

Simplicity Bancorp, Inc.
Form 10-K
September 10, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) of
THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended: June 30, 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: 001-34979

SIMPLICITY BANCORP, INC.

(Exact name of registrant as specified in its charter)

Maryland
(State or other jurisdiction of incorporation)

1359 N. Grand Avenue, Covina, CA
(Address of principal executive offices)

26-1500698
(I.R.S. Employer Identification No.)

91724
(Zip Code)

(800) 524-2274

(Registrant's telephone number, including area code)

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

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Title of each class	Name of exchange on which registered
<u>Common Stock, \$.01 par value per share</u>	<u>The NASDAQ Stock Market LLC</u>

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

None.

Indicated by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act

Yes No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes No

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

Yes No

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

Yes No

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller Reporting Company

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

The aggregate market value of the voting stock held by non-affiliates of the Registrant, based on the closing sales price of the Registrant's common stock as of December 30, 2012 was \$116.7 million. There were 8,061,840 shares of the registrant's common stock, \$.01 par value per share, outstanding at September 6, 2013.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive Proxy Statement for the fiscal 2013 Annual Meeting of Shareholders ("Proxy Statement") are incorporated by reference into Part III.

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Part I.

SPECIAL NOTE ABOUT FORWARD-LOOKING STATEMENTS

Certain statements in this report, other than purely historical information, including estimates, projections, statements relating to our business plans, objectives and expected operating results, and the assumptions upon which those statements are based, are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995, Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements generally are identified by the words believe, expect, intend, anticipate, estimate, project, strategy, plan, or future conditional verbs such as will, should, could, or may and similar expressions or the negative of these words. Forward-looking statements are based on current expectations and assumptions that are subject to risks and uncertainties which may cause actual results to differ materially from the forward-looking statements. A detailed discussion of these and other risks and uncertainties that could cause actual results and events to differ materially from such forward-looking statements is included in the section entitled Risk Factors in Item 1A of this report. We undertake no obligation to update or revise publicly any forward-looking statements, whether as a result of new information, future events or otherwise. Accordingly, there can be no assurance that our expectations will be realized.

Item 1. Business.

General

Simplicity Bancorp, Inc. (the Company) is a Maryland corporation that owns all of the outstanding common stock of Simplicity Bank (the Bank). In November 2012, the Company changed its name to Simplicity Bancorp, Inc. from Kaiser Federal Financial Group, Inc. and its trading symbol to SMPL. Concurrently, the Bank was renamed Simplicity Bank from Kaiser Federal Bank as part of a broader business strategy to operate as a community bank serving the financial needs of all customers within its communities. On November 19, 2010, the Company became the successor to K-Fed Bancorp as it completed the conversion from the mutual holding company structure to a fully public stock holding company form of organization and related public offering. The Company sold a total of 6,375,000 shares of common stock in the offering at a purchase price of \$10.00 per share. The offering raised capital of \$59.1 million, which was net of costs of \$4.7 million. Concurrent with the completion of the offering, shares of K-Fed Bancorp common stock owned by public stockholders were exchanged for 0.7194 of a share of the Company's common stock. All share and per share information in this annual report for years prior to the conversion has been revised to reflect the 0.7194:1 conversion ratio on shares outstanding, including shares of the former mutual holding company that were not publically traded.

The Company's business activities generally are limited to passive investment activities and oversight of its investment in the Bank. Unless the context otherwise requires, all references to the Company include the Bank and the Company on a consolidated basis, and prior to November 19, 2010, the Company refers to K-Fed Bancorp and the Bank on a consolidated basis.

At June 30, 2013, the Company had consolidated assets of \$867.4 million, deposits of \$654.6 million and stockholders' equity of \$145.4 million. The Company does not maintain offices separate from those of the Bank or utilize persons other than certain Bank officers. Our executive offices are located at 1359 North Grand Avenue, Covina, California 91724 and our telephone number is (800) 524-2274.

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The Bank is a community oriented financial institution offering a variety of financial services to meet the needs of the communities it serves. The Bank is headquartered in Covina, California, with branches in Glendora, Downey, Harbor City, Los Angeles, Panorama City and Pasadena to serve Los Angeles County and a financial service center in Fontana to serve San Bernardino county. Financial service centers in Riverside and Santa Clara California were closed in fiscal 2013 in order to focus our strategic efforts and resources in retail markets that allow us to compete more effectively. There was not a material impact to the Consolidated Financial Statements due to these closures. Financial service centers provide all of the services as our full service branches except they do not disburse cash; however, there is an on-site Automated Teller Machine (ATM) that dispenses cash. We have a network of 58 ATMs located in Southern California and the San Francisco Metropolitan Area, primarily located within Kaiser Permanente Medical Centers and office buildings.

We began operations as a credit union in 1953 initially serving the employees of the Kaiser Foundation Hospital in Los Angeles, California. As the Kaiser Permanente Medical Care Program evolved so did the credit union, and in 1972, it changed its name to Kaiser Permanente Federal Credit Union. The credit union grew to primarily serve Kaiser Permanente employees and physicians who worked or lived in California. However, as a credit union, the credit union was legally restricted to serve only individuals who shared a common bond such as a common employer.

After receiving the necessary regulatory and membership approvals, on November 1, 1999, Kaiser Permanente Federal Credit Union converted to a federal mutual savings bank known as Kaiser Federal Bank which served the general public as well as Kaiser Permanente employees. Kaiser Federal Bank reorganized into the mutual holding company structure in 2003 and became the wholly owned subsidiary of K-Fed Bancorp. On March 30, 2004, K-Fed Bancorp completed a minority stock offering where it sold approximately 39% of its shares to the public. In November 2010, the Company completed the second step conversion and offering and the Bank became the wholly owned subsidiary of Kaiser Federal Financial Group, Inc.

Effective November 13, 2012, the Bank was renamed Simplicity Bank. In addition, the Company changed its name to Simplicity Bancorp, Inc. This new name aligns well with the core principles the Bank was founded upon to provide value, personal service and financial well being for its customers and communities. As Simplicity Bank, we will continue this legacy as the Bank grows and simplifies the banking experience for its customers with more options, better technology, enhanced service capacity, a fresh look and a renewed vision. In conjunction with the name change, the Bank launched an extensive branding campaign which includes signage, branch remodeling, and advertising. The integrated campaign will help to align our new name with our commitment to deliver exceptional service and convenience to our customers and the communities we serve. Under our new name, we continue to serve Kaiser Permanente employees and their family members, but will be better positioned to serve the needs of all customers within our market footprint.

Simplicity Bank's principal business activity consists of attracting retail deposits from the general public and originating or purchasing primarily loans secured by first mortgages on owner-occupied one-to-four family residences and multi-family residences located in its market area and, to a lesser extent, commercial real estate, automobile and other consumer loans. We also engage in mortgage banking activities which primarily consists of the origination and sale of fixed rate conforming one-to-four family residential real estate loans in the secondary market with servicing primarily retained. While the Bank originates different types of residential loans, the Bank purchased in fiscal 2012, using its own underwriting standards, a significant number of first mortgages on owner-occupied, one-to-four family residences secured by properties located throughout California. These

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purchases were primarily funded with Federal Home Loan Bank (FHLB) borrowings and deposits. Depending on market conditions and the interest rate environment, we may consider future loan purchases on a case by case basis. Prior to January 2009, we also originated commercial real estate loans. Currently, we consider the origination of commercial real estate loans on a case by case basis based on the borrower's credit qualification and the property offered for collateral. We have not originated any new commercial real estate loans since 2009. Historically, we have not originated, or purchased, commercial business, commercial construction, or residential construction loans and have no current plans to do so.

Our revenues are derived principally from interest on loans and mortgage-backed and related securities. We also generate revenue from sale of loans held for sale, service charges and other income.

We offer a variety of deposit accounts having a wide range of interest rates and terms, which generally include savings accounts, money market accounts, demand deposit accounts and certificate of deposit accounts with varied terms ranging from 90 days to five years. We solicit deposits in our primary market areas of Los Angeles, Orange, San Diego, San Bernardino and Riverside counties, in California.

Available Information

Our Internet address is www.simplicitybancorp.com. We make available free of charge, through our web site, annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K and amendments to those reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after we electronically file such material with, or furnish it to, the Securities and Exchange Commission (the SEC). All SEC filings of the Company are also available at the SEC's website, www.sec.gov.

Market Area

Our success depends primarily on the general economic conditions in the counties of Los Angeles, Orange, San Diego, San Bernardino, Riverside, Santa Clara and Alameda, as nearly all of our loans are to customers in these market areas. There have been positive developments in current economic conditions since the end of the recession. Improving financial conditions, increasing credit availability, accommodative monetary policy, and healthier labor and housing markets all support the economic growth in our market area. According to the Beige Book published by the Federal Reserve Bank in July 2013, overall economic activity continued to increase at a modest pace. In the Twelfth Federal Reserve District (San Francisco), demand for housing strengthened, and commercial real estate activity continued to trend up in most areas. In some areas, the supply of homes for sale remained low, and some properties are receiving multiple offers from prospective buyers.

Lenders continue to face margin compression due to the low interest rate environment, ample liquidity and generally stiff competition over well-qualified borrowers. Future growth opportunities will be influenced by the stability of the regional economy and other trends within California, including unemployment rates and housing market conditions. According to the U.S. Census Bureau, while unemployment rates improved during the year ended June 30, 2013, unemployment rates in California remain high at 8.5% at June 30, 2013 as compared to 10.7% at June 30, 2012 and 11.8% at June 30, 2011. This compares to the national unemployment rates of 7.6% at June 30, 2013, 8.2% at June 30, 2012 and 9.2% at June 30, 2011.

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During the year ended June 30, 2013, there were some positive signs of an improving housing market. The S&P/Case-Shiller U.S. National Home Price Index, which covers all nine U.S. census divisions, recorded a 10.1% gain at June 30, 2013 on a year-over-year basis. This compares to the S&P/Case-Shiller Home Price Index for the Los Angeles Metropolitan Area which experienced a 19.9% gain at June 30, 2013 on a year-over-year basis. According to the U.S. Census Bureau, one-to-four family and multi-family building permits declined significantly in 2008 and 2009, and remained low throughout the years from 2010 to 2012, both nationally and in California. The pace of residential construction continued to show signs of recovery during 2012 and 2013. In California, one-to-four family building permits increased 2.0% in 2010, declined 16.0% in 2011, rose by 29.1% in 2012, and increased 44.5% year-to-date as of June 30, 2013. On a national level, one-to-four family building permits increased 3.0% in 2010 and 2011, trended up 33% in 2012, and continued to rise by 22.0% year-to-date as of June 30, 2013.

Competition

We face strong competition in originating real estate and other loans and in attracting deposits. Competition in originating real estate loans comes primarily from other savings institutions, commercial banks, credit unions and mortgage bankers. Other savings institutions, commercial banks, credit unions and finance companies provide vigorous competition in consumer lending.

We attract all of our deposits through our branch and ATM network. Competition for those deposits is principally from other savings institutions, commercial banks and credit unions, as well as mutual funds and other alternative investments. We compete for these deposits by offering superior service and a variety of deposit accounts at competitive rates. We have less than a 1% market share of deposits in each of the markets in which we compete.

Lending Activities

General. We originate first lien one-to-four family real estate loans throughout our market area to be held for sale and for investment. We consider loan purchases for first lien one-to-four family real estate loans held for investment on a case by case basis based on market conditions and the interest rate environment. Beginning in 2007, we have also focused our efforts on originating multi-family residential loans. Additionally, we originate consumer loans, primarily automobile loans. Prior to January 2009, we also originated commercial real estate loans. Currently, we consider the origination of commercial real estate loans on a case by case basis based on the borrower's credit qualification and the property offered for collateral. We have not originated any new commercial real estate loans since 2009.

Our loans carry either a fixed or an adjustable rate of interest. Loans originated for sale are fixed rate one-to-four family conforming mortgage loans. We do not offer adjustable rate loans where the initial rate is below the otherwise applicable index rate (i.e., teaser rates). Mortgage loans generally have a longer term amortization, with maturities up to 30 years, depending upon the type of property with principal and interest due each month. Consumer loans are generally short term and amortize monthly or have interest payable monthly. We also have loans in our portfolio that only require interest payments on a monthly basis. At June 30, 2013, our net loan portfolio, excluding loans held for sale of \$4.5 million, totaled \$689.7 million, which constituted 79.5% of our total assets. In fiscal 2012, we purchased \$80.9 million in one-to-four family real estate loans. We underwrote each purchased loan in accordance with our underwriting standards with the exception of the \$28.4 million in loans we purchased in the prior year that included a credit guarantee. The majority of the loans we purchased were acquired with servicing retained by the seller. We generally purchased these loans without recourse against the seller.

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At June 30, 2013, the maximum amount we could have loaned to any one borrower and the borrower's related entities under applicable regulations was \$20.7 million, or 15% of our unimpaired capital. At June 30, 2013, we had no loans or group of loans to related borrowers with outstanding balances in excess of this amount. Our five largest lending relationships at June 30, 2013 were as follows:

six loans to an individual and a related party for \$8.5 million secured by six multi-family dwelling properties;

seven loans to an individual for \$7.1 million secured by seven multi-family dwelling properties;

three loans to an individual for \$6.3 million secured by a single tenant retail building, a single tenant supermarket building and a 15 tenant mixed use office building;

three loans to an individual and the related party for \$5.6 million secured by three multi-family dwelling properties; and

four loans to an individual and the related family trust for \$5.3 million secured by four multi-family dwelling properties. All of the loans noted in the above relationships were performing in accordance with their terms as of June 30, 2013.

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The following table presents information concerning the composition of the loan portfolio in dollar amounts and in percentages as of the dates indicated. Loans held for sale of \$4.5 million at June 30, 2013 are not included in the table below. We had no loans held for sale at any of the other dates noted below.

	2013		2012		At June 30, 2011		2010		2009	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Real estate										
One-to-four										
family	\$ 319,631	46.03%	\$ 371,251	48.18%	\$ 282,068	39.87%	\$ 335,631	43.55%	\$ 377,230	50.22%
Multi-family	280,771	40.44	283,553	36.79	287,808	40.69	278,397	36.12	196,575	26.17
Commercial	55,621	8.01	86,964	11.28	107,961	15.26	113,458	14.72	121,143	16.13
Total real estate loans	656,023	94.48	741,768	96.25	677,837	95.82	727,486	94.39	694,948	92.52
Other loans										
Consumer:										
Automobile	26,711	3.85	17,349	2.26	18,008	2.55	29,492	3.83	41,798	5.56
Home equity	682	0.10	808	0.10	940	0.13	1,096	0.14	1,299	0.17
Other	10,917	1.57	10,722	1.39	10,604	1.50	12,672	1.64	13,119	1.75
Total other loans	38,310	5.52	28,879	3.75	29,552	4.18	43,260	5.61	56,216	7.48
Total loans	694,333	100.00%	770,647	100.00%	707,389	100.00%	770,746	100.00%	751,164	100.00%
Less:										
Net deferred loan origination costs	506		615		659		607		376	
Net premium (discount) on purchased loans	512		957		(35)		(59)		(79)	
Allowance for loan losses	(5,643)		(7,502)		(11,367)		(13,309)		(4,586)	
Total loans receivable, net	\$ 689,708		\$ 764,717		\$ 696,646		\$ 757,985		\$ 746,875	

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Loan Maturity. The following schedule illustrates certain information at June 30, 2013 regarding the dollar amount of loans maturing in the portfolio based on their contractual terms-to-maturity, but does not include scheduled payments or potential prepayments. Demand loans, loans having no stated schedule of repayments and no stated maturity are reported as due in one year or less. Loan balances do not include loans held for sale, undisbursed loan proceeds, unearned discounts, unearned income and allowance for loan losses.

	Real Estate		Consumer				Total
	One-to-four family	Multi-family	Commercial	Automobile	Home equity	Other	
At June 30, 2013	(In thousands)						
Within 1 year ⁽¹⁾	\$ 22	\$ 123	\$ 2,764	\$ 451	\$ 12	\$ 3,201	\$ 6,573
After 1 year:							
After 1 year through 3 years	45	114	12,838	4,197	-	2,913	20,107
After 3 years through 5 years	1,863	3,501	29,181	19,387	-	3,391	57,323
After 5 years through 10 years	27,677	38,850	10,838	2,676	-	1,412	81,453
After 10 years through 15 years	33,964	214,380	-	-	-	-	248,344
After 15 years	256,060	23,803	-	-	670	-	280,533
Total due after 1 year	319,609	280,648	52,857	26,260	670	7,716	687,760
Total	\$ 319,631	\$ 280,771	\$ 55,621	\$ 26,711	\$ 682	\$ 10,917	\$ 694,333

(1) Includes demand loans and loans that have no stated maturity.

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The following table sets forth the dollar amount of all loans at June 30, 2013 that are due after June 30, 2014, which have fixed interest rates and adjustable interest rates.

	Fixed	Due after June 30, 2014 Adjustable (In thousands)	Total
Real Estate Loans			
One-to-four family	\$ 234,928	\$ 84,681	\$ 319,609
Multi-family	-	280,648	280,648
Commercial	-	52,857	52,857
Real estate loans	234,928	418,186	653,114
Other Loans			
Consumer			
Automobile	26,260	-	26,260
Home equity	670	-	670
Other loans	7,716	-	7,716
Other loans due	34,646	-	34,646
Total loans	\$ 269,574	\$ 418,186	\$ 687,760

One-to-four Family Residential Lending. At June 30, 2013, our one-to-four family residential mortgage loans totaled \$319.6 million, or 46.0%, of our gross loan portfolio, of which \$318.2 million were first lien one-to-four family residential mortgage loans. We generally underwrite our one-to-four family residential loans based on the applicant's employment, credit history and the appraised value of the subject property. With the exception of the \$28.4 million of loans purchased with a credit guarantee in fiscal 2012, we underwrote each purchased loan based upon our underwriting standards prior to making the purchase. Presently, we lend up to 80% of the lesser of the appraised value or purchase price of the subject property for one-to-four family residential loans without private mortgage insurance (PMI). We also lend up to 97% of the lesser of the appraised value or purchase price of the subject property with PMI. Properties securing our one-to-four family residential loans are appraised by independent state licensed fee appraisers approved by our Credit Committee. We require our borrowers to obtain title and hazard insurance, and flood insurance, if necessary, in an amount not less than the value of the property improvements.

We currently originate one-to-four family mortgage loans on a fixed rate and adjustable rate basis. Our pricing strategy for mortgage loans includes setting interest rates that are competitive with other local financial institutions and consistent with our internal needs. Adjustable rate loans are tied to indices based on the one year London Inter Bank Offering Rate and U.S. Treasury securities adjusted to a constant maturity of one year. A majority of our adjustable rate loans carry an initial fixed rate of interest for either three or five years which then converts to an interest rate that is adjusted annually based upon the applicable index. Our one-to-four family residential mortgage loans are structured with a range of 10-year to 30-year maturities and with amortization terms up to the maturity date. All of our one-to-four family residential loans are secured by properties located in California. All of our real estate loans contain a due on sale clause allowing us to declare the unpaid principal balance due and payable upon the sale of the property.

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Adjustable rate one-to-four family mortgage loans generally pose different credit risks than fixed rate one-to-four family mortgage loans, primarily because as interest rates rise, the borrower's payment rises, increasing the potential for default. At June 30, 2013, our one-to-four family adjustable rate mortgage loan portfolio totaled \$84.7 million, or 12.2% of our gross loan portfolio. At that date, the fixed rate one-to-four family mortgage loan portfolio totaled \$234.9 million, or 33.8% of our gross loan portfolio. Included in non-accrual loans at June 30, 2013 were \$1.3 million in adjustable rate one-to-four family mortgage loans and \$9.0 million in fixed rate one-to-four family mortgage loans.

In addition, prior to early 2007 we purchased interest-only one-to-four family residential mortgage loans and loans underwritten based upon stated income. An interest-only loan typically provides for the payment of interest (rather than both principal and interest) for a fixed period of three, five or seven years, thereafter the loan payments adjust to include both principal and interest for the remaining term. One-to-four family interest-only mortgage loans have decreased by \$7.8 million, or 33.5% to \$15.4 million at June 30, 2013 from \$23.2 million at June 30, 2012. A stated income loan is a loan where the borrower's income source is not subject to verification through the application process, but the reasonableness of the stated income is verified through review of other sources, such as compensation surveys. One-to-four family stated income mortgage loans have decreased by \$13.6 million, or 27.5% to \$35.8 million at June 30, 2013 from \$49.4 million at June 30, 2012. As of June 30, 2013, \$23.1 million of stated income mortgage loans were fixed rate loans and \$12.7 million were adjustable rate loans. Included in non-accrual loans at June 30, 2013 were \$5.2 million in one-to-four family loans that were interest-only or stated income loans that were individually evaluated for impairment and carried a valuation allowance of \$184,000. During the year ended June 30, 2013, \$969,000 in interest-only or stated income loans were modified as troubled debt restructurings and included in non-accrual loans. We do not intend to originate or purchase interest-only one-to-four family residential mortgage loans or stated income loans in the future.

The following table describes certain risk characteristics of our one-to-four family nonconforming mortgage loans held for investment as of June 30, 2013 and 2012:

Category	Weighted-Average			
	Outstanding Balance	Credit Score ⁽¹⁾	Weighted Average LTV ⁽²⁾	Weighted-Average Seasoning ⁽³⁾
(Dollars in thousands)				
June 30, 2013				
Interest-only ⁽⁴⁾	\$ 15,431	723	72.48%	6.67 years
Stated income ⁽⁴⁾⁽⁵⁾	35,816	735	69.58	7.98
Credit score less than or equal to 660	17,866	641	69.47	6.64
June 30, 2012				
Interest-only ⁽⁴⁾	\$ 23,209	739	72.75%	5.68 years
Stated income ⁽⁴⁾⁽⁵⁾	49,389	735	68.16	7.01
Credit score less than or equal to 660	21,122	642	71.32	6.17

- (1) The credit score is one factor in determining the credit worthiness of a borrower based on the borrower's credit history. The credit score is as of origination.
- (2) LTV (loan-to-value) is the ratio calculated by dividing the original loan balance by the original appraised value of the real estate collateral.
- (3) Seasoning describes the number of years since the funding date of the loan.
- (4) At June 30, 2013 and 2012 there were \$4.0 million and \$5.4 million in loans that are both stated income and interest-only, respectively.
- (5) Stated income is defined as a borrower provided level of income which is not subject to verification during the loan origination process through the borrower's application, but the reasonableness of the borrower's income is verified through other sources.

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Multi-Family Residential Real Estate Lending. We also offer multi-family residential real estate loans through our staff at the Covina executive office. These loans are secured by real estate located in our primary market areas, within the state of California. We generally originate multi-family residential loans through our loan officers. We generally seek to originate multi-family residential loans with initial principal balances of \$5.0 million or less. At June 30, 2013, multi-family residential loans totaled \$280.8 million, or 40.4%, of our gross loan portfolio, and consisted of 443 loans outstanding with an average loan balance of approximately \$634,000 although we originate loans with balances greater than this average.

Our multi-family residential loans are originated with adjustable interest rates. We use a number of indices to set the interest rate, including a rate based on the constant maturity of one year U.S. Treasury securities. Our adjustable rate loans generally carry an initial fixed rate of interest for one, three, five or seven years which then convert to an interest rate that is adjusted annually based upon the applicable index. Presently, our underwriting guidelines allow us to lend up to 75% of the lesser of the appraised value or purchase price of multi-family residential real estate. These loans require monthly payments, amortize over a period of up to 30 years and have a maximum maturity of 30 years and carry prepayment penalties. We have not purchased multi-family residential real estate loans.

Loans secured by multi-family residential real estate are underwritten based on non-discriminatory underwriting standards and loan origination procedures established by Simplicity Bank's Credit Committee. Loan policies are reviewed annually or more frequently if warranted, and approved by the Credit Committee and/or Simplicity Bank's board of directors. The loan underwriting process is intended to assess the income producing potential of the property and the financial strength of the borrower. We review the borrower's sources of income, cash flow, assets, and credit history. We evaluate the historical and projected income and expenses of the borrower and property. We also evaluate a guarantor when a guarantee is provided as part of the loan. The net operating income, which is the income derived from the operation of the property less all operating expenses, must be sufficient to cover the payments related to the outstanding debt. Appraisals and secondary review appraisals on properties securing multi-family residential loans are performed by independent state licensed fee appraisers approved by our Credit Committee.

Loans secured by multi-family residential properties are generally larger and involve a greater degree of credit risk than one-to-four family residential mortgage loans. Because payments on loans secured by multi-family residential properties are often dependent on the successful operation or management of the properties, repayment of such loans may be subject to adverse conditions in the real estate market or the economy. If the cash flow from the project is reduced, or if leases are not obtained or renewed, the borrower's ability to repay the loan may be impaired. In order to monitor the adequacy of cash flows on income-producing properties, the borrowers are required to provide periodic financial information. Included in non-accrual loans at June 30, 2013 were four multi-family residential real estate loans totaling \$1.5 million, two of which totaling \$633,000 were classified as troubled debt restructurings and are current under the modified terms. See Asset Quality Non-Performing Assets.

Commercial Real Estate Lending. Prior to January 2009, we also originated commercial real estate loans. Currently, we consider the origination of commercial real estate loans on a case by case basis based on the borrower's credit qualification and the property offered for collateral. We have not originated any new commercial real estate loans since 2009. The existing portfolio is secured primarily

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by small retail establishments, small industrial warehouse buildings and small office buildings located in our primary market area, within the state of California, and are both owner and non-owner occupied. These loans were originated through our staff at our Covina executive office. Generally, we have not purchased commercial real estate loans. At June 30, 2013, commercial real estate loans totaled \$55.6 million, or 8.0% of our gross loan portfolio, of which \$13.9 million or 25.0% of this portfolio was to borrowers who occupy the property.

The table below shows the number and outstanding balance by collateral type of our commercial real estate loans at June 30, 2013.

Type of Loan	Number of Loans	Outstanding Balance (In thousands)
Owner occupied	21	\$ 13,893
Non-owner occupied:		
Office	17	15,098
Manufacturing facilities	10	10,252
Retail	8	8,956
Medical office	3	1,668
Other	7	5,754
	45	41,728
Total	66	\$ 55,621

We originated only adjustable rate commercial real estate loans. The interest rate on these loans was tied to either the 1 year CMT, a rate based on the constant maturity of one-year U.S. Treasury securities, or the 12-month MTA, a rate based on the 12-month average of US Treasury Securities. A majority of our adjustable rate loans carry an initial fixed rate of interest for either three, five or seven years which then converts to an interest rate that is adjusted annually based upon the index. Presently, our underwriting guidelines allow us to lend up to 65% of the lesser of the appraised value or purchase price for the commercial real estate. These loans require monthly payments, amortize up to 25 years, have maturities of up to 15 years and carry prepayment penalties.

Loans secured by commercial real estate were underwritten based on the income producing potential of the property, the financial strength of the borrower and any guarantors. The net operating income, which is the income derived from the operation of the property less all operating expenses, must be sufficient to cover the payments related to the outstanding debt. We may require an assignment of rents or leases in order to be assured that the cash flow from the project will be used to repay the debt. All loans required an appraisal and secondary review from two different independent state licensed fee appraisers on our approved appraiser list, which is approved by the Credit Committee.

Loans secured by commercial real estate properties are generally larger and involve a greater degree of credit risk than one-to-four family residential mortgage loans. Because payments on loans secured by commercial real estate properties are often dependent on the successful operation or management of the properties, repayment of such loans may be subject to adverse conditions in the real estate market or the economy. If the cash flow from the project is reduced, or if leases are not obtained or renewed, the borrower's ability to repay the loan may be impaired. In order to monitor the adequacy

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of cash flows on income-producing properties, the borrowers are required to provide periodic financial information. Included in non-accrual loans as of June 30, 2013 were three commercial real estate loans with an aggregate balance of \$4.0 million, one of which with a balance of \$2.5 million was classified as a troubled debt restructuring and is currently in payment default under the modified terms. See Asset Quality Non-Performing Assets.

Consumer Loans. We offer a variety of secured consumer loans, including home equity lines of credit, new and used automobile loans, unsecured loans, and loans secured by savings deposits. Consumer loans generally have shorter terms to maturity, which reduces our exposure to changes in interest rates, and carry higher rates of interest than do one-to-four family residential mortgage loans. At June 30, 2013, our consumer loan portfolio, exclusive of automobile loans, totaled \$11.6 million, or 1.7%, of our gross loan portfolio.

The most significant component of our consumer lending is automobile loans. We originate automobile loans only on a direct basis with the borrower. Loans secured by automobiles totaled \$26.7 million, or 3.9%, of our gross loan portfolio at June 30, 2013. Automobile loans may be written for up to seven years for new automobiles and a maximum of five years for used automobiles and have fixed rates of interest. Loan-to-value ratios for automobile loans are up to 120% of the manufacturer's suggested retail price for new automobiles and up to 120% of retail value on used cars, based on valuation from official used car guides including tax, license, mechanical breakdown insurance, and guaranteed automobile protection.

Each automobile loan requires the borrower to keep the financed vehicle fully insured against loss for damage by fire, theft and collision. Nevertheless, there can be no assurance that each financed vehicle will continue to be covered by physical damage insurance provided by the borrower during the entire term which the related loan is outstanding. In addition, we have the right to force place insurance coverage in the event the required physical damage insurance on an automobile is not maintained by the borrower.

Our primary focus when originating automobile loans is on the ability of the borrower to repay the loan rather than the value of the underlying collateral. The amount financed by us is generally up to the manufacturer's suggested retail price of the financed vehicle plus sales tax, dealer preparation fees, license fees and title fees, plus the cost of service and warranty contracts obtained in connection with the vehicle.

Consumer loans may entail greater risk than do one-to-four family residential mortgage loans, particularly in the case of consumer loans which are secured by rapidly depreciable assets, such as automobiles. In these cases, any repossessed collateral for a defaulted loan may not provide an adequate source of repayment of the outstanding loan balance. As a result, consumer loan collections are dependent on the borrower's continuing financial stability and, thus, are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy.

Loan Approval Procedures and Authority. All multi-family residential and commercial real estate loans require an appraisal and a secondary review appraisal as part of the underwriting process. One-to-four family residential loans require an appraisal and may be subject to a secondary review appraisal. Secured consumer loans require evaluation of collateral. Additionally, any multi-family residential and commercial real estate loan request that results in a total credit exposure to one borrower of over \$500,000 and up to \$1.5 million requires the approval of a senior underwriter. Total

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credit exposure from \$1.5 million up to \$2.5 million requires approval by the Vice President of Income Property, Chief Executive Officer, Chief Financial Officer or Chief Lending Officer; total credit exposure to one borrower of over \$2.5 million and up to \$5.0 million requires the approval by the Chief Executive Officer, Chief Financial Officer or Chief Lending Officer. Any one-to-four family residential loan that results in a total credit exposure to one borrower of over \$1.0 million and up to \$1.5 million requires approval by a real estate lending manager or a Credit Committee member. Any request that results in a total credit exposure to one borrower over \$1.5 million for one-to-four family residential mortgage loans and \$5.0 million for income properties, up to \$10.0 million requires the approval by three Credit Committee members provided one of the three members is the Chief Executive Officer. Loan requests that result in a credit exposure to one borrower over \$10.0 million require the board of directors' approval. All loan approvals granted by the Credit Committee are documented in the meeting minutes and reported to the board of directors.

Loan Originations, Purchases, Sales and Repayments. We originate loans through employees located at our executive office and at certain full service offices. Walk-in customers and referrals from our current customer base, advertisements, real estate brokers and mortgage loan brokers are also important sources of loan originations.

While we originate adjustable rate and fixed rate loans, our ability to originate loans is dependent upon customer demand for loans in our market area. Demand is affected by local competition and the interest rate environment. We did not purchase any loans for the year ended June 30, 2013. For the year ended June 30, 2012, we purchased approximately \$80.9 million of primarily adjustable rate one-to-four family residential mortgage loans, including \$32.6 million of loans with a credit guarantee by the seller that requires any loans 60 days or more delinquent be substituted or repurchased by the seller at the Bank's option. The servicing rights of all purchased loans were generally retained by the sellers. All loans purchased in fiscal 2012 were current at the time of purchase and were not sub-prime loans. The purchased loans with a credit guarantee are seasoned loans with borrowers who have stable employment and properties with generally less than 80% loan-to-value ratio (LTV). Depending on market conditions and the interest rate environment, we may consider future loan purchases on a case by case basis.

In May and November 2012, we successfully obtained the servicing of \$128.5 million in loans previously serviced by two third party servicers. At June 30, 2013, our real estate loan portfolio totaled \$656.0 million or 94.5% of the gross loan portfolio. Purchased real estate loans serviced by others at June 30, 2013 totaled \$44.9 million, or 14.1% of the gross loan portfolio. At June 30, 2012, our real estate loan portfolio totaled \$741.8 million or 96.3% of the gross loan portfolio. Purchased real estate loans serviced by others at June 30, 2012 totaled \$148.0 million, or 19.2% of the gross loan portfolio.

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

	2013	Year ended June 30, 2012 (In thousands)	2011
<u>Originations by type:</u>			
Adjustable rate:			
Real estate- one-to-four family	\$ 8,782	\$ 763	\$ -
-multi-family	73,835	51,873	40,675
-commercial	-	-	-
Non-real estate -other consumer	1,257	1,541	1,724
Total adjustable rate	83,874	54,177	42,399
Fixed rate:			
Real estate- one-to-four family	127,744	96,667	10,771
Non-real estate -consumer automobile	20,359	11,379	4,881
-other consumer	10,070	7,902	4,821
Total fixed rate	158,173	115,948	20,473
Total loans originated	242,047	170,125	62,872
<u>Purchases:</u>			
Adjustable rate:			
Real estate- one-to-four family			