FIRST CAPITAL INC
Form 10-K
March 27, 2014
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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, 2013

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from __________ to __________

Commission File Number: 0-25023

FIRST CAPITAL, INC.

(Exact name of registrant as specified in its charter)

Indiana	**35-2056949**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
220 Federal Drive, N.W., Corydon, Indiana	**47112**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (812) 738-2198

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	**Nasdaq Global Stock Market**

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

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

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No 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 whether the registrant has submitted electronically and posted on its corporate Web Site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes 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. ¨

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

(Check one): Large accelerated filer ¨ Accelerated filer ¨

Non-accelerated filer ¨ Smaller reporting company x

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates was $53.2 million, based upon the closing price of $20.57 per share as quoted on the Nasdaq Stock Market as of the last business day of the registrant s most recently completed second fiscal quarter.

The number of shares outstanding of the registrant s common stock as of March 4, 2014 was 2,784,088.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2014 Annual Meeting of Stockholders

are incorporated by reference in Part III of this Form 10-K.

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This report contains certain forward-looking statements within the meaning of the federal securities laws. These statements are not historical facts, rather statements based on First Capital, Inc. s current expectations regarding its business strategies, intended results and future performance. Forward-looking statements are preceded by terms such as expects, believes, anticipates, intends and similar expressions.

Forward-looking statements are not guarantees of future performance. Management s ability to predict results or the effect of future plans or strategies is inherently uncertain. Numerous risks and uncertainties could cause or contribute to the Company s actual results, performance and achievements to materially differ from those expressed or implied by the forward-looking statements. Factors which could affect actual results include, but are not limited to, interest rate trends; the general economic climate in the specific market area in which First Capital operates, as well as nationwide; First Capital s ability to control costs and expenses; competitive products and pricing; loan delinquency rates; changes in federal and state legislation and regulation; and other factors disclosed periodically in the Company s filings with the Securities and Exchange Commission. Additional factors that may affect our results are discussed in Item 1A to this Annual Report on Form 10-K titled Risk Factors below. These factors should be considered in evaluating the forward-looking statements and undue reliance should not be placed on such statements, whether included in this report or made elsewhere from time to time by the Company or on its behalf. Except as may be required by applicable law or regulation, First Capital assumes no obligation to update any forward-looking statements.

PART I

ITEM 1. BUSINESS

General

First Capital, Inc. (the Company or First Capital) was incorporated under Indiana law on September 11, 1998. On December 31, 1998, the Company became the holding company for First Federal Bank, A Federal Savings Bank (the Bank) upon the Bank s reorganization as a wholly owned subsidiary of the Company resulting from the conversion of First Capital, Inc., M.H.C. (the MHC), from a federal mutual holding company to a stock holding company. On January 12, 2000, the Company completed a merger of equals with HCB Bancorp, the former holding company for Harrison County Bank, and the Bank changed its name to First Harrison Bank. On March 20, 2003, the Company acquired Hometown Bancshares, Inc. (Hometown), a bank holding company located in New Albany, Indiana.

The Company has no significant assets, other than all of the outstanding shares of the Bank and the portion of the net proceeds from the offering retained by the Company, and no significant liabilities. Management of the Company and the Bank are substantially similar and the Company neither owns nor leases any property, but instead uses the premises, equipment and furniture of the Bank in accordance with applicable regulations.

The Bank is regulated by the Office of the Comptroller of the Currency (the OCC) and the Federal Deposit Insurance Corporation (the FDIC). The Bank s deposits are federally insured by the FDIC under the Deposit Insurance Fund. The Bank is a member of the Federal Home Loan Bank System.

Availability of Information

The Company s Annual Report on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K and any amendments to such reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 are made available free of charge on the Company s Internet website, www.firstharrison.com, as soon as practicable after the Company electronically files such material with, or furnishes it to, the Securities and Exchange Commission. The contents of the Company s website shall not be incorporated by reference into this Form 10-K or into any reports the Company files with or furnishes to the Securities and Exchange Commission.

Market Area and Competition

The Bank considers Harrison, Floyd, Clark and Washington counties in Indiana its primary market area. All of its offices are located in these four counties, which results in most of the Bank s loans being made in these four counties. The main office of the Bank is located in Corydon, Indiana, 35 miles west of Louisville, Kentucky. The Bank aggressively competes for business with local banks, as well as large regional banks. Its most direct competition for deposit and loan business comes from the commercial banks operating in these four counties. Based on data published by the FDIC, the Bank is the leader among FDIC-insured institutions in deposit market share in Harrison County, the Bank s primary county of operation.

Lending Activities

General. Over the last few years, the Bank has continued to transform the composition of its balance sheet from that of a traditional thrift institution to that of a commercial bank. On the asset side, this is being accomplished in part by selling in the secondary market the newly-originated qualified fixed-rate residential mortgage loans while retaining variable rate residential mortgage loans in the portfolio. This transformation is also enhanced by an expanded commercial lending staff dedicated to growing commercial real estate and commercial business loans. The Bank also continues to originate consumer loans and residential construction loans for the loan portfolio. The Bank does not offer, and has not offered, Alt-A, sub-prime or no-document mortgage loans.

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Loan Portfolio Analysis. The following table presents the composition of the Bank s loan portfolio by type of loan at the dates indicated.

	At December 31,									
	2013		2012		2011		2010		2009	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
	(Dollars in thousands)									
Mortgage Loans:										
Residential[1]	$ 107,029	35.65%	$ 108,097	37.37%	$ 116,338	40.84%	$ 130,143	43.11%	$ 139,085	43.45%
Land	10,309	3.43	9,607	3.32	9,910	3.48	9,534	3.16	10,288	3.21
Commercial real estate	76,496	25.48	68,731	23.76	57,680	20.25	59,901	19.84	60,580	18.92
Residential construction[2]	14,423	4.80	12,753	4.41	10,988	3.86	8,151	2.70	13,862	4.33
Commercial real estate construction	1,715	0.57	3,299	1.14	743	0.26	0	0.00	0	0.00
Total mortgage loans	209,972	69.93	202,487	70.00	195,659	68.69	207,729	68.81	223,815	69.91
Consumer Loans:										
Home equity and second mortgage loans	34,815	11.60	36,962	12.78	38,641	13.57	43,046	14.26	46,360	14.48
Automobile loans	23,983	7.99	21,922	7.58	20,627	7.24	19,384	6.42	17,714	5.53
Loans secured by savings accounts	1,138	0.38	770	0.27	767	0.27	1,042	0.34	1,361	0.43
Unsecured loans	3,541	1.18	3,191	1.10	3,126	1.10	3,076	1.02	2,677	0.84
Other[3]	4,824	1.61	5,303	1.84	5,312	1.86	5,732	1.90	5,321	1.66
Total consumer loans	68,301	22.76	68,148	23.57	68,473	24.04	72,280	23.94	73,433	22.94
Commercial business loans	21,956	7.31	18,612	6.43	20,722	7.27	21,911	7.25	22,861	7.15
Total gross loans	300,229	100.00%	289,247	100.00%	284,854	100.00%	301,920	100.00%	320,109	100.00%

Less:					
Due to borrowers on loans in process	7,142	4,306	4,768	3,119	4,372
Deferred loan fees net of direct costs	(341)	(202)	(143)	(222)	(286)
Allowance for loan losses	4,922	4,736	4,182	4,473	4,931
Total loans, net	$ 288,506	$ 280,407	$ 276,047	$ 294,550	$ 311,092

(1) Includes conventional one- to four-family and multi-family residential loans.
(2) Includes construction loans for which the Bank has committed to provide permanent financing.
(3) Includes loans secured by lawn and farm equipment, mobile homes and other personal property.

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Residential Loans. The Bank s lending activities have concentrated on the origination of residential mortgages, both for sale in the secondary market and for retention in the Bank s loan portfolio. Residential mortgages secured by multi-family properties totaled $14.4 million, or 13.4% of the residential loan portfolio at December 31, 2013. Substantially all residential mortgages are collateralized by properties within the Bank s market area.

The Bank offers both fixed-rate mortgage loans and adjustable rate mortgage (ARM) loans typically with terms of 15 to 30 years. The Bank uses loan documents approved by the Federal National Mortgage Corporation (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) whether the loan is originated for investment or sale in the secondary market.

Historically, the Bank has retained its residential loan originations in its portfolio. Retaining fixed-rate loans in its portfolio subjects the Bank to a higher degree of interest rate risk. See *Item 1A. Risk Factors Above Average Interest Rate Risk Associated with Fixed-Rate Loans* for a further discussion of the risks of rising interest rates. Beginning in 2004, one of the Bank s strategic goals was to expand its mortgage business by originating mortgage loans for sale, while offering a full line of mortgage products to prospective customers. This practice increases the Bank s lending capacity and allows the Bank to more effectively manage its profitability since it is not required to predict the prepayment, credit or interest rate risks associated with retaining either the loan or the servicing asset. For the year ended December 31, 2013, the Bank originated and funded $36.7 million of residential mortgage loans for sale in the secondary market. For a full discussion of the Bank s mortgage banking operations, see *Item 1. Business Mortgage Banking Activities*.

ARM loans originated have interest rates that adjust at regular intervals of one to five years, with up to 2.0% caps per adjustment period and 6.0% lifetime caps, based upon changes in the prevailing interest rates on United States Treasury Bills. The Bank also originates hybrid ARM loans, which are fixed for an initial period three or five years and adjust annually thereafter. The Bank may occasionally use below market interest rates and other marketing inducements to attract ARM loan borrowers. The majority of ARM loans provide that the amount of any increase or decrease in the interest rate is limited to 2.0% (upward or downward) per adjustment period and generally contains minimum and maximum interest rates. Borrower demand for ARMs versus fixed-rate mortgage loans is a function of the level of interest rates, the expectations of changes in the level of interest rates and the difference between the interest rates and loan fees offered for fixed-rate mortgage loans and interest rates and loan fees for ARM loans. The relative amount of fixed-rate and ARM loans that can be originated at any time is largely determined by the demand for each in a competitive environment.

The Bank s lending policies generally limit the maximum loan-to-value ratio on fixed-rate and ARM loans to 80% of the lesser of the appraised value or purchase price of the underlying residential property unless private mortgage insurance to cover the excess over 80% is obtained, in which case the mortgage is limited to 95% (or 97% under a Freddie Mac program) of the lesser of appraised value or purchase price. The loan-to-value ratio, maturity and other provisions of the loans made by the Bank are generally reflected in the policy of making less than the maximum loan permissible under federal regulations, in accordance with established lending practices, market conditions and underwriting standards maintained by the Bank. The Bank requires title, fire and extended insurance coverage on all mortgage loans originated. All of the Bank s real estate loans contain due on sale clauses. The Bank generally obtains appraisals on all its real estate loans from outside appraisers.

Construction Loans. The Bank originates construction loans for residential properties and, to a lesser extent, commercial properties. Although the Bank originates construction loans that are repaid with the proceeds of a limited number of mortgage loans obtained by the borrower from another lender, the majority of the construction loans that the Bank originates are permanently financed in the secondary market by the Bank. Construction loans originated without a commitment by the Bank to provide permanent financing are generally originated for a term of six to 12

months and at a fixed interest rate based on the prime rate.

The Bank originates speculative construction loans to a limited number of builders operating and based in the Bank s primary market area and with whom the Bank has well-established business relationships. At December 31, 2013, the Bank had approved speculative construction loans, a construction loan for which there is not a commitment for permanent financing in place at the time the construction loan was originated, with total commitments of $4.7 million and outstanding balances of $2.9 million. The Bank limits the number of speculative construction loans outstanding to any one builder based on the Bank s assessment of the builder s capacity to service the debt.

Most construction loans are originated with a loan-to-value ratio not to exceed 80% of the appraised estimated value of the completed property. The construction loan documents require the disbursement of the loan proceeds in increments as construction progresses. Disbursements are based on periodic on-site inspections by an independent appraiser.

Construction lending is inherently riskier than residential mortgage lending. Construction loans, on average, generally have higher loan balances than residential mortgage loans. In addition, the potential for cost overruns because of the inherent difficulties in estimating construction costs and, therefore, collateral values and the difficulties and costs associated with monitoring construction progress, among other things, are major contributing factors to this greater credit risk. Speculative construction loans have the added risk that there is not an identified buyer for the completed home when the loan is originated, with the risk that the builder will have to service the construction loan debt and finance the other carrying costs of the completed home for an extended time period until a buyer is identified. Furthermore, the demand for construction loans and the ability of construction loan borrowers to service their debt depends highly on the state of the general economy, including market interest rate levels and the state of the economy of the Bank s primary market area. A material downturn in economic conditions could be expected to have a material adverse effect on the credit quality of the construction loan portfolio.

Commercial Real Estate Loans. Commercial real estate loans are generally secured by small retail stores, professional office space and, in certain instances, farm properties. Commercial real estate loans are generally originated with a loan-to-value ratio not to exceed 75% of the appraised value of the property. Property appraisals are performed by independent appraisers approved by the Bank s board of directors. The Bank seeks to originate commercial real estate loans at variable interest rates based on the prime lending rate or the United States Treasury Bill rate for terms ranging from ten to 15 years and with interest rate adjustment intervals of five years. The Bank also originates fixed-rate balloon loans with a short maturity, but a longer amortization schedule.

Commercial real estate lending affords the Bank an opportunity to receive interest at rates higher than those generally available from residential mortgage lending. However, loans secured by such properties usually are greater in amount, more difficult to evaluate and monitor and, therefore, involve a greater degree of risk than residential mortgage loans. Because payments on loans secured by multi-family and commercial properties are often dependent on the successful operation and management of the properties, repayment of such loans may be affected by adverse conditions in the real estate market or the economy. The Bank seeks to minimize these risks by limiting the maximum loan-to-value ratio to 75% and strictly scrutinizing the financial condition of the borrower, the quality of the collateral and the management of the property securing the loan. The Bank also obtains loan guarantees from financially capable parties based on a review of personal financial statements.

Commercial Business Loans. Commercial business loans are generally secured by inventory, accounts receivable, and business equipment such as trucks and tractors. Many commercial business loans also have real estate as collateral. The Bank generally requires a personal guaranty of payment by the principals of a corporate borrower, and reviews the personal financial statements and income tax returns of the guarantors. Commercial business loans are generally originated with loan-to-value ratios not exceeding 75%.

Aside from lines of credit, commercial business loans are generally originated for terms not to exceed seven years with variable interest rates based on the prime lending rate. Approved credit lines totaled $31.1 million at December 31, 2013, of which $13.5 million was outstanding. Lines of credit are originated at fixed and variable interest rates for one-year renewable terms.

A director of the Bank is a shareholder of a farm implement dealership that contracts with the Bank to provide sales financing to the dealership s customers. The Bank does not grant preferential credit under this arrangement. During the year ended December 31, 2013, the Bank granted approximately $574,000 of credit to customers of the dealership and all loans purchased from the corporation had an aggregate outstanding balance of $951,000 at December 31, 2013. At December 31, 2013, three loans purchased from the corporation were delinquent 30 days or more with an aggregate outstanding balance of $17,000.

Commercial business lending generally involves greater risk than residential mortgage lending and involves risks that are different from those associated with residential and commercial real estate lending. Real estate lending is generally considered to be collateral-based lending with loan amounts based on predetermined loan-to-collateral values and liquidation of the underlying real estate collateral is viewed as the primary source of repayment in the event of borrower default. Although commercial business loans are often collateralized by equipment, inventory, accounts receivable or other business assets, the liquidation of collateral in the event of a borrower default is often an insufficient source of repayment because accounts receivable may be uncollectible and inventories and equipment may be obsolete or of limited use, among other things. Accordingly, the repayment of a commercial business loan depends primarily on the creditworthiness of the borrower (and any guarantors), while liquidation of collateral is a secondary, and often insufficient, source of repayment. The Bank has four commercial lenders and two commercial credit analysts committed to growing commercial business loans to facilitate the changes desired in the Bank s balance sheet. The Bank also uses an outside loan review company to review selected commercial credits on an annual basis.

Consumer Loans. The Bank offers a variety of secured or guaranteed consumer loans, including automobile and truck loans, home equity loans, home improvement loans, boat loans, mobile home loans and loans secured by savings deposits. In addition, the Bank offers unsecured consumer loans. Consumer loans are generally originated at fixed interest rates and for terms not to exceed seven years. The largest portion of the Bank s consumer loan portfolio consists of home equity and second mortgage loans followed by automobile and truck loans. Automobile and truck loans are originated on both new and used vehicles. Such loans are generally originated at fixed interest rates for terms up to five years and at loan-to-value ratios up to 90% of the blue book value in the case of used vehicles and 90% of the purchase price in the case of new vehicles.

The Bank originates variable-rate home equity and fixed-rate second mortgage loans generally for terms not to exceed five years. The loan-to-value ratio on such loans is limited to 80%, taking into account the outstanding balance on the first mortgage loan.

The Bank s underwriting procedures for consumer loans includes an assessment of the applicant s payment history on other debts and ability to meet existing obligations and payments on the proposed loans. Although the applicant s creditworthiness is a primary consideration, the underwriting process also includes a comparison of the value of the security, if any, to the proposed loan amount. The Bank underwrites and originates the majority of its consumer loans internally, which management believes limits exposure to credit risks relating to loans underwritten or purchased from brokers or other outside sources.

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

Loan Maturity and Repricing

The following table sets forth certain information at December 31, 2013 regarding the dollar amount of loans maturing in the Bank s portfolio based on their contractual terms to maturity, but does not include potential prepayments. Demand loans, which are loans having neither a stated schedule of repayments nor a stated maturity, and overdrafts are reported as due in one year or less. Loan balances do not include undisbursed loan proceeds, unearned income and allowance for loan losses.

	Within One Year	After One Year Through 3 Years	After 3 Years Through 5 Years	After 5 Years Through 10 Years	After 10 Years Through 15 Years	After 15 Years	Total
	(Dollars in thousands)						
Mortgage loans:							
Residential	$ 5,752	$ 14,400	$ 12,941	$ 26,603	$ 18,921	$ 28,412	$ 107,029
Commercial real estate and land loans(1)	13,777	11,321	12,431	27,631	14,565	8,795	88,520
Residential construction(2)	14,423	0	0	0	0	0	14,423
Consumer loans	19,474	24,321	10,456	13,930	18	113	68,301
Commercial business	11,526	5,858	1,862	1,553	756	401	21,956
Total gross loans	$ 64,952	$ 55,889	$ 37,690	$ 69,717	$ 34,260	$ 37,721	$ 300,229

(1) Includes commercial real estate construction loans.
(2) Includes construction loans for which the bank has committed to provide permanent financing.

The following table sets forth the dollar amount of all loans due after December 31, 2014, which have fixed interest rates and floating or adjustable interest rates.

	Fixed Rates	Floating or Adjustable Rates
	(Dollars in thousands)	

Mortgage loans:		
Residential	$ 57,944	$ 43,333
Commercial real estate and land loans	22,939	51,804
Residential construction	0	0
Consumer loans	26,798	22,029
Commercial business	5,300	5,130
Total gross loans	$ 112,981	$ 122,296

Loan Solicitation and Processing. A majority of the Bank s loan originations are made to existing customers. Walk-ins and customer referrals are also a source of loan originations. Upon receipt of a loan application, a credit report is ordered to verify specific information relating to the loan applicant s employment, income and credit standing. A loan applicant s income is verified through the applicant s employer or from the applicant s tax returns. In the case of a real estate loan, an appraisal of the real estate intended to secure the proposed loan is undertaken, generally by an independent appraiser approved by the Bank. The mortgage loan documents used by the Bank conform to secondary market standards.

The Bank requires that borrowers obtain certain types of insurance to protect its interest in the collateral securing the loan. The Bank requires either a title insurance policy insuring that the Bank has a valid first lien on the mortgaged real estate or an opinion by an attorney regarding the validity of title. Fire and casualty insurance is also required on collateral for loans.

Loan Commitments and Letters of Credit. The Bank issues commitments for fixed- and adjustable-rate single-family residential mortgage loans and commercial loans conditioned upon the occurrence of certain events. Such commitments are made in writing on specified terms and conditions and are honored for up to 60 days from the date of application, depending on the type of transaction. The Bank had outstanding loan commitments of approximately $6.3 million at December 31, 2013.

As an accommodation to its commercial business loan borrowers, the Bank issues standby letters of credit or performance bonds usually in favor of municipalities for whom its borrowers are performing services. At December 31, 2013, the Bank had outstanding letters of credit of $1.2 million.

Loan Origination and Other Fees. Loan fees and points are a percentage of the principal amount of the mortgage loan that is charged to the borrower for funding the loan. The Bank usually charges a fixed origination fee on residential real estate loans and long-term commercial real estate loans. Current accounting standards require loan origination fees and certain direct costs of underwriting and closing loans to be deferred and amortized into interest income over the contractual life of the loan. Deferred fees and costs associated with loans that are sold are recognized as income at the time of sale. The Bank had $341,000 of net deferred loan costs at December 31, 2013.

Mortgage Banking Activities. Mortgage loans originated and funded by the Bank and intended for sale in the secondary market are carried at the lower of aggregate cost or market value. Aggregate market value is determined based on the quoted prices under a best efforts sales agreement with a third party. Net unrealized losses are recognized through a valuation allowance by charges to income. Realized gains on sales of mortgage loans are included in noninterest income.

Commitments to originate and fund mortgage loans for sale in the secondary market are considered derivative financial instruments to be accounted for at fair value. The Bank s mortgage loan commitments subject to derivative accounting are fixed rate mortgage commitments at market rates when initiated. At December 31, 2013, the Bank had commitments to originate $280,000 in fixed-rate mortgage loans intended for sale in the secondary market after the loans are closed. Fair value is estimated based on fees that would be charged on commitments with similar terms.

Delinquencies. The Bank s collection procedures provide for a series of contacts with delinquent borrowers. A late charge is assessed and a late charge notice is sent to the borrower after the 15th day of delinquency. After 20 days, the collector places a phone call to the borrower. When a payment becomes 60 days past due, the collector issues a default letter. If a loan continues in a delinquent status for 90 days or more, the Bank generally initiates foreclosure or other litigation proceedings.

Nonperforming Assets. Loans are reviewed regularly and when loans become 90 days delinquent, the loan is placed on nonaccrual status and the previously accrued interest income is reversed unless, in the opinion of management, the outstanding interest remains collectible. Typically, payments received on a nonaccrual loan are applied to the outstanding principal and interest as determined at the time of collection of the loan when the likelihood of further loss on the loan is remote. Otherwise, the Bank applies the cost recovery method and applies all payments as a reduction of the unpaid principal balance.

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The following table sets forth information with respect to the Bank s nonperforming assets for the dates indicated. Nonperforming assets include nonaccrual loans, accruing loans that are 90 days or more past due, and foreclosed real estate.

	At December 31,				
	2013	2012	2011	2010	2009
	(Dollars in thousands)				
Loans accounted for on a nonaccrual basis:					
Residential real estate(1)	$ 1,533	$ 2,773	$ 2,528	$ 3,230	$ 2,295
Commercial real estate(2)	1,576	2,961	2,858	1,780	3,445
Commercial business	1,898	1,776	1,928	2,148	2,238
Consumer	252	73	87	390	456
Total	5,259	7,583	7,401	7,548	8,434
Accruing loans past due 90 days or more:					
Residential real estate(1)	180	215	143	334	563
Commercial real estate(2)	0	0	38	0	202
Commercial business	0	0	0	20	0
Consumer	47	74	182	25	317
Total	227	289	363	379	1,082
Total nonperforming loans	5,486	7,872	7,764	7,927	9,516
Foreclosed real estate, net	466	295	661	591	877
Total nonperforming assets	$ 5,952	$ 8,167	$ 8,425	$ 8,518	$ 10,393
Total nonperforming loans to net loans	1.90%	2.81%	2.81%	2.69%	3.06%
Total nonperforming loans to total assets	1.23%	1.71%	1.77%	1.75%	2.09%
Total nonperforming assets to total assets	1.34%	1.78%	1.92%	1.88%	2.28%

(1) Includes residential construction loans.
(2) Includes commercial real estate construction and land loans.

The Bank accrues interest on loans over 90 days past due when, in the opinion of management, the estimated value of collateral and collection efforts are deemed sufficient to ensure full recovery. The Bank recognized $4,000 in interest income on nonaccrual loans for the fiscal year ended December 31, 2013. The Bank would have recorded interest income of $261,000 for the year ended December 31, 2013 had nonaccrual loans been current in accordance with their original terms.

Restructured Loans. Periodically, the Bank modifies loans to extend the term or make other concessions to help borrowers stay current on their loans and avoid foreclosure. The Bank does not forgive principal or interest on loans or modify interest rates to rates that are below market rates. These modified loans are also referred to as troubled debt restructurings.

Restructured loans can involve loans remaining on nonaccrual, moving to nonaccrual, or continuing on accrual status, depending on the individual facts and circumstances of the borrower. Generally, a nonaccrual loan that is restructured in a TDR remains on nonaccrual status for a period of at least six months following the restructuring to ensure that the borrower performs in accordance with the restructured terms including consistent and timely payments. At December 31, 2013, troubled debt restructurings totaled $3.6 million and the related allowance for loan losses on troubled debt restructurings was $1.3 million. Troubled debt restructurings on nonaccrual status totaling $1.9 million at December 31, 2013 are included in the nonperforming loans totals above. Troubled debt restructurings performing according to their restructured terms and on accrual status totaled $1.7 million at December 31, 2013. See Note 4 in the accompanying Notes to Consolidated Financial Statements for additional information regarding troubled debt restructurings.

Classified Assets. The OCC has adopted various regulations regarding problem assets of financial institutions. The regulations require that each insured institution review and classify its assets on a regular basis. In addition, in connection with examinations of insured institutions, OCC examiners have the authority to identify problem assets and, if appropriate, require them to be classified. There are three classifications for problem assets: substandard, doubtful and loss. Substandard assets have one or more defined weaknesses and are characterized by the distinct possibility that the insured institution will sustain some loss if the deficiencies are not corrected. Doubtful assets have the weaknesses of substandard assets with the additional characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss. An asset classified as loss is considered uncollectible and of such little value that continuance as an asset of the institution is not warranted. If an asset or portion thereof is classified as loss, the insured institution charges off an amount equal to 100% of the portion of the asset classified as loss. The regulations also provide for a special mention category, described as assets which do not currently expose the institution to sufficient risk to warrant adverse classification, but have potential weaknesses that deserve management s close attention.

The Company held a corporate collateralized mortgage obligation security that was downgraded to a substandard regulatory classification in 2009 due to a downgrade of the security s credit quality rating by various rating agencies. Based on an independent third party analysis performed in December 2011, the Company recognized at that time an other-than-temporary impairment loss on this security of $36,000 representing the credit loss component of the unrealized loss. In December 31, 2012, the Company sold the remainder of the impaired privately-issued CMO which resulted in a realized loss on the sale of $9,000.

At December 31, 2013, the Bank had $5.3 million in doubtful loans and $5.9 million in substandard loans, of which all but $5.7 million are included in total nonperforming loans disclosed in the above table. In addition, the Bank identified $4.1 million in loans as special mention loans at December 31, 2013.

Current accounting rules require that impaired loans be measured based on the present value of expected future cash flows discounted at the loan s effective interest rate, the loan s observable market price or the fair value of collateral if the loan is collateral dependent. A loan is classified as impaired by management when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due in accordance with the terms of the loan agreement. If the fair value, as measured by one of these methods, is less than the recorded investment in the impaired loan, the Bank establishes a valuation allowance with a provision charged to expense. Management reviews the valuation of impaired loans on a quarterly basis to consider changes due to the passage of time or revised estimates. At December 31, 2013, all impaired loans were considered to be collateral dependent for the purposes of determining fair value.

Values for collateral dependent loans are generally based on appraisals obtained from independent licensed real estate appraisers, with adjustments applied for estimated costs to sell the property, costs to complete unfinished or repair damaged property and other factors. New appraisals are generally obtained for all significant properties when a loan is identified as impaired, and a property is considered significant if the value of the property is estimated to exceed $200,000. Subsequent appraisals are obtained as needed or if management believes there has been a significant change in the market value of the property. In instances where it is not deemed necessary to obtain a new appraisal, management bases its impairment and allowance for loan loss analysis on the original appraisal with adjustments for current conditions based on management s assessment of market factors and management s inspection of the property. At December 31, 2013, discounts from appraised values used to value impaired loans for estimates of changes in market conditions, the condition of the collateral, and estimated costs to sell the property ranged from 10% to 48%.

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An insured institution is required to establish and maintain an allowance for loan losses at a level that is adequate to absorb estimated credit losses associated with the loan portfolio, including binding commitments to lend. General allowances represent loss allowances which have been established to recognize the inherent risk associated with lending activities. When an insured institution classifies problem assets as loss, it is required either to establish an allowance for losses equal to 100% of the amount of the assets, or charge off the classified asset. The amount of its valuation allowance is subject to review by the OCC, which can order the establishment of additional general loss allowances. The Bank regularly reviews the loan portfolio to determine whether any loans require classification in accordance with applicable regulations.

At December 31, 2013, 2012 and 2011, the aggregate amounts of the Bank s classified assets were as follows:

	At December 31,		
	2013	2012	2011
	(Dollars in thousands)		
Classified assets:			
Loss	$	$	$
Doubtful	5,259	7,583	7,401
Substandard[1]	5,904	8,072	6,981
Special mention	4,066	4,041	8,385

(1) Includes substandard loans and one available for sale security downgraded below investment grade by various rating agencies with a carrying value of $237,000 at December 31, 2011.

Loans classified as impaired in accordance with accounting standards included in the above regulatory classifications and the related allowance for loan losses are summarized below at the dates indicated:

	At December 31,		
	2013	2012	2011
	(Dollars in thousands)		
Impaired loans with related allowance	$ 3,129	$ 4,093	$ 4,698
Impaired loans with no allowance	3,791	3,711	3,165
Total impaired loans	$ 6,920	$ 7,804	$ 7,863
Allowance for loan losses:			
Related to impaired loans	$ 1,529	$ 1,652	$ 1,658
Related to other loans	3,393	3,084	2,524

See Note 4 in the accompanying Notes to Consolidated Financial Statements for additional information regarding impaired loans and the related allowance for loan losses.

Foreclosed Real Estate. Foreclosed real estate held for sale is carried at fair value minus estimated costs to sell. Costs of holding foreclosed real estate are charged to expense in the current period, except for significant property improvements, which are capitalized. Valuations are periodically performed by management and an allowance is established by a charge to non-interest expense if the carrying value exceeds the fair value minus estimated costs to

sell. The net income from operations of foreclosed real estate held for sale is reported in non-interest income. At December 31, 2013, the Bank had foreclosed real estate totaling $466,000. See Note 6 in the accompanying Notes to Consolidated Financial Statements for additional information regarding foreclosed real estate.

Allowance for Loan Losses. Loans are the Bank s largest concentration of assets and continue to represent the most significant potential risk. In originating loans, the Bank recognizes that losses will be experienced and that the risk of loss will vary with, among other things, the type of loan made, the creditworthiness of the borrower over the term of the loan, general economic conditions and, in the case of a secured loan, the quality of the collateral. The Bank maintains an allowance for loan losses to absorb losses inherent in the loan portfolio. The allowance for loan losses represents management s estimate of probable loan losses based on information available as of the date of the financial statements. The allowance for loan losses is based on management s evaluation of the loan portfolio, including historical loan loss experience, delinquencies, known and inherent risks in the nature and volume of the loan portfolio, information about specific borrower situations, estimated collateral values, and economic conditions.

The loan portfolio is reviewed quarterly by management to evaluate the adequacy of the allowance for loan losses to determine the amount of any adjustment required after considering the loan charge-offs and recoveries for the quarter. Management applies a systematic methodology that incorporates its current judgments about the credit quality of the loan portfolio. In addition, the OCC, as an integral part of its examination process, periodically reviews the Bank s allowance for loan losses and may require the Bank to make additional provisions for estimated losses based on their judgments about information available to them at the time of their examination.

The methodology used in determining the allowance for loan losses includes segmenting the loan portfolio by identifying risk characteristics common to pools of loans, determining and measuring impairment of individual loans based on the present value of expected future cash flows or the fair value of collateral, and determining and measuring impairment for pools of loans with similar characteristics by applying loss factors that consider the qualitative factors which may affect the loss rates.

Specific allowances related to impaired loans and other classified loans are established where the present value of the loan s discounted cash flows, observable market price or collateral value (for collateral dependent loans) is lower than the carrying value of the loan. The identification of these loans results from the loan review process that identifies and monitors credits with weaknesses or conditions which call into question the full collection of the contractual payments due under the terms of the loan agreement. Factors considered by management include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. At December 31, 2013, the Company s specific allowances totaled $1.5 million, including a specific allowance of $1.3 million on a commercial loan secured by a medical office facility and medical equipment. The loan had a balance of $1.7 million at December 31, 2013 and the loan was on nonaccrual status.

For loans evaluated on a pool basis, management applies loss factors to pools of loans with common risk characteristics (i.e., residential mortgage loans, home equity loans, commercial real estate loans). The loss factors are derived from the Bank s historical loss experience. Loss factors are adjusted for significant qualitative factors that, in management s judgment, affect the collectability of the loan portfolio segment. The significant qualitative factors include the levels and trends in charge-offs and recoveries, trends in volume and terms of loans, levels and trends in delinquencies, the effects of changes in underwriting standards and other lending practices or procedures, the experience and depth of the lending management and staff, effects of changes in credit concentration, changes in industry and market conditions and national and local economic trends and conditions. Management evaluates these conditions on a quarterly basis and evaluates and modifies the assumptions used in establishing the loss factors.

At December 31, 2011, the historical loss experience used to estimate the allowance for loan losses was for the most recent eight calendar quarters. Effective as of December 31, 2012, the Company began using the most recent twelve calendar quarters as the basis for developing the historical loss factors, which increased the estimated allowance for loan losses by approximately $575,000. Also at December 31, 2012, management adjusted the qualitative factors for the home equity and second mortgage portfolio segment which increased the estimated allowance for loan losses

related to that portfolio segment by approximately $511,000. These qualitative factors applied to the home equity and second mortgage loan portfolio considered risks associated with loan to value ratios, delinquency history and whether the Bank does not hold the first lien on the collateral. These changes were made to better reflect management s analysis of inherent losses in the loan portfolio at December 31, 2012.

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At December 31, 2013, management adjusted the qualitative factors for the commercial real estate, commercial business, vacant land, and home equity and second mortgage portfolio segments which increased the estimated allowance for loan losses related to those portfolio segments by approximately $1.1 million. These changes we made to better reflect management s analysis of inherent losses in these portfolio segments at December 31, 2013.

At December 31, 2013, for each loan portfolio segment management applied an overall qualitative factor of 1.18 to the Company s historical loss factors. The overall qualitative factor is derived from management s analysis of changes and trends in the following qualitative factors:

Underwriting Standards Management reviews the findings of periodic internal audit loan reviews, independent outsourced loan reviews and loan reviews performed by the banking regulators to evaluate the risk associated with changes in underwriting standards. At December 31, 2013, management assessed the risk associated with this component as neutral, requiring no adjustment to the historical loss factors.

Economic Conditions Management analyzes trends in housing and unemployment data in the Harrison, Floyd and Clark counties of Indiana, the Company s primary market area, to evaluate the risk associated with economic conditions. Due to a decrease in new home construction and an increase in unemployment in the Company s primary market area, management assigned a risk factor of 1.20 for this component at December 31, 2013.

Past Due Loans Management analyzes trends in past due loans for the Company to evaluate the risk associated with delinquent loans. In general, past due loan ratios have remained at elevated levels compared to historical amounts since 2007, and management assigned a risk factor of 1.20 for this component at December 31, 2013.

Other Internal and External Factors This component includes management s consideration of other qualitative factors such as loan portfolio composition. The Company has focused on origination of commercial business and real estate loans in an effort to convert the Company s balance sheet from that of a traditional thrift institution to a commercial bank. In addition, the Company has increased its investment in mortgage loans in which it does not hold a first lien position. Commercial loans and second mortgage loans generally entail greater credit risk than residential mortgage loans secured by a first lien. As a result of changes in the loan portfolio composition, management assigned a risk factor of 1.30 for this component at December 31, 2013.

Each of the four factors above was assigned an equal weight to arrive at an average for the overall qualitative factor of 1.18 at December 31, 2013. The effect of the overall qualitative factor was to increase the estimated allowance for loan losses by $471,000 at December 31, 2013.

Management also adjusts the historical loss factors for loans classified as watch, special mention and substandard that are not individually evaluated for impairment. The adjustments consider the increased likelihood of loss on classified loans based on the Company s separate historical loss experience for classified loans. The effect of these adjustments for classified loans was to increase the estimated allowance for loan losses by $521,000 at December 31, 2013.

See Notes 1 and 4 in the accompanying Notes to Consolidated Financial Statements for additional information regarding management s methodology for estimating the allowance for loan losses.

The following table sets forth an analysis of the Bank s allowance for loan losses for the periods indicated.

	Year Ended December 31,				
	2013	2012	2011	2010	2009
	(Dollars in thousands)				
Allowance at beginning of period	$ 4,736	$ 4,182	$ 4,473	$ 4,931	$ 2,662
Provision for loan losses	725	1,525	1,825	2,037	4,289
	5,461	5,707	6,298	6,968	6,951
Recoveries:					
Residential real estate	60	16	18	9	26
Commercial real estate and land	17	1	0	4	6
Commercial business	74	10	45	9	14
Consumer	202	200	248	214	209
Total recoveries	353	227	311	236	255
Charge-offs:					
Residential real estate	353	418	819	620	425
Commercial real estate and land	92	108	396	1,326	920
Commercial business	20	17	333	29	181
Consumer	427	655	879	756	749
Total charge-offs	892	1,198	2,427	2,731	2,275
Net (charge-offs) recoveries	(539)	(971)	(2,116)	(2,495)	(2,020)
Balance at end of period	$ 4,922	$ 4,736	$ 4,182	$ 4,473	$ 4,931
Ratio of allowance to total loans outstanding at the end of the period	1.64%	1.64%	1.47%	1.48%	1.54%
Ratio of net charge-offs to average loans outstanding during the period	0.19%	0.35%	0.72%	0.80%	0.63%

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Allowance for Loan Losses Analysis

The following table sets forth the breakdown of the allowance for loan losses by loan category at the dates indicated.

	At December 31,									
	2013		2012		2011		2010		2009	
	Amount	Percent of Outstanding Loans in Category	Amount	Percent of Outstanding Loans in Category	Amount	Percent of Outstanding Loans in Category	Amount	Percent of Outstanding Loans in Category	Amount	Percent of Outstanding Loans in Category
	(Dollars in thousands)									
Residential real estate[1]	$ 874	40.45%	$ 922	41.78%	$ 861	44.70%	$ 1,045	45.81%	$ 1,297	47.78%
Commercial real estate and land loans[2]	1,436	29.48	1,381	28.22	1,362	23.99	1,106	23.00	1,772	22.13
Commercial business	1,446	7.31	1,223	6.43	1,160	7.27	1,251	7.25	1,264	7.15
Consumer	1,116	22.76	1,210	23.57	799	24.04	1,071	23.94	598	22.94
Total allowance for loan losses	$ 4,922	100.00%	$ 4,736	100.00%	$ 4,182	100.00%	$ 4,473	100.00%	$ 4,931	100.00%

(1) Includes residential construction loans.
(2) Includes commercial real estate construction loans.

Investment Activities

Federally chartered savings institutions have authority to invest in various types of liquid assets, including United States Treasury obligations, securities of various federal agencies and of state and municipal governments, deposits at the applicable Federal Home Loan Bank, certificates of deposit of federally insured institutions, certain bankers acceptances and federal funds. Subject to various restrictions, such savings institutions may also invest a portion of their assets in commercial paper, corporate debt securities and mutual funds, the assets of which conform to the investments that federally chartered savings institutions are otherwise authorized to make directly. Savings institutions are also required to maintain minimum levels of liquid assets that vary from time to time. The Bank may decide to increase its liquidity above the required levels depending upon the availability of funds and comparative yields on investments in relation to return on loans.

The Bank is required under federal regulations to maintain a minimum amount of liquid assets and is also permitted to make certain other securities investments. The balance of the Bank s investments in short-term securities in excess of regulatory requirements reflects management s response to the significantly increasing percentage of deposits with

short maturities. Management intends to hold securities with short maturities in the Bank s investment portfolio in order to enable the Bank to match more closely the interest-rate sensitivities of its assets and liabilities.

The Bank periodically invests in mortgage-backed securities, including mortgage-backed securities guaranteed or insured by Ginnie Mae, Fannie Mae or Freddie Mac. Mortgage-backed securities generally increase the quality of the Bank s assets by virtue of the guarantees that back them, are more liquid than individual mortgage loans and may be used to collateralize borrowings or other obligations of the Bank. Of the Bank s total mortgage-backed securities portfolio at December 31, 2013, securities with a market value of $282,000 have adjustable rates as of that date.

The Bank also invests in collateralized mortgage obligations (CMOs) issued by Ginnie Mae, Fannie Mae and Freddie Mac, as well as private issuers. CMOs are complex mortgage-backed securities that restructure the cash flows and risks of the underlying mortgage collateral.

At December 31, 2013, neither the Company nor the Bank had an investment in securities (other than United States Government and agency securities), which exceeded 10% of the Company s consolidated stockholders equity at that date.

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The following table sets forth the securities portfolio at the dates indicated.

	At December 31,										
	2013				2012				2011		
	Fair Value	Amortized Cost	Percent of Portfolio	Weighted Average Yield[1]	Fair Value	Amortized Cost	Percent of Portfolio	Weighted Average Yield[1]	Fair Value	Amortized Cost	Percent W... of A... Portfolio
	(Dollars in thousands)										
s Held rity[2]											
e-backed [3]	9	9	0.01	1.63%	12	12	0.01	1.96%	16	16	0.01
	$ 9	$ 9	0.01%		$ 12	$ 12	0.01%		$ 16	$ 16	0.01%
s e for											
urities:											
ncy:											
ne year	$ 0	$ 0	0.00%	0.00%	$ 0	$ 0	0.00%	0.00%	$ 894	$ 892	0.82%
one ugh five	7,005	7,045	6.41	0.92%	7,509	7,445	6.19	1.27%	8,607	8,543	7.84
five ough ten	16,460	16,857	15.33	1.41%	7,098	6,999	5.82	1.50%	11,134	11,014	10.11
ten ough ars	7,449	7,692	7.00	1.73%	23,946	23,829	19.80	1.63%	21,728	21,522	19.76
e-backed and	38,610	38,894	35.38	1.85%	45,866	45,220	37.58	1.84%	36,388	35,781	32.85
l:											
ne year	0	0	0.00	0.00%	507	505	0.42	5.51%	1,419	1,407	1.29
one ugh five	2,019	1,961	1.78	4.01%	1,074	1,018	0.85	5.55%	2,000	1,952	1.79
five ough ten	14,065	13,841	12.59	4.83%	9,299	8,915	7.41	4.37%	6,443	6,011	5.52
ten	19,956	20,398	18.55	4.40%	23,437	22,167	18.42	4.98%	17,439	16,430	15.08
curities:											

unds	3,198	3,238	2.95	N/A	4,237	4,213	3.50	N/A	5,388	5,369	4.93
	$ 108,762	$ 109,926	99.99%		$ 122,973	$ 120,311	99.99%		$ 111,440	$ 108,921	99.99%

(1) Yields are calculated on a fully taxable equivalent basis using a marginal federal income tax rate of 34%. Weighted average yields are calculated using average prepayment rates for the most recent three-month period.

(2) Securities held to maturity are carried at amortized cost.

(3) The expected maturities of mortgage-backed securities and collateralized mortgage obligations (CMOs) may differ from contractual maturities because the mortgages underlying the obligations may be prepaid without penalty.

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Deposit Activities and Other Sources of Funds

General. Deposits and loan repayments are the major source of the Bank s funds for lending and investment activities and for its general business purposes. Loan repayments are a relatively stable source of funds, while deposit inflows and outflows and loan prepayments are significantly influenced by general interest rates and money market conditions. Borrowing may be used on a short-term basis to compensate for reductions in the availability of funds from other sources or may also be used on a longer-term basis for interest rate risk management.

Deposit Accounts. Deposits are attracted from within the Bank s primary market area through the offering of a broad selection of deposit instruments, including non-interest bearing checking accounts, negotiable order of withdrawal (NOW) accounts, money market accounts, regular savings accounts, certificates of deposit and retirement savings plans. Deposit account terms vary, according to the minimum balance required, the time periods the funds must remain on deposit and the interest rate, among other factors. In determining the terms of its deposit accounts, the Bank considers the rates offered by its competition, profitability to the Bank, matching deposit and loan products and its customer preferences and concerns. The Bank generally reviews its deposit mix and pricing weekly.

The following table presents the maturity distributions of time deposits of $100,000 or more as of December 31, 2013.

Maturity Period	Amount at December 31, 2013 (Dollars in thousands)
Three months or less	$ 4,299
Over three through six months	3,065
Over six through 12 months	4,959
Over 12 months	13,083
Total	$ 25,406

The following table sets forth the balances of deposits in the various types of accounts offered by the Bank at the dates indicated.

	At December 31,								
	2013			2012			2011		
	Amount	Percent of Total	Increase/ (Decrease)	Amount	Percent of Total	Increase/ (Decrease)	Amount	Percent of Total	Increase/ (Decrease)
	(Dollars in thousands)								
Non-interest bearing demand	$ 56,436	15.10%	$ (279)	$ 56,715	14.76%	$ 9,402	$ 47,313	12.99%	$ 6,539
NOW accounts	150,763	40.33	(3,850)	154,613	40.23	12,762	141,851	38.93	(12,534)
Savings accounts	67,968	18.18	7,016	60,952	15.86	12,849	48,103	13.20	4,615

Money market accounts	11,321	3.03	81	11,240	2.92	(3,270)	14,510	3.98	951
Fixed rate time deposits which mature:									
Within one year	42,181	11.28	(11,192)	53,373	13.89	3,276	50,097	13.75	(31,117)
After one year, but within three years	33,942	9.08	(5,194)	39,136	10.18	(10,174)	49,310	13.53	12,787
After three years, but within five years	11,111	2.97	2,884	8,227	2.14	(4,850)	13,077	3.59	5,138
After five years	0	0.00	(5)	5	0.00	(33)	38	0.01	(20)
Club accounts	108	0.03	26	82	0.02	7	75	0.02	12
Total	$ 373,830	100.00%	$ (10,513)	$ 384,343	100.00%	$ 19,969	$ 364,374	100.00%	$ (13,629)

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The following table sets forth the amount and maturities of time deposits by rates at December 31, 2013.

		Amount Due					
		Less Than One Year	1 - 3 Years	3 - 5 Years	After 5 Years	Total	Percent of Total
		(Dollars in thousands)					
0.00%	0.99%	$ 25,480	$ 15,543	$ 9,759	$ 0	$ 50,782	58.21%
1.00%	1.99%	12,376	17,855	1,327	0	31,558	36.18
2.00%	2.99%	4,146	381	0	0	4,527	5.19
3.00%	3.99%	45	0	0	0	45	0.05
4.00%	4.99%	0	163	25	0	188	0.22
5.00%	5.99%	134	0	0	0	134	0.15
6.00%	6.99%	0	0	0	0	0	0.00
Total		$ 42,181	$ 33,942	$ 11,111	$ 0	$ 87,234	100.00%

Borrowings. The Bank has at times relied upon advances from the Federal Home Loan Bank of Indianapolis to supplement its supply of lendable funds and to meet deposit withdrawal requirements. Advances from the Federal Home Loan Bank of Indianapolis are secured by certain first mortgage loans and a mutual fund investment. The Bank also uses retail repurchase agreements as a source of borrowings.

The Federal Home Loan Bank functions as a central reserve bank providing credit for savings and loan associations and certain other member financial institutions. As a member, the Bank is required to own capital stock in the Federal Home Loan Bank and is authorized to apply for advances on the security of such stock and certain of its mortgage loans and other assets (principally a mutual fund investment held by the Bank) provided certain standards related to creditworthiness have been met. Advances are made pursuant to several different programs. Each credit program has its own interest rate and range of maturities. Depending on the program, limitations on the amount of advances are based either on a fixed percentage of an institution s net worth or on the Federal Home Loan Bank s assessment of the institution s creditworthiness. Under its current credit policies, the Federal Home Loan Bank generally limits advances to 20% of a member s assets, and short-term borrowing of less than one year may not exceed 10% of the institution s assets. The Federal Home Loan Bank determines specific lines of credit for each member institution.

The following table sets forth certain information regarding the Bank s use of Federal Home Loan Bank advances.

	At or For the Years Ended December 31,		
	2013	2012	2011
	(Dollars in thousands)		
Maximum balance at any month end	$ 5,500	$ 10,925	$ 16,529
Average balance	4,135	10,287	14,557
Period end balance	5,500	5,100	12,350
Weighted average interest rate:			
At end of period	0.50%	3.63%	3.78%
During the period	3.65%	3.75%	4.02%

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The following table sets forth certain information regarding the Bank s use of retail repurchase agreements.

	At or For the Years Ended December 31, 2013	2012	2011
	(Dollars in thousands)		
Maximum balance at any month end	$ 13,041	$ 14,092	$ 9,608
Average balance	11,015	10,074	9,174
Period end balance	9,310	14,092	9,125
Weighted average interest rate:			
At end of period	0.26%	0.25%	0.51%
During the period	0.25%	0.38%	0.64%

Subsidiary Activities

The Bank is the Company s only subsidiary, and is wholly-owned by the Company. First Harrison Investments, Inc. and First Harrison Holdings, Inc. are wholly-owned Nevada corporate subsidiaries of the Bank that jointly own First Harrison, LLC, a Nevada limited liability corporation that holds and manages an investment securities portfolio. First Harrison REIT, Inc. was incorporated on July 3, 2008 to hold a portion of the Bank s real estate mortgage loan portfolio. First Harrison REIT, Inc. is a wholly-owned subsidiary of First Harrison Holdings, Inc.

Personnel

As of December 31, 2013, the Bank had 116 full-time employees and 29 part-time employees. A collective bargaining unit does not represent the employees and the Bank considers its relationship with its employees to be good.

REGULATION AND SUPERVISION

General

As a savings and loan holding company, the Company is required by federal law to report to, and otherwise comply with the rules and regulations of, the Board of Governors of the Federal Reserve Board (the Federal Reserve Board). The Bank, an insured federal savings association, is subject to extensive regulation, examination and supervision by the OCC, as its primary federal regulator, and the FDIC, as the deposit insurer.

The Bank is a member of the Federal Home Loan Bank System and, with respect to deposit insurance, of the Deposit Insurance Fund managed by the FDIC. The Bank must file reports with the OCC and the FDIC concerning its activities and financial condition and obtain regulatory approvals before entering into certain transactions such as mergers with, or acquisitions of, other savings associations. The OCC and/or the FDIC conduct periodic examinations to test the Bank s safety and soundness and compliance with various regulatory requirements. This regulation and supervision establishes a comprehensive framework of activities in which an institution can engage and is intended primarily for the protection of the insurance fund and depositors. The regulatory structure also gives the regulatory authorities extensive discretion in connection with their supervisory and enforcement activities and examination policies, including policies with respect to the classification of assets and the establishment of adequate loan loss reserves for regulatory purposes. Any change in such regulatory requirements and policies, whether by the OCC, the FDIC or Congress, could have a material adverse impact on the Company, the Bank and their operations.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act) made extensive changes to the regulation of the Bank. Under the Dodd-Frank Act, the Office of Thrift Supervision (the OTS) was eliminated and responsibility for the supervision and regulation of federal savings associations such as the Bank was transferred to the OCC on July 21, 2011. The OCC is the agency that is primarily responsible for the regulation and supervision of national banks. Additionally, the Dodd-Frank Act created a new Consumer Financial Protection Bureau as an independent bureau of the Federal Reserve Board. The Consumer Financial Protection Bureau assumed responsibility for the implementation of the federal financial consumer protection and fair lending laws and regulations and has authority to impose new requirements. However, institutions of less than $10 billion in assets, such as the Bank, will continue to be examined for compliance with consumer protection and fair lending laws and regulations by, and be subject to the enforcement authority of, their prudential regulators.

Certain regulatory requirements applicable to the Bank and to the Company are referred to below or elsewhere herein. The summary of statutory provisions and regulations applicable to savings associations and their holding companies set forth below and elsewhere in this document does not purport to be a complete description of such statutes and regulations and their effects on the Bank and the Company and is qualified in its entirety by reference to the actual laws and regulations.

Holding Company Regulation

General. The Company is a unitary savings and loan holding company within the meaning of federal law. As such, the Company is registered with the Federal Reserve Board and subject to Federal Reserve Board regulations, examination, supervision and reporting requirements. In addition, the Federal Reserve board has enforcement authorities over the Company and its non-savings association subsidiaries. Among other things, that authority permits the Federal Reserve Board to restrict or prohibit activities that it determines to be a serious risk to the subsidiary savings association.

Activities Restrictions. Pursuant to federal law and regulations and policy, a savings and loan holding company such as the Company may generally engage in the activities permitted for financial holding companies under Section 4(k) of the Bank Holding Company Act and certain other activities that have been authorized for savings and loan holding companies by regulation.

Federal law prohibits a savings and loan holding company from, directly or indirectly, or through one or more subsidiaries, acquiring more than 5% of the voting stock of another savings association or savings and loan holding company, without prior written approval of the Federal Reserve Board or from acquiring or retaining, with certain exceptions, more than 5% of a non-subsidiary savings association, a non-subsidiary holding company, or a non-subsidiary company engaged in activities other than those authorized by federal law, or from acquiring or retaining control of a depository institution that is not insured by the FDIC. In evaluating applications by holding companies to acquire savings associations, the Federal Reserve Board considers, among other things, factors such as the financial and managerial resources and future prospects of the Company and institution involved, the effect of the acquisition on the risk to the deposit insurance funds, the convenience and needs of the community and competitive effects.

The Federal Reserve Board may not approve any acquisition that would result in a multiple savings and loan holding company controlling savings associations in more than one state, subject to two exceptions: (i) the approval of interstate supervisory acquisitions by savings and loan holding companies; and (ii) the acquisition of a savings association in another state if the laws of the state of the target savings association specifically permit such acquisitions. The states vary in the extent to which they permit interstate savings and loan holding company acquisitions.

Capital. Savings and loan holding companies are not currently subject to specific regulatory capital requirements. The Dodd-Frank Act, however, requires the Federal Reserve Board to promulgate consolidated capital requirements for depository institution holding companies that are no less stringent, both quantitatively and in terms of components of capital, than those applicable to institutions themselves. Instruments such as cumulative preferred stock and trust preferred securities will no longer be includable as Tier 1 capital as is currently the case with bank holding companies. Instruments issued by May 19, 2010 will be grandfathered for companies with consolidated assets of $15 billion or less. There is a five-year transition period (from the July 21, 2010 effective date of the Dodd-Frank Act) before the capital requirements will apply to savings and loan holding companies.

Source of Strength. The Dodd-Frank Act also extends the source of strength doctrine to savings and loan holding companies. The regulatory agencies must issue regulations requiring that all bank and savings and loan holding companies serve as a source of strength to their subsidiary depository institutions by providing capital, liquidity and other support to their subsidiary depository institutions in times of financial stress.

Dividends. The Bank must notify the Federal Reserve Board thirty (30) days before declaring any dividend to the Company. The financial impact of a holding company on its subsidiary institution is a matter that is evaluated by the Federal Reserve Board and the agency has authority to order cessation of activities or divestiture of subsidiaries deemed to pose a threat to the safety and soundness of the institution.

Acquisition of the Company. Under the Federal Change in Control Act, a notice must be submitted to the Federal Reserve Board if any person (including a company), or group acting in concert, seeks to acquire direct or indirect control of a savings and loan holding company or savings association. Under certain circumstances, a change of control may occur, and prior notice is required, upon the acquisition of 10% or more of the Company s outstanding voting stock, unless the Federal Reserve Board has found that the acquisition will not result in control of the Company. A change in control definitively occurs upon the acquisition of 25% or more of the Company s outstanding voting stock. Under the Change in Control Act, the Federal Reserve Board generally has 60 days from the filing of a complete notice to act, taking into consideration certain factors, including the financial and managerial resources of the acquirer and the competitive effects of the acquisition. Any company that acquires control would then be subject to regulation as a savings and loan holding company.

Federal Banking Regulation

Business Activities. The activities of federal savings banks are governed by federal laws and regulations. Those laws and regulations delineate the nature and extent of the business activities in which federal savings banks may engage. In particular, certain lending authority for federal savings banks, *e.g.*, commercial, non-residential real property loans and consumer loans, is limited to a specified percentage of the institution s capital or assets.

The Dodd-Frank Act authorized the payment of interest on commercial checking accounts, effective July 21, 2011.

Capital Requirements. The applicable capital regulations require savings associations to meet three minimum capital standards: a 1.5% tangible capital to total assets ratio; a 4% tier 1 capital to total assets leverage ratio (3% for institutions receiving the highest rating on the CAMELS examination rating system) and an 8% risk-based capital ratio. In addition, the prompt corrective action standards discussed below also establish, in effect, a minimum 2% tangible capital standard, a 4% leverage ratio (3% for institutions receiving the highest rating on the CAMELS system) and, together with the risk-based capital standard itself, a 4% Tier 1 risk-based capital standard. The regulations also require that, in meeting the tangible, leverage and risk-based capital standards, institutions must generally deduct investments in and loans to subsidiaries engaged in activities as principal that are not permissible for a national bank.

The risk-based capital standard for savings associations requires the maintenance of Tier 1 (core) and total capital (which is defined as core capital and supplementary capital less certain specified deductions from total capital such as reciprocal holdings of depository institution capital instruments and equity investments) 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 activities, recourse obligations, residual interests and direct credit substitutes, are multiplied by a risk-weight factor of 0% to 100%, assigned by the capital regulation based on the risks believed inherent in the type of asset. Core (Tier 1) capital is generally defined as common stockholders equity (including retained earnings), certain non-cumulative 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 (Tier 2 Capital) includes cumulative preferred stock, long-term perpetual preferred stock, mandatory convertible debt securities, subordinated debt and intermediate preferred stock, the allowance for loan and lease losses limited to a maximum of 1.25% of risk-weighted assets, and up to 45% of 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.

The OCC also has authority to establish individual minimum capital requirements in appropriate cases upon a determination that an institution s capital level is or may become inadequate in light of the particular circumstances.

At December 31, 2013, the Bank met each of its capital requirements. See Note 19 in the accompanying Notes to Consolidated Financial Statements.

In early July 2013, the Federal Reserve Board and the OCC approved revisions to their capital adequacy guidelines and prompt corrective action rules that implement the revised standards of the Basel Committee on Banking Supervision, commonly called Basel III, and address relevant provisions of the Dodd-Frank Act. Basel III refers to two consultative documents released by the Basel Committee on Banking Supervision in December 2009, the rules text released in December 2010, and loss absorbency rules issued in January 2011, which include significant changes to bank capital, leverage and liquidity requirements.

The rules include new risk-based capital and leverage ratios, which are effective January 1, 2015, and revise the definition of what constitutes capital for purposes of calculating those ratios. The new minimum capital level requirements applicable to the Company and the Bank will be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4% for all institutions. The rules eliminate the inclusion of certain instruments, such as trust preferred securities, from Tier 1 capital. Instruments issued prior to May 19, 2010 will be grandfathered for companies with consolidated assets of $15 billion or less. The rules also establish a capital conservation buffer of 2.5% above the new regulatory minimum capital requirements, which must consist entirely of common equity Tier 1 capital and would result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement will be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase by that amount each year until fully implemented in January 2019. An institution would be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations would establish a maximum percentage of eligible retained income that could be utilized for such actions.

Prompt Corrective Regulatory Action. The OCC is required to take certain supervisory actions against undercapitalized institutions, the severity of which depends upon the institution s degree of undercapitalization. Generally, a savings association that has a ratio of total capital to risk weighted assets of less than 8%, a ratio of Tier 1 (core) capital to risk-weighted assets of less than 4% or a ratio of core capital to total assets of less than 4% (3% or less for institutions with the highest examination rating) is considered to be undercapitalized. A savings association that has a total risk-based capital ratio less than 6%, a Tier 1 capital ratio of less than 3% or a leverage ratio that is less than 3% is considered to be significantly undercapitalized and a savings association that has a tangible capital to assets ratio equal to or less than 2% is deemed to be critically undercapitalized. Subject to a narrow exception, the OCC is required to appoint a receiver or conservator within specified time frames for an institution that is critically undercapitalized. The regulation also provides that a capital restoration plan must be filed with the OCC within 45 days of the date a savings association is deemed to have received notice that it is undercapitalized, significantly undercapitalized or critically undercapitalized. Compliance with the plan must be guaranteed by any parent holding company up to the lesser of 5% of the savings association s total assets when it was deemed to be undercapitalized or the amount necessary to achieve compliance with applicable capital requirements. In addition, numerous mandatory supervisory actions become immediately applicable to an undercapitalized institution, including, but not limited to, increased monitoring by regulators and restrictions on growth, capital distributions and expansion. The OCC could also take any one of a number of discretionary supervisory actions, including the issuance of a capital directive and the replacement of senior executive officers and directors. Significantly and critically undercapitalized institutions are subject to additional mandatory and discretionary measures.

Insurance of Deposit Accounts. The Bank s deposits are insured up to applicable limits by the Deposit Insurance Fund of the FDIC. Deposit insurance per account owner is currently $250,000. Under the Federal Deposit Insurance Corporation s risk-based assessment system, insured institutions are assigned a risk category based on supervisory evaluations, regulatory capital levels and certain other factors. An institution s assessment rate depends upon the category to which it is assigned, and certain adjustments specified by FDIC regulations. Institutions deemed less risky pay lower assessments. The FDIC may adjust the scale uniformly, except that no adjustment can deviate more than two basis points from the base scale without notice and comment. No institution may pay a dividend if in default of the federal deposit insurance assessment.

The Dodd-Frank Act required the FDIC to revise its procedures to base its assessments upon each insured institution s total assets less tangible equity instead of deposits. The FDIC finalized a rule, effective April 1, 2011, that set the assessment range at 2.5 to 45 basis points of total assets less tangible equity.

The FDIC has authority to increase insurance assessments. A significant increase in insurance premiums would likely have an adverse effect on the operating expenses and results of operations of the Bank. Management cannot predict what insurance assessment rates will be in the future.

Insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or regulatory condition imposed in writing by the FDIC or the OCC. The management of the Bank does not know of any practice, condition or violation that might lead to termination of deposit insurance.

Loans to One Borrower. Federal law provides that savings associations are generally subject to the limits on loans to one borrower applicable to national banks. Generally, subject to certain exceptions, a savings association may not make a loan or extend credit to a single or related group of borrowers in excess of 15% of its unimpaired capital and surplus. An additional amount may be lent, equal to 10% of unimpaired capital and surplus, if secured by specified readily-marketable collateral.

Qualified Thrift Lender (QTL) Test. Federal law requires savings associations to meet a qualified thrift lender test. Under the test, a savings association is required to either qualify as a domestic building and loan association under the Internal Revenue Code or maintain at least 65% of its portfolio assets (total assets less: (i) specified liquid assets up to 20% of total assets; (ii) intangibles, including goodwill; and (iii) the value of property used to conduct business) in certain qualified thrift investments (primarily residential mortgages and related investments, including certain mortgage-backed securities but also including education, credit card and small business loans) in at least nine months out of each 12-month period.

A savings association that fails the qualified thrift lender test is subject to certain operating restrictions and the Dodd-Frank Act also specifies that failing the qualified thrift lender test is a violation of law that could result in an enforcement action and dividend limitations. As of December 31, 2013, the Bank maintained 70% of its portfolio assets in qualified thrift investments and, therefore, met the qualified thrift lender test.

Limitation on Capital Distributions. Federal regulations impose limitations upon all capital distributions by a savings association, including cash dividends, payments to repurchase its shares and payments to shareholders of another institution in a cash-out merger. Under the regulations, an application to and prior approval of the OCC is required before any capital distribution if the institution does not meet the criteria for expedited treatment of applications under OCC regulations (i.e., generally, examination and Community Reinvestment Act ratings in the two top categories), the total capital distributions for the calendar year exceed net income for that year plus the amount of retained net income for the preceding two years, the institution would be undercapitalized following the distribution or the distribution would otherwise be contrary to a statute, regulation or agreement with the OCC. If an application is not required, the institution must still provide 30 days prior written notice to Federal Reserve Board of the capital distribution if, like the Bank, it is a subsidiary of a holding company, as well as an informational notice filing to the OCC.

If the Bank s capital fell below its regulatory requirements or the OCC notified it that it was in need of increased supervision, the Bank s ability to make capital distributions could be restricted. In addition, the OCC could prohibit a proposed capital distribution by any institution, which would otherwise be permitted by the regulation, if the OCC determines that such distribution would constitute an unsafe or unsound practice.

Standards for Safety and Soundness. The federal banking agencies have adopted Interagency Guidelines prescribing Standards for Safety and Soundness in various areas such as internal controls and information systems, internal audit, loan documentation and credit underwriting, interest rate exposure, asset growth and quality, earnings and compensation, fees and benefits. The guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. If the OCC determines that a savings association fails to meet any standard prescribed by the guidelines, the OCC may require the institution to submit an acceptable plan to achieve compliance with the standard.

Community Reinvestment Act. All federal savings associations have a responsibility under the Community Reinvestment Act and related regulations to help meet the credit needs of their communities, including low- and moderate-income neighborhoods. An institution s failure to satisfactorily comply with the provisions of the Community Reinvestment Act could result in denials of regulatory applications. Responsibility for administering the Community Reinvestment Act, unlike other fair lending laws, is not being transferred to the Consumer Financial Protection Bureau. The Bank received a satisfactory Community Reinvestment Act rating in its most recently completed examination.

Transactions with Related Parties. The Bank s authority to engage in transactions with affiliates (e.g., any entity that controls or is under common control with the Bank, including the Company and its other subsidiaries) is limited by federal law. The aggregate amount of covered transactions with any individual affiliate is limited to 10% of the capital and surplus of the savings association. The aggregate amount of covered transactions with all affiliates is limited to 20% of the savings association s capital and surplus. Certain transactions with affiliates are required to be secured by collateral in an amount and of a type specified by federal law. The purchase of low quality assets from affiliates is generally prohibited. Transactions with affiliates must generally be on terms and under circumstances, that are at least as favorable to the institution as those prevailing at the time for comparable transactions with non-affiliated companies. In addition, savings associations are prohibited from lending to any affiliate that is engaged in activities that are not permissible for bank holding companies and no savings association may purchase the securities of any affiliate other than a subsidiary.

The Sarbanes-Oxley Act of 2002 generally prohibits loans by the Company to its executive officers and directors. However, the law contains a specific exception for loans by a depository institution to its executive officers and directors in compliance with federal banking laws. Under such laws, the Bank s authority to extend credit to executive officers, directors and 10% shareholders (insiders), as well as entities such persons control, is limited. The laws limit both the individual and aggregate amount of loans that the Bank may make to insiders based, in part, on the Bank s capital level and requires that certain board approval procedures be followed. Such loans are required to be made on terms substantially the same as those offered to unaffiliated individuals and not involve more than the normal risk of repayment. There is an exception for loans made pursuant to a benefit or compensation program that is widely available to all employees of the institution and does not give preference to insiders over other employees. Loans to executive officers are subject to additional limitations based on the type of loan involved.

Enforcement. The OCC has primary enforcement responsibility over savings associations and has authority to bring actions against the institution and all institution-affiliated parties, including stockholders, and any 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 to institution of receivership, conservatorship or termination of deposit insurance. Civil penalties cover a wide range of violations and can amount to $25,000 per day, or even $1 million per day in especially egregious cases. The FDIC has the authority to recommend to the Director of the OCC that enforcement action to be taken with respect to a particular savings association. If action is not taken by the Director, the FDIC has authority to take such action under certain circumstances. Federal law also establishes criminal penalties for certain violations.

Assessments. Savings associations were previously required to pay assessments to the OTS to fund the agency s operations. The general assessments, paid on a semi-annual basis, are computer based upon the savings association s (including consolidated subsidiaries) total assets, condition and complexity of portfolio. The OCC assessments paid by the Bank for the year ended December 31, 2013 totaled $128,000.

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 provides a central credit facility primarily for member institutions. The Bank, as a member of the Federal Home Loan Bank, is required to acquire and hold shares of capital stock in that Federal Home Loan Bank. The Bank was in compliance with this requirement with an investment in Federal Home Loan Bank stock at December 31, 2013 of $2.8 million.

The Federal Home Loan Banks have been required to provide funds for the resolution of insolvent thrifts in the late 1980s and contribute funds for affordable housing programs. These and similar requirements, or general economic conditions, could reduce the amount of dividends that the Federal Home Loan Banks pay to their members and result in the Federal Home Loan Banks imposing a higher rate of interest on advances to their members. If dividends were reduced, or interest on future Federal Home Loan Bank advances increased, the Bank s net interest income would likely also be reduced.

Federal Reserve System

The Federal Reserve Board regulations require savings associations to maintain non-interest earning reserves against their transaction accounts (primarily NOW and regular checking accounts). The regulations generally provide that reserves be maintained against aggregate transaction accounts as follows: a 3% reserve ratio is assessed on net transaction accounts up to and including $71.0 million; a 10% reserve ratio is applied above $71.0 million. The first $11.5 million of otherwise reservable balances (subject to adjustments by the Federal Reserve Board) are exempted from the reserve requirements. The amounts are adjusted annually and, for 2014, require a 3% ratio for up to $79.5 million and an exemption of $12.4 million. The Bank complies with the foregoing requirements. In October 2008, the Federal Reserve Board began paying interest on certain reserve balances.

Other Regulations

The Bank s operations are also subject to federal laws applicable to credit transactions, including the:

- Truth-In-Lending Act, governing disclosures of credit terms to consumer borrowers;

- Home Mortgage Disclosure Act of 1975, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves;

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

Fair Credit Reporting Act of 1978, governing the use and provision of information to credit reporting agencies;

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

Rules and regulations of the various federal agencies charged with the responsibility of implementing such federal laws.

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The operations of the Bank also are subject to laws such as the:

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

Electronic Funds Transfer Act and Regulation E promulgated thereunder, which govern automatic deposits to and withdrawals from deposit accounts and customers rights and liabilities arising from the use of automated teller machines and other electronic banking services; and

Check Clearing for the 21st Century Act (also known as Check 21), which gives substitute checks, such as digital check images and copies made from that image, the same legal standing as the original paper check.

FEDERAL AND STATE TAXATION

Federal Taxation

General. The Company and the Bank report their income on a calendar year basis using the accrual method of accounting and are subject to federal income taxation in the same manner as other corporations with some exceptions, including particularly the Bank s reserve for bad debts, as discussed below. The following discussion of tax matters is intended only as a summary and does not purport to be a comprehensive description of the tax rules applicable to the Bank or the Company. The Company and the Bank have not been audited by the Internal Revenue Service in the past five years.

Bad Debt Reserve. For taxable years beginning after December 31, 1995, the Bank is entitled to take a bad debt deduction for federal income tax purposes which is based on its current or historic net charge-offs by applying the experience reserve method for banks. For tax years beginning before December 31, 1995, the Bank as a qualifying thrift had been permitted to establish a reserve for bad debts and to make annual additions to such reserve, which were deductible for federal income tax purposes. Under such prior tax law, generally the Bank recognized a bad debt deduction equal to 8% of taxable income.

Under the 1996 Tax Act, the Bank was required to recapture all or a portion of its additions to its bad debt reserve made subsequent to the base year (which is the Bank s last taxable year beginning before January 1, 1988). This recapture was required to be made, after a deferral period based on certain specified criteria, ratably over a six-year period commencing in the Bank s calendar 1998 tax year. All post-1987 additions to the statutory bad debt reserve have been recaptured in taxable income as of December 31, 2002.

Potential Recapture of Base Year Bad Debt Reserve. The Bank s bad debt reserve as of the base year is not subject to automatic recapture as long as the Bank continues to carry on the business of banking and does not meet the definition of a large bank as discussed below. If the Bank no longer qualifies as a bank, the balance of the pre-1988 reserves (the base year reserves) are restored to income over a six-year period beginning in the tax year the Bank no longer qualifies as a bank. Such base year bad debt reserve is subject to recapture to the extent that the Bank makes non-dividend distributions that are considered as made from the base year bad debt reserve. To the extent that such reserves exceed the amount that would have been allowed under the experience method (Excess Distributions), then an amount based on the amount distributed will be included in the Bank s taxable income. Non-dividend distributions include

distributions in excess of the Bank s current and accumulated earnings and profits, distributions in redemption of stock, and distributions in partial or complete liquidation. However, dividends paid out of the Bank s current or accumulated earnings and profits, as calculated for federal income tax purposes, will not be considered to result in a distribution from the Bank s bad debt reserve. Thus, any dividends to the Company that would reduce amounts appropriated to the Bank s bad debt reserve and deducted for federal income tax purposes would create a tax liability for the Bank. The amount of additional taxable income created from an Excess Distribution is an amount that, when reduced by the tax attributable to the income, is equal to the amount of the distribution. If the Bank makes a non-dividend distribution, then approximately one and one-half times the amount so used would be includable in gross income for federal income tax purposes, assuming a 34% corporate income tax rate (exclusive of state and local taxes). The Bank does not intend to pay dividends that would result in a recapture of any portion of its bad debt reserve.

Corporate Alternative Minimum Tax. The Internal Revenue Code imposes a tax on alternative minimum taxable income (AMTI) at a rate of 20%. The excess of the bad debt reserve deduction claimed by the Bank over the deduction that would have been allowable under the experience method is treated as a preference item for purposes of computing the AMTI. Only 90% of AMTI can be offset by net operating loss carry-overs, of which the Bank currently has none. AMTI is increased by an amount equal to 75% of the amount by which the Bank s adjusted current earnings exceed its AMTI (determined without regard to this preference and before reduction for net operating losses). In addition, for taxable years beginning after June 30, 1986 and before January 1, 1996, an environmental tax of 0.12% of the excess of AMTI (with certain modifications) over $2.0 million is imposed on corporations, including the Bank, whether or not an Alternative Minimum Tax (AMT) is paid. The Bank does not expect to be subject to the AMT.

Dividends Received Deduction and Other Matters. The Company may exclude from its income 100% of dividends received from the Bank as a member of the same affiliated group of corporations. The corporate dividends received deduction is generally 70% in the case of dividends received from unaffiliated corporations with which the Company and the Bank will not file a consolidated tax return, except that if the Company or the Bank own more than 20% of the stock of a corporation distributing a dividend, then 80% of any dividends received may be deducted.

Indiana Taxation

Indiana imposes an 8.5% franchise tax based on a financial institution s adjusted gross income as defined by statute. The Indiana franchise tax rate will be reduced to 8.0%, 7.5%, 7.0% and 6.5% for the Company s tax years ending December 31, 2014, 2015, 2016 and 2017, respectively, and will remain at 6.5% for the tax years ending after December 31, 2017. In computing adjusted gross income, deductions for municipal interest, United States Government interest, the bad debt deduction computed using the reserve method and pre-1990 net operating losses are disallowed. The Company s Indiana state income tax returns have not been audited in the past five years.

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ITEM 1A. RISK FACTORS

Above average interest rate risk associated with fixed-rate loans may have an adverse effect on our financial position or results of operations.

The Bank s loan portfolio includes a significant amount of loans with fixed rates of interest. At December 31, 2013, $143.4 million, or 47.8% of the Bank s total loans receivable, had fixed interest rates all of which were held for investment. The Bank offers ARM loans and fixed-rate loans. Unlike ARM loans, fixed-rate loans carry the risk that, because they do not reprice to market interest rates, their yield may be insufficient to offset increases in the Bank s cost of funds during a rising interest rate environment. Accordingly, a material and prolonged increase in market interest rates could be expected to have a greater adverse effect on the Bank s net interest income compared to other institutions that hold a materially larger portion of their assets in ARM loans or fixed-rate loans that are originated for committed sale in the secondary market. For a discussion of the Bank s loan portfolio, see *Item 1. Business Lending Activities*.

Higher loan losses could require the Company to increase its allowance for loan losses through a charge to earnings.

When we loan money we incur the risk that our borrowers do not repay their loans. We reserve for loan losses by establishing an allowance through a charge to earnings. The amount of this allowance is based on our assessment of loan losses inherent in our loan portfolio. The process for determining the amount of the allowance is critical to our financial results and condition. It requires subjective and complex judgments about the future, including forecasts of economic or market conditions that might impair the ability of our borrowers to repay their loans. We might underestimate the loan losses inherent in our loan portfolio and have loan losses in excess of the amount reserved. We might increase the allowance because of changing economic conditions. For example, in a rising interest rate environment, borrowers with adjustable-rate loans could see their payments increase. There may be a significant increase in the number of borrowers who are unable or unwilling to repay their loans, resulting in our charging off more loans and increasing our allowance. In addition, when real estate values decline, the potential severity of loss on a real estate-secured loan can increase significantly, especially in the case of loans with high combined loan-to-value ratios. Our allowance for loan losses at any particular date may not be sufficient to cover future loan losses. We may be required to increase our allowance for loan losses, thus reducing earnings.

Commercial business lending may expose the Company to increased lending risks.

At December 31, 2013, the Bank s commercial business loan portfolio amounted to $22.0 million, or 7.3% of total loans. Subject to market conditions and other factors, the Bank intends to expand its commercial business lending activities within its primary market area. Commercial business lending is inherently riskier than residential mortgage lending. Although commercial business loans are often collateralized by equipment, inventory, accounts receivable or other business assets, the liquidation value of these assets in the event of a borrower default is often an insufficient source of repayment because accounts receivable may be uncollectible and inventories and equipment may be obsolete or of limited use, among other things. See *Item 1. Business Lending Activities Commercial Business Loans*.

Commercial real estate lending may expose the Company to increased lending risks.

At December 31, 2013, the Bank s commercial real estate loan portfolio amounted to $76.5 million, or 25.5% of total loans. Commercial real estate lending is inherently riskier than residential mortgage lending. Because payments on loans secured by commercial properties often depend upon the successful operation and management of the properties, repayment of such loans may be affected by adverse conditions in the real estate market or the economy, among other things. See *Item 1. Business Lending Activities Commercial Real Estate Loans*.

Current economic conditions pose significant challenges that could adversely affect our financial condition and results of operations.

Our success depends to a large degree on the general economic conditions in our market areas. Our market has experienced a significant downturn in which we have seen falling home prices, rising foreclosures and an increased level of commercial and consumer delinquencies. If economic conditions do not improve or continue to decline, we could experience any of the following consequences, each of which could further adversely affect our business: demand for our products and services could decline; problem assets and foreclosures may increase; and loan losses may increase.

We could experience further adverse consequences in the event of a prolonged economic downturn in our market due to our exposure to commercial loans across various lines of business. A prolonged economic downturn could adversely affect collateral values or cash flows of the borrowing businesses, and as a result our primary source of repayment could be insufficient to service the debt. Another adverse consequence in the event of a prolonged economic downturn in our market could be the loss of collateral value on commercial and real estate loans that are secured by real estate located in our market area. A further significant decline in real estate values in our market would mean that the collateral for many of our loans would provide less security. As a result, we would be more likely to suffer losses on defaulted loans because our ability to fully recover on defaulted loans by selling the real estate collateral would be diminished.

Future economic conditions in our market will depend on factors outside of our control such as political and market conditions, broad trends in industry and finance, legislative and regulatory changes, changes in government, military and fiscal policies and inflation.

Strong competition within the Bank s market area could hurt the Company s profit and growth.

The Bank faces intense competition both in making loans and attracting deposits. This competition has made it more difficult for it to make new loans and at times has forced it to offer higher deposit rates. Price competition for loans and deposits might result in the Bank earning less on loans paying more on deposits, which would reduce net interest income. Competition also makes it more difficult to grow loans and deposits. Some of the institutions with which the Bank competes have substantially greater resources and lending limits than it has and may offer services that the Bank does not provide. Future competition will likely increase because of legislative, regulatory and technological changes and the continuing trend of consolidation in the financial services industry. The Company s profitability depends upon the Bank s continued ability to compete successfully in its market area.

We are subject to federal regulations that seek to protect the Deposit Insurance Fund and the depositors and borrowers of the Bank, and our federal regulators may impose restrictions on our operations that are detrimental to holders of the Company s common stock.

We are subject to extensive regulation, supervision and examination by the Federal Reserve Board and the OCC, our primary federal regulators, and the FDIC, as insurer of our deposits. Such regulation and supervision governs the activities in which an institution and its holding company may engage, and are intended primarily for the protection of the insurance fund and the depositors and borrowers of the Bank rather than for holders of the Company s common stock. Our regulators may subject us to supervisory and enforcement actions, such as the imposition of certain restrictions on our operations, the classification of our assets and the determination of the level of our allowance for loan losses, that are aimed at protecting the insurance fund and the depositors and borrowers of the Bank but that are detrimental to holders of the Company s common stock. Any change in our regulation or oversight, whether in the form of regulatory policy, regulations, legislation or supervisory action, may have a material impact on our operations.

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Financial regulatory reform may have a material impact on the Company s operations.

On July 21, 2010, the President signed into law the Dodd-Frank Act. The Dodd-Frank Act contains various provisions designed to enhance the regulation of depository institutions and prevent the recurrence of a financial crisis such as occurred in 2008 and 2009. These include provisions strengthening holding company capital requirements, requiring retention of a portion of the risk of securitized loans and regulating debit card interchange fees. The Dodd-Frank Act also created the Consumer Financial Protection Bureau to administer consumer protection and fair lending laws, a function that was formerly performed by the depository institution regulators. The full impact of the Dodd-Frank Act on our business and operations will not be known for years until regulations implementing the statute are written and adopted. However, it is likely that the provisions of the Dodd-Frank Act will have an adverse impact on our operations, particularly through increased regulatory burden and compliance costs.

Additionally, in July 2013, the federal banking agencies issued a final rule to revise their risk-based and leverage capital requirements and their method for calculating risk-weighted assets, to make them consistent with the agreements that were reached by the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. The final rule applies to all depository institutions, top-tier bank holding companies with total consolidated assets of $500 million or more, and top-tier savings and loan holding companies (banking organizations). Among other things, the rule establishes a new common equity Tier 1 minimum capital requirement (4.5% of risk-weighted assets), increases the minimum Tier 1 capital to risk-based assets requirement (from 4% to 6% of risk-weighted assets) and assigns a higher risk weight (150%) to exposures that are more than 90 days past due or are on nonaccrual status and to certain commercial real estate facilities that finance the acquisition, development or construction of real property. The final rule also limits a banking organization s capital distributions and certain discretionary bonus payments if the banking organization does not hold a capital conservation buffer consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets in addition to the amount necessary to meet its minimum risk-based capital requirements. The final rule becomes effective for us on January 1, 2015. The capital conservation buffer requirement will be phased in beginning January 1, 2016 and ending January 1, 2019, when the full capital conservation buffer requirement will be effective.

Compliance with these rules, which are still being analyzed, will impose additional costs on banking entities and their holding companies.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

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ITEM 2. PROPERTIES

The following table sets forth certain information regarding the Bank s offices as of December 31, 2013.

Location	Year Opened	Net Book Value[1] (Dollars in thousands)	Owned/ Leased	Approximate Square Footage
Main Office:				
220 Federal Drive, N.W. Corydon, Indiana 47112	1997	$ 1,528	Owned	12,000
Branch Offices:				
391 Old Capital Plaza, N.E. Corydon, Indiana 47112	1997	13	Leased[2]	425
8095 State Highway 135, N.W. New Salisbury, Indiana 47161	1999	578	Owned	3,500
710 Main Street Palmyra, Indiana 47164	1991	943	Owned	6,000
9849 Highway 150 Greenville, Indiana 47124	1986	166	Owned	2,484
5100 State Road 64 (Edwardsville Branch) Georgetown, Indiana 47122	2008	1,261	Owned	4,988
317 East U.S. Highway 150 Hardinsburg, Indiana 47125	1996	113	Owned	1,834
4303 Charlestown Crossing New Albany, Indiana 47150	1999	731	Owned	3,500
3131 Grant Line Road New Albany, Indiana 47150	2003	1,494	Owned	12,200
5609 Williamsburg Station Road Floyds Knobs, Indiana 47119	2003	554	Owned	4,160
2744 Allison Lane Jeffersonville, Indiana 47130	2003	1,140	Owned	4,090
1312 S. Jackson Street	2007	936	Owned	3,400

Salem, Indiana 47167				
2420 Barron Avenue NE Lanesville, Indiana 47136	2010	835	Owned	1,450

(1) Represents the net value of land, buildings, furniture, fixtures and equipment owned by the Bank.
(2) Lease expires in April 2015.

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ITEM 3. LEGAL PROCEEDINGS

At December 31, 2013, neither the Company nor the Bank was involved in any pending legal proceedings believed by management to be material to the Company s financial condition or results of operations. From time to time, the Bank is involved in legal proceedings occurring in the ordinary course of business. Such routine legal proceedings, in the aggregate, are believed by management to be immaterial to the Company s financial condition, results of operations or cash flows.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

PART II

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

The common shares of the Company are traded on the NASDAQ Capital Market under the symbol FCAP. As of December 31, 2013, the Company had 1,181 stockholders of record and 2,784,088 common shares outstanding. This does not reflect the number of persons whose shares are in nominee or street name accounts through brokers. See Note 18 in the accompanying Notes to Consolidated Financial Statements for information regarding dividend restrictions applicable to the Company.

The following table lists quarterly market price and dividend information per common share for the years ended December 31, 2013 and 2012 as reported by NASDAQ.

	High Sale	Low Sale	Dividends	Market price end of period
2013:				
First Quarter	$ 20.50	$ 19.31	$ 0.20	$ 20.37
Second Quarter	20.60	19.40	0.20	20.57
Third Quarter	21.86	19.75	0.20	21.34
Fourth Quarter	21.96	19.40	0.20	21.26
2012:				
First Quarter	$ 21.95	$ 18.51	$ 0.19	$ 21.17
Second Quarter	21.50	20.10	0.19	20.77
Third Quarter	21.00	19.07	0.19	19.50
Fourth Quarter	21.67	18.38	0.19	19.47

Purchases of Equity Securities

The following table provides certain information with regard to shares repurchased by the Company in the fourth quarter of 2013.

Period	(a) Total Number of Shares Purchased	(b) Average Price Paid Per Share	(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	(d) Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs
October 1 through October 31, 2013	100	$ 21.34	100	189,000
November 1 through November 30, 2013	327	$ 21.56	327	188,673
December 1 through December 31, 2013	0	N/A	0	188,673
Total	427		427	

On August 19, 2008, the board of directors authorized the repurchase of up to 240,467 shares of the Company s outstanding common stock. The stock repurchase program will expire upon the purchase of the maximum number of shares authorized under the program, unless the board of directors terminates the program earlier.

ITEM 6. SELECTED FINANCIAL DATA

The consolidated financial data presented below is qualified in its entirety by the more detailed financial data appearing elsewhere in this report, including the Company s audited consolidated financial statements.

FINANCIAL CONDITION DATA:	At December 31,				
	2013	2012	2011	2010	2009
	(In thousands)				
Total assets	$ 444,384	$ 459,132	$ 438,886	$ 452,378	$ 455,534
Cash and cash equivalents (1)	11,136	21,811	18,923	21,575	15,857
Securities available for sale	108,762	122,973	111,440	100,851	93,729
Securities held to maturity	9	12	16	32	62
Net loans	288,506	280,407	276,047	294,550	311,092
Deposits	373,830	384,343	364,374	378,003	374,476
Retail repurchase agreements	9,310	14,092	9,125	8,669	7,949
Advances from Federal Home Loan Bank	5,500	5,100	12,350	15,729	47,830
Stockholders equity, net of noncontrolling interest in subsidiary	53,227	52,824	50,942	47,893	45,944

OPERATING DATA:	For the Year Ended December 31,				
	2013	2012	2011	2010	2009
	(In thousands)				
Interest income	$ 18,411	$ 18,800	$ 20,273	$ 21,834	$ 22,969
Interest expense	1,653	2,465	3,760	5,502	8,388
Net interest income	16,758	16,335	16,513	16,332	14,581
Provision for loan losses	725	1,525	1,825	2,037	4,289
Net interest income after provision for loan losses	16,033	14,810	14,688	14,295	13,371
Noninterest income	4,640	4,537	4,051	3,906	3,373
Noninterest expense	13,331	13,853	13,211	12,762	13,473
Income before income taxes	7,342	5,494	5,528	5,439	192
Income tax expense (benefit)	2,255	1,559	1,543	1,561	(586)
Net Income	5,087	3,935	3,985	3,878	778
Less: net income attributable to noncontrolling interest in subsidiary	13	13	13	13	12

Net Income Attributable to First Capital, Inc.	$	5,074	$	3,922	$	3,972	$	3,865	$	766
PER SHARE DATA (2):										
Net income basic	$	1.82	$	1.41	$	1.43	$	1.39	$	0.28
Net income diluted		1.82		1.41		1.43		1.39		0.28
Dividends		0.80		0.76		0.76		0.74		0.72

(1) Includes cash and due from banks, interest-bearing deposits in other depository institutions and federal funds sold.

(2) Per share data excludes net income attributable to noncontrolling interest in subsidiary.

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SELECTED FINANCIAL RATIOS:	At or For the Year Ended December 31,				
	2013	2012	2011	2010	2009
Performance Ratios:					
Return on assets (1)	1.11%	0.86%	0.90%	0.84%	0.17%
Return on average equity (2)	9.56%	7.54%	8.04%	8.10%	1.62%
Dividend payout ratio (3)	43.96%	53.90%	53.15%	53.24%	257.14%
Average equity to average assets	11.65%	11.46%	11.13%	10.43%	10.34%
Interest rate spread (4)	3.98%	3.86%	3.98%	3.74%	3.26%
Net interest margin (5)	4.07%	4.00%	4.14%	3.96%	3.56%
Noninterest expense to average assets	2.93%	3.05%	2.98%	2.79%	2.95%
Average interest earning assets to average interest bearing liabilities	124.42%	124.39%	118.79%	116.24%	115.08%
Regulatory Capital Ratios (Bank only):					
Tier I adjusted total assets	10.89%	10.00%	10.06%	9.32%	8.66%
Tier I risk based	14.86%	14.35%	16.11%	14.83%	13.39%
Total risk-based	16.11%	15.60%	17.05%	15.54%	13.99%
Asset Quality Ratios:					
Nonperforming loans as a percent of net loans (6)	1.90%	2.81%	2.81%	2.69%	3.06%
Nonperforming assets as a percent of total assets (7)	1.34%	1.78%	1.92%	1.88%	2.28%
Allowance for loan losses as a percent of gross loans receivable	1.64%	1.64%	1.47%	1.48%	1.54%

(1) Net income attributable to First Capital, Inc. divided by average assets.
(2) Net income attributable to First Capital, Inc. divided by average equity.
(3) Common stock dividends declared per share divided by net income per share.
(4) Difference between weighted average yield on interest-earning assets and weighted average cost of interest-bearing liabilities.

Tax exempt income is reported on a tax equivalent basis using a federal marginal tax rate of 34%.

(5) Net interest income as a percentage of average interest-earning assets.
(6) Nonperforming loans consist of loans accounted for on a nonaccrual basis and accruing loans 90 days or more past due.
(7) Nonperforming assets consist of nonperforming loans and real estate acquired in settlement of loans.

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

General

As the holding company for the Bank, the Company conducts its business primarily through the Bank. The Bank s results of operations depend primarily on net interest income, which is the difference between the income earned on its interest-earning assets, such as loans and investments, and the cost of its interest-bearing liabilities, consisting primarily of deposits, retail repurchase agreements and borrowings from the Federal Home Loan Bank of Indianapolis. The Bank s net income is also affected by, among other things, fee income, provisions for loan losses, operating expenses and income tax provisions. The Bank s results of operations are also significantly affected by general economic and competitive conditions, particularly changes in market interest rates, government legislation and policies concerning monetary and fiscal affairs, housing and financial institutions and the intended actions of the regulatory authorities.

Management uses various indicators to evaluate the Company s financial condition and results of operations, all of which show positive trends and improvement, including the following:

Net income and earnings per share Net income attributable to the Company was $5.1 million, or $1.82 per share for 2013 compared to $3.9 million, or $1.41 per share for 2012. However, had the voluntary early retirement program discussed below not been established in 2012, net income would have been $4.3 million, or $1.53 per share for 2012.

Return on average assets and return on average equity Return on average assets for 2013 was 1.11% compared to 0.86% for 2012, and return on average equity for 2013 was 9.56% compared to 7.54% for 2012. Excluding the net effect of the voluntary early retirement program would increase the return on average assets for 2012 to 0.94% and the return on average equity to 8.20%.

Efficiency ratio The Company s efficiency ratio (defined as noninterest expenses divided by net interest income plus noninterest income) was 62.3% for 2013 compared to 66.4% for 2012. Excluding the expense associated with the voluntary early retirement program, the efficiency ratio would have been 63.7% for 2012.

Asset quality Net loan charge-offs decreased from $971,000 for 2012 to $539,000 for 2013. In addition, total nonperforming assets (consisting of nonperforming loans and foreclosed real estate) decreased from $8.2 million, or 1.78% of total assets at December 31, 2012 to $6.0 million, or 1.34% of total assets at December 31, 2013. The allowance for loan losses was 1.64% of total loans and 89.72% of nonperforming loans at December 31, 2013 compared to 1.64% of total loans and 60.16% at December 31, 2012.

Shareholder return Total shareholder return, including the increase in the Company s stock price from $19.47 at December 31, 2012 to $21.26 at December 31, 2013 and dividends of $0.80 per share, was 13.3% for 2013.

Management s discussion and analysis of financial condition and results of operations is intended to assist in understanding the financial condition and results of operations of the Company and the Bank. The information contained in this section should be read in conjunction with the consolidated financial statements and the accompanying notes to consolidated financial statements included elsewhere in this report.

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Operating Strategy

The Company is the parent company of an independent community-oriented financial institution that delivers quality customer service and offers a wide range of deposit, loan and investment products to its customers. The commitment to customer needs, the focus on providing consistent customer service, and community service and support are the keys to the Bank s past and future success. The Company has no other material income other than that generated by the Bank and its subsidiaries.

The Bank s primary business strategy is attracting deposits from the general public and using those funds to originate residential mortgage loans, multi-family residential loans, commercial real estate and business loans and consumer loans. The Bank invests excess liquidity primarily in interest-bearing deposits with the Federal Home Loan Bank of Indianapolis and other financial institutions, federal funds sold, U.S. government and agency securities, local municipal obligations and mortgage-backed securities.

In recent years, the Company s operating strategy has also included strategies designed to enhance profitability by increasing sources of noninterest income and improving operating efficiency while managing its capital and limiting its credit risk and interest rate risk exposures. To accomplish these objectives, the Company has focused on the following:

- Monitoring asset quality and credit risk in the loan and investment portfolios, with an emphasis on reducing nonperforming assets and originating high-quality commercial and consumer loans.

- Being active in the local community, particularly through our efforts with local schools, to uphold our high standing in our community and marketing to our next generation of customers.

- Improving profitability by expanding our product offerings to customers and investing in technology to increase the productivity and efficiency of our staff.

- Continuing to emphasize commercial real estate and other commercial business lending as well as consumer lending. The Bank will also continue to focus on increasing secondary market lending as a source of noninterest income.

- Growing commercial and personal demand deposit accounts which provide a low-cost funding source.

- Evaluating vendor contracts for potential cost savings and efficiencies.

- Continuing our capital management strategy to enhance shareholder value through the repurchase of Company stock and the payment of dividends.

Evaluating growth opportunities to expand the Bank s market area and market share through acquisitions of other financial institutions or branches of other institutions.

Ensuring that the Company attracts and retains talented personnel and that an optimal level of performance and customer service is promoted at all levels of the Company.

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Critical Accounting Policies and Estimates

The accounting and reporting policies of the Company comply with accounting principles generally accepted in the United States of America and conform to general practices within the banking industry. The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions. The financial position and results of operations can be affected by these estimates and assumptions, which are integral to understanding reported results. Critical accounting policies are those policies that require management to make assumptions about matters that are highly uncertain at the time an accounting estimate is made; and different estimates that the Company reasonably could have used in the current period, or changes in the accounting estimate that are reasonably likely to occur from period to period, would have a material impact on the Company s financial condition, changes in financial condition or results of operations. Most accounting policies are not considered by management to be critical accounting policies. Several factors are considered in determining whether or not a policy is critical in the preparation of financial statements. These factors include, among other things, whether the estimates are significant to the financial statements, the nature of the estimates, the ability to readily validate the estimates with other information including third parties or available prices, and sensitivity of the estimates to changes in economic conditions and whether alternative accounting methods may be utilized under generally accepted accounting principles.

Significant accounting policies, including the impact of recent accounting pronouncements, are discussed in Note 1 of the accompanying Notes to Consolidated Financial Statements. Those policies considered to be critical accounting policies are described below.

Allowances for Loan Losses. The allowance for loan losses is the amount estimated by management as necessary to cover losses inherent in the loan portfolio at the balance sheet date. The allowance is established through the provision for loan losses, which is charged to income. Determining the amount of the allowance for loan losses necessarily involves a high degree of judgment. Among the material estimates required to establish the allowance are: loss exposure at default; the amount and timing of future cash flows on impacted 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. Management reviews the level of the allowance at least quarterly and establishes the provision for loan losses based upon an evaluation of the portfolio, past loss experience, current economic conditions and other factors related to the collectability of the loan portfolio. 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 economic or other conditions differ substantially from the assumptions used in making the evaluation. In addition, the OCC, as an integral part of its examination process, periodically reviews our allowance for loan losses and may require us to recognize adjustments to the allowance based on its judgments about information available to it at the time of its examination. A large loss could deplete the allowance and require increased provisions to replenish the allowance, which would adversely affect earnings. Note 1 and Note 4 of the accompanying Notes to Consolidated Financial Statements describe the methodology used to determine the allowance for loan losses as well as changes to the methodology for determining the allowance for loan losses during the year ended December 31, 2013.

Valuation Methodologies. In the ordinary course of business, management applies various valuation methodologies to assets and liabilities that often involve a significant degree of judgment, particularly when active markets do not exist for the items being valued. Generally, in evaluating various assets for potential impairment, management compares the fair value to the carrying value. Quoted market prices are referred to when estimating fair values for certain assets, such as certain investment securities. For investment securities for which quoted market prices are not available, the Company obtains fair value measurements from an independent pricing service. However, for those items for which market-based prices do not exist and an independent pricing service is not readily available, management utilizes significant estimates and assumptions to value such items. Examples of these items include goodwill and other

intangible assets, foreclosed and other repossessed assets, impaired loans, stock-based compensation and certain other financial investments. The use of different assumptions could produce significantly different results, which could have material positive or negative effects on the Company s results of operations. Note 20 and Note 21 of the accompanying Notes to Consolidated Financial Statements describe the methodologies used to determine the fair value of investment securities, impaired loans, foreclosed real estate and other assets. There were no changes in the valuation techniques and related inputs used during the year ended December 31, 2013.

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Results of Operations for the Year Ended December 31, 2013 Compared to the Year Ended December 31, 2012

Net Income. Net income attributable to the Company was $5.1 million ($1.82 per share diluted; weighted average common shares outstanding of 2,784,690, as adjusted) for the year ended December 31, 2013 compared to $3.9 million ($1.41 per share diluted; weighted average common shares outstanding of 2,785,286, as adjusted) for the year ended December 31, 2012.

Net Interest Income. Net interest income increased $423,000, or 2.6%, from $16.3 million for 2012 to $16.8 million for 2013 primarily due to an increase in the interest rate spread, the difference between the average tax-equivalent yield on interest-earning assets and the average cost of interest-bearing liabilities.

Total interest income decreased 2.1% from $18.8 million for 2012 to $18.4 million for 2013. This decrease was primarily a result of the average tax-equivalent yield on interest-earning assets decreasing from 4.59% for 2012 to 4.46% for 2013 partially offset by an increase in the average balance of interest-earning assets from $421.8 million for 2012 to $426.6 million for 2013. Interest on loans decreased $172,000 as a result of the average tax-equivalent yield on loans decreasing from 5.70% for 2012 to 5.50% for 2013 partially offset by the average balance of loans increasing from $281.4 million for 2012 to $288.9 million for 2013. Interest on investment securities (including Federal Home Loan Bank stock) decreased $231,000 for 2013 compared to 2012 due to decreases in the average tax-equivalent yield of investment securities from 2.73% for 2012 to 2.64% for 2013 and the average balance of investment securities from $118.4 million for 2012 to $116.5 million for 2013. Management continued to focus loan origination efforts on commercial and consumer loans during 2013. Market interest rates remained at near historic lows throughout 2013, so as loans and investment securities mature or pay down they are replaced with lower yielding new loan originations and investment purchases.

Total interest expense decreased $812,000, from $2.5 million for 2012 to $1.7 million for 2013, due to a decrease in the average cost of funds from 0.73% for 2012 to 0.48% for 2013, partially offset by an increase in the average balance of interest-bearing liabilities from $339.1 million for 2012 to $342.9 million for 2013. Interest expense on deposits decreased 27.8% from $2.0 million for 2012 to $1.5 million for 2013 as a result of a decrease in the average cost of interest-bearing deposits, which decreased from 0.64% for 2012 to 0.45% for 2013 partially offset by an increase in the average balance of interest-bearing deposits from $318.7 million for 2012 to $327.7 million for 2013. Interest expense on Federal Home Loan Bank advances decreased 60.9% from $386,000 for 2012 to $151,000 for 2013. The average cost of Federal Home Loan Bank advances decreased from 3.75% for 2012 to 3.65% for 2013, and the average balance of Federal Home Loan Bank advances decreased from $10.3 million for 2012 to $4.2 million for 2013, due to scheduled advance maturities. For further information, see *Average Balance Sheets* below. The changes in interest income and interest expense resulting from changes in volume and changes in rates for 2013 and 2012 are shown in the schedule captioned *Rate/Volume Analysis* included herein.

Provision for Loan Losses. The provision for loan losses was $725,000 for 2013 compared to $1.5 million for 2012. The consistent application of management s allowance methodology resulted in a decrease in the provision for loan losses for 2013 compared to the prior year primarily due to a decrease in net charge-offs and a decrease in nonperforming loans. Net charge-offs decreased when comparing the two periods, from $971,000 for 2012 to $539,000 for 2013, and nonperforming loans decreased from $7.9 million at December 31, 2012 to $5.3 million at December 31, 2013. The provisions were recorded to bring the allowance to the level determined in applying the allowance methodology after reduction for net charge-offs during the year and to allow for inherent loss exposure due to weakened general economic conditions such as depreciating collateral values, job losses and continued pressures on household budgets in the Bank s market area.

Provisions for loan losses are charges to earnings to maintain the total allowance for loan losses at a level considered reasonable by management to provide for probable known and inherent loan losses based on management s evaluation of the collectability of the loan portfolio, including the nature of the portfolio, credit concentrations, trends in historical loss experience, specified impaired loans and economic conditions. Although management uses the best information available, future adjustments to the allowance may be necessary due to changes in economic, operating, regulatory and other conditions that may be beyond the Bank s control. While the Bank maintains the allowance for loan losses at a level that it considers adequate to provide for estimated losses, there can be no assurance that further additions will not be made to the allowance for loan losses and that actual losses will not exceed the estimated amounts.

Noninterest income. Noninterest income increased $103,000 to $4.6 million for 2013 compared to $4.5 million for 2012. Service charges on deposit accounts and commission income increased by $158,000 and $135,000, respectively, when comparing the two periods. These increases were partially offset by a $203,000 decrease in gains on the sale of loans primarily due to a decrease in sales activity during the quarter ended December 31, 2013 as a result of higher interest rates.

Noninterest expense. Noninterest expense decreased $522,000, or 3.8%, to $13.3 million for 2013 compared to $13.9 million for 2012. The decrease was primarily due to a decrease of $764,000 in compensation and benefits expenses. This decrease was primarily due to the Bank s voluntary early retirement program which resulted in a pre-tax charge to earnings of $693,000 during the quarter ended September 30, 2012. The decrease in compensation and benefits expenses was partially offset by a $134,000 increase in data processing expenses primarily due to higher costs associated with alternative customer delivery channels.

Income tax expense. The Company recognized income tax expense of $2.3 million (effective tax rate of 30.7%) for 2013, compared to $1.6 million (effective tax rate of 28.4%) for 2012. The increase in income tax expense and the effective tax rate for 2013 is primarily due to a decrease in tax exempt income as a percentage of total income.

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Average Balances and Yields. The following table sets forth certain information for the periods indicated regarding average balances of assets and liabilities, as well as the total dollar amounts of interest income from average interest-earnings assets and interest expense on average interest-bearing liabilities and average yields and costs. Such yields and costs for the periods indicated are derived by dividing income or expense by the average historical cost balances of assets or liabilities, respectively, for the periods presented and do not give effect to changes in fair value that are included as a separate component of stockholders equity. Average balances are derived from daily balances. Tax-exempt income on loans and investment securities has been adjusted to a tax equivalent basis using the federal marginal tax rate of 34%.

	Year Ended December 31,								
	2013			2012			2011		
(Dollars in thousands)	Average Balance	Interest	Average Yield/ Cost	Average Balance	Interest	Average Yield/ Cost	Average Balance	Interest	Average Yield/ Cost
Interest-earning assets:									
Loans (1) (2):									
Taxable (3)	$ 286,514	$ 15,748	5.50%	$ 278,874	$ 15,916	5.71%	$ 290,527	$ 17,124	5.89%
Tax-exempt	2,382	129	5.42%	2,501	135	5.40%	1,533	84	5.48%
Total loans	288,896	15,877	5.50%	281,375	16,051	5.70%	292,060	17,208	5.89%
Investment securities:									
Taxable (3)	83,876	1,392	1.66%	92,980	1,771	1.90%	81,085	2,017	2.49%
Tax-exempt	32,654	1,689	5.17%	25,417	1,464	5.76%	26,585	1,574	5.92%
Total investment securities	116,530	3,081	2.64%	118,397	3,235	2.73%	107,670	3,591	3.34%
Federal funds sold and interest-bearing deposits with banks	21,198	72	0.34%	21,998	58	0.26%	12,466	38	0.30%
Total interest-earning assets	426,624	19,030	4.46%	421,770	19,344	4.59%	412,196	20,837	5.06%
Noninterest-earning assets	28,959			31,953			31,596		
Total assets	$ 455,583			$ 453,723			$ 443,792		
Interest-bearing liabilities:									
Interest-bearing demand deposits	$ 168,774	$ 412	0.24%	$ 156,704	$ 487	0.31%	$ 157,667	$ 842	0.53%
Savings accounts	65,587	65	0.10%	55,369	61	0.11%	46,234	90	0.19%
Time deposits	93,375	997	1.07%	106,625	1,493	1.40%	119,359	2,184	1.83%

Total deposits	327,736	1,474	0.45%	318,698	2,041	0.64%	323,260	3,116	0.96%
Retail repurchase agreements	11,015	28	0.25%	10,074	38	0.38%	9,174	59	0.64%
FHLB advances	4,135	151	3.65%	10,287	386	3.75%	14,557	585	4.02%
Total interest-bearing liabilities	342,886	1,653	0.48%	339,059	2,465	0.73%	346,991	3,760	1.08%
Noninterest-bearing liabilities:									
Noninterest-bearing deposits	58,167			60,509			46,001		
Other liabilities	1,462			2,169			1,422		
Total liabilities	402,515			401,737			394,414		
Stockholders equity	53,068			51,986			49,378		
Total liabilities and stockholders equity (4)	$ 455,583			$ 453,723			$ 443,792		
Net interest income		$ 17,377			$ 16,879			$ 17,077	
Interest rate spread			3.98%			3.86%			3.98%
Net interest margin			4.07%			4.00%			4.14%
Ratio of average interest earning assets to average interest-bearing liabilities			124.42%			124.39%			118.79%

(1) Interest income on loans includes fee income of $754,000, $654,000 and $662,000 for the years ended December 31, 2013, 2012, and 2011, respectively.
(2) Average loan balances include loans held for sale and nonperforming loans.
(3) Includes taxable debt and equity securities and Federal Home Loan Bank Stock.
(4) Stockholders equity attributable to First Capital, Inc.

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Rate/Volume Analysis. The following table sets forth the effects of changing rates and volumes on net interest income and interest expense computed on a tax-equivalent basis. Information is provided with respect to (i) effects on interest income attributable to changes in volume (changes in volume multiplied by prior rate); (ii) effects attributable to changes in rate (changes in rate multiplied by prior volume); and (iii) effects attributable to changes in rate and volume (change in rate multiplied by changes in volume). Tax exempt income on loans and investment securities has been adjusted to a tax-equivalent basis using the federal marginal tax rate of 34%.

	2013 Compared to 2012 Increase (Decrease) Due to				2012 Compared to 2011 Increase (Decrease) Due to			
	Rate	Volume	Rate/ Volume	Net	Rate	Volume	Rate/ Volume	Net
	(In thousands)							
Interest-earning assets:								
Loans:								
Taxable	$ (587)	$ 435	$ (16)	$ (168)	$ (533)	$ (696)	$ 21	$ (1,208)
Tax-exempt	1	(7)	0	(6)	(1)	53	(1)	51
Total loans	(586)	428	(16)	(174)	(534)	(643)	20	(1,157)
Investment securities:								
Taxable	(226)	(175)	22	(379)	(476)	300	(70)	(246)
Tax-exempt	(150)	418	(43)	225	(43)	(69)	2	(110)
Total investment securities	(376)	243	(21)	(154)	(519)	231	(68)	(356)
Federal funds sold and interest-bearing deposits with banks	17	(2)	(1)	14	(5)	29	(4)	20
Total net change in income on interest- earning assets	(945)	669	(38)	(314)	(1,058)	(383)	(52)	(1,493)
Interest-bearing liabilities:								
Interest-bearing deposits	(608)	58	(17)	(567)	(1,044)	(46)	15	(1,075)
Retail repurchase agreements	(13)	4	(1)	(10)	(25)	6	(2)	(21)
FHLB advances	(10)	(231)	6	(235)	(39)	(172)	12	(199)
Total net change in expense on interest- bearing liabilities	(631)	(169)	(12)	(812)	(1,108)	(212)	25	(1,295)
Net change in net interest income	$ (314)	$ 838	$ (26)	$ 498	$ 50	$ (171)	$ (77)	$ (198)

Comparison of Financial Condition at December 31, 2013 and 2012

Total assets decreased 3.2% from $459.1 million at December 31, 2012 to $444.4 million at December 31, 2013 primarily due to decreases in securities available for sale and cash and cash equivalents partially offset by an increase in net loans receivable.

Net loans increased 2.9% from $280.4 million at December 31, 2012 to $288.5 million at December 31, 2013. The primary contributing factor to the increase in net loans was an increase of $7.8 million in commercial real estate loans. This was partially offset by decreases of $2.1 million in home equity and second mortgage loans and $1.1 million in residential mortgage loans as the Bank continued to sell the majority of newly originated residential mortgage loans in the secondary market. The Bank originated $36.7 million in new residential mortgages for sale in the secondary market during 2013 compared to $42.7 million in 2012. These loans were originated and funded by the Bank and sold in the secondary market. Of this total, $9.9 million paid off existing loans in the Bank s portfolio. Originating mortgage loans for sale in the secondary market allows the Bank to better manage its interest rate risk, while offering a full line of mortgage products to prospective customers. In addition to commercial mortgage loans, commercial business loans and other consumer loans also increased by $3.3 million and $2.3 million, respectively, during 2013.

Securities available for sale, at fair value, consisting primarily of U. S. agency mortgage-backed obligations, U. S. agency notes and bonds, and municipal obligations, decreased $14.2 million, from $123.0 million at December 31, 2012 to $108.8 million at December 31, 2013. Purchases of securities available for sale totaled $25.9 million in 2013. These purchases were offset by maturities of $22.2 million, principal repayments of $12.7 million and sales of $517,000. The Bank invests excess cash in securities that provide safety, liquidity and yield. Accordingly, we purchase mortgage-backed securities to provide cash flow for loan demand and deposit changes, we purchase federal agency notes for short-term yield and low risk, and municipals are purchased to improve our tax equivalent yield focusing on longer term profitability.

Cash and cash equivalents decreased from $21.8 million at December 31, 2012 to $11.1 million at December 31, 2013. The decrease is due primarily to a decrease in federal funds sold as a result of decreases in deposit accounts during 2013 and the investment of excess liquidity in interest-bearing time deposits with other financial institutions which increased by $3.0 million during 2013.

Total deposits decreased 2.7%, from $384.3 million at December 31, 2012 to $373.8 million at December 31, 2013. Time deposits decreased $13.5 million during 2013 as some customers are unwilling to lock into long-term commitments while interest rates are at their current low levels. Interest-bearing demand deposits decreased $3.8 million during 2013 primarily due to normal fluctuations in the balance of operating accounts of public entities, such as counties, cities and school corporations. Savings accounts increased $7.0 million during 2013.

Federal Home Loan Bank borrowings increased $400,000 from $5.1 million at December 31, 2012 to $5.5 million at December 31, 2013. New advances of $5.5 million were drawn during the year while principal payments on advances totaled $5.1 million during 2013.

Retail repurchase agreements, which represent overnight borrowings from business and local municipal deposit customers, decreased from $14.1 million at December 31, 2012 to $9.3 million at December 31, 2013, primarily due to normal balance fluctuations.

Total stockholders equity attributable to the Company increased from $52.8 million at December 31, 2012 to $53.2 million at December 31, 2013. This increase is primarily the result of retained net income of $2.8 million, partially offset by a net unrealized loss on available for sale securities of $2.4 million. During 2013, the Company repurchased

909 shares of its stock at a weighted average price of $20.78 per share. As of December 31, 2013, the Company had repurchased 51,794 shares of the 240,467 shares authorized by the Board of Directors under the current stock repurchase program which was announced in August 2008 and 380,328 shares since the original repurchase program began in 2001.

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Off-Balance-Sheet Arrangements

The Company is a party to financial instruments with off-balance-sheet risk including commitments to extend credit under existing lines of credit and commitments to originate loans. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated financial statements.

Off-balance-sheet financial instruments whose contract amounts represent credit and interest rate risk are summarized as follows:

	At December 31,	
	2013	2012
	(In thousands)	
Commitments to originate new loans	$ 6,318	$ 13,194
Undisbursed portion of construction loans	7,142	4,306
Unfunded commitments to extend credit under existing commercial and personal lines of credit	44,285	38,480
Standby letters of credit	1,184	781

The Company does not have any special purpose entities, derivative financial instruments or other forms of off-balance-sheet financing arrangements.

Commitments to originate new loans or to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Most equity line commitments are for a term of five to 10 years and commercial lines of credit are generally renewable on an annual basis. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer s creditworthiness on a case-by-case basis. The amounts of collateral obtained, if deemed necessary by the Company upon extension of credit, are based on management s credit evaluation of the borrower.

Contractual Obligations

The following table summarizes information regarding the Company s contractual obligations as of December 31, 2013:

		Payments due by period			
	Total	Less than 1 Year	1 3 Years	3 5 Years	More than 5 Years
		(In thousands)			
Deposits	$ 373,830	$ 328,777	$ 33,942	$ 11,111	$ 0
Federal Home Loan Bank advances	5,500	5,500	0	0	0
Retail repurchase agreements	9,310	9,310	0	0	0
Operating lease obligations	19	15	4	0	0
Total contractual obligations	$ 388,659	$ 343,602	$ 33,946	$ 11,111	$ 0

Liquidity and Capital Resources

Liquidity refers to the ability of a financial institution to generate sufficient cash flow to fund current loan demand, meet deposit withdrawals and pay operating expenses. The Bank s primary sources of funds are new deposits, proceeds from loan repayments and prepayments and proceeds from the maturity of securities. The Bank may also borrow from the Federal Home Loan Bank of Indianapolis. While loan repayments and maturities of securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by market interest rates, general economic conditions and competition. At December 31, 2013, the Bank had cash and interest-bearing deposits with banks of $15.6 million and securities available for sale with a fair value of $108.8 million. If the Bank requires funds beyond its ability to generate them internally, it has additional borrowing capacity with the Federal Home Loan Bank of Indianapolis and collateral eligible for repurchase agreements.

The Bank must maintain an adequate level of liquidity to ensure the availability of sufficient funds to support loan growth and deposit withdrawals, to satisfy financial commitments and to take advantage of investment opportunities. At December 31, 2013, the Bank had total commitments to extend credit of $58.9 million. See Note 16 in the accompanying Notes to Consolidated Financial Statements. At December 31, 2013, the Bank had certificates of deposit scheduled to mature within one year of $42.2 million. Historically, the Bank has been able to retain a significant amount of its deposits as they mature.

The Company is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, the Company requires funds to pay any dividends to its shareholders and to repurchase any shares of its common stock. The Company s primary source of income is dividends received from the Bank. The amount of dividends the Bank may declare and pay to the Company in any calendar year, without the receipt of prior approval from the OCC but with prior notice to the OCC, cannot exceed net income for that year to date plus retained net income (as defined) for the preceding two calendar years. At December 31, 2013, the Company (on an unconsolidated basis) had liquid assets of $132,000.

The Bank is required to maintain specific amounts of capital pursuant to OCC regulations. As of December 31, 2013 the Bank was in compliance with all regulatory capital requirements which were effective as of such date with tangible capital to adjusted total assets, Tier I capital to risk-weighted assets and risk-based capital to risk-weighted assets ratios of 10.9%, 14.9% and 16.1%, respectively. See Note 19 in the accompanying Notes to Consolidated Financial Statements.

Effect of Inflation and Changing Prices

The consolidated financial statements and related financial data presented in this report have been prepared in accordance with generally accepted accounting principles in the United States of America, which generally require the measurement of financial position and operating results in terms of historical dollars, without considering the changes in relative purchasing power of money over time due to inflation. The primary impact of inflation is reflected in the increased cost of the Bank s operations. Unlike most industrial companies, virtually all the assets and liabilities of the financial institution are monetary in nature. As a result, interest rates generally have a more significant impact on the financial institution s performance than do general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

Market Risk Analysis

Qualitative Aspects of Market Risk. Market risk is the risk that the estimated fair value of our assets an d liabilities will decline as a result of changes in interest rates or financial market volatility, or that our net income will be

significantly reduced by interest rate changes.

The Company s principal financial objective is to achieve long-term profitability while reducing its exposure to fluctuating market interest rates by operating within acceptable limits established for interest rate risk and maintaining adequate levels of funding and liquidity. The Company has sought to reduce the exposure of its earnings to changes in market interest rates by attempting to manage the mismatch between asset and liability maturities and interest rates. In order to reduce the exposure to interest rate fluctuations, the Company has developed strategies to manage its liquidity, shorten its effective maturities of certain interest-earning assets and decrease the interest rate sensitivity of its asset base. Management has sought to decrease the average maturity of its assets by emphasizing the origination of short-term commercial and consumer loans, all of which are retained by the Company for its portfolio. The Company relies on retail deposits as its primary source of funds. Management believes the use of retail deposits, compared to brokered deposits, reduces the effects of interest rate fluctuations because they generally represent a more stable source of funds.

Quantitative Aspects of Market Risk. The Company does not maintain a trading account for any class of financial instrument nor does the Company engage in hedging activities or purchase high-risk derivative instruments. Furthermore, the Company is not subject to foreign currency exchange rate risk or commodity price risk.

Potential cash flows, sales, or replacement value of many of our assets and liabilities, especially those that earn or pay interest, are sensitive to changes in the general level of interest rates. This interest rate risk arises primarily from our normal business activities of gathering deposits, extending loans and investing in investment securities. Many factors affect the Company s exposure to changes in interest rates, such as general economic and financial conditions, customer preferences, historical pricing relationships, and re-pricing characteristics of financial instruments. The Company s earnings can also be affected by the monetary and fiscal policies of the U.S. Government and its agencies, particularly the Federal Reserve Board.

An element in the Company s ongoing process is to measure and monitor interest rate risk using a Net Interest Income at Risk simulation to model the interest rate sensitivity of the balance sheet and to quantify the impact of changing interest rates on the Company. The model quantifies the effects of various possible interest rate scenarios on projected net interest income over a one-year horizon. The model assumes a semi-static balance sheet and measures the impact on net interest income relative to a base case scenario of hypothetical changes in interest rates over twelve months and provides no effect given to any steps that management might take to counter the effect of the interest rate movements. The scenarios include prepayment assumptions, changes in the level of interest rates, the shape of the yield curve, and spreads between market interest rates in order to capture the impact from re-pricing, yield curve, option, and basis risks.

Results of the Company s simulation modeling, which assumes an immediate and sustained parallel shift in market interest rates, project that the Company s net interest income could change as follows over a one-year horizon, relative to our base case scenario, based on December 31, 2013 and 2012 financial information.

	At December 31, 2013 One Year Horizon		**At December 31, 2012 One Year Horizon**	
Immediate Change in the Level of Interest Rates	**Dollar Change**	**Percent Change**	**Dollar Change**	**Percent Change**
	(Dollars in thousands)			
300bp	$ (152)	(0.88)%	$ 112	0.70%
200bp	197	1.14	480	2.97

100bp	280	1.62	488	3.02
Static				
(100)bp	(232)	(1.34)	(183)	(1.13)

At December 31, 2013, the Company s simulated exposure to an increase in interest rates shows that an immediate and sustained increase in rates of 1.00% would increase the Company s net interest income by $280,000, or 1.62%, over a one year horizon compared to a flat interest rate scenario. Furthermore, a rate increase of 2.00% and would cause net interest income to increase by 1.14%. Alternatively, an immediate and sustained decrease in rates of 1.00% or an increase of 3.00% would decrease the Company s net interest income by 1.34% or 0.88 %, respectively, over a one year horizon compared to a flat interest rate scenario.

The Company also has longer term interest rate risk exposure, which may not be appropriately measured by Net Interest Income at Risk modeling. Therefore, the Company also uses an Economic Value of Equity (EVE) interest rate sensitivity analysis in order to evaluate the impact of its interest rate risk on earnings and capital. This is measured by computing the changes in net EVE for its cash flows from assets, liabilities and off-balance sheet items in the event of a range of assumed changes in market interest rates. EVE modeling involves discounting present values of all cash flows for on and off balance sheet items under different interest rate scenarios and provides no effect given to any steps that management might take to counter the effect of the interest rate movements. The discounted present value of all cash flows represents the Company s EVE and is equal to the market value of assets minus the market value of liabilities, with adjustments made for off-balance sheet items. The amount of base case EVE and its sensitivity to shifts in interest rates provide a measure of the longer term re-pricing and option risk in the balance sheet.

Results of the Company s simulation modeling, which assumes an immediate and sustained parallel shift in market interest rates, project that the Company s EVE could change as follows, relative to the Company s base case scenario, based on December 31, 2013 and 2012 financial information.

	At December 31, 2013				
Immediate Change	**Economic Value of Equity**			**Economic Value of Equity as a**	
in the Level	**Dollar**	**Dollar**	**Percent**	**Percent of Present Value of Assets**	
of Interest Rates	**Amount**	**Change**	**Change**	**EVE Ratio**	**Change**
	(Dollars in thousands)				
300bp	$ 44,399	$ (15,949)	(26.43)%	11.01%	(271)bp
200bp	51,134	(9,214)	(15.27)	12.31	(141)bp
100bp	56,380	(3,968)	(6.57)	13.19	(53)bp
Static	60,348			13.72	bp
(100)bp	64,329	3,981	6.60	14.22	50 bp

	At December 31, 2012				
Immediate Change	**Economic Value of Equity**			**Economic Value of Equity as a**	
in the Level	**Dollar**	**Dollar**	**Percent**	**Percent of Present Value of Assets**	
of Interest Rates	**Amount**	**Change**	**Change**	**EVE Ratio**	**Change**
	(Dollars in thousands)				
300bp	$ 50,786	$ (13,193)	(20.62)%	11.73%	(193)bp
200bp	56,976	(7,003)	(10.95)	12.81	(85)bp
100bp	61,694	(2,285)	(3.57)	13.51	(15)bp
Static	63,979			13.66	bp
(100)bp	66,799	2,820	4.41	13.92	26 bp

The previous table indicates that at December 31, 2013, the Company would expect a decrease in its EVE in the event of a sudden and sustained 100 to 300 basis point increase in prevailing interest rates, and would expect an increase in its EVE in the event of a sudden and sustained 100 basis point decrease in prevailing interest rates.

The models are driven by expected behavior in various interest rate scenarios and many factors besides market interest rates affect the Company s net interest income and EVE. For this reason, the Company models many different combinations of interest rates and balance sheet assumptions to understand its overall sensitivity to market interest rate changes. Therefore, as with any method of measuring interest rate risk, certain shortcomings are inherent in the method of analysis presented in the foregoing tables and it is recognized that the model outputs are not guarantees of actual results. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets, such as adjustable-rate mortgage loans, have features that restrict changes in interest rates on a short-term basis and over the life of the asset. Further, in the event of a change in interest rates, expected rates of prepayments on loans and early withdrawals from certificates of deposit could deviate significantly from those assumed in the modeling scenarios.

Impact of Recent Accounting Pronouncements

For a discussion of the impact of recent accounting pronouncements, see Note 1 of the accompanying Notes to Consolidated Financial Statements.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information required by this item is incorporated herein by reference to the section captioned *Management s Discussion and Analysis of Financial Condition and Results of Operations* in this Annual Report on Form 10-K.

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The financial statements required by this item begin on page F-1.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures

The Company s management, including the Company s principal executive officer and principal financial officer, have evaluated the effectiveness of the Company s disclosure controls and procedures, as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act). Based upon their evaluation, the principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, the Company s disclosure controls and procedures were effective for the purpose of ensuring that the information required to be disclosed in the reports that the Company files or submits under the Exchange Act with the Securities and Exchange Commission (the SEC): (1) is recorded, processed, summarized and reported within the time periods specified in the SEC s rules and forms, and (2) is accumulated and communicated to the Company s

management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

Internal Control Over Financial Reporting

The management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. The internal control process has been designed under our supervision to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company s financial statements for external reporting purposes in accordance with accounting principles generally accepted in the United States of America.