BankFinancial CORP
Form 10-K
March 15, 2007

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2006

or

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF

THE SECURITIES EXCHANGE ACT OF 1934

For transition period from ______ to ______

Commission File Number 0-51331

BANKFINANCIAL CORPORATION

(Exact Name of Registrant as Specified in Charter)

Maryland	**75-3199276**
(State or Other Jurisdiction of Incorporation)	**(I.R.S. Employer Identification No.)**
15W060 North Frontage Road, Burr Ridge, Illinois	**60527**
(Address of Principal Executive Offices)	**(Zip Code)**

Registrant s telephone number, including area code: (800) 894-6900

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

Title of Each Class:	**Name of Each Exchange on Which Registered:**
Common Stock, par value $0.01 per share	**The NASDAQ Stock Market LLC**

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

None

Indicate by check mark whether the issuer is a well-known seasoned issuer as defined in Rule 405 of the Securities Act of 1933. Yes ¨ No x.

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Exchange Act. Yes ¨ No x.

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 x 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. x

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 x Non-accelerated filer ¨

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

At March 13, 2007, there were 23,442,441 shares of common stock, $0.01 par value, outstanding.

The aggregate market value of the registrant s outstanding voting common stock held by non-affiliates on June 30, 2006, determined using a per share closing price on that date of $17.30, as quoted on The Nasdaq Stock Market, was $385,423,205.

DOCUMENTS INCORPORATED BY REFERENCE

None

PART I

ITEM 1. BUSINESS

Forward Looking Statements

This Annual Report on Form 10-K contains, and other periodic reports and press releases of BankFinancial Corporation may contain, forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended, that involve significant risks and uncertainties. We intend such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995, and are including this statement for purposes of invoking these safe harbor provisions. These forward-looking statements, which are based on certain assumptions and describe our future plans, strategies and expectations, are generally identifiable by use of the words believe, expect, intend, anticipate, estimate, project, plan, or similar expressions. Our abi predict results or the actual effect of future plans or strategies is inherently uncertain and actual results may differ from those predicted. We undertake no obligation to update these forward-looking statements in the future. Factors that could have a material adverse effect on operations and could affect management s outlook or our future prospects include, but are not limited to: higher than expected overhead, infrastructure and compliance costs, changes in market interest rates, a flattening or inversion of the yield curve, less than anticipated balance sheet growth, lack of demand for loan products, unanticipated changes in secondary mortgage market conditions, deposit flows, pricing, underwriting and other forms of competition, adverse federal or state legislative or regulatory developments, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and Federal Reserve Board, deteriorating economic conditions that could result in increased delinquencies in our loan portfolio, the quality or composition of our loan or investment portfolios, demand for financial services and multi-family, commercial and residential real estate loans in our market area, the possible short-term dilutive effect of potential acquisitions or de novo branches, if any, changes in accounting principles, policies and guidelines, and future adverse developments concerning Freddie Mac or the Federal Home Loan Bank of Chicago. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. We do not undertake any obligation to update any forward-looking statement to reflect circumstances and events that occur after the date on which the forward-looking statement was made.

BankFinancial Corporation

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

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

BankFinancial Corporation, the Maryland corporation, did not engage in any business prior to the completion of the mutual-to-stock conversion on June 23, 2005. Consequently, this Annual Report on Form 10-K reflects the financial condition and operating results of BankFinancial MHC and BankFinancial Corporation, the federal corporation, and their subsidiaries, including the Bank, until June 23, 2005, and of BankFinancial Corporation, the Maryland corporation, and its subsidiaries, including the Bank, thereafter. The words Company, we and our thus are intended to refer to BankFinancial MHC, BankFinancial Corporation, the federal corporation, and their subsidiaries with respect to matters and time periods occurring on or before June 23, 2005, and to BankFinancial Corporation, the Maryland corporation, and its subsidiaries, with respect to matters and time periods occurring thereafter.

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

BankFinancial, F.S.B.

The Bank is a full-service, community-oriented savings bank principally engaged in the business of commercial, family and personal banking, and offers our customers a broad range of loan, deposit, and other financial products and services through 18 full-service banking offices located in Cook, DuPage, Lake and Will Counties, Illinois, and through our Internet Branch, www.bankfinancial.com.

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

The Bank s primary lending area consists of the counties where our branch offices are located, and contiguous counties in the States of Illinois and Indiana. We derive substantially all of our revenues from these geographic areas. The Bank s primary market for deposits is currently concentrated around the areas where our full-service banking offices are located.

The Bank was organized in 1924, and was operated as a traditional savings bank until 2000, when we implemented a strategy to transform the Bank into a multi-faceted financial institution with a diversified balance sheet, enhanced capabilities in commercial banking products and services, an expanded geographic presence in the Chicago metropolitan area, and managerial and technological resources and an infrastructure capable of supporting future growth. In furtherance of this strategy, we have actively sought to change the composition of our loans and deposits, expand our multi-family and commercial real estate lending activities, and implement additional commercial lending and leasing capabilities and product lines. We also acquired Success Bancshares, Inc. and its subsidiary, Success National Bank in 2001, and University National Bank in Chicago s Hyde Park community on April 5, 2006. See Acquisition.

Lending Activities

Our loan portfolio consists primarily of investment and business loans (multi-family, nonresidential real estate, commercial, construction and land loans, and commercial leases), which represent 69.6% of our loan portfolio. At December 31, 2006, $297.1 million, or 22.2%, of our total loan portfolio consisted of multi-family mortgage loans; $320.7 million, or 24.0%, of our total loan portfolio consisted of nonresidential real estate loans; $89.3 million, or 6.7%, of our total loan portfolio consisted of commercial loans; $139.2 million, or 10.4%, of our total loan portfolio consisted of commercial leases; $85.2 million, or 6.4%, of our total loan portfolio consisted of construction and land loans; and $397.5 million, or 29.7%, of our total loan portfolio consisted of one- to four-family residential mortgage loans, including home equity loans and lines of credit and other second mortgage loans.

Deposit Activities

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

At December 31, 2006, our deposits totaled $1.130 billion. Interest-bearing deposits totaled $995.5 million and noninterest-bearing demand deposits totaled $134.1 million, which included $8.2 million in internal checking accounts such as bank cashier checks and money orders, and $11.2 million in title insurance escrow funds. Savings, money market and NOW deposits totaled $650.0 million, and certificates of deposit totaled $345.5 million, of which $281.1 million had maturities of one year or less.

Related Products and Services

The Bank s Wealth Management Group provides investment, financial planning and other wealth management services to our customers through arrangements with a third party broker-dealer. The Bank s wholly-owned subsidiary, Financial Assurance Services, Inc., sells life insurance, fixed annuities, property and casualty insurance and other insurance products on an agency basis, and also offers title insurance and title agency services through its Financial Title Services Division. During the year ended December 31, 2006, Financial Assurance Services reported net income of $381,000, and had 16 employees. The Bank s other wholly owned subsidiary, BF Asset Recovery Corporation, is in the business of holding title to certain Bank-owned real estate, and had no net income or loss for the year ended December 31, 2006.

Acquisition

On April 5, 2006, the Company completed its acquisition of University National Bank, a privately held community bank with approximately $113 million in assets and $104 million in deposits, and two banking offices in the Hyde Park community in Chicago, Illinois, for approximately $24 million in cash pursuant to the terms of a Stock Purchase Agreement with University Bancorporation dated November 29, 2005. Immediately upon the completion of the stock purchase, University National Bank was merged into the Bank. The acquisition, which was accounted for under the purchase method of accounting, resulted in goodwill of $11.7 million and an other intangible of $3.3 million. The transaction was treated, for federal and state income tax purposes, as a purchase of University National Bank s assets pursuant to applicable provisions of the Internal Revenue Code, making the goodwill and core deposit intangible arising from the transaction tax-deductible over a period of 15 years. University National Bank s results of operations have been included in the Company s results of operations only since the effective date of the acquisition.

Website and Stockholder Information

The website for the Company and the Bank is located at www.bankfinancial.com. Information on this website does not constitute part of this Form 10-K.

The Company makes available, free of charge, its Form 10-K, its quarterly reports on Form 10-Q, its current reports on Form 8-K and amendments to such reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the Exchange Act), as soon as reasonably practicable after such forms are filed with or furnished to the SEC. Copies of these documents are available to stockholders at BankFinancial s Internet site, www.bankfinancial.com under Stockholder Information and at the SEC s Internet site, www.sec.gov.

Competition

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

We seek to meet this competition by emphasizing personalized banking and local decision-making. Specifically, we promote and maintain relationships and build customer loyalty within local communities by emphasizing decentralized regional management and by focusing our marketing and community involvement on the specific needs of individual neighborhoods. In addition, we, from time to time, seek to meet competition for loans by offering our current and prospective borrowers preferred rates and terms on deposit products for new lending business. We do not rely on any individual, group, or entity for a material portion of our deposits.

Employees

At December 31, 2006, we had 420 full-time employees and 32 part-time employees. The employees are not represented by a collective bargaining unit and we consider our relationship with our employees to be good.

Supervision And Regulation

General

As a federally chartered savings bank, the Bank is regulated and supervised by the Office of Thrift Supervision (OTS) and the Federal Deposit Insurance Corporation (FDIC). This regulation and supervision establishes a comprehensive framework of activities in which a financial institution may engage, and is intended primarily for the protection of the FDIC s deposit insurance funds and depositors. Under this system of federal regulation, financial institutions are periodically examined to ensure that they satisfy applicable standards with respect to their capital adequacy, assets, management, earnings, liquidity and sensitivity to market interest rates. After completing an examination, the primary federal regulator of the institution critiques the financial institution s operations in a report of examination and assigns its rating (known as an institution s CAMELS rating). Under federal law, an institution may not disclose its CAMELS rating to the public.

The Bank is a member of, and owns stock in, the Federal Home Loan Bank of Chicago (FHLBC or FHLB), which is one of the 12 regional banks in the Federal Home Loan Bank System. The Bank also is regulated to a lesser extent by the Board of Governors of the Federal Reserve System with regard to reserves it must maintain against deposits and other matters. The OTS examines the Bank and prepares reports for the consideration of its Board of Directors on any identified operating deficiencies. The Bank s relationship with its depositors and borrowers also is regulated to a great extent by both federal and state laws, especially in matters concerning the ownership of deposit accounts and the form and content of the Bank s loan documents.

There can be no assurance that laws, rules and regulations will not change in the future, which could make compliance more difficult or expensive or otherwise adversely affect our business, financial condition, results of operations or prospects. Any change in these laws or regulations, or in regulatory policy, whether by the FDIC, the OTS, the Board of Governors of the Federal Reserve System or Congress, could have a material adverse impact on the Company, the Bank and their respective operations.

Federal Banking Regulation

Business Activities. A federal savings bank derives its lending and investment powers from the Home Owners Loan Act, as amended, and the regulations of the OTS. Under these laws and regulations, the Bank may invest in mortgage loans secured by residential and nonresidential real estate, commercial business and consumer loans, certain types of securities and certain other loans and assets. The Bank also may establish subsidiaries that may engage in activities not otherwise permissible for the Bank directly, including real estate investment and insurance agency activities.

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

The risk-based capital standard for savings banks requires the maintenance of Tier 1, or core capital, and total capital (which is defined as core capital and supplementary capital) to risk-weighted assets of at least 4% and 8%, respectively. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet assets, are multiplied by a risk-weight factor of 0% to 100%, assigned by the OTS capital regulation based on the risks inherent in the type of asset. Core capital is defined as common stockholders equity (including retained earnings), certain noncumulative perpetual preferred stock and related surplus and minority interests in equity accounts of consolidated subsidiaries, less intangibles other than certain mortgage servicing rights and credit card relationships.

The components of supplementary capital currently include cumulative perpetual preferred stock, long-term preferred stock, mandatory convertible securities, subordinated debt and intermediate-term preferred stock, allowance for loan and lease losses up to a maximum of 1.25% of risk-weighted assets and up to 45% of net unrealized gains on available-for-sale equity securities with readily determinable fair market values. Overall, the amount of supplementary capital included as part of total capital cannot exceed 100% of core capital.

At December 31, 2006, the Bank s capital exceeded all applicable requirements.

Loans to One Borrower. A federal savings bank generally may not make a loan or extend credit to a single or related group of borrowers in excess of 15% of unimpaired capital and surplus. An additional amount may be loaned, equal to 10% of unimpaired capital and surplus, if the loan is secured by readily marketable collateral, which generally does not include real estate. As of December 31, 2006, the Bank was in compliance with the loans-to-one-borrower limitations.

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

Qualified thrift investments include various types of loans made for residential and housing purposes, investments related to those purposes, including certain mortgage-backed and related securities, and loans for personal, family, household and certain other purposes up to a limit of 20% of portfolio assets. Qualified thrift investments also include 100% of an institution s credit card loans, education loans and small business loans. The Bank also may satisfy the QTL test by qualifying as a domestic building and loan association as defined in the Internal Revenue Code of 1986. At December 31, 2006, the Bank maintained approximately 71.19% of its portfolio assets in qualified thrift investments, and as of that date, satisfied the QTL test. A savings bank that fails the QTL test must either convert to a bank charter or operate under specified restrictions, including limits on growth, branching, new investment, FHLB advances and dividends. The OTS order approving our mutual-to-stock conversion requires us to maintain our federal savings bank charter until at least June 23, 2008.

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

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

Even if an application is not otherwise required, every savings bank that is a subsidiary of a holding company must still file a notice with the OTS at least 30 days before the board of directors declares a dividend or approves a capital distribution.

The OTS may disapprove a notice or application if:

- the savings bank would be undercapitalized following the distribution;
- the proposed capital distribution raises safety and soundness concerns; or

the capital distribution would violate a prohibition contained in any statute, regulation or agreement.

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

Community Reinvestment Act and Fair Lending Laws. All savings banks have a responsibility under the Community Reinvestment Act and related regulations of the OTS to help meet the credit needs of their communities, including low and moderate income neighborhoods. In connection with its examination of a federal savings bank, the OTS is required to assess the savings bank s record of compliance with the Community Reinvestment Act. In addition, the Equal Credit Opportunity Act and the Fair Housing Act prohibit lenders from discriminating in their lending practices on the basis of characteristics specified in those statutes. A savings bank s failure to comply with the provisions of the Community Reinvestment Act could, at a minimum, result in regulatory restrictions on its activities. The failure to comply with the Equal Credit Opportunity Act and the Fair Housing Act could result in enforcement actions by the OTS, as well as other federal regulatory agencies and the Department of Justice. The Bank received an Outstanding Community Reinvestment Act rating in its most recent OTS examination in 2005.

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

The OTS and other federal banking agencies have adopted guidelines establishing standards for safeguarding customer information to implement certain provisions of the Gramm-Leach-Bliley Act. The guidelines describe the agencies expectations for the creation, implementation and maintenance of an information security program, which would include administrative, technical and physical safeguards appropriate to the size and complexity of a financial institution and the nature and scope of its activities. The standards set forth in the guidelines are intended to ensure the security and confidentiality of customer records and information, to protect against any anticipated threats or hazards to the security or integrity of such records, and to protect against unauthorized access to or use of such records or other information that could result in substantial harm or inconvenience to any customer. The Bank has implemented these guidelines, and such implementation did not have a material adverse effect on our operations.

Transactions with Related Parties. A federal savings bank s authority to engage in transactions with its affiliates is limited by OTS regulations and by Sections 23A and 23B of the Federal Reserve Act and its implementing Regulation W. The term affiliates for these purposes generally means any company that controls or is under common control with an insured depository institution, although subsidiaries of federal savings banks are generally not considered affiliates for the purposes of Sections 23A 8

and 23B of the Federal Reserve Act. The Company is an affiliates of the Bank. In general, transactions with affiliates must be on terms that are as favorable to the savings bank as comparable transactions with non-affiliates. In addition, certain types of these transactions are restricted to an aggregate percentage of the savings bank s capital. Collateral in specified amounts must usually be provided by affiliates in order to receive loans from the savings bank. OTS regulations also prohibit a savings bank from lending to any of its affiliates that are engaged in activities that are not permissible for bank holding companies, and from purchasing the securities of any affiliate, other than a subsidiary.

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

Enforcement. The OTS has primary enforcement responsibility over federal savings institutions, and has the authority to bring enforcement action against the Bank and all institution-affiliated parties, including stockholders, attorneys, appraisers and accountants who knowingly or recklessly participate in wrongful action likely to have an adverse effect on an insured institution. Formal enforcement action may range from the issuance of a capital directive or cease and desist order to removal of officers and/or directors of the institution, receivership, conservatorship or the termination of deposit insurance. Civil monetary penalties cover a wide range of violations and actions, and range up to $25,000 per day, unless a finding of reckless disregard is made, in which case penalties may be as high as $1 million per day. The FDIC also has the authority to recommend to the Director of the OTS that enforcement action be taken with respect to a particular savings institution. If action is not taken by the Director, the FDIC has authority to take action under specified circumstances.

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

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

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

Generally, the banking regulator is required to appoint a receiver or conservator for a savings bank that is critically undercapitalized. The regulation also provides that a capital restoration plan must be filed with the OTS within 45 days of the date a bank receives notice that it is undercapitalized, significantly undercapitalized or critically undercapitalized. In addition, numerous mandatory supervisory actions become immediately applicable to the savings bank, including, but not limited to, restrictions on growth, investment activities, capital distributions and affiliate transactions. The OTS may also take any one of a number of discretionary supervisory actions against undercapitalized savings banks, including the issuance of a capital directive and the replacement of senior executive officers and directors.

At December 31, 2006, the Bank met the criteria for being considered well-capitalized.

Insurance of Deposit Accounts. Deposit accounts in the Bank are insured by the Deposit Insurance Fund (DIF) of the FDIC (effective March 31, 2006, the FDIC merged the Bank Insurance Fund and the Savings Insurance Fund into a single insurance fund, the DIF), generally up to a maximum of $100,000 per separately insured depositor and up to a maximum of $250,000 for self-directed retirement accounts. The Bank s deposits, therefore, are subject to FDIC deposit insurance assessments. The FDIC has adopted a risk-based system for determining deposit insurance assessments. The FDIC is authorized to raise the assessment rates as necessary to maintain the required ratio of reserves to insured deposits of 1.25%. In addition, all FDIC-insured institutions must pay assessments to the FDIC at an annual rate of approximately 0.0122% of insured deposits to fund interest payments on bonds maturing in 2017 that were issued by a federal agency to recapitalize the predecessor to the Savings Association Insurance Fund.

On February 15, 2006, federal legislation to reform federal deposit insurance was signed into law. This law requires, among other things, the merger of the Savings Association Insurance Fund and the Bank Insurance Fund into a unified insurance deposit fund, an increase in the amount of federal deposit insurance coverage per separately insured deposits (with a cost of living adjustment to become effective in five years), and the reserve ratio to be modified to provide for a range between 1.15% and 1.50% of estimated insured deposits.

On November 2, 2006, the Federal Deposit Insurance Corporation adopted final regulations that assess insurance premiums based on risk. As a result, the new regulation will enable the Federal Deposit Insurance Corporation to more closely tie each financial institution s deposit insurance premiums to the risk it poses to the deposit insurance fund. Under the new risk-based assessment system, which becomes effective in the beginning of 2007, the Federal Deposit Insurance Corporation will evaluate the risk of each financial institution based on its supervisory rating, its financial ratios, and its long-term debt issuer rating. The new rates for nearly all of the financial institution industry will vary between five and seven cents for every $100 of domestic deposits. We received a notification from the FDIC on October 16, 2006, that our one-time assessment credit was $1.8 million. At the same time, the Federal Deposit Insurance Corporation also adopted final regulations designating the reserve ratio for the deposit insurance fund during 2007 at 1.25% of estimated insured deposits.

Prohibitions Against Tying Arrangements. Federal savings banks are prohibited, subject to some exceptions, from extending credit to or offering any other service, or fixing or varying the consideration for such extension of credit or service, on the condition that the customer obtain some additional service from the institution or its affiliates or not obtain services of a competitor of the institution.

Federal Home Loan Bank System. The Bank is a member of the Federal Home Loan Bank System, which consists of 12 regional Federal Home Loan Banks. The Federal Home Loan Bank System provides a central credit facility primarily for member institutions. As a member of the FHLBC, the Bank is required to acquire and hold shares of capital stock in the FHLBC in an amount at least equal to 1% of the aggregate principal amount of its unpaid residential mortgage loans and similar obligations at the beginning of each year, or 1/20 of its borrowings from the FHLBC, whichever is greater. As of December 31, 2006, the Bank was in compliance with this requirement.

Federal Reserve System

Federal Reserve Board regulations require savings banks to maintain noninterest-earning reserves against their transaction accounts, such as negotiable order of withdrawal and regular checking accounts. At December 31, 2006, the Bank was in compliance with these reserve requirements. The balances maintained to meet the reserve requirements imposed by the Federal Reserve Board may be used to satisfy liquidity requirements imposed by the OTS.

The USA PATRIOT Act and the Bank Secrecy Act

The USA PATRIOT Act and the Bank Secrecy Act require financial institutions to develop programs to detect and report money-laundering and terrorist activities, as well as suspicious activities. The USA PATRIOT Act also gives the federal government new powers to address terrorist threats through enhanced domestic security measures, expanded surveillance powers, increased information sharing and broadened anti-money laundering requirements. The federal banking agencies are required to take into consideration the effectiveness of controls designed to combat money-laundering activities in determining whether to approve a merger or other acquisition application of a member institution. Accordingly, if we engage in a merger or other acquisition, our controls designed to combat money laundering would be considered as part of the application process. In addition, non-compliance with these laws and regulations could result in fines, penalties and other enforcement measures. We have developed policies and continue to augment procedures and systems designed to comply with these laws and regulations.

Holding Company Regulation

The Company is a unitary savings and loan holding company, subject to regulation and supervision by the OTS. The OTS has enforcement authority over the Company and its non-savings institution subsidiaries. Among other things, this authority permits the OTS to restrict or prohibit activities that are determined to be a risk to the Bank.

Under prior law, a unitary savings and loan holding company generally had no regulatory restrictions on the types of business activities in which it could engage, provided that its subsidiary savings bank was a qualified thrift lender. The Gramm-Leach-Bliley Act of 1999, however, restricts the activities of unitary savings and loan holding companies not existing on, or applied for before, May 4, 1999 to those permissible for financial holding companies or for multiple savings and loan holding companies. The Company is not a grandfathered unitary savings and loan holding company, and therefore is limited to the activities permissible for financial holding companies or for multiple savings and loan holding companies. A financial holding company may engage in activities that are financial in nature, including underwriting equity securities and insurance, incidental to financial activities or complementary to a financial activity. A multiple savings and loan holding company is generally limited to activities permissible for bank holding companies under Section 4(c)(8) of the Bank Holding Company Act, subject to the prior approval of the OTS, and certain additional activities authorized by OTS regulations.

Federal law prohibits a savings and loan holding company, directly or indirectly, or through one or more subsidiaries, from acquiring control of another savings institution or holding company thereof, without prior written approval of the OTS. It also prohibits the acquisition or retention of, with specified exceptions, more than 5% of the equity securities of a company engaged in activities that are not closely related to banking or financial in nature or acquiring or retaining control of an institution that is not federally insured. In evaluating applications by holding companies to acquire savings institutions, the OTS must consider the financial and managerial resources and future prospects of the savings institution involved, the effect of the acquisition on the risk to the insurance fund, the convenience and needs of the community and competitive factors.

Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 was enacted in response to public concerns regarding corporate accountability in connection with certain accounting scandals. The stated goals of the Sarbanes-Oxley Act are to increase corporate responsibility, to provide for enhanced penalties for accounting and auditing improprieties at publicly traded companies, and to protect investors by improving the accuracy and reliability of corporate disclosures pursuant to the securities laws. The Sarbanes-Oxley Act generally applies to all companies that file or are required to file periodic reports with the Securities and Exchange Commission, under the Securities Exchange Act of 1934.

The Sarbanes-Oxley Act includes specific additional disclosure requirements, requires the Securities and Exchange Commission and national securities exchanges to adopt extensive additional disclosure, corporate governance and other related rules, and mandates further studies of certain issues by the Securities and Exchange Commission. The Sarbanes-Oxley Act represents significant federal involvement in matters traditionally left to state regulatory systems, such as the regulation of the accounting profession, and to state corporate law, such as the relationship between a board of directors and management and between a board of directors and its committees.

Federal Securities Laws

The Company s common stock is registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended. the Company is subject to the information, proxy solicitation, insider trading restrictions and other requirements of the Securities Exchange Act of 1934.

The registration under the Securities Act of 1933 of shares of common stock issued in the offering does not cover the resale of those shares. Shares of common stock purchased by persons who are not affiliates of the Company may be resold without registration. Shares purchased by an affiliate of the Company will be subject to the resale restrictions of Rule 144 under the Securities Act of 1933. If the Company meets the current public information reporting requirements of Rule 144 under the Securities Act of 1933, each affiliate of the Company that complies with the other conditions of Rule 144, including those that require the affiliate s sale to be aggregated with those of other persons, would be able to sell in the public market, without registration, a number of shares not to exceed, in any three-month period, the greater of 1% of the outstanding shares of the Company or the average weekly volume of trading in the shares during the preceding four calendar weeks. In the future, the Company may permit affiliates to have their shares registered for sale under the Securities Act of 1933.

Taxation

Federal Taxation. The Company and the Bank are subject to federal income taxation in the same general manner as other corporations, with some exceptions discussed below. The following discussion of federal taxation is intended only to summarize material federal income tax matters and is not a comprehensive description of the tax rules applicable to the Company and the Bank.

Method of Accounting. For federal income tax purposes, the Company currently reports its income and expenses on the accrual method of accounting and uses a tax year ending December 31 for filing its consolidated federal income tax returns. The Small Business Protection Act of 1996 eliminated the use of the reserve method of accounting for bad debt reserves by savings institutions, effective for taxable years beginning after 1995.

Bad Debt Reserves. Prior to the Small Business Protection Act of 1996, the Bank was permitted to establish a reserve for bad debts for tax purposes and to make annual additions to the reserve. These additions could, within specified formula limits, be deducted in arriving at the Bank s taxable income. As a result of the Small Business Protection Act of 1996, the Bank must use the specific charge off method in computing its bad debt deduction for tax purposes.

Taxable Distributions and Recapture. Prior to the Small Business Protection Act of 1996, bad debt reserves created prior to 1988 were subject to recapture into taxable income if the Bank failed to meet certain thrift asset and definition tests. The Small Business Protection Act of 1996 eliminated these thrift-related recapture rules. However, under current law, pre-1988 reserves remain subject to tax recapture should the Bank make certain distributions from its tax bad debt reserve or cease to maintain a financial institution charter. At December 31, 2006, the Bank s total federal pre-1988 reserve was approximately $14.9 million. This reserve reflects the cumulative effects of federal tax deductions by the Bank for which no federal income tax provision has been made.

Alternative Minimum Tax. The Internal Revenue Code of 1986, as amended, imposes an alternative minimum tax at a rate of 20% on a base of regular taxable income plus certain tax preferences, referred to as alternative minimum taxable income. The alternative minimum tax is payable to the extent alternative minimum taxable income is in excess of an exemption amount. Net operating losses can, in general, offset no more than 90% of alternative minimum taxable income. Certain payments of alternative minimum tax may be used as credits against regular tax liabilities in future years. At December 31, 2006, the Company had an alternative minimum tax credit carryforward of approximately $900,000.

Net Loss Carryovers. A financial institution may carry back net operating losses to the preceding two taxable years (five years for losses incurred in 2001 and 2002) and forward to the succeeding 20 taxable years. At December 31, 2006, the Company had no net operating loss carryforward for federal income tax purposes. At December 31, 2006, the Company included in deferred tax assets a $1.1 million asset for capital loss carryforwards, which expires in 2011. Based upon projections of future taxable income, including capital gains, management believes that it is more likely than not that the deferred tax assets will be fully realized and thus a valuation allowance is not needed.

Corporate Dividends. We may exclude from our income 100% of dividends received from the Bank as a member of the same affiliated group of corporations.

State and Local Taxation. We pay income tax to the State of Illinois. As a Maryland business corporation, we are required to file annual returns and pay annual fees to the State of Maryland, but these fees are not material in amount. At December 31, 2006, the Company had no net operating loss carryforward for state income tax purposes.

ITEM 1A. RISK FACTORS

The risks set forth below may adversely affect our business, financial condition and operating results. In addition to the risks set forth below and the other risks described in Item 1, Business, Forward-Looking Statements, and Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, there may also be additional risks and uncertainties that are not currently known to us or that we currently deem to be immaterial that could materially and adversely affect our business, financial condition or operating results. As a result, past financial performance may not be a reliable indicator of future performance, and historical trends should not be used to anticipate results or trends in future periods.

Changes in Market Interest Rates Could Adversely Affect Our Financial Condition and Results of Operations

Our financial condition and results of operations are significantly affected by changes in market interest rates because our assets, primarily loans, and our liabilities, primarily deposits, are monetary in nature. Our results of operations depend substantially on our net interest income, which is the difference between the interest income that we earn on our interest-earning assets and the interest expense that we pay on our interest-bearing liabilities. We are unable to predict changes in market interest rates that are affected by many factors beyond our control, including inflation, recession, unemployment, money supply, domestic and international events and changes in the United States and other financial markets. Our net interest income is affected not only by the level and direction of interest rates, but also by the shape of the yield curve and relationships between interest sensitive instruments and key driver rates, including credit risk spreads, and by balance sheet growth, customer loan and deposit preferences and the timing of changes in these variables which themselves are impacted by changes in market interest rates. As a result, changes in market interest rates can significantly impact our net interest income as well as the fair market valuation of our assets and liabilities.

Our Return on Stockholders Equity Will Continue to Be Low In the Near Future as a Result of the 2005 Subscription Offering

Net income divided by average stockholders equity, known as return on equity, is a ratio that many investors use to compare the performance of a financial institution to its peers. Our capital remains relatively high by industry standards pending a more optimal deployment of the additional capital raised in our mutual-to-stock conversion. Until we can increase our net interest income and noninterest income, we expect our return on equity to continue to be below the industry average, which may negatively affect the value of our shares of common stock.

Our Nonresidential Real Estate Loans, Multi-family Mortgage Loans, Construction and Land Loans, Commercial Loans and Commercial Leases Expose Us to Increased Credit Risks

At December 31, 2006, our portfolio of nonresidential real estate loans totaled $320.7 million, or 24.0% of total loans; our portfolio of multi-family mortgage loans totaled $297.1 million, or 22.2% of total loans; our portfolio of construction and land loans totaled $85.2 million, or 6.4% of total loans; our portfolio of commercial loans totaled $89.3 million, or 6.7% of total loans; and our portfolio of commercial leases totaled $139.2 million, or 10.4% of total loans. We plan to continue to originate these types of loans and retain them in our portfolio, although we may participate portions of some of these loans to other financial institutions. These types of loans generally have greater credit risk than one- to four-family residential mortgage loans because repayment of the loans often depends on the successful business operations of the borrower. These loans typically have larger loan balances to single borrowers or groups of related borrowers compared to one- to four-family residential mortgage loans. Many of our borrowers also have more than one nonresidential real estate, multi-family mortgage, construction or commercial loan or lease outstanding with us. Consequently, an adverse development involving one or more loans or credit relationships can expose us to significantly greater risk of loss compared to an adverse development involving a one- to four-family residential mortgage loan.

Our Concentration of Loans within Certain Segments of the Healthcare Industry Exposes Us to Increased Credit Risk

At December 31, 2006, we had $53.0 million of loans to healthcare providers, including loans to nursing homes and hospice care companies and leases to hospitals for equipment. These loans represented 4.0% of our total loan portfolio as of that date. Of these loans, $20.9 million, or 39.4%, were collateralized by real estate. The remainder consisted of working capital lines of credit secured by government accounts receivable, of which we are a joint payee, or by leased equipment. Loans to healthcare providers have unique credit risks. A healthcare provider s income stream is subject to many factors beyond the control of the healthcare provider, including the risk that the provider will not be reimbursed for all services provided. The State of Illinois has experienced budget shortfalls in recent years, causing delays in state reimbursement for healthcare costs. Government reimbursement rates are also subject to change, including retroactive adjustments. For example, a significant overpayment to a healthcare provider can result in the provider owing significant governmental repayments to the federal or state government. A healthcare provider s profitability also depends on its ability to maintain certain levels of occupancy. Unexpected declines in occupancy rates can restrict a provider s cash flow. Any of these factors can impair the ability of our healthcare provider borrowers to make loan repayments, which could result in significant loss to us.

At December 31, 2006, we had not taken any charge-offs within this segment of our loan portfolio, but we have established a specific loan loss reserve allowance in the amount of $253,000 for loans to one borrower with an aggregate principal balance of $6.3 million. This loan loss reserve was reduced during 2006 primarily due to our receipt of current appraisals reflecting increases in the value of certain non-residential real estate securing loans. The loans to this borrower are also partially secured by additional collateral, including home equity and other personal assets. In addition, based on weaknesses in the financial performance of, and untimely or incomplete financial statements for, certain nursing homes operated by another borrower, we classified as substandard loans to this other borrower, which had an aggregate principal balance of $5.5 million, even though we did not establish a specific loan loss allowance for these loans. These loans were current on their loan payments to us as of December 31, 2006.

If Our Allowance for Loan Losses is Not Sufficient to Cover Actual Loan Losses, Our Earnings Could Decrease

In the event that our loan customers do not repay their loans according to the terms of the loans, and the collateral securing the repayment of these loans is insufficient to cover any remaining loan balance, we could experience significant loan losses or increase our provision for loan losses or both, which could have a material adverse effect on our operating results. We make various assumptions and judgments about the collectibility of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets, if any, serving as collateral for the repayment of our loans. At December 31, 2006, our allowance for loan losses was $10.6 million, representing 0.79% of total loans and 115.1% of nonperforming loans as of that date. In determining the amount of our allowance for loan losses, we rely on our loan quality reviews, our experience and our evaluation of economic conditions, among other factors. We also make assumptions concerning our legal positions and the priority of our interests in contested legal or bankruptcy proceedings, and at times we may lack sufficient information to establish specific reserves for loans involved in such proceedings. For example, we have not yet established specific reserves for $16.2 million in highly-seasoned residential mortgage loans and $4.6 million in commercial loans that we purchased from a loan servicing company that commenced bankruptcy proceedings in December of 2006 pending the receipt of additional information and future developments in the bankruptcy proceeding. If our assumptions concerning any of these matters are incorrect, our allowance for loan losses may not be sufficient to cover probable incurred losses in our loan portfolio, which may require additions to our allowance. Any material additions to our allowance for loan losses would materially decrease our net income.

Our Ability to Successfully Conduct Acquisitions Will Affect Our Ability to Grow Our Franchise and Compete Effectively in Our Marketplace

On April 5, 2006, we completed the acquisition of University National Bank. We will also consider the possible acquisition of other banks, thrifts and other financial services companies to supplement internal growth. Our efforts to acquire other financial institutions and financial service companies may not be successful. Numerous potential acquirors exist for most acquisition candidates, creating intense competition, which particularly affects the purchase price for which the institution can be acquired. In many cases, our competitors have significantly greater resources than we have, and greater flexibility to structure the consideration for the transaction. We may not participate in specific acquisition opportunities if we consider the proposed transaction unacceptable. We also may not be the successful bidder in acquisition opportunities that we pursue due to the willingness or ability of other potential acquirors to propose a higher purchase price or more attractive terms and conditions than we are willing or able to propose. If we are unable to or do not conduct acquisitions, our ability to deploy effectively the capital we raised in the offering, expand our geographic presence and improve our results of operations could be adversely affected.

The Risks Presented by the Acquisition of Other Institutions Could Adversely Affect Our Financial Condition and Results of Operations

If we are successful in conducting acquisitions, we will be presented with many risks that could have a material adverse effect on our financial condition and results of operations. An institution that we acquire may have unknown asset quality issues or unknown or contingent liabilities that we did not discover or fully recognize in the due diligence process, thereby resulting in unanticipated losses. The acquisition of other institutions typically requires the integration of different corporate cultures, loan and deposit products, pricing strategies, data processing systems and other technologies, accounting, internal audit and financial reporting systems, operational processes, policies, procedures and internal controls, marketing programs and personnel of the acquired institution in order to make the transaction economically advantageous. The integration process is complicated and time consuming, and could divert our attention from other business concerns and be disruptive to our customers and the customers of the acquired institution. Our failure to successfully integrate an acquired institution could result in the loss of key customers and employees, and prevent us from achieving expected synergies and cost savings. Acquisitions also result in professional fees, purchase price adjustments, the amortization of core deposit intangibles and other expenses that could adversely affect our earnings, and in goodwill that could become impaired, requiring us to recognize further charges. We may finance acquisitions with borrowed funds, thereby increasing our leverage and reducing our liquidity, or with potentially dilutive issuances of equity securities.

Since Our Business is Concentrated in the Chicago Metropolitan Area, a Downturn in the Economy of This Area May Adversely Affect Our Business

Our lending and deposit gathering activities are concentrated primarily in the Chicago metropolitan area. Our success depends on the general economic conditions of this area and surrounding areas. In addition, many of the loans in our loan portfolio are secured by real estate located in the Chicago metropolitan area. Negative conditions in the real estate markets where collateral for a mortgage loan is located could adversely affect the borrower s ability to repay the loan and the value of the collateral securing the loan. Real estate values are affected by various other factors, including supply and demand, changes in general or regional economic conditions, interest rates, governmental rules or policies and natural disasters. Adverse changes in the regional and general economy could also reduce our growth rate, impair our ability to collect loans and generally have a negative effect on our financial condition and results of operations.

Non-Compliance with USA PATRIOT Act, Bank Secrecy Act, or Other Laws and Regulations Could Result in Fines or Sanctions, and Curtail Expansion Opportunities

Financial institutions are required under the USA PATRIOT and Bank Secrecy Acts to develop programs to prevent financial institutions from being used for money laundering and terrorist activities. Financial institutions are also obligated to file suspicious activity reports with the U.S. Treasury Department s Office of Financial Crimes Enforcement Network if such activities are detected. These rules also require financial institutions to establish procedures for identifying and verifying the identity of customers seeking to open new financial accounts. Failure or the inability to comply with these regulations could result in fines or penalties, curtailment of expansion opportunities, intervention or sanctions by regulators and costly litigation or expensive additional controls and systems. During the last few years, several banking institutions have received large fines for non-compliance with these laws and regulations. We have developed policies and continue to augment procedures and systems designed to assist in compliance with these laws and regulations.

The Bank s Ability to Pay Dividends is Subject to Regulatory Limitations Which, to the Extent the Company Requires Such Dividends in the Future, May Affect its Ability to Pay Dividends

The Company is a separate legal entity from its subsidiaries and does not have significant operations of its own. Dividends from the Bank provide a significant source of cash for the Company. The availability of dividends from the Bank is limited by various statutes and regulations. It is possible, depending upon the financial condition of the Bank and other factors, that the OTS, as the Bank s primary regulator, could assert that the payment of dividends or other payments by the Bank are an unsafe or unsound practice. In the event the Bank is unable to pay dividends to the Company, the Company may not be able to pay dividends on its common stock. Consequently, the potential inability to receive dividends from the Bank could adversely affect the Company s financial condition, results of operations and prospects.

Our Future Success Is Dependent On Our Ability To Compete Effectively In The Highly Competitive Banking Industry

We face substantial competition in all phases of our operations from a variety of different competitors. Our future growth and success will depend on our ability to compete effectively in this highly competitive environment. To date, we have grown our business successfully by focusing on our geographic markets and emphasizing the high level of service and responsiveness desired by our customers. We compete for loans, deposits and other financial services with other commercial banks, thrifts, credit unions, brokerage houses, mutual funds, insurance companies, real estate conduits, and specialized finance companies. Many of our competitors offer products and services that we do not offer, and many have substantially greater resources and lending limits, name recognition and market presence that benefit them in attracting business. In addition, larger competitors may be able to price loans and deposits more aggressively than we do, and smaller newer competitors may also be more aggressive in pricing loans and deposits in order to increase their market share. Some of the financial institutions and financial services organizations with which we compete are not subject to the extensive regulations imposed on savings banks and their holding companies. As a result, these nonbank competitors have certain advantages over us in accessing funding and in providing various financial services.

Various Factors May Make Takeover Attempts That You Want to Succeed More Difficult to Achieve, Which May Affect the Value of Shares of Our Common Stock

Provisions of our articles of incorporation and bylaws, federal regulations, Maryland law and various other factors may make it more difficult for companies or persons to acquire control of the Company without the consent of our board of directors. You may want a takeover attempt to succeed because, for example, a potential acquiror could offer a premium over the then prevailing price of our shares of common stock. The Office of Thrift Supervision regulations prohibit, for three years following the completion of a mutual-to-stock conversion, the direct or indirect acquisition of more than 10% of any class of equity security of a converted savings institution without the prior approval of the Office of Thrift Supervision. Provisions of our articles of incorporation and bylaws also may make it difficult to remove our current board of directors or management if our board of directors opposes the removal. We have elected to be subject to the Maryland Business Combination Act, which places restrictions on mergers and other business combinations with large stockholders. In addition, our articles of incorporation provide that certain mergers and other similar transactions, as well as amendments to our articles of incorporation, must be approved by stockholders owning at least two-thirds of our shares of common stock entitled to vote on the matter unless first approved by at least two-thirds of the number of our authorized directors, assuming no vacancies. If approved by at least two-thirds of the number of our authorized directors, assuming no vacancies, the action must still be approved by a majority of our shares entitled to vote on the matter. In addition, a director can be removed from office, but only for cause, if such removal is approved by stockholders owning at least two-thirds of our shares of common stock entitled to vote on the matter, unless first approved by at least two-thirds of the number of our authorized directors (excluding the director whose removal is sought), assuming no vacancies. If approved by at least two-thirds of the number of our authorized directors, assuming no vacancies, the removal may be with or without cause, but must still be approved by a majority of our voting shares entitled to vote on the matter. Additional provisions include limitations on the voting rights of any beneficial owners of more than 10% of our common stock. Our bylaws, which can only be amended by the board of directors, also contain provisions regarding the timing, content and procedural requirements for stockholder proposals and nominations.

We Continually Encounter Technological Change, and May Have Fewer Resources Than Many of Our Competitors to Continue to Invest In Technological Improvements

The financial services industry is undergoing rapid technological changes, with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. Our future success will depend, in part, upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands for convenience, as well as to create additional efficiencies in our operations. Many of our competitors have substantially greater resources to invest in technological improvements. We may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers.

Our Business May Be Adversely Affected by the Highly Regulated Environment In Which We Operate

We are subject to extensive federal and state legislation, regulation, examination and supervision. Recently enacted, proposed and future legislation and regulations could have an adverse effect on our business and operations. Our success depends on our continued ability to comply with these laws and regulations. Some of these regulations may increase our costs. While we cannot predict what effect any future changes in these laws or regulations or their interpretations would have on us, these changes or interpretations may adversely affect our future operations.

ITEM 1B. UNRESOLVED STAFF COMMENTS
None.

ITEM 2. PROPERTIES

As of December 31, 2006, the net book value of our properties was $31.0 million. The following is a list of our offices:

Burr Ridge (Executive Office) 15W060 North Frontage Road Burr Ridge, IL 60527	Deerfield 630 N. Waukegan Road Deerfield, IL 60015	Northbrook 1368 Shermer Road Northbrook, IL 60062
Calumet City 1901 Sibley Boulevard Calumet City, IL 60409	Hazel Crest 3700 W. 183rd Street Hazel Crest, IL 60429	Olympia Fields 21110 S. Western Avenue Olympia Fields, IL 60461
Calumet Park 1333 W. 127th Street Calumet Park, IL 60827	Joliet 1401 N. Larkin Joliet, IL 60435	Orland Park 48 Orland Square Drive Orland Park, IL 60462
Chicago Hyde Park 1354 East 55th Street Chicago, IL 60615	Lincolnshire One Marriott Drive Lincolnshire, IL 60069	Schaumburg 1005 Wise Road Schaumburg, IL 60193
Chicago Hyde Park East 55th at Lake Park Avenue Chicago, IL 60637	Lincolnwood 3443 W. Touhy Lincolnwood, IL 60712	South Libertyville 1123 S. Milwaukee Avenue Libertyville, IL 60048
Chicago Ridge 6415 W. 95th Street Chicago Ridge, IL 60415	Naperville 1200 East Ogden Avenue Naperville, IL 60563	
Chicago-Lincoln Park 2424 N. Clark Street Chicago-Lincoln Park, IL 60614	North Libertyville 1409 W. Peterson Road Libertyville, IL 60048	

Except for our Chicago-Lincoln Park, Northbrook, and Hyde Park East offices, which are leased, all of our offices are owned.

ITEM 3. LEGAL PROCEEDINGS

The Company and its subsidiaries are subject to various legal actions arising in the normal course of business. In the opinion of management, based on currently available information, the resolution of these legal actions is not expected to have a material adverse effect on the Company s results of operations.

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

During the fourth quarter of the fiscal year covered by this report, the Company did not submit any matters to the vote of security holders.

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

Our shares of common stock are traded on the Nasdaq Global Market under the symbol BFIN. The approximate number of holders of record of the Company s common stock as of December 31, 2006 was 2,191. Certain shares of the Company s common stock are held in nominee or street name, and accordingly, the number of beneficial owners of such shares is not known or included in the foregoing number.

The following table presents quarterly market information provided by the Nasdaq Stock Market for the Company s common stock and cash dividends paid for the periods ended December 31, 2006 and 2005. The Company began trading on the Nasdaq National Market on June 24, 2005. Accordingly, no information prior to that date is available.

2005 and 2006 Quarterly Periods	High	Low	Close	Cash Dividends Paid
Quarter ended December 31, 2006	$ 18.50	$ 17.23	$ 17.81	$ 0.06
Quarter ended September 30, 2006	18.11	16.31	17.49	0.06
Quarter ended June 30, 2006	17.30	15.15	17.30	0.06
Quarter ended March 31, 2006	16.41	14.55	15.92	
Quarter ended December 31, 2005	14.91	12.99	14.68	
Quarter ended September 30, 2005	15.00	13.10	14.20	
Quarter ended June 30, 2005	13.86	13.02	13.33	

For a discussion of the Bank s ability to pay dividends, see Part I, Item I, Business Supervision and Regulation Federal Banking Regulation Capital Distributions.

Recent Sales of Unregistered Securities

The Company had no sales of unregistered stock during the fiscal year ended December 31, 2006.

Repurchases of Our Equity Securities

The following table sets forth information in connection with purchases of our common stock made by or on behalf of us during the fourth quarter of 2006:

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet be Purchased under the Plans or Programs (1)
October 1, 2006 through October 31, 2006	28,600	$ 17.458	28,600	1,667,325
November 1, 2006 through November 30, 2006	161,100	17.391	161,100	1,506,225
December 1, 2006 through December 31, 2006	36,900	17.555	36,900	1,469,325
Totals	226,600	$ 17.426	226,600	

(1) On August 30, 2006, our Board of Directors approved the repurchase, from time to time, on the open market or through negotiated transactions, and pursuant to any trading plan that may be adopted in accordance with Rule 10b5-1 of the Securities and Exchange Commission, of up to 2,446,625 outstanding shares of the Company s common stock. The authorization will expire on March 31, 2007.

Securities Authorized for Issuance under Equity Compensation Plan

The following table sets forth information regarding the securities authorized for issuance under our 2006 Equity Incentive Plan as of December 31, 2006:

	(Column A)	(Column B)	Column C)
Plan Category	**Number of Securities to be Issued Upon Exercise of Outstanding Options, Warrants and Rights**	**Weighted-Average Exercise Price of Outstanding Options, Warrants and Rights**	**Number of Securities Remaining Available for Future Issuance under 2006 Equity Incentive Plan (Excluding Securities Reflected in Column (A))**
Equity compensation plans approved by stockholders	1,942,950	$ 17.63	1,308,275
Equity compensation plans not approved by stockholders			
Total	1,942,950	17.63	1,308,275

Column (A) represents stock options and restricted stock outstanding under the Company s 2006 Equity Incentive Plan. Future equity awards under the 2006 Equity Incentive Plan may take the form of stock options, stock appreciation rights, performance unit awards, restricted stock, restricted performance stock, restricted stock units, stock awards or cash. Column (B) represents the weighted-average exercise price of the outstanding stock options only; the outstanding restricted stock awards are not included in this calculation. Column (C) represents the maximum aggregate number of future equity awards that can be made under the 2006 Equity Incentive Plan as of December 31, 2006.

Stock Performance Graph

The following Performance Graph and related information shall not be deemed soliciting material or to be filed with the Securities and Exchange Commission, nor shall such information be incorporated by reference into any future filing under the Securities Act of 1933 or Securities Exchange Act of 1934, each as amended, except to the extent that the Company specifically incorporates it by reference into such filing.

We completed our mutual-to-stock conversion on June 23, 2005, in connection with which the Company sold an aggregate of 24,466,250 shares of common stock at a price of $10.00 per share. The Company s common stock began trading on the Nasdaq National Market under the symbol BFIN on June 24, 2005, and the per share closing price of one share of the Company s common stock on that date was $13.60. The following graph represents $100 invested in our common stock at the $13.60 per share closing price on June 24, 2005. The graph illustrates the comparison of the cumulative total returns for the common stock of the Company, the Russell 2000 Index, the NASDAQ Bank Index and the America s Community Bankers NASDAQ Index for the periods indicated.

There can be no assurance that our stock performance will continue in the future with the same or similar trend depicted in the graph below. We will not make or endorse any predictions as to future stock performance.

June 24, 2005 = 100

	6/24/2005	12/31/2005	12/31/2006
BankFinancial Corporation	100.00	107.94	132.36
Russell 2000 Index	100.00	107.49	127.24
NASDAQ Bank Index	100.00	103.94	116.64
America s Community Bankers NASDAQ Index	100.00	104.94	118.97

ITEM 6. SELECTED FINANCIAL DATA

The following information is derived from the audited consolidated financial statements of the Company, or, prior to June 24, 2005, BankFinancial MHC, Inc. For additional information, reference is made to Management s Discussion and Analysis of Financial Condition and Results of Operations and the Consolidated Financial Statements of the Company and related notes included elsewhere in this Annual Report.

	At December 31,				
	2006	2005	2004	2003	2002
	(Dollars in thousands)				
Selected Financial Condition Data:					
Total assets	$ 1,613,122	$ 1,614,436	$ 1,492,782	$ 1,457,911	$ 1,490,726
Loans, net	1,329,915	1,231,891	1,091,952	1,067,248	1,077,932
Loans held-for-sale	298	375	5,531	5,280	11,166
Securities available-for-sale at fair value	117,853	248,238	268,093	257,520	233,572
Goodwill	22,579	10,865	10,865	10,865	10,865
Core deposit intangible	9,648	8,248	9,882	11,583	13,352
Deposits	1,129,585	1,067,874	1,115,696	1,073,897	1,054,762
Borrowings	138,148	191,388	264,742	268,225	307,180
Equity	326,015	328,777	94,888	96,687	103,498

	Years Ended December 31,				
	2006	2005	2004	2003	2002
	(Dollars in thousands)				
Selected Operating Data:					
Interest and dividend income	$ 94,086	$ 80,212	$ 66,738	$ 68,686	$ 82,633
Interest expense	37,489	28,802	23,470	30,552	38,765
Net interest income	56,597	51,410	43,268	38,134	43,868
Provision (credit) for loan losses	(136)	518	(22)	(579)	(422)
Net interest income after provision (credit) for loan losses	56,733	50,892	43,290	38,713	44,290
Noninterest income	10,509	8,665	8,618	8,355	6,424
Noninterest expense (1)	52,370	44,206	50,715	64,061	44,920
Income (loss) before income tax expense	14,872	15,351	1,193	(16,993)	5,794
Income tax expense (benefit)	4,826	4,278	(264)	(7,415)	748
Net income (loss)	$ 10,046	$ 11,073	$ 1,457	$ (9,578)	$ 5,046
Basic earnings per common share	$ 0.45	$ 0.29	N.A.	N.A.	N.A.
Diluted earnings per common share	$ 0.45	$ 0.29	N.A.	N.A.	N.A.

N.A. Not applicable

(footnotes on following page)

	At or For the Years Ended December 31,				
	2006	2005	2004	2003	2002
Selected Financial Ratios and Other Data:					
Performance Ratios:					
Return on assets (ratio of net income (loss) to average total assets)	0.61%	0.70%	0.10%	(0.66%)	0.33%
Return on equity (ratio of net income (loss) to average equity)	3.02	5.18	1.54	(9.98)	4.98
Net interest rate spread (2)	2.89	3.04	2.96	2.50	2.71
Net interest margin (3)	3.68	3.44	3.14	2.77	2.99
Efficiency ratio (4)	78.04	73.58	97.74	137.80	89.32
Noninterest expense to average total assets	3.19	2.79	3.46	4.39	2.89
Average interest-earning assets to average interest-bearing liabilities	132.67	120.45	110.49	111.72	110.76
Dividends declared per share	$ 0.18	$	N.A.	N.A.	N.A.
Dividend payout ratio	44.3%		N.A.	N.A.	N.A.
Asset Quality Ratios:					
Nonperforming assets to total assets	0.57%	0.36%	0.44%	0.60%	0.99%
Nonperforming loans to total loans	0.69	0.46	0.59	0.66	1.27
Allowance for loan losses to nonperforming loans	115.13	201.19	168.90	169.02	90.51
Allowance for loan losses to total loans	0.79	0.93	1.00	1.12	1.15
Net charge-offs (recoveries) to average loans outstanding	0.07	0.00	0.09	(0.01)	0.05
Capital Ratios:					
Equity to total assets at end of period	20.21%	20.36%	6.36%	6.63%	6.94%
Average equity to average assets	20.25	13.48	6.45	6.58	6.53
Tier 1 leverage ratio (bank only)	15.05	13.82	7.12	7.18	7.59
Other Data:					
Number of full service offices	18	16	16	16	16
Employees (full time equivalents)	438	451	446	482	483

(1) Noninterest expense for the year ended December 31, 2004 includes $8.8 million of impairment loss on securities available-for-sale. Noninterest expense for the year ended December 31, 2003 includes $8.3 million of prepayment penalties related to the restructuring of Federal Home Loan Bank advances and $12.5 million of impairment loss on securities available-for-sale.

(2) The net interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average interest-bearing liabilities for the period.

(3) The net interest margin represents net interest income divided by average total interest-earning assets for the period.

(4) The efficiency ratio represents noninterest expense divided by the sum of net interest income and noninterest income.

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

The discussion and analysis that follows focuses on the factors affecting our consolidated financial condition at December 31, 2006 and December 31, 2005, and our consolidated results of operations for the years ended December 31, 2006, 2005 and 2004. The consolidated financial statements and related notes and the discussion of our critical accounting policies appearing elsewhere in this Annual Report should be read in conjunction with this discussion and analysis.

Overview

Loans. Net loans receivable increased by $98.0 million, or 8.0%, to $1.330 billion at December 31, 2006, from $1.232 billion at December 31, 2005. Non-residential real estate loans increased by $45.3 million. Commercial loans increased by $20.4 million. Commercial leases increased by $17.3 million. Multi-family real estate loans increased by $16.9 million. Construction and land loans increased by $4.5 million. One- to four-family residential mortgage loans decreased by $6.7 million.

Securities Available for Sale. Securities available for sale decreased $130.3 million, or 52.5%, to $117.9 million at December 31, 2006, from $248.2 million at December 31, 2005. The decrease reflected $81.0 million of securities acquired in our University National Bank acquisition, offset by sales of approximately $230.0 million of investment securities during the year. We continued to evaluate the securities available for sale portfolio for opportunities to improve yields and reduce liquidity volatility. The proceeds of these sales were used primarily to fund loan growth, retire maturing wholesale certificates of deposit and Federal Home Loan Bank advances, and to fund stock repurchases. Given the inverted yield curve during the latter half of 2006, we concluded that it was financially beneficial to reduce our holdings of investment securities and reduce wholesale funding.

Deposits. Deposits increased $61.7 million, or 5.8%, to $1.130 billion at December 31, 2006, from $1.068 billion at December 31, 2005. The increase reflects approximately $103.5 million in deposits relating to the University National Bank acquisition, including $32.9 million in non-interest-bearing deposits. Net of the University National Bank acquisition, deposits decreased $41.8 million, partially due to our retirement of $18.5 million in maturing wholesale certificates of deposit.

Borrowings. Borrowings decreased $53.3 million, or 27.8%, to $138.1 million at December 31, 2006, from $191.4 million at December 31, 2005. Consistent with our planning, we repaid borrowings with the proceeds of the securities sales that took place during the year, given the lack of profitable opportunities for reinvestment resulting from the inverted yield curve.

Stockholders Equity. Total stockholders equity totaled $326.0 million at December 31, 2006, compared to $328.8 million at December 31, 2005, due primarily to the repurchase of 977,300 shares of common stock at an aggregate cost of $17.3 million and the declaration of cash dividends totaling $4.4 million, which were partially offset by our 2006 net income of $10.0 million and a $3.2 million increase in accumulated other comprehensive income.

Net Income. We had net income of $10.0 million for the year ended December 31, 2006, compared to net income of $11.1 million in 2005 and $1.5 million in 2004. Our basic earnings per common share was $0.45 for the year ended December 31, 2006. Our basic earnings per share in 2005 was $0.29 which is calculated based only on the period of time from the completion of our mutual-to-stock conversion on June 23, 2005, through the period ended December 31, 2005. There were no common shares outstanding during 2004.

Net Interest Income. Net interest income increased $5.2 million to $56.6 million for the year ended December 31, 2006, from $51.4 million for the year ended December 31, 2005. Factors contributing to the increase in net interest income included a 24 basis point increase in our net interest margin to 3.68%, a $168.2 million increase in average loans to $1.300 billion, a $111.5 million decrease in average investment securities available-for-sale to $203.9 million and a $82.5 million decrease in average interest-bearing liabilities to $1.159 billion. In 2004, net interest income was $43.3 million.

Provision for Loan Losses. We recorded a credit for loan losses of $136,000 for the year ended December 31, 2006, compared to provision for loan losses of $518,000 in 2005 and a credit for loan losses of $22,000 for 2004.

Noninterest Income. Noninterest income increased to $10.5 million for the year ended December 31, 2006, compared to $8.7 million for 2005 and $8.6 million in 2004. Deposit service charges and fees increased by $310,000, insurance commissions and annuities income increased by $473,000 and title insurance agency commissions and fees increased by $395,000. There were $101,000 in gains on the sale of securities and $395,000 in gains on the disposition of premises and equipment recorded in 2006, compared to no gains or losses on the sale of securities and gains on the disposition of premises and equipment of $21,000 and $91,000 for the years ended December 31, 2005 and 2004, respectively. For the year ended December 31, 2004, we recorded net gains of $599,000 in gains on the sale of securities, and no gains or losses on the sale of securities in 2005.

Noninterest Expense. Noninterest expense for the year ended December 31, 2006 was $52.4 million, compared to $44.2 million for 2005 and $50.7 million for 2004. Noninterest expense for 2006 includes $5.4 million in stock-based compensation expense compared to $718,000 in 2005. Noninterest expense for 2004 included $8.8 million of pre-tax impairment losses on our Fannie Mae and Freddie Mac floating rate preferred stocks due to our application of SEC Staff Accounting Bulletin No. 59 (SAB No. 59) to those securities.

Income Taxes. We recorded income tax expense of $4.8 million for the year ended December 31, 2006, compared to $4.3 million for 2005 and an income tax benefit of $264,000 for 2004.

Key Strategic Initiatives And Events

Mutual-to-Stock Conversion. Our mutual-to-stock conversion was completed on June 23, 2005. In the conversion, we issued 24,466,250 shares of common stock in a subscription offering for $10.00 per share. The net proceeds of the subscription offering totaled $220.7 million, excluding $19.6 million in stock purchased by our ESOP.

Completed Acquisition. On April 5, 2006, the Company completed its acquisition of University National Bank, a privately held community bank with approximately $113 million in assets and $104 million in deposits, and two banking offices in the Hyde Park community in Chicago, Illinois, for approximately $24 million in cash. Immediately upon the completion of the stock purchase, University National Bank was merged into the Bank. The acquisition, which was accounted for under the purchase method of accounting, resulted in goodwill of $11.7 million and an other intangible of $3.3 million. The transaction was treated, for federal and state income tax purposes, as a purchase of University National Bank s assets pursuant to applicable provisions of the Internal Revenue Code, making the goodwill and core deposit intangible arising from the transaction tax-deductible over a period of 15 years. University National Bank s results of operations have been included in the Company s results of operations only since the effective date of the acquisition.

Stock Repurchase Program. On August 30, 2006, the Company announced that its Board of Directors had authorized the repurchase of up to 2,446,625 shares of its common stock, which represented approximately 10% of the Company s issued and outstanding shares of common stock. The authorization permits shares to be repurchased in open market or negotiated transactions, and pursuant to any trading plan that may be adopted in accordance with Rule 10b5-1 of the Securities and Exchange Commission. The authorization may be utilized at management s discretion, subject to the limitations set forth in Rule 10b-18 of the Securities and Exchange Commission and other applicable legal requirements, and to price and other internal limitations established by the Company s Board of Directors. The authorization will expire on March 31, 2007. As of December 31, 2006, we had repurchased 977,300 shares of common stock at an aggregate cost of $17.3 million under this authorization.

Quarterly Cash Dividends. The Board of Directors declared our first quarterly cash dividend of $0.06 per share on March 29, 2006 for payment in the second quarter, and subsequently paid quarterly dividends of $0.06 in each of the third and fourth quarters. Total cash dividends paid in 2006 were $4.4 million. On January 31, 2007, the Board of Directors declared an increased quarterly dividend of $0.07 per share payable on March 2, 2007.

Investment Securities Portfolio Sales. During 2006, we sold approximately $230.0 million of investment securities. The sales of the securities occurred for several reasons. First, we increased borrowings during the first quarter of

2006 to provide short-term funding for targeted loan originations in anticipation of the closing of our acquisition of University National Bank, and consistent with our planning, we repaid the increased borrowings with the proceeds of the sale of a substantial portion of University National Bank s securities portfolio following our closing of the acquisition. Second, given the inverted yield curve that existed during the last half of 2006 and the diminishing effect it had on the profitability of investment securities, we used some of the proceeds of the sales to further reduce our balances of higher-cost borrowings or wholesale deposits. In addition, we may reinvest a portion of the sale proceeds in bank-owned life insurance in an effort to mitigate existing and potential employee benefits expense.

Equity Incentive Plan. On June 27, 2006, the Company s stockholders approved the BankFinancial Corporation 2006 Equity Incentive Plan, which authorized the Human Resources Committee of the Board of Directors of the Company to grant a variety of cash-based and equity-based incentive awards, including stock options, stock appreciation rights, restricted stock, performance shares and other incentive awards, to employees and directors aggregating up to 3,425,275 shares of the Company s common stock. Subsequently in 2006, the Human Resources Committee granted stock options to purchase 1,301,000 shares of the Company s common stock and 816,000 shares of restricted stock to certain employees and directors of the Company. The 2006 Equity Incentive Plan was established by the Board of Directors to promote the long-term financial success of the Company, to attract, retain and reward persons who can and do contribute to such success, and to further align the participants interests with those of the Company s stockholders.

Economic And Competitive Conditions

Business conditions remained relatively stable during 2006. Despite intensifying pressures throughout the year on credit spreads and overall yields on higher-quality loans to commercial borrowers and lessees, we experienced loan growth rates in the multi-family, commercial real estate, commercial loan and commercial lease portfolios that modestly exceeded our expectations. We do not necessarily anticipate these annualized growth rates continuing into 2007 absent fundamental changes to market conditions. Construction loans remained essentially constant, with disbursements on existing projects slightly exceeding repayments on sold properties. Consistent with our expectations for 2006 and 2007, residential loans decreased, with home equity loans declining somewhat more than expected due to continuing competition both as to price and underwriting standards. We expect the pressures on the credit spreads and the underwriting standards on loans to continue in 2007.

The overall portfolio quality of multi-family and commercial real estate portfolios remained stable. The healthcare loan portfolio continued to receive priority resolution attention with our exposure expected to continue its decline in 2007. Our construction loan portfolio quality remained stable in 2006 but as absorption periods lengthen, we will continue to closely monitor our borrowers capability to continue making debt service payments on their construction projects and fund any unbudgeted construction costs. Our portfolios of commercial leases and loans remained consistent in 2006; we expect the portfolio to generally follow the strength of the overall US and global economy in terms of credit performance for 2007. Overall residential loan portfolio quality also remained consistent as we continue to underwrite loans consistent with our historical standards.

Competition for deposits, especially in the rates paid on money market and certificate of deposit accounts, steadily intensified throughout the year. The addition of University National Bank and our generally competitive position during the year mitigated the effect of these trends on deposit retention and growth rates as of December 31, 2006, but a greater impact is likely in 2007 if conditions persist. Our concerns remain about the migration of long-term core deposits to higher-rate accounts and to out-of-market institutions. We will continue to focus on new small business accounts in 2007 as our 2006 marketing efforts resulted in a somewhat faster growth rate in new account openings and enrollments in business-related services such as merchant processing and cash management in the second half of the year. We also noted that competition for lower-cost checking customers is also impacting the predictability of non-interest income related to deposit accounts as customers may respond more frequently to highly aggressive promotions of overdraft protection plans and other no-fee offers on these account types.

Though the net interest margin and net interest spread values exhibited stable to positive behavior during 2006, we believe that narrowing commercial credit spreads, coupled with future deposit migration risk, make it likely that the Company will experience some future compression in these vital measurements. The principal drivers of any such compression will be the current pricing conditions for high-quality organic loan growth, together with actions needed to retain valuable commercial credit customers and deposit customers in addition to the continuing adverse effects of the current yield curve.

The addition of University National Bank and the adoption of the 2006 Equity Incentive Plan increased non-interest expenses during 2006. We continue our reviews of products, services and functions to ensure they are appropriate to current and anticipated business conditions as well as the core focus of the Company. Of primary importance is the ongoing targeting of resources to core customer service, internal controls and compliance and our outreach efforts for new customers within our communities. We believe that one of the principal ways to deliver results for stockholders in this difficult operating environment is to optimize the organization s discretionary expenditures towards those customer segments that most closely align to the Company s commercial community bank mission.

Critical Accounting Policies

Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and could potentially result in materially different results under different assumptions and conditions. We believe that the most critical accounting policies upon which our financial condition and results of operation depend, and which involve the most complex subjective decisions or assessments, are as follows:

Allowance for Loan Losses. Arriving at an appropriate level of allowance for loan losses involves a high degree of judgment. Our allowance for loan losses provides for probable incurred losses based upon evaluations of known and inherent risks in the loan portfolio. We review the level of the allowance on a quarterly basis and establish the provision for loan losses based upon historical loan loss experience, the nature and volume of the loan portfolio, information about specific borrower situations, estimated collateral values, economic conditions and other factors to assess the adequacy of the allowance for loan losses. Among the material estimates that we must make to establish the allowance are: loss exposure at default; the amount and timing of future cash flows on affected loans; value of collateral; and determination of loss factors to be applied to the various elements of the portfolio. All of these estimates are susceptible to significant change. Although we believe that we use the best information available to establish the allowance for loan losses, future adjustments to the allowance may be necessary if borrower financial, collateral valuation or economic conditions differ substantially from the information and assumptions used in making the evaluation. In addition, as an integral part of their examination process, our regulatory agencies periodically review the allowance for loan losses. These agencies may require us to recognize additions to the allowance based on their judgments of information available to them at the time of their examination. A large loss could deplete the allowance and require increased provisions to replenish the allowance, which would negatively affect earnings.

Intangible Assets. Acquisitions accounted for under purchase accounting must follow Statement of Financial Accounting Standard (SFAS) No. 141, Business Combinations, and SFAS No. 142, Goodwill and Other Intangible Assets. SFAS No. 141 requires us to record as assets on our financial statements both goodwill, an intangible asset which is equal to the excess of the purchase price which we pay for another company over the estimated fair value of the net assets acquired, and identifiable intangible assets such as core deposit intangibles and non-compete agreements. Under SFAS No. 142, we evaluate goodwill at least annually, or when business conditions suggest an impairment may have occurred, for impairment, and we will reduce its carrying value through a charge to earnings if impairment exists. Core deposit and other identifiable intangible assets are amortized to expense over their estimated useful lives and are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the asset may not be recoverable. The valuation techniques used by us to determine the carrying value of tangible and intangible assets acquired in acquisitions and the estimated lives of identifiable intangible assets involve estimates for discount rates, projected future cash flows and time period calculations, all of which are susceptible to change based on changes in economic conditions and other factors. Future events or changes in the estimates that we used to determine the carrying value of our goodwill and identifiable intangible assets or which otherwise adversely affect their value or estimated lives could have a material adverse impact on our results of operations. As of December 31, 2006, our intangible assets consisted of goodwill of $22.6 million and core deposit intangibles of $9.6 million.

Mortgage Servicing Rights. Mortgage servicing rights represent the present value of the future servicing fees from the right to service loans in our loan servicing portfolio. Mortgage servicing rights are recognized as assets for both purchased rights and for the allocation value of retained servicing rights on loans sold. The most critical accounting policy associated with mortgage servicing is the methodology used to determine the fair value of capitalized mortgage servicing rights, which requires a number of estimates, the most critical of which is the mortgage loan prepayment speed assumption. The mortgage loan prepayment speed assumption is significantly affected by interest rates. In general, during periods of falling interest rates, mortgage loans prepay faster and the value of our mortgage servicing assets declines. Conversely, during periods of rising rates, the value of mortgage servicing rights generally increases due to slower rates of prepayments. The amount and timing of mortgage servicing rights amortization is adjusted monthly based on actual results. In addition, on a quarterly basis, we perform a valuation review of mortgage servicing rights for potential declines in value. This quarterly valuation review entails applying current assumptions to the portfolio classified by interest rates and, secondarily, by geographic and prepayment characteristics. Based on the significance of any changes in assumptions since the preceding appraisal, this valuation may include an independent appraisal of the fair value of our servicing portfolio.

Income Taxes. We consider accounting for income taxes a critical accounting policy due to the subjective nature of certain estimates that are involved in the calculation. We use the asset/liability method of accounting for income taxes in which deferred tax assets and liabilities are established for the temporary differences between the financial reporting basis and the tax basis of our assets and liabilities. We must assess the realization of the deferred tax asset and, to the extent that we believe that recovery is not likely, a valuation allowance is established. Adjustments to increase or decrease the valuation allowance are charged or credited, respectively, to income tax expense. No valuation allowances were required at December 31, 2006. Although we have determined a valuation allowance is not required for any deferred tax assets, there is no guarantee that these assets will be recognizable in the future.

Comparison of Financial Condition at December 31, 2006 and December 31, 2005

Balance Sheet

Total assets decreased $1.3 million, or 0.1%, to $1.613 billion at December 31, 2006, from $1.614 billion at December 31, 2005, due primarily to the combined effect of sales of investment securities, reductions in wholesale deposits and Federal Home Loan Bank borrowings, deposit declines and cash expenditures to fund stock repurchases, dividend payments and our acquisition of University National Bank, the effect of which was partially offset by an increase in net loans receivable.

Our loan portfolio consists primarily of investment and business loans, which make up approximately 69.7% of our gross loans. Net loans receivable increased by $98.0 million, or 8.0%, to $1.330 billion at December 31, 2006, from $1.232 billion at December 31, 2005. Commercial leases increased by $17.3 million, or 14.2%, to $139.2 million. Commercial loans increased by $20.4 million, or 29.5%, to $89.3 million. Multi-family real estate loans increased by $16.9 million, or 6.0%, to $297.1 million. Construction and land loans increased by $4.5 million, or 5.6%, to $85.2 million. One- to four-family residential mortgage loans decreased by $6.7 million, or 1.6%, to $397.5 million.

The allowance for loan losses decreased by $892,000 from December 31, 2005 to December 31, 2006, due principally to a $1.4 million decrease in the portion of the allowance for loan losses that we allocated to impaired loans pursuant to SFAS No. 114, offset by a $509,000 increase in the portion of the allowance that we allocated to general loan and lease losses pursuant to SFAS No. 5. Of the $1.4 million decrease in SFAS No. 114 allocated reserves, $693,000 resulted from a charge-off of a fully reserved commercial loan due to the conclusion of legal proceedings. We acquired this loan in our acquisition of Success Bancshares in 2001 and have been maintaining specific reserves against it since we closed that acquisition. As a result of the combined effect of this activity, we recorded a credit for loan losses of $136,000 for the year ended December 31, 2006.

Net securities available-for-sale decreased $130.3 million, or 52.5%, to $117.9 million at December 31, 2006, from $248.2 million at December 31, 2005. The decrease was primarily the result of the sale of $230.0 million of investment securities and $81.8 million of principal repayments, offset by $81.0 million of investment securities acquired in the University National Bank transaction. The proceeds of the sale of these securities were used principally to fund loan growth, retire maturing wholesale certificates of deposits and maturing Federal Home Loan Bank advances, and fund stock repurchases. We continue to evaluate the securities available for sale portfolio for opportunities to improve yields and reduce liquidity volatility.

Cash and cash equivalents increased by $29.3 million to $67.3 million at December 31, 2006, compared to $38.0 million at December 31, 2005. Other assets decreased by $4.9 million, or 41.2%, to $7.0 million at December 31, 2006, from $11.9 million at December 31, 2005, principally due to a decrease in deferred taxes.

Deposits increased $61.7 million, or 5.8%, to $1.130 billion at December 31, 2006, from $1.068 billion at December 31, 2005. The increase was primarily due to the $103.5 million in deposits resulting from the acquisition of University National Bank, offset by net outflows in core deposits and reductions in wholesale deposits. Core deposits (savings, money market, noninterest bearing demand and NOW accounts) increased $66.7 million, or 9.3%, totaling 69.4% of total deposits at December 31, 2006, compared to 67.2% of total deposits at December 31, 2005.

Borrowings decreased $53.3 million, or 27.8%, to $138.1 million at December 31, 2006, from $191.4 million at December 31, 2005. The decrease in borrowings was due in part to the impact of our near term strategy to sell a portion of our investment securities and use the net proceeds to reduce wholesale funding in order to mitigate the impact of the inverted yield curve environment.

Total stockholders equity was $326.0 million at December 31, 2006, compared to $328.8 million at December 31, 2005. Total stockholders equity at December 31, 2006 reflected the repurchase and retirement of 977,300 shares of common stock at an aggregate cost of approximately $17.3 million, cash dividends declared totaling $4.4 million, which were partially offset by $3.0 million in unrealized net gains on securities available-for-sale, net of tax, and net income of $10.0 million.

Loan Portfolio

We originate multi-family mortgage loans, nonresidential real estate loans, commercial loans, commercial leases, and construction and land loans. In addition, we originate one- to four-family residential mortgage loans and consumer loans. We also purchase and sell loan participations from time to time. The following briefly describes our principal loan products.

Multi-family Mortgage Loans. Loans secured by multi-family mortgages totaled approximately $297.1 million, or 22.2% of our total loan portfolio, at December 31, 2006. Multi-family mortgage loans generally are secured by multi-family rental properties, such as apartment buildings, including subsidized apartment units. The majority of our multi-family mortgage loans have adjustable interest rates following an initial fixed-rate period, typically between three and five years.

Nonresidential Real Estate Loans. Loans secured by nonresidential real estate totaled $320.7 million, or 24.0% of our total loan portfolio at December 31, 2006. We emphasize nonresidential real estate loans with initial principal balances between $1.0 million and $5.0 million. The nonresidential real estate properties securing these loans are predominantly office buildings, light industrial buildings, shopping centers and mixed-use developments and, to a lesser extent, more specialized properties such as nursing homes and other healthcare facilities. Substantially all of our nonresidential real estate loans are secured by properties located in our primary market area. Our nonresidential real estate loans are typically written as three- or five-year adjustable-rate mortgage loans or mortgage loans with balloon maturities of three or five years. Amortization of these loans is typically based on 20- to 25-year payout schedules. We also originate some 15-year fixed-rate, fully amortizing loans.

Commercial Loans. Commercial loans amounted to $89.3 million, or 6.7% of the total loan portfolio at December 31, 2006. These totals include unsecured commercial loans with an aggregate outstanding balance of $10.1 million. We generally make commercial loans to customers in our market area for the purpose of financing equipment acquisition, expansion, working capital and other general business purposes. The terms of these loans generally range from less than one year to five years. The loans are either negotiated on a fixed-rate basis or carry adjustable interest rates indexed to a lending rate that is determined internally, or a short-term market rate index.

Commercial Leases. Commercial leases totaled $139.2 million, or 10.4% of our total loan portfolio at December 31, 2006. Our commercial leases are secured primarily by technology equipment and other capital equipment through an assignment of the lease and a security interest in the equipment being leased. Leases generally are non-recourse to the leasing company. Consequently, we underwrite leases by examining the creditworthiness of the lessee rather than the lessor. The lessee acknowledges our security interest in the leased equipment and agrees to send lease payments directly to us. Lessees tend to be publicly-traded companies with investment-grade rated debt or companies that have not issued public debt and therefore do not have a public debt rating. We require that a minimum of 50% of our commercial leases be to companies with an investment grade public debt rating by Moody s or Standard & Poors, or an equivalent rating. Commercial leases to these entities have a maximum maturity of ten years and a maximum outstanding credit exposure of $7.3 million to any single entity. Leases to companies without public debt ratings generally involve companies with net worth in excess of $25.0 million and are subjected to the same internal credit analysis as any other commercial customer. Commercial leases to these lessees have a maximum maturity of five years and a maximum outstanding credit exposure of $5.0 million.

Construction and Land Loans. Construction and land loans amounted to $85.2 million, or 6.4% of the total loan portfolio at December 31, 2006. These loans generally consist of land acquisition loans to help finance the purchase of land intended for further development, including single-family houses, multi-family housing and commercial income property, development loans to builders in our market area to finance improvements to real estate, consisting mostly of single-family subdivisions, typically to finance the cost of utilities, roads, sewers and other development costs. Builders generally rely on the sale of single-family homes to repay development loans, although in some cases the improved building lots may be sold to another builder, often in conjunction with development loans. In general, the maximum loan-to-value ratio for a land acquisition loan is 65% of the appraised value of the property, and the maximum term of these loans is two years. The maximum amount loaned on a development loan is generally limited to the cost of the improvements, and advances are made in accordance with a schedule reflecting the cost of the improvements. Advances are generally limited to 90% of actual construction costs and, as required by applicable regulations, a 75% loan to completed appraised value ratio.

One- to Four-Family Residential Mortgage Lending. Conforming and non-conforming fixed-rate and adjustable-rate residential mortgage loans totaled $397.5 million, or 29.7% of our total loan portfolio at December 31, 2006, including home equity loans and lines of credit totaling $10.7 million, or 0.8% of our total loan portfolio, and $75.9 million, or 5.7% of our total loan portfolio, respectively. We generally originate both fixed- and adjustable-rate loans in amounts up to the maximum conforming loan limits as established by Fannie Mae, which is currently $417,000 for single-family homes. At December 31, 2006, our adjustable-rate residential mortgage loan portfolio totaled $223.7 million, and included $11.4 million in loans that reprice once a year and $212.3 million in loans that reprice periodically after an initial fixed-rate period of three years or more. During 2005, we securitized some of our conforming adjustable-rate residential mortgage loans and retained the servicing rights. In addition to traditional one- to four-family residential mortgage loans, we offer home equity loans and home equity lines of credit that are secured by the borrower s primary residence.

Loan Portfolio Composition. The following table sets forth the composition of our loan portfolio, excluding loans held for sale, by type of loan at the dates indicated.

	At December 31,									
	2006		2005		2004		2003		2002	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
	(Dollars in thousands)									
One- to four-family residential	$ 397,545	29.71%	$ 404,196	32.63%	$ 362,701	32.97%	$ 350,275	32.54%	$ 453,884	42.00%
Multi-family mortgage	297,131	22.21	280,238	22.62	241,713	21.97	240,733	22.36	212,441	19.65
Nonresidential real estate	320,729	23.97	275,418	22.23	277,380	25.22	270,128	25.09	251,459	23.27
Construction and land	85,222	6.37	80,705	6.52	59,369	5.40	64,403	5.98	36,879	3.41
Commercial loans	89,346	6.68	68,988	5.58	63,727	5.79	67,950	6.31	79,459	7.35
Commercial leases	139,164	10.40	121,898	9.84	86,362	7.85	72,962	6.78	37,166	3.44
Consumer	3,869	0.29	2,022	0.16	2,755	0.25	3,502	0.32	3,909	0.36
Other (1)	4,959	0.37	5,219	0.42	6,044	0.55	6,621	0.62	5,572	0.52
Total loans	1,337,965	100.00%	1,238,684	100.00%	1,100,051	100.00%	1,076,574	100.00%	1,080,769	100.00%
Loans in process	148		2,180		824		993		8,466	
Net deferred loan origination costs	2,424		2,541		2,096		1,715		1,158	
Allowance for loan losses	(10,622)		(11,514)		(11,019)		(12,034)		(12,461)	
Total loans, net	$ 1,329,915		$ 1,231,891		$ 1,091,952		$ 1,067,248		$ 1,077,932	

(1) Includes municipal loans.

Loan Portfolio Maturities

The following table summarizes the scheduled repayments of our loan portfolio at December 31, 2006. Demand loans, loans having no stated repayment schedule or maturity and overdraft loans are reported as being due in one year or less.

Scheduled Repayments of Loans:	Within 1 Year	One Year Through Five Years	Beyond Five Years	Total
	(Dollars in thousands)			
One- to four-family residential	$ 82,808	$ 22,033	$ 292,704	$ 397,545
Multi-family mortgage	15,599	69,379	212,153	297,131
Nonresidential real estate	73,752	193,167	53,810	320,729
Construction and land	84,947		275	85,222
Commercial loans, leases and other	84,652	136,882	11,935	233,469
Consumer	2,036	1,501	332	3,869
Total loans	$ 343,794	$ 422,962	$ 571,209	$ 1,337,965

	Total
Loans maturing after one year:	
Predetermined (fixed) interest rates	$ 465,742
Adjustable interest rates	528,429
Total loans	$ 994,171

Nonperforming Loans and Assets

We review loans on a regular basis, and place loans on nonaccrual status when either principal or interest is 90 days or more past due. In addition, we place loans on nonaccrual status when we believe that there is sufficient reason to question the borrower s ability to continue to meet contractual principal or interest payment obligations. Interest accrued and unpaid at the time a loan is placed on nonaccrual status is reversed from interest income. Interest payments received on nonaccrual loans are not recognized as income unless warranted based on the borrower s financial condition and payment record.

At December 31, 2006, we had nonaccrual loans of $9.2 million, an increase of $3.5 million from December 31, 2005. Increases in nonaccrual loans occurred in nonresidential real estate loans ($1.9 million), one- to four-family residential loans ($728,000), multifamily real estate loans ($688,000) and commercial loans ($260,000). No interest income was recognized on these nonaccrual loans. The gross interest income that would have been recorded at December 31, 2006 had the nonaccrual loans remained on accrual status in 2006 totaled $391,000.

Real estate acquired as a result of foreclosure or by deed in lieu of foreclosure is classified as real estate owned (REO) until such time as it is sold. When real estate is acquired through foreclosure or by deed in lieu of foreclosure, it is recorded at its fair value, less estimated costs of disposal. If the fair value of the property is less than the loan balance, the difference is charged against the allowance for loan losses. At December 31, 2006, we had no REO.

The following table below sets forth the amounts and categories of our nonperforming loans and nonperforming assets at the dates indicated.

	At December 31,				
	2006	2005	2004	2003	2002
	(Dollars in thousands)				
Nonaccrual loans:					
One- to four-family residential	$ 2,212	$ 1,484	$ 1,725	$ 2,793	$ 4,233
Multi-family mortgage	1,165	477	1,226		751
Nonresidential real estate	4,378	2,464	2,093	3,616	7,298
Construction and land				345	
Commercial loans	1,419	1,159	1,259	366	1,486
Commercial leases	47	139	221		
Consumer	5				
Total nonperforming loans	9,226	5,723	6,524	7,120	13,768
Real estate owned:					
One- to four-family residential		153		749	723
Nonresidential real estate					230
Land				885	
Total real estate owned		153		1,634	953
Total nonperforming assets	$ 9,226	$ 5,876	$ 6,524	$ 8,754	$ 14,721
Ratios:					
Nonperforming loans to total loans	0.69%	0.46%	0.59%	0.66%	1.27%
Nonperforming assets to total assets	0.57	0.36	0.44	0.60	0.99

Risk Classification of Assets

Our policies, consistent with regulatory guidelines, provide for the classification of loans and other assets that are 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 the collateral pledged, if any. Substandard assets include those characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all of the weaknesses inherent in assets classified substandard with the added characteristic that the weaknesses present also 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 is not warranted.

On the basis of our review of our assets at December 31, 2006, classified assets consisted of substandard assets of $24.0 million and doubtful assets of $371,000, and we had no loans classified as loss assets. The classified assets total includes $8.8 million of nonperforming loans. Included in substandard assets are $17.8 million of loans to healthcare providers. As of December 31, 2006, we had not taken any charge-offs on these types of loans, but we established a specific loan loss reserve allowance in the amount of $253,000 for loans to one health care borrower with an aggregate principal balance of $6.3 million. At December 31, 2006 we also classified loans to a second health care borrower as substandard based on weaknesses in the financial performance of, and untimely or incomplete financial statements for, certain nursing homes operated by this borrower, which had an aggregate principal balance of $5.5 million. We did not establish a specific loan loss allowance for this relationship at this time and these loans were current on their loan payments to us as of December 31, 2006. Also classified at December 31, 2006 were two well-secured commercial real estate loans to a single borrower totaling $2.2 million; these loans were brought current in the first quarter of 2007 through the borrower s exercise of its statutory right to reinstate the loans during a foreclosure proceeding that we initiated. As of December 31, 2006, we had $12.1 million of assets designated as special mention.

Allowance for Loan Losses

We establish provisions for loan losses, which are charged to operations in order to maintain the allowance for loan losses at a level we consider necessary to absorb probable incurred credit losses in the loan portfolio. In determining the level of the allowance for loan losses, we consider past and current loss experience, evaluations of real estate collateral, current economic conditions, volume and type of lending, adverse situations that may affect a borrower s ability to repay a loan and the levels of nonperforming and other classified loans. The amount of the allowance is based on estimates and the ultimate losses may vary from such estimates as more information becomes available or later events change. We assess the allowance for loan losses on a quarterly basis and make provisions for loan losses in order to maintain the allowance.

We provide for loan losses based on the allowance method. Accordingly, all loan losses are charged to the related allowance and all recoveries are credited to it. Additions to the allowance for loan losses are provided by charges to income based on various factors which, in our judgment, deserve current recognition in estimating probable incurred losses. We regularly review the loan portfolio and make provisions for loan losses in order to maintain the allowance for loan losses in accordance with accounting principles generally accepted in the United States of America. The allowance for loan losses consists of three components:

specific allowances established for any impaired multi-family mortgage, nonresidential real estate, construction and land, commercial, and commercial lease loans for which the recorded investment in the loan exceeds the measured value of the loan;

allowances for loan losses for each loan type based on historical loan loss experience; and

adjustments to historical loss experience (general allowances), maintained to cover uncertainties that affect our estimate of probable incurred losses for each loan type.

The adjustments to historical loss experience are based on our evaluation of several factors, including levels of, and trends in, past due and classified loans; levels of, and trends in, charge-offs and recoveries; trends in volume and terms of loans, including any credit concentrations in the loan portfolio; experience, ability, and depth of lending management and other relevant staff; and national and local economic trends and conditions.

We evaluate the allowance for loan losses based upon the combined total of the specific, historical loss and general components. Generally, when the loan portfolio increases, absent other factors, the allowance for loan loss methodology results in a higher dollar amount of estimated probable incurred losses than would be the case without the increase. Conversely, when the loan portfolio decreases, absent other factors, the allowance for loan loss methodology generally results in a lower dollar amount of estimated probable losses than would be the case without the decrease.

We regularly review our loan portfolio to determine whether any loans require classification in accordance with applicable regulations. When we classify loans as either substandard or doubtful, we allocate a portion of the related general loss allowances to such loans as we deem prudent. The allowance for loan losses represents amounts that have been established to recognize incurred losses in the loan portfolio that are both probable and reasonably estimable at the date of the financial statements. When we classify problem loans as loss, we charge-off such amount. While we use the best information available to make evaluations, future adjustments to the allowance may be necessary if conditions differ substantially from the information used in making the evaluations. Our determination as to the risk classification of our loans and the amount of our loss allowances are subject to review by our regulatory agencies, which can require that we establish additional loss allowances.

We acquired a portfolio of highly-seasoned residential mortgage loans in 2006 with an approximate balance at December 31, 2006 of $16.2 million from a loan servicing company. We also acquired a portfolio of commercial loans in 2005 with an approximate balance at December 31, 2006 of $4.6 million from the same loan servicing company. The loan servicing company filed a Chapter 11 bankruptcy petition in late December, 2006, thus creating substantial doubt as to the value of its recourse obligation if we experience any losses in the acquired residential loan portfolio. The bankruptcy court appointed a bankruptcy trustee in late January, 2007. The bankruptcy trustee has suspended servicing remittances to all loan servicing clients of the debtor pending the completion of an accounting and further direction from the bankruptcy court, and as a result, we have not received the monthly scheduled servicing remittances that were due in January, 2007 and February, 2007, which approximate $350,000 each month. The bankruptcy trustee recently reported that the loan servicing trust account has a current balance in excess of $4.6 million, but that the trust account is substantially out of balance and is insufficient to pay all of the debtor s obligations to its servicing clients. On March 2, 2007, the Bankruptcy Court entered an order permitting the Company to transfer the servicing of these loans. The Company has arranged for a substitute loan servicing company and the transfer is now in process. The Bankruptcy Court also established a timetable by which the Trustee will provide an accounting of all funds and documents in the Trustee s possession and perform other tasks related to the transfer of the loan servicing rights. We have engaged counsel to seek a turnover of past servicing remittances that have not been paid, and to defend against competing claims that have been asserted to the serviced loans or the servicing remittances. We have not yet established any specific reserves for these purchased loans pending the receipt of additional information and future developments in the bankruptcy proceeding, including the outcome of the Trustee s reports scheduled for late March, 2007 or early April, 2007.

The following table sets forth activity in our allowance for loan losses for the years indicated.

	At or For the Years Ended December 31,				
	2006	2005	2004	2003	2002
	(Dollars in thousands)				
Balance at beginning of year	$ 11,514	$ 11,019	$ 12,034	$ 12,461	$ 13,465
Charge-offs:					
One- to four-family residential				(29)	(100)
Multi-family mortgage					(31)
Nonresidential real estate			(1,127)		(70)
Construction and land					
Commercial loans	(946)	(49)	(218)	(368)	(1,046)
Commercial leases					
Consumer	(26)	(66)	(48)	(36)	(45)
Total charge-offs	(972)	(115)	(1,393)	(433)	(1,292)
Recoveries:					
One- to four-family residential			68	26	286
Multi-family mortgage					
Nonresidential real estate				275(1)	275(1)
Construction and land					
Commercial loans		88	311	278	
Commercial leases					149
Consumer	4	4	21	6	
Total recoveries	4	92	400	585	710
Net (charge-offs) recoveries	(968)	(23)	(993)	152	(582)
Allowance of acquired bank	212				
Provision (credit) for loan losses	(136)	518	(22)	(579)	(422)
Balance at end of year	$ 10,622	$ 11,514	$ 11,019	$ 12,034	$ 12,461
Ratios:					
Net charge-offs (recoveries) to average loans outstanding	0.07%	0.00%	0.09%	(0.01)%	0.05%
Allowance for loan losses to nonperforming loans	115.13	201.19	168.90	169.02	90.51
Allowance for loan losses to total loans	0.79	0.93	1.00	1.12	1.15

(1) Recoveries relate to loans previously charged off by Success Bancshares.

Net Charge-offs and Recoveries

Net charge-offs increased by $945,000 to $968,000 for the year ended December 31, 2006, from $23,000 for the year ended December 31, 2005. Total charge-offs increased by $857,000 to $972,000 for the year ended December 31, 2006, from $115,000 for the year ended December 31, 2005. Total recoveries in 2006 decreased by $88,000.

Net charge-offs decreased by $970,000 to $23,000 for the year ended December 31, 2005, from $993,000 for the year ended December 31, 2004. Total charge-offs decreased by $1.3 million to $115,000 for the year ended December 31, 2005, from $1.4 million for the year ended December 31, 2004. Total recoveries in 2005 decreased by $308,000 compared to 2004. Total recoveries in 2004 included a $300,000 recovery on a commercial loan that Success National Bank had charged-off prior to our acquisition of Success Bancshares.

The credit for loan losses was $136,000 in 2006 compared to provision for loan losses of $518,000 in 2005 and a credit for loan losses of $22,000 in 2004.

Allocation of Allowance for Loan Losses

The following table sets forth our allowance for loan losses allocated by loan category. The allowance for loan losses allocated to each category is not necessarily indicative of future losses in any particular category and does not restrict the use of the allowance to absorb losses in other categories.

	At December 31,								
	2006			2005			2004		
	Allowance for Loan Losses	Loan Balances by Category	Percent of Loans in Each Category to Total Loans	Allowance for Loan Losses	Loan Balances by Category	Percent of Loans in Each Category to Total Loans	Allowance for Loan Losses	Loan Balances by Category	Percent of Loans in Each Category to Total Loans
	(Dollars in thousands)								
One- to four-family residential	$ 1,855	$ 397,545	29.71%	$ 1,418	$ 404,196	32.63%	$ 1,289	$ 362,701	32.97%
Multi-family mortgage	1,908	297,131	22.21	2,102	280,238	22.62	1,950	241,713	21.97
Nonresidential real estate	2,846	320,729	23.97	3,423	275,418	22.23	3,304	277,380	25.22
Construction and land	1,120	85,222	6.37	1,210	80,705	6.52	899	59,369	5.40
Commercial loans	1,667	89,346	6.68	2,362	68,988	5.58	2,736	63,727	5.79
Commercial leases	1,112	139,164	10.40	718	121,898	9.84	543	86,362	7.85
Consumer	40	3,869	0.29	17	2,022	0.16	18	2,755	0.25
Other (1)	74	4,959	0.37	104	5,219	0.42	121	6,044	0.55
Unallocated				160			159		
Total	$ 10,622	$ 1,337,965	100.00%	$ 11,514	$ 1,238,684	100.00%	$ 11,019	$ 1,100,051	100.00%

	At December 31,					
	2003			2002		
	Allowance for Loan Losses	Loan Balances by Category	Percent of Loans in Each Category to Total Loans	Allowance for Loan Losses	Loan Balances by Category	Percent of Loans in Each Category to Total Loans
	(Dollars in thousands)					
One- to four-family residential	$ 1,322	$ 350,275	32.54%	$ 1,643	$ 453,884	42.00%
Multi-family mortgage	1,797	240,733	22.36	1,592	212,441	19.65
Nonresidential real estate	4,313	270,128	25.09	5,410	251,459	23.27
Construction and land	976	64,403	5.98	553	36,879	3.41
Commercial loans	2,908	67,950	6.31	2,727	79,459	7.35
Commercial leases	365	72,962	6.78	186	37,166	3.44
Consumer	26	3,502	0.32	51	3,909	0.36
Other (1)	166	6,621	0.62	139	5,572	0.52
Unallocated	161			160		
Total	$ 12,034	$ 1,076,574	100.00%	$ 12,461	$ 1,080,769	100.00%

(1) Includes municipal loans.

Investment Securities

Our investment policy is established by our Board of Directors. The policy emphasizes safety of the investment, liquidity requirements, potential returns, cash flow targets, and consistency with our interest rate risk management strategy.

At December 31, 2006, our debt securities consisted of mortgage-backed pass-through securities issued or sponsored by Fannie Mae, Freddie Mac or Ginnie Mae, collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs) guaranteed by Fannie Mae, Freddie Mac or Ginnie Mae, SBA guaranteed loan participation certificates, Federal agency notes, and municipal securities. Our equity securities consisted almost entirely of shares of two floating rate preferred stocks issued by Freddie Mac, a government-sponsored entity and one Freddie Mac fixed-rate preferred stock. All securities were classified as available for sale pursuant to SFAS No. 115 as of December 31, 2006, 2005 and 2004.

We hold the FHLBC common stock to qualify for membership in the Federal Home Loan Bank System and to be eligible to borrow funds under the FHLBC s advance program. The aggregate cost and fair value of our FHLBC common stock as of December 31, 2006 was $15.6 million based on its par value. There is no market for our FHLBC common stock. Due to our receipt of stock dividends and a reduction of our outstanding FHLBC advances, we owned shares of FHLBC common stock at December 31, 2006 with a par value that was $7.2 million more than we were required to own, to maintain our membership, in the Federal Home Loan Bank System and to be eligible to obtain advances (excess or voluntary capital stock).

During 2006, the FHLBC was allowed to carry out limited redemptions of excess or voluntary capital stock. We redeemed $9.8 million of excess or voluntary FHLBC capital stock during the year.

The following table sets forth the composition, amortized cost and fair value of our securities available for sale at the dates indicated.

	At December 31,					
	2006		2005		2004	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(Dollars in thousands)					
Investment Securities:						
Municipal securities	$ 2,660	$ 2,711	$ 3,085	$ 3,145	$ 3,470	$ 3,464
SBA guaranteed loan participation certificates	628	623	1,859	1,853	1,958	1,941
Equity securities:						
Freddie Mac	38,275	43,112	65,600	67,375	65,600	63,960
Fannie Mae			18,360	19,795	18,360	18,360
Other debt securities	45,746	45,723				
Total investment securities available-for-sale	87,309	92,169	88,904	92,168	89,388	87,725
Mortgage-Backed Securities:						
Pass-through securities:						
Fannie Mae	14,506	14,630	146,433	143,098	161,768	161,002
Freddie Mac	3,967	3,971	10,182	10,009	16,360	16,166
Ginnie Mac	1,238	1,202	1,349	1,321	1,504	1,500
CMOs and REMICs	5,841	5,881	1,615	1,642	1,673	1,700
Total mortgage-backed securities available-for-sale	25,552	25,684	159,579	156,070	181,305	180,368
Total securities available-for-sale	$ 112,861	$ 117,853	$ 248,483	$ 248,238	$ 270,693	$ 268,093

We determine the fair value of our investment securities in accordance with the guidance set forth in SFAS No. 115, Accounting for Certain Investments in Debt and Equity Securities, and SFAS No. 107, Disclosures about Fair Value of Financial Instruments. Pursuant to this guidance, we determine fair value based on the most recent quoted market price, if available, for the security as of the applicable balance sheet date. If a quoted market price for a specific security is not currently available, we estimate the fair value based on the quoted market price of another security with similar characteristics, adjusted to reflect objectively measurable differences such as coupon rates and reset dates. In the absence of current quoted market prices for the same or a similar security, we use other valuation techniques to determine fair value, such as obtaining broker-dealer valuations or estimating fair value based on valuation modeling. The fair value of a security is used to determine the amount of any unrealized losses that must be reflected in our other comprehensive income and the net book value of our investment securities. Similarly, if we determine that a security is other-than-temporarily impaired pursuant to SAB No. 59, we use the fair value of the security to determine the amount of the impairment loss and the adjusted cost basis for the security.

The Company evaluated the securities in its investment portfolio that had significant declines in fair value at December 31, 2006 and 2005, and concluded that the declines were primarily attributable to changes in market interest rates rather than credit quality or other issuer-specific factors. Since the Company had the ability and intent at December 31, 2006, to hold these investments until a recovery occurred or the securities matured, and the carrying cost of these securities was projected to recover as market interest rates change and or the securities approached maturities, the Company did not consider the declines in fair value to be other-than-temporary impairments. No unrealized losses existed at December 31, 2006 or 2005 with respect to our marketable equity securities, including our Freddie Mac floating rate preferred stocks. The Company previously reduced the combined carrying value of certain of the Fannie Mae and Freddie Mac preferred stocks by recording an impairment charge of $8.8 million for the year ended December 31, 2004.

Portfolio Maturities and Yields. The composition and maturities of the investment debt securities portfolio and the mortgage-backed securities portfolio at December 31, 2006 are summarized in the following table. Maturities are based on the final contractual payment dates, and do not reflect the impact of prepayments or early redemptions that may occur. Municipal securities yields have not been adjusted to a tax-equivalent basis as the amount is immaterial.

	One Year or Less		More than One Year through Five Years		More than Five Years through Ten Years		More than Ten Years		Total Securities		
	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Fair Value
	(Dollars in thousands)										
Mortgage-Backed Securities:											
Pass-through securities:											
Fannie Mae	$	%	$	%	$ 1,850	5.14%	$ 12,656	6.24%	$ 14,506	6.10%	$ 14,630
Freddie Mac			42	6.42	239	5.24	3,686	5.75	3,967	5.73	3,971
Ginnie Mae							1,238	5.11	1,238	5.11	1,202
CMOs and REMICs	10	5.88	1,251	5.17	681	5.45	3,899	5.91	5,841	5.70	5,881
Total	10	5.88	1,293	5.21	2,770	5.22	21,479	6.03	25,552	5.90	25,684
Investment Securities:											
Municipal securities	450	4.06	1,695	4.32	515	4.47			2,660	4.31	2,711
SBA guaranteed loan participation certificates							628	5.94	628	5.94	623
Corporate bonds and other securities	45,746	4.97							45,746	4.97	45,723
Equity securities							38,275	5.85	38,275	5.85	43,112
Total	46,196	4.96	1,695	4.32	515	4.47	38,903	5.86	87,309	5.34	92,169
Total securities available-for-sale	$ 46,206	4.96%	$ 2,988	4.71%	$ 3,285	5.11%	$ 60,382	5.92%	$ 112,861	5.47%	$ 117,853

Sources of Funds

Deposits. At December 31, 2006, our deposits totaled $1.130 billion. Interest-bearing deposits totaled $995.5 million and noninterest-bearing demand deposits totaled $134.1 million. NOW, savings and money market deposits totaled $650.0 million at December 31, 2006. Demand deposits at December 31, 2006 included $8.2 million in internal checking accounts, such as bank cashier checks and money orders, and $11.2 million in title insurance escrow funds. At December 31, 2006, we had a total of $345.5 million in certificates of deposit, of which $281.1 million had maturities of one year or less. Although we have a significant portion of our deposits in shorter-term certificates of deposit, we monitor activity on these accounts and, based on historical experience and our current pricing strategy, we believe we will retain a significant portion of these accounts upon maturity.

Our deposits are obtained predominantly from the areas in which our branch offices are located. We rely on our favorable locations, customer service, competitive pricing, our Internet Branch and related deposit services such as cash management to attract and retain these deposits. While we accept certificates of deposit in excess of $100,000 for which we may provide preferential rates, we generally do not solicit such deposits because they are more difficult to retain than core deposits. At December 31, 2006, we had a total of $10.4 million of brokered certificates of deposits.

The following table sets forth the distribution of total deposit accounts, by account type, for the periods indicated.

	Years Ended December 31,								
	2006			2005			2004		
	Average Balance	Percent	Weighted Average Rate	Average Balance	Percent	Weighted Average Rate	Average Balance	Percent	Weighted Average Rate
	(Dollars in thousands)								
Demand deposits:									
Retail	$ 33,020	3.00%	%	$ 23,512	2.10%	%	$ 23,643	2.15%	%
Commercial	90,594	8.24		85,435	7.62		79,455	7.22	
Total demand deposits	123,614	11.24		108,947	9.72		103,098	9.37	
NOW deposits	241,378	21.95	1.71	268,404	23.93	0.85	232,193	21.10	0.54
Savings deposits	123,413	11.22	0.83	128,867	11.49	0.78	134,491	12.22	0.61
Money market deposits	252,109	22.93	4.00	223,334	19.92	2.84	181,596	16.50	1.47
Certificates of deposit	359,119	32.66	4.10	391,883	34.94	2.79	449,218	40.81	2.11
Total deposits	$ 1,099,633	100.00%		$ 1,121,435	100.00%		$ 1,100,596	100.00%	

The following table sets forth certificates of deposit by time remaining until maturity at December 31, 2006.

	Maturity				
	3 Months or Less	Over 3 to 6 Months	Over 6 to 12 Months	Over 12 Months	Total
	(Dollars in thousands)				
Certificates of deposit less than $100,000	$ 77,326	$ 63,756	$ 58,184	$ 51,394	$ 250,660
Certificates of deposit of $100,000 or more	33,118	32,730	16,012	12,930	94,790
Total of certificates of deposit	$ 110,444	$ 96,486	$ 74,196	$ 64,324	$ 345,450

Borrowings. Our borrowings consist primarily of Federal Home Loan Bank advances and repurchase agreements. The following table sets forth information concerning balances and interest rates on our borrowings at the dates and for the periods indicated.

	At or For the Years Ended December 31,		
	2006	2005	2004
	(Dollars in thousands)		
Balance at end of year	$ 138,148	$ 191,388	$ 264,742
Average balance during year	183,286	229,355	251,331
Maximum outstanding at any month end	241,048	274,311	268,832
Weighted average interest rate at end of year	4.30%	3.72%	2.97%
Average interest rate during year	4.11%	3.58%	3.69%

At December 31, 2006, we had the ability to borrow an additional $167.0 million under our credit facilities with the FHLBC. Furthermore, we had unpledged securities that could be used to support borrowings in excess of $47.0 million.

At December 31, 2006, we had available pre-approved overnight federal funds borrowing capacity of $65.0 million. At December 31, 2006, there were no outstanding federal funds borrowings. At December 31, 2006, we also had a line of credit available with the Federal Reserve Bank of Chicago for $20.3 million. At December 31, 2006, there was no outstanding balance on the line of credit.

Comparison of Operating Results For the Years Ended December 31, 2006, 2005 and 2004

Comparability Considerations

Mutual-to-Stock Conversion. Our operating results for the years ended December 31, 2006, 2005 and 2004 do not lend themselves to ready comparison due to, among other things, various factors relating to the consummation of our mutual-to-stock conversion in June of 2005, including cash inflows resulting from stock subscription order receipts and the issuance of common stock, cash outflows resulting from subscription order refunds, the transitory impact that refundable subscription order receipts had on earnings and deposit balances during the second and third quarters of 2005 and the subsequent deployment of the net proceeds of the subscription offering.

Comparison of Year 2006 to 2005. In 2006, we acquired University National Bank in the second quarter of 2006 and the second half of the year included expenses related to equity-based compensation. These and other related factors had varying degrees of impact on the changes that occurred to our financial condition and operating results between the years ended December 31, 2006 and 2005, including changes to the composition of our assets and liabilities that affected our results of operation.

Comparison of Year 2005 to 2004. In 2004 we recorded impairment losses relating to our Fannie Mae and Freddie Mac floating rate preferred stocks due to our application of SAB No. 59 to those securities, and yield adjustment amortization expense in 2004 and 2005 relating to our restructuring of $170.0 million of Federal Home Loan Bank borrowings in July 2003. These and other related factors had varying degrees of impact on the changes that occurred to our financial condition and operating results between the years ended December 31, 2005 and 2006, including changes to the composition of our assets and liabilities that affected our results of operation.

Net Income

Comparison of Year 2006 to 2005. We recorded net income of $10.0 million for the year ended December 31, 2006, compared to net income of $11.1 million for the year ended December 31, 2005. The principal factors affecting the change in net income from year to year included a $5.2 million, or 10.1%, increase in our net interest income; a $1.8 million, or 21.3%, increase in noninterest income; and a $654,000 decrease in our provision for loan losses. These increases were offset by a $8.2 million, or 18.5%, increase in noninterest expense; and a $548,000, or 12.8%, increase in income tax expense. Our net income for the full year 2006 and for the last six months of 2005 was favorably affected by the completion of our mutual-to-stock conversion on June 23, 2005, and reflected increased interest income and reduced interest expense on borrowings resulting from our deployment of the net proceeds from the subscription offering undertaken in connection with the mutual-to-stock conversion, which totaled $220.7 million (excluding the $19.6 million in stock purchased by our ESOP), to increase average interest-earning assets and reduce average borrowings and wholesale deposits. Our operating results for 2006 included $5.4 million in expenses for equity-based compensation and benefits, compared to $717,000 for 2005, relating to equity-based awards that were made during the third and fourth quarters of 2006 pursuant to the Equity Incentive Plan that our stockholders approved in June of 2006, and additional expenses arising from our first full year of making contributions to the ESOP that we established in connection with our mutual-to-stock conversion in June of 2005. Our 2005 net income was also negatively affected by a $388,000 yield adjustment amortization expense, pre-tax, relating to our restructuring of $170.0 million of Federal Home Loan Bank borrowings in July 2003. There was no remaining yield adjustment amortization expense recorded during 2006. Our earnings per share of common stock for year ended December 31, 2006 was $0.45 per share. Earnings per share for the year ended December 31, 2005 was $0.29 and only includes the net income for the period for which common shares were outstanding which was from the completion of our mutual-to-stock conversion on June 23, 2005 through December 31, 2005.

Comparison of Year 2005 to 2004. We recorded net income of $11.1 million for the year ended December 31, 2005, compared to net income of $1.5 million for the year ended December 31, 2004. Our 2005 net income was favorably affected by the completion of our mutual-to-stock conversion on June 23, 2005, and reflected increased interest income and reduced interest expense on borrowings resulting from our deployment of the net proceeds from the subscription offering undertaken in connection with the mutual-to-stock conversion, which totaled $220.7 million (excluding the $19.6 million in stock purchased by our ESOP), to increase average interest earning assets and reduce average borrowings and wholesale deposits. Our 2004 net income was negatively affected, in part, by our recording an $8.8 million impairment loss, pre-tax, on our Fannie Mae and Freddie Mac floating rate preferred stocks due to our application of SAB No. 59 to those securities. The impairment loss reduced our 2004 net income by $5.3 million, after-tax. Our 2004 net income was also negatively affected by a $2.5 million yield adjustment amortization expense, pre-tax, relating to our restructuring of $170.0 million of Federal Home Loan Bank borrowings in July 2003 compared to $388,000 recorded in 2005. The yield adjustment amortization expense reduced our 2004 and 2005 net income by $1.5 million and $234,000, after tax, respectively. Earnings per share for the year ended December 31, 2005 is reported as $0.29 and only includes the net income for the period for which common shares were outstanding, which was from the completion of our mutual-to-stock conversion on June 23, 2005 through December 31, 2005. There were no common shares outstanding during 2004.

Net Interest Income

Comparison of Year 2006 to 2005. Net interest income increased by $5.2 million, or 10.1%, to $56.6 million for the year ended December 31, 2006, from $51.4 million for the year ended December 31, 2005. Our net interest rate spread decreased by 15 basis points to 2.89% for the year ended December 31, 2006, from 3.04% for 2005. The decrease resulted primarily from the flattening and inverting of the yield curve that has occurred since early 2005, and increasing competition in the Chicago banking market for loans and deposits. Notwithstanding these market conditions and the resulting decrease in our net interest rate spread, our net interest margin increased by 24 basis points to 3.68% for 2006, from 3.44% for 2005, due to our deployment of the $220.7 million in net proceeds of our subscription offering to retire term debt and reduce borrowings and wholesale deposits, and our replacement of a significant portion of the short-term securities and interest-bearing deposits in which the offering proceeds were initially invested with higher yielding loans. As expected, our acquisition of University National Bank on April 5, 2006, helped to mitigate the adverse impact that these market conditions had on our net interest margin. In addition, our average earning assets increased $42.2 million to $1.538 billion in 2006, from $1.496 billion in 2005, and our average interest-bearing liabilities decreased $82.5 million to $1.159 billion in 2006, from $1.242 billion in 2005, principally as a result of our deployment of the net proceeds of our subscription offering. Our net interest income for the year ended December 31, 2005, included approximately $450,000 in net interest spread that we earned on the investment of approximately $167.1 million in subscription order receipts that we subsequently refunded to depositors whose subscription orders could not be filled.

Interest income increased by $13.9 million, or 17.3%, to $94.1 million for the year ended December 31, 2006, from $80.2 million for the year ended December 31, 2005. The increase in interest income resulted primarily from a 76 basis point increase in the average yield on interest earning assets to 6.12% for the year ended December 31, 2006, from 5.36% for the year ended December 31, 2005, and from a $42.2 million increase in total average interest-earning assets to $1.538 billion for the year ended December 31, 2006, from $1.496 billion for the year ended December 31, 2005.

Interest income on loans increased by $16.9 million, or 25.3%, to $83.5 million for the year ended December 31, 2006, from $66.6 million for the year ended December 31, 2005. The increase in interest income on loans resulted primarily from a 54 basis point increase in the average yield on loans to 6.43% for the year ended December 31, 2006, from 5.89% for the year ended December 31, 2005, due to higher market interest rates, and from a $168.2 million, or 14.9%, increase in the average balance of loans outstanding to $1.300 billion for the year ended December 31, 2006, from $1.131 billion for the year ended December 31, 2005.

Interest income on securities available-for-sale decreased $2.4 million, or 21.1%, to $9.2 million for the year ended December 31, 2006, from $11.6 million for the year ended December 31, 2005. The decrease resulted primarily from a decrease of $111.5 million, or 35.3%, in the average balance of securities available-for-sale to $203.9 million for the year ended December 31, 2006, from $315.4 million for the year ended December 31, 2005. This decrease in average balances since 2005 reflected the impact of holding and investing approximately $436.8 million of subscription order receipts in short-term government agency securities until the subscription offering was completed on June 23, 2005. Thereafter, funds representing accepted subscription orders were paid to the Company, and funds due the subscribers for unfilled subscription orders were refunded. By the end of the third quarter of 2005, substantially all of the subscription order refunds had been paid. We also decided to reduce our portfolio of investment securities available-for-sale during 2006 as the flat or inverted yield curve did not present profitable opportunities for carrying such additional investments. Partially offsetting the decrease in average balances was an 81 basis point increase in the yield on securities available-for-sale to 4.50% for the year ended December 31, 2006, from 3.69% for the year ended December 31, 2005, due to increases in the coupon rates for certain securities.

Dividend income on our Federal Home Loan Bank of Chicago stock decreased $484,000, or 40.1%, to $724,000 for the year ended December 31, 2006, from $1.2 million for the year ended December 31, 2005. The average balance of these securities decreased by $3.1 million to $21.8 million for the year ended December 31, 2006, due to the redemption of $9.8 million of these securities in 2006. The Federal Home Loan Bank of Chicago also reduced its dividend rate from 5.5% as of the first quarter of 2005 to 3.10% as of the fourth quarter of 2006. As a result, the average dividend yield on our Federal Home Loan Bank stock decreased to 3.32% for the year ended December 31, 2006, from 4.86% for the year ended December 31, 2005.

Interest income on interest-bearing deposit accounts that we owned decreased $70,000, or 9.4%, to $676,000 for the year ended December 31, 2006, from $746,000 for the year ended December 31, 2005. The average balance of these interest-bearing deposits decreased by $11.5 million to $12.7 million for the year ended December 31, 2006. The average yield on our interest-bearing deposits increased to 5.32% for the year ended December 31, 2006, from 3.08% for the year ended December 31, 2005.

Interest expense increased by $8.7 million, or 30.2%, to $37.5 million for the year ended December 31, 2006, from $28.8 million for the year ended December 31, 2005. The increase was primarily due to increased interest expense on deposits, which was partially offset by decreased interest expense on borrowings.

Interest expense on deposits increased by $9.4 million, or 45.4%, to $30.0 million for the year ended December 31, 2006, from $20.6 million for the year ended December 31, 2005. The increase in interest expense on deposits was primarily due to a 104 basis point increase in the average rates paid on deposits, which was partially offset by a $36.5 million, or 3.6%, decrease in the average balance of deposits. The average balances of money market deposits increased $28.8 million, or 12.9% for the year ended December 31, 2006. The average balances of savings accounts, NOW deposits and certificates of deposit decreased $5.5 million, or 4.2%, $27.0 million, or 10.1%, and $32.8 million, or 8.4%, respectively, for the year ended December 31, 2006. The average cost of deposits was 3.07% for the year ended December 31, 2006, compared to 2.03% for the year ended December 31, 2005. All categories of interest-bearing deposit accounts showed increases in average rates paid for 2006 compared to 2005. The average cost of certificates of deposits increased 131 basis points to 4.10% for the year ended December 31, 2006, from 2.79% for the year ended December 31, 2005. The average cost of all other interest-bearing deposit accounts also increased for the year ended December 31, 2006, with the most significant increase occurring with respect to money market accounts. The average cost of money market accounts increased 116 basis points to 4.00% for the year ended December 31, 2006, from 2.84% for the year ended December 31, 2005.

Interest expense on borrowings decreased by $672,000, or 8.2%, to $7.5 million for the year ended December 31, 2006, from $8.2 million for the year ended December 31, 2005. This decrease was due in part to a $46.1 million, or 20.1%, decrease in the average balance of borrowings, which was offset by a 53 basis point increase in the average cost of such borrowings to 4.11% for the year ended December 31, 2006, from 3.58% for the year ended December 31, 2005. The decrease in average borrowings is due in part to our use of a portion of the net proceeds of the sale of investment securities to repay wholesale borrowings. Interest expense for the year ended December 31, 2005 also included $388,000 in yield adjustment amortization expense relating to the prepayment penalty that we incurred in restructuring our Federal Home Loan Bank borrowings in July of 2003, while there was no yield adjustment expense recorded in 2006 in connection with the restructuring as final amortization was completed in 2005.

Comparison of Year 2005 to 2004. Net interest income increased by $8.1 million, or 18.8%, to $51.4 million for the year ended December 31, 2005, from $43.3 million for the year ended December 31, 2004. Several factors favorably affected this increase in net interest income in 2005. Our net interest margin increased 30 basis points to 3.44% for the year ended December 31, 2005, from 3.14% for the year ended December 31, 2004, and our net interest rate spread increased 8 basis points to 3.04% for the year ended December 31, 2005, from 2.96% for the year ended December 31, 2004. In addition, our average earning assets increased $116.0 million to $1.496 billion in 2005, from $1.380 billion in 2004, and our average interest-bearing liabilities decreased $7.0 million to $1.242 billion in 2005, from $1.249 billion in 2004, principally as a result of our deployment of the net proceeds of our subscription offering totaling $220.7 million.

Interest income increased by $13.5 million, or 20.2%, to $80.2 million for the year ended December 31, 2005, from $66.7 million for the year ended December 31, 2004. The increase in interest income resulted primarily from a 52 basis point increase in the average yield on interest earning assets to 5.36% for the year ended December 31, 2005, from 4.84% for the year ended Decem