BSA, requires the Bank to implement a risk-based compliance program in order to protect the Bank from being used as a conduit for financial or other illicit crimes including but not limited to money laundering and terrorist financing. These rules are administered by the Financial Crimes Enforcement Network, a bureau of the U.S. Treasury

Department, which we refer to as FinCEN. Under the law, the Bank must have a board-approved written BSA-Anti-Money Laundering, which we refer to as AML program which must contain the following key requirements: (1) appointing responsible persons to manage the program, including a BSA Officer; (2) ongoing training of all appropriate Bank staff and management on BSA-AML compliance; (3) developing a system of internal controls (including appropriate policies, procedures and processes); and (4) requiring independent testing to ensure effective implementation of the program and appropriate compliance. Under BSA regulations, the Bank is subject to various reporting requirements such as currency transaction reporting (CTR) for all cash transactions initiated by or on behalf of a customer which, when aggregated, exceed \$10,000 per day. The Bank is also required to monitor customer activity and transactions and file a suspicious activity report (SAR) upon a certain transaction threshold amount when suspicious activity is observed. The BSA also contains numerous recordkeeping requirements.

On June 21, 2010, FinCEN proposed new rules as directed by the Credit Card Accountability Responsibility and Disclosure Act of 2009 to expand the reach of BSA-AML related compliance responsibilities to certain defined “prepaid access providers and sellers, a class of money services businesses formerly either outside or lightly regulated under the BSA.” On July 26, 2011, FinCEN issued its final rule imposing these affirmative BSA-AML compliance obligations. The Bank has evaluated the impact of these rules on its operations and its third-party relationships, and has established internal processes accordingly.

USA PATRIOT Act. The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, which we refer to as the USA PATRIOT Act, amended, in part, the BSA, by, in pertinent part, criminalizing the financing of terrorism and augmented the existing BSA framework by strengthening customer identification procedures, requiring financial institutions to have due diligence procedures, including enhanced due diligence procedures certain accounts and, most significantly, improving information sharing between financial institutions and the U.S. government. .

Under the USA PATRIOT Act, FinCEN, can send bank regulatory agencies lists of the names of persons suspected of involvement in terrorist activities or money laundering. The Bank must search its records for any relationships or transactions with persons on those lists. If the Bank finds any relationships or transactions, it must report specific information to FinCEN and implement other internal compliance procedures in accordance with the Bank’s BSA-AML compliance procedures.

The Office of Foreign Assets Control, which we refer to as OFAC, is a division of the U.S. Treasury Department, and administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals against targeted foreign countries, terrorists, international narcotics traffickers, and those engaged in activities related to the proliferation of weapons of mass destruction. OFAC functions under the President’s wartime and national emergency powers, as well as under authority granted by specific legislation, to impose controls on transactions and freeze assets under U.S. jurisdiction. In addition, many of the sanctions are based on United Nations and other international mandates, and typically involve close cooperation with allied governments. OFAC maintains lists of names of persons and organizations suspected of aiding, harboring or engaging in terrorist acts, as well as sanctions programs for certain countries. If the Bank finds a name on any transaction, account or wire transfer that is on an OFAC list, the Bank must freeze or block such account, and perform additional procedures as required by OFAC regulations. The Bank filters its customer base and transactional activity against OFAC-issued lists. The Bank performs these checks utilizing purpose directed software, which is updated each time a modification is made to the lists provided by OFAC and other agencies of Specially Designated Nationals and Blocked Persons.

Other consumer protection regulations. The Bank is subject to a wide range of consumer protection regulations which may have an enterprise-wide impact or may principally govern its lending or deposit operations. To the extent the Bank engages third party service providers in any aspect of its products and services, these third parties may also be subject to compliance with applicable law, and must therefore be subject to Bank oversight.

Unfair or deceptive or abusive acts or practices. Section 5 of the Federal Trade Commission Act prohibits all persons, including financial institutions, from engaging in any unfair or deceptive acts or practices in or affecting commerce. The Dodd-Frank Act codifies this prohibition, and expands it even further by prohibiting “abusive” practices as well. These prohibitions, which we refer to as UDAAP, apply in all areas of the Bank, including marketing and advertising practices, product features, terms and conditions, operational practices, and the conduct of third parties with whom the Bank may partner or on whom the Bank may rely in bringing Bank products and services to consumers.

The Bank's loan operations are also subject to federal consumer protection laws applicable to credit transactions, including but not limited to:

- the federal "Truth-In-Lending Act," governing disclosures of credit terms to consumer borrowers;
- the "Home Mortgage Disclosure Act of 1975," requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves;

the “Equal Credit Opportunity Act,” prohibiting discrimination on the basis of race, creed or other prohibited factors in extending credit;

the “Fair Credit Reporting Act of 1978,” as amended by the “Fair and Accurate Credit Transactions Act,” governing the use and provision of information to credit reporting agencies, certain identity theft protections and certain credit and other disclosures;

the “Fair Debt Collection Practices Act,” governing the manner in which consumer debts may be collected by collection agencies;

the “Home Ownership and Equity Protection Act” and Regulation prohibiting unfair, abusive or deceptive home mortgage lending practices, restricting certain mortgage lending activities and advertising and mortgage disclosure standards.

• the “Service Members Civil Relief Act;” and

the rules and regulations of the various federal agencies charged with the responsibility of implementing these federal laws;

In addition to the foregoing, interest and other charges collected or contracted for by the Bank will be subject to state usury laws and federal laws concerning interest rates.

The deposit operations of the Bank are subject to various consumer protection laws including but not limited to:

the “Truth in Savings Act,” which imposes disclosure obligations to enable consumers to make informed decisions about accounts at depository institutions;

the “Right to Financial Privacy Act,” which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;

the “Expedited Funds Availability Act” which establishes standards related to when financial institutions must make various deposit items available for withdrawal, and requires depository institutions to disclose their availability policies to their depositors;

the “Electronic Fund Transfer Act” and which governs electronic fund transfers to and withdrawals from deposit accounts and customers’ rights and liabilities arising from the use of automated teller machines and other electronic banking services; and

the rules and regulations of various federal agencies charged with the responsibility of implementing these federal laws.

Community Reinvestment Act. Under the Community Reinvestment Act of 1977, which we refer to as the CRA, a federally-insured institution has a continuing and affirmative obligation to help meet the credit needs of its community, including low-and moderate-income neighborhoods, consistent with the safe and sound operation of the institution. The CRA requires the board of directors of federally-insured institutions, such as the Bank, to adopt a CRA statement for its assessment area that, among other things, describes its efforts to help meet community credit needs and the specific types of credit that the institution is willing to extend. The CRA further re