

Kentucky First Federal Bancorp  
Form 10-K  
September 28, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

**Washington, DC 20549**

**FORM 10-K**

*(Mark One)*

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
<sup>x</sup> 1934**

For the fiscal year ended June 30, 2012

**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 **0-51176**

**KENTUCKY FIRST FEDERAL BANCORP**

(Exact name of registrant as specified in its charter)

United States	61-1484858
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

479 Main Street, Hazard, Kentucky	41702
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(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (502) 223-1638

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

Common Stock (par value \$0.01 per share)	The Nasdaq Stock Market, LLC
(Title of each class)	(Name of each exchange on which registered)

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files. Yes ☒ No ☐

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

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

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Large accelerated filer ☐

Accelerated filer ☐

Non-accelerated filer ☐

Smaller Reporting Company ☒

(Do not check if smaller reporting company)

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

Yes ☐ No ☒

The aggregate market value of the common stock held by nonaffiliates was \$21.1 million as of June 30, 2012.

Number of shares of common stock outstanding as of September 17, 2012: 7,539,564

#### **DOCUMENTS INCORPORATED BY REFERENCE**

The following lists the documents incorporated by reference and the Part of the Form 10-K into which the document is incorporated:

1. Portions of the Annual Report to Stockholders for the fiscal year ended June 30, 2012. (Part II)
2. Portions of Proxy Statement for the 2012 Annual Meeting of Stockholders. (Part III)

**INDEX**

	PAGE
PART I	
Item 1. Business	1
Item 1A. Risk Factors	17
Item 1B. Unresolved Staff Comments	21
Item 2. Properties	22
Item 3. Legal Proceedings	22
Item 4. Mine Safety Disclosures	22
PART II	
Item 5. Market for Registrant’s Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	23
Item 6. Selected Financial Data	23
Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operation	23
Item 7A. Quantitative and Qualitative Disclosures About Market Risk	23
Item 8. Financial Statements and Supplementary Data	24
Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	24
Item 9A. Controls and Procedures	24
Item 9B. Other Information	25
PART III	
Item 10. Directors, Executive Officers and Corporate Governance	26
Item 11. Executive Compensation	26
Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	26
Item 13. Certain Relationships and Related Transactions, and Director Independence	27

Item 14.	Principal Accountant Fees and Services	27
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**PART IV**

Item 15.	Exhibits and Financial Statement Schedules	27
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**SIGNATURES**

## PART I

### Item 1. Business

#### Forward-looking Statements

*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 Kentucky First Federal Bancorp’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.*

*Management’s ability to predict results or the effect of future plans or strategies is inherently uncertain. Factors which could affect actual results include the following: interest rate trends; the general economic climate in the market areas in which Kentucky First Federal Bancorp operates, as well as nationwide; Kentucky First Federal Bancorp’s ability to control costs and expenses; competitive products and pricing; loan delinquency rates; and changes in federal and state legislation and regulation. These factors should be considered in evaluating the forward-looking statements and undue reliance should not be placed on such statements. Kentucky First Federal Bancorp assumes no obligation to update any forward-looking statements.*

#### General

*References in this Annual Report on Form 10-K to “we,” “us” and “our” refer to Kentucky First, and where appropriate, collectively to Kentucky First, First Federal of Hazard and First Federal of Frankfort.*

**Kentucky First Federal Bancorp.** Kentucky First Federal Bancorp (“Kentucky First” or the “Company”) was incorporated as a mid-tier holding company under the laws of the United States on March 2, 2005 upon the completion of the reorganization of First Federal Savings and Loan Association of Hazard (“First Federal of Hazard”) into a federal mutual holding company form of organization (the “Reorganization”). On that date, Kentucky First completed its minority stock offering and issued a total of 8,596,064 shares of common stock, of which 4,727,938 shares, or 55%, were issued to First Federal MHC, a federally chartered mutual holding company formed in connection with the Reorganization, in exchange for the transfer of all of First Federal of Hazard’s capital stock, and 2,127,572 shares were sold at a cash price of \$10.00 per share. Also on March 2, 2005, Kentucky First completed its acquisition of Frankfort First Bancorp, Inc. (“Frankfort First Bancorp”) and its wholly owned subsidiary First Federal Savings Bank of Frankfort, Frankfort, Kentucky (“First Federal of Frankfort”) (the “Merger”). Following the Reorganization and Merger,

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the Company retained Frankfort First Bancorp as a wholly owned subsidiary and holds all of the capital stock of First Federal of Hazard and First Federal of Frankfort. The Company is operating First Federal of Hazard and First Federal of Frankfort as two independent, community-oriented savings institutions.

Kentucky First's and First Federal of Hazard's executive offices are located at 479 Main Street, Hazard, Kentucky, 41702 and the telephone number for investor relations is (888) 818-3372.

At June 30, 2012, Kentucky First had total assets of \$223.0 million, deposits of \$134.6 million and stockholders' equity of \$58.9 million. The discussion in this Annual Report on Form 10-K relates primarily to the businesses of First Federal of Hazard and First Federal of Frankfort (collectively, the "Banks"), as Kentucky First's operations consist primarily of operating the Banks and investing funds retained in the Reorganization.

First Federal of Hazard and First Federal of Frankfort are subject to examination and comprehensive regulation by the Office of the Comptroller of the Currency and their savings deposits are insured up to applicable limits by the Deposit Insurance Fund, which is administered by the Federal Deposit Insurance Corporation. Both of the Banks are members of the Federal Home Loan Bank of Cincinnati, which is one of the 12 regional banks in the FHLB System. See *"Regulation and Supervision."*

***First Federal Savings and Loan Association of Hazard.*** First Federal of Hazard was formed as a federally chartered mutual savings and loan association in 1960. First Federal of Hazard operates from a single office in Hazard, Kentucky as a community-oriented savings and loan association offering traditional financial services to consumers in Perry and surrounding counties in eastern Kentucky. It engages primarily in the business of attracting deposits from the general public and using such funds to originate, when available, loans secured by first mortgages on owner-occupied, residential real estate and occasionally other loans secured by real estate. To the extent there is insufficient loan demand in its market area, and where appropriate under its investment policies, First Federal of Hazard has historically invested in mortgage-backed and investment securities, although since the reorganization, First Federal of Hazard has been purchasing whole loans and participations in loans originated at First Federal of Frankfort. At June 30, 2012, First Federal of Hazard had total assets of \$98.2 million, net loans of \$74.6 million, total mortgage-backed and other securities of \$4.8 million, deposits of \$67.6 million and total capital of \$20.8 million.

***First Federal Savings Bank of Frankfort.*** First Federal of Frankfort is a federally chartered savings bank, which is primarily engaged in the business of attracting deposits from the general public and originating primarily adjustable-rate loans secured by first mortgages on owner-occupied and nonowner-occupied one- to four-family residences in Franklin, Anderson, Scott, Shelby, Woodford and other counties in Kentucky. First Federal of Frankfort also originates, to a lesser extent, home equity loans and loans secured by churches, multi-family properties, professional office buildings and other types of property. At June 30, 2012, First Federal of Frankfort had total assets of \$137.8 million, net loans of \$107.9 million, deposits of \$82.3 million and total capital of \$34.1 million.

First Federal of Frankfort's main office is located at 216 W. Main Street, Frankfort, Kentucky 40602 and its main telephone number is (502) 223-1638.

## **Pending Merger**

On November 3, 2011, Kentucky First entered into an agreement of merger with CKF Bancorp, Inc. and Central Kentucky Federal Savings Bank, whereby CKF Bancorp, Inc. will merge with and into Kentucky First with Kentucky First being the surviving corporation. In connection with the merger, Central Kentucky Federal Savings Bank will merge into First Federal of Frankfort and will operate under the name "Central Kentucky Federal Savings Bank" as a division of First Federal of Frankfort. The CKF Bancorp, Inc. stockholders approved the merger on July 3, 2012. The merger is also subject to regulatory approval and Kentucky First has filed the appropriate applications with its primary regulator, the Board of Governors of the Federal Reserve System. The merger is expected to be completed during the fourth quarter of 2012.

## **Market Areas**

First Federal of Hazard and First Federal of Frankfort operate in two distinct market areas.

First Federal of Hazard's market area consists of Perry County, where the business office is located, as well as the surrounding counties of Letcher, Knott, Breathitt, Leslie and Clay Counties in eastern Kentucky. The economy in its market area has been distressed in recent years. The local economy depends on the coal industry and other industries, such as health care and manufacturing. Still, the economy in First Federal of Hazard's market area continues to lag behind the economies of Kentucky and the United States. In the most recent available data, using information from the State of Kentucky Economic Development Information System ([www.thinkkentucky.com](http://www.thinkkentucky.com)), per capita personal income in Perry County averaged \$30,995 in 2010, compared to personal income of \$32,316 in Kentucky and \$39,937 in the United States. Total population in Perry County has remained stable over the last five years at approximately 29,000. However, as a regional economic center, Hazard tends to draw consumers and workers who commute from surrounding counties. Employment in the market area, particularly in Perry County, consists primarily of the trade, transportation and utilities industry (17.6%), the mining industry (17.3%), and the services sector, including health care (16.2%). During the last five years, the unemployment rate has been 6.9% or higher, and in June 2012, was 12.8%, compared to 8.4% in Kentucky and 8.9% in the United States.

First Federal of Frankfort's primary lending area includes the Kentucky counties of Franklin, Anderson, Scott, Shelby and Woodford, with the majority of lending originated on properties located in Franklin County. Franklin County has a population of approximately 49,000, of which approximately 27,000 live within the city of Frankfort, which serves as the capital of Kentucky. The primary employer in the area is the state government, which employs about 39.4% of the work force. In addition, there are several large industrial, financial and government employers in the community. Despite this large, relatively stable source of employment, the unemployment rate was 7.0% in June 2012 after having experienced an unemployment rate which had ranged from 4.5 to 9.0% in prior years.

## **Lending Activities**

**General.** Our loan portfolio consists primarily of one- to four-family residential mortgage loans. As opportunities arise, we also offer loans secured by churches, commercial real estate, and multi-family real estate. We also offer loans secured by deposit accounts and, through First Federal of Frankfort, home equity loans. Substantially all of our loans are made within the Banks' respective market areas.

**Residential Mortgage Loans.** Our primary lending activity is the origination of mortgage loans to enable borrowers to purchase or refinance existing homes in the Banks' respective market areas. At June 30, 2012, residential mortgage loans totaled \$165.5 million, or 90.0%, of our total loan portfolio. We offer a mix of adjustable-rate and fixed-rate mortgage loans with terms up to 40 years. Adjustable-rate loans have an initial fixed term of one, three, five or seven years. After the initial term, the rate adjustments on First Federal of Frankfort's adjustable-rate loans are indexed to the National Average Contract Interest Rate for Major Lenders on the Purchase of Previously Occupied Homes. The interest rates on these mortgages are adjusted once a year, with limitations on adjustments of one percentage point per adjustment period, and a lifetime cap of five percentage points. We determine loan fees charged, interest rates and other provisions of mortgage loans on the basis of our own pricing criteria and competitive market conditions. Some loans originated by the Banks have an additional advance clause which allows the borrower to obtain additional funds at prevailing interest rates, subject to managements' approval.

At June 30, 2012, the Company's loan portfolio included \$125.9 million in adjustable-rate residential mortgage loans, or 76.1%, of the Company's residential mortgage loan portfolio.

The retention of adjustable-rate loans in the portfolio helps reduce our exposure to increases in prevailing market interest rates. However, there are unquantifiable credit risks resulting from potential increases in costs to borrowers in the event of upward repricing of adjustable-rate loans. It is possible that during periods of rising interest rates, the risk of default on adjustable-rate loans may increase due to increases in interest costs to borrowers. However, despite their popularity in some parts of the country, neither bank has offered adjustable-rate loans that contractually allow for negative amortization. Such loans, under some circumstances, can cause the balance of a closed-end loan to exceed the original balance and perhaps surpass the value of the collateral. Further, although adjustable-rate loans allow us to increase the sensitivity of our interest-earning assets to changes in interest rates, the extent of this interest sensitivity is

limited by the initial fixed-rate period before the first adjustment and the periodic and lifetime interest rate adjustment limitations. Accordingly, there can be no assurance that yields on our adjustable-rate loans will fully adjust to compensate for increases in our cost of funds. Finally, adjustable-rate loans may decrease at a pace faster than decreases in our cost of funds, resulting in reduced net income.

While one- to four-family residential real estate loans are normally originated with up to 30-year terms, (with terms up to 40 years available for some products) such loans typically remain outstanding for substantially shorter periods because borrowers often prepay their loans in full upon sale of the mortgaged property or upon refinancing the original loan. Therefore, average loan maturity is a function of, among other factors, the level of purchase and sale activity in the real estate market, prevailing interest rates and the interest rates payable on outstanding loans. As interest rates declined and remained low over the past few years, we have experienced high levels of loan repayments and refinancings.

The Banks offer various programs for the purchase and refinance of one- to four-family loans. Most of these loans have loan-to-value ratios of 80% or less, based on an appraisal provided by a state licensed or certified appraiser. For owner-occupied properties, the borrower may be able to borrow up to 95% of the value if they secure and pay for private mortgage insurance or they may be able to obtain a second mortgage (at a higher interest rate) in which they borrow up to 90% of the value. On a rare case-by-case basis, the Boards of Directors of the Banks may approve a loan above the 80% loan-to-value ratio without such enhancements.

**Construction Loans.** We originate loans to individuals to finance the construction of residential dwellings for personal use or for use as rental property. On limited occasions we have made construction loans to builders for the construction of a single-family residence for subsequent sale. At June 30, 2012, construction loans totaled \$964,000, or 0.5%, of our total loan portfolio. Our construction loans generally provide for the payment of interest only during the construction phase, which is usually less than one year. Loans generally can be made with a maximum loan to value ratio of 80% of the appraised value. Funds are disbursed as progress is made toward completion of the construction based on site inspections by qualified bank staff.

Construction financing is generally considered to involve a higher degree of risk of loss than long-term financing on improved, occupied real estate. Risk of loss on a construction loan depends largely upon the accuracy of the initial estimate of the property's value at completion of construction or development and the estimated cost (including interest) of construction. During the construction phase, a number of factors could result in delays and cost overruns. If the estimate of construction costs proves to be inaccurate, we may be required to advance funds beyond the amount originally committed to permit completion of the development. If the estimate of value proves to be inaccurate, we may be confronted, at or before the maturity of the loan, with a project having a value which is insufficient to assure full repayment. As a result of the foregoing, construction lending often involves the disbursement of substantial funds with repayment dependent, in part, on the success of the ultimate project rather than the ability of the borrower or guarantor to repay principal and interest. If we are forced to foreclose on a project before or at completion due to a default, there can be no assurance that we will be able to recover the unpaid balance and accrued interest on the loan, as well as related foreclosure and holding costs.

**Multi-Family and Nonresidential Loans.** As opportunities arise, we offer mortgage loans secured by multi-family (residential property comprised of five or more units) or nonresidential real estate, which is generally secured by commercial office buildings, churches, condominiums and properties used for other purposes. At June 30, 2012, multi-family and nonresidential loans totaled \$15.5 million and \$11.1 million, respectively, or 8.4% and 6.0%, respectively, of our total loan portfolio. We originate multi-family and nonresidential real estate loans for terms of generally 25 years or less. Loan amounts generally do not exceed 80% of the appraised value and tend to range much lower.

Loans secured by multi-family and commercial real estate generally have larger balances and involve a greater degree of risk than one- to four-family residential mortgage loans. Of primary concern in multi-family and commercial real estate lending is the borrower's creditworthiness and the feasibility and cash flow potential of the project. Payments on loans secured by income properties often depend on successful operation and management of the properties. As a result, repayment of such loans may be subject to a greater extent than residential real estate loans to adverse conditions in the real estate market or the economy. To monitor cash flows on income properties, we require borrowers and/or loan guarantors to provide annual financial statements on larger multi-family and commercial real estate loans. In reaching a decision on whether to make a multi-family or commercial real estate loan, we consider the net cash flow of the project, the borrower's expertise, credit history and the value of the underlying property.

**Consumer Lending.** Our consumer loans include home equity lines of credit and loans secured by savings deposits. At June 30, 2012, our consumer loan balance totaled \$7.1 million, or 4.0%, of our total loan portfolio. Of the consumer loan balance at June 30, 2012, \$4.8 million were home equity loans and \$2.3 million were loans secured by savings deposits.

Our home equity loans are made at First Federal of Frankfort and are made on the security of residential real estate and have terms of up to 10 years. Most of First Federal of Frankfort's home equity loans are second mortgages subordinate only to first mortgages also held by the bank and do not exceed 80% of the estimated value of the property, less the outstanding principal of the first mortgage. First Federal of Frankfort does offer home equity loans up to 90% of the value less the balance of the first mortgage at a premium rate to qualified borrowers. These loans are not secured by private mortgage insurance. First Federal of Frankfort's home equity loans require the monthly payment of 2% of the unpaid principal until maturity, when the remaining unpaid principal, if any, is due. First Federal of Frankfort's home equity loans bear variable rates of interest indexed to the prime rate for loans with 80% or less loan-to-value ratio, and 2% above the prime rate for loans with a loan-to-value ratio in excess of 80%. Interest rates on these loans can be adjusted monthly. At June 30, 2012, the total outstanding home equity loans amounted to 2.7% of the Company's total loan portfolio.

Loans secured by savings are originated for up to 90% of the depositor's savings account balance. The interest rate is normally two percentage points above the rate paid on the savings account, and the account must be pledged as collateral to secure the loan. At June 30, 2012, loans on savings accounts totaled 1.3% of the Company's total loan portfolio.

Consumer loans generally entail greater risk than do residential mortgage loans, particularly in the case of consumer loans which are unsecured or secured by rapidly depreciable assets. However, these risks are considerably reduced in our case, since all of our consumer loans are secured loans.

***Loan Originations, Purchases and Sales.*** Loan originations come from a number of sources. The primary source of loan originations are our in-house loan originators, and to a lesser extent, advertising and referrals from customers and real estate agents. We currently do not purchase loans. First Federal of Frankfort sells fixed-rate loans with longer maturities to the Federal Home Loan Bank of Cincinnati ("FHLB-Cincinnati"). We earn income on the loans sold through fees we charge on the origination, interest spread premiums earned when we sell the loans, and loan servicing fees on an on-going basis, because servicing rights are retained on such loans. At June 30, 2012, \$12.6 million in loans were being serviced by First Federal of Frankfort for the FHLB-Cincinnati.

***Loan Approval Procedures and Authority.*** Our lending activities follow written, nondiscriminatory, underwriting standards and loan origination procedures established by each Bank's Board of Directors and management. First Federal of Hazard's loan committee, consisting of its two senior officers, has authority to approve loans of up to \$275,000. Loans above this amount and loans with non-standard terms such as longer repayment terms or high loan-to-value ratios, must be approved by our Board of Directors. First Federal of Frankfort's loan approval process allows for various combinations of experienced bank officers to approve or deny loans which are one- to four-family properties totaling \$275,000 or less, church loans of under \$150,000, home equity lines of credit of \$100,000 or less and loans to individuals whose aggregate borrowings with the Bank is less than \$500,000. Loans that do not conform to these criteria must be submitted to the Board of Directors or Executive Committee composed of at least three directors, for approval.

It is the Company's practice to record a lien on the real estate securing a loan. The Banks generally do not require title insurance, although it may be required for loans made in certain programs. The Banks do require fire and casualty insurance on all security properties and flood insurance when the collateral property is located in a designated flood hazard area. First Federal of Frankfort also requires an earthquake provision in all policies for new loans.

***Loans to One Borrower.*** The maximum amount either Bank may lend to one borrower and the borrower's related entities is limited, by regulation, to generally 15% of that Bank's stated capital and the allowance for loan losses. At June 30, 2012, the regulatory limit on loans to one borrower was \$3.2 million for First Federal of Hazard and \$3.0 million for First Federal of Frankfort. Neither of the banks had lending relationships in excess of their respective lending limits. However, loans or participations in loans may be sold among the Banks, which may allow a borrower's

total loans with the Company to exceed the limit of either individual bank.

***Loan Commitments.*** The Banks issue commitments for the funding of mortgage loans. Generally, these commitments exist from the time the underwriting of the loan is completed and the closing of the loan. Generally, these commitments are for a maximum of 30 or 60 days but management routinely extends the commitment if circumstances delay the closing. Management reserves the right to verify or re-evaluate the borrower's qualifications and to change the rates and terms of the loan at that time.

If conditions exist whereby either Bank experiences a significant increase in loans outstanding or commits to originate loans that are riskier than a typical one- to four-family mortgage, management and the boards will consider reflecting the anticipated loss exposure in a separate liability. As residential loans are approved in the normal course of business, and those loans are underwritten to the standards of the Banks, management does not believe alteration of the allowance for loan losses is warranted. At June 30, 2012, no commitment losses were reflected in a separate liability.

First Federal of Frankfort offers construction loans in which the borrower obtains the loan for a short term, less than one year, and simultaneously extends a commitment for permanent financing. First Federal of Hazard offers a construction loan that is convertible to permanent financing, thus no additional commitment is made.

***Interest Rates and Loan Fees.*** Interest rates charged on mortgage loans are primarily determined by competitive loan rates offered in our market areas and our yield objectives. Mortgage loan rates reflect factors such as prevailing market interest rate levels, the supply of money available to the savings industry and the demand for such loans. These factors are in turn affected by general economic conditions, the monetary policies of the federal government, including the Board of Governors of the Federal Reserve System, the general supply of money in the economy, tax policies and governmental budget matters.

We receive fees in connection with late payments on our loans. Depending on the type of loan and the competitive environment for mortgage loans, we may charge an origination fee on all or some of the loans we originate. We may also offer a menu of loans whereby the borrower may pay a higher fee to receive a lower rate or to pay a smaller or no fee for a higher rate.

***Delinquencies.*** When a borrower fails to make a required loan payment, we take a number of steps to have the borrower cure the delinquency and restore the loan to current status. We make initial contact with the borrower when the loan becomes 15 days past due. Subsequently, bank staff under the direct supervision of senior management and with consultation by the Banks' attorneys, attempt to contact the borrower and determine their status and plans for resolving the delinquency. However, once a delinquency reaches 90 days, management considers foreclosure and, if the borrower has not provided a reasonable plan (such as selling the collateral, a commitment from another lender to refinance the loan or a plan to repay the delinquent principal, interest, escrow, and late charges) the foreclosure suit may be initiated. In some cases, management may delay initiating the foreclosure suit if, in management's opinion, the Banks' chance of loss is minimal (such as with loans where the estimated value of the property greatly exceeds the amount of the loan) or if the original borrower is deceased or incapacitated. If a foreclosure action is initiated and the loan is not brought current, paid in full, or refinanced with another lender before the foreclosure sale, the real property securing the loan is sold at foreclosure. The Banks are represented at the foreclosure sale and in most cases will bid an amount equal to the Banks' investment (including interest, advances for taxes and insurance, foreclosure costs, and attorney's fees). If another bidder outbids the Bank, the Bank's investment is received in full. If another bidder does not outbid the Banks, the Banks acquire the property and attempt to sell it to recover their investment.

A borrower's filing for bankruptcy can alter the methods available to the Banks to seek collection. In such cases, the Banks work closely with legal counsel to resolve the delinquency as quickly as possible.

We may consider loan workout arrangements with certain borrowers under certain conditions. Management of each bank provides a report to its board of directors on a monthly basis of all loans more than 60 days delinquent, including loans in foreclosure, and all property acquired through foreclosure.

### **Investment Activities**

We have legal authority to invest in various types of liquid assets, including U.S. Treasury obligations, securities of various federal agencies and state and municipal governments, mortgage-backed securities and certificates of deposit of federally insured institutions. We also are required to maintain an investment in FHLB-Cincinnati stock, the level of which is largely dependent on our level of borrowings from the FHLB.

At June 30, 2012, our investment portfolio consisted of mortgage-backed securities issued and guaranteed by Fannie Mae, Freddie Mac and Ginnie Mae with stated final maturities of 30 years or less. The Company held no equity position with Fannie Mae or Freddie Mac.

Our investment objectives are to provide an alternate source of low-risk investments when loan demand is insufficient, to provide and maintain liquidity, to maintain a balance of high quality, diversified investments to minimize risk, to provide collateral for pledging requirements, to establish an acceptable level of interest rate risk, and to generate a favorable return. The Banks' Board of Directors has the overall responsibility for each institution's investment portfolio, including approval of investment policies. The management of each Bank may authorize investments as prescribed in each of the Bank's investment policies.

### **Bank Owned Life Insurance**

First Federal of Frankfort owns several Bank Owned Life Insurance policies totaling \$2.7 million at June 30, 2012. The purpose of these policies is to offset future escalation of the costs of non-salary employee benefit plans such as First Federal of Frankfort's defined benefit retirement plan and First Federal of Frankfort's health insurance plan. The lives of certain key Bank employees are insured, and First Federal of Frankfort is the sole beneficiary and will receive any benefits upon the employee's death. The policies were purchased from four highly-rated life insurance companies. The design of the plan allows for the cash value of the policy to be designated as an asset of First Federal of Frankfort. The asset's value will increase by the crediting rate, which is a rate set by each insurance company and is subject to change on an annual basis. The growth of the value of the asset will be recorded as other operating income. Management does not foresee any expense associated with the plan. Because this is a life insurance product, current federal tax laws exempt the income from federal income taxes.

Bank owned life insurance is not secured by any government agency nor are the policies' asset values or death benefits secured specifically by tangible property. Great care was taken in selecting the insurance companies, and the bond ratings and financial condition of these companies are monitored on a quarterly basis. The failure of one of these companies could result in a significant loss to First Federal of Frankfort. Other risks include the possibility that the favorable tax treatment of the income could change, that the crediting rate will not be increased in a manner comparable to market interest rates, or that this type of plan will no longer be permitted by First Federal of Frankfort's regulators. This asset is considered illiquid because, although First Federal of Frankfort may terminate the policies and receive the original premium plus all earnings, such an action would require the payment of federal income taxes on all earnings since the policies' inception.

### **Deposit Activities and Other Sources of Funds**

**General.** Deposits, loan repayments and maturities, redemptions, sales and repayments of investment and mortgage-backed securities are the major sources of our funds for lending and other investment 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.

**Deposit Accounts.** The vast majority of our depositors are residents of the Banks' respective market areas. Deposits are attracted from within our market areas through the offering of passbook savings and certificate accounts, and, at First Federal of Frankfort, checking accounts and individual retirement accounts ("IRAs"). We do not utilize brokered funds. 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 our deposit accounts, we consider the rates offered by our competition, profitability to us, asset liability management and customer preferences and concerns. We review our deposit mix and pricing on an ongoing basis as needed.

**Borrowings.** First Federal of Hazard and First Federal of Frankfort borrow from the FHLB-Cincinnati to supplement their supplies of investable funds and to meet deposit withdrawal requirements. The Federal Home Loan Bank functions as a central reserve bank providing credit for member financial institutions. As members, each Bank is required to own capital stock in the FHLB-Cincinnati and is authorized to apply for advances on the security of such stock and certain of our mortgage loans and other assets (principally securities which are obligations of, or guaranteed by, the United States), provided certain standards related to creditworthiness have been met. Advances are made under several different programs, each having 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.

## Subsidiary Activities

The Company has no other wholly owned subsidiaries other than First Federal of Hazard and Frankfort First Bancorp. Frankfort First Bancorp has one subsidiary, First Federal of Frankfort.

As federally chartered savings institutions, the Banks are permitted to invest an amount equal to 2% of assets in subsidiaries, with an additional investment of 1% of assets where such investment serves primarily community, inner-city and community-development purposes. Under such limitations, as of June 30, 2012, First Federal of Hazard and First Federal of Frankfort were authorized to invest up to \$2.9 million and \$4.1 million, respectively, in the stock of or loans to subsidiaries, including the additional 1% investment for community, inner-city and community development purposes.

## Competition

We face significant competition for the attraction of deposits and origination of loans. Our most direct competition for deposits has historically come from the banks and credit unions operating in our market areas and, to a lesser extent, from other financial services companies, such as investment brokerage firms. We also face competition for depositors' funds from money market funds and other corporate and government securities. Several of our competitors are significantly larger than us and, therefore, have significantly greater resources. We expect competition to increase in the future as a result of legislative, regulatory and technological changes and the continuing trend of consolidation in the financial services industry. Technological advances, for example, have lowered the barriers to enter new market areas, allowed banks to expand their geographic reach by providing services over the Internet and made it possible for non-depository institutions to offer products and services that traditionally have been provided by banks. Changes in federal law permit affiliation among banks, securities firms and insurance companies, which promotes a competitive environment in the financial services industry. Competition for deposits and the origination of loans could limit our growth in the future.

According to the Federal Deposit Insurance Corporation ("FDIC"), at June 30, 2011 (the most recent information available,) First Federal of Hazard had a deposit market share of 12.3% in Perry County. Its largest competitors, Peoples Bank & Trust Company of Hazard (approximately \$290 million in assets), Community Trust Bank, Inc. (approximately \$3.6 billion in assets) and 1<sup>st</sup> Trust Bank (approximately \$136 million in assets), have Perry County deposit market shares of 41.9%, 16.4% and 20.1%, respectively. First Federal of Hazard's competition for loans comes primarily from financial institutions in its market area and, to a lesser extent, from other financial services providers, such as mortgage companies and mortgage brokers. Competition for loans also comes from the increasing number of non-depository financial services companies entering the mortgage market, such as insurance companies, securities companies and specialty finance companies.

First Federal of Frankfort's principal competitors for deposits in its market area are other banking institutions, such as commercial banks and credit unions, as well as mutual funds and other investments. First Federal of Frankfort principally competes for deposits by offering a variety of deposit accounts, convenient business hours and branch locations, customer service and a well-trained staff. According to the FDIC, at June 30, 2011, First Federal of Frankfort had a deposit market share of 9.6%. Its largest competitors for depositors are the Farmers Bank and Capital Trust (\$726 million in assets) at a 44.9% market share, Whitaker Bank (\$1.5 billion in assets) at 17.6%, Mainsource Bank (\$2.7 billion in assets) at 4.6%, Fifth Third Bank (\$115.0 billion in assets) at 5.5%, and Republic Bank (\$3.2 billion in assets) at 3.3%. The Bank also faces considerable competition from credit unions including the Commonwealth Credit Union (\$924.0 million in assets) and the Kentucky Employees Credit Union (\$57.9 million in assets). First Federal of Frankfort competes for loans with other depository institutions, as well as specialty mortgage lenders and brokers and consumer finance companies. First Federal of Frankfort principally competes for loans on the basis of interest rates and the loan fees it charges, the types of loans it originates and the convenience and service it provides to borrowers. In addition, First Federal of Frankfort believes it has developed strong relationships with the businesses, real estate agents, builders and general public in its market area. Despite First Federal of Frankfort's small size relative to the many and various other depository and lending institutions in its market area, First Federal of Frankfort usually ranks first with respect to the origination of single-family purchase mortgages made on properties located in Franklin County. Nevertheless, the level of competition in First Federal of Frankfort's market area has limited, to a certain extent, the lending opportunities in its market area.

## Personnel

At June 30, 2012, we had 40 full-time employees and no part-time employees, none of whom was represented by a collective bargaining unit. We believe our relationship with our employees is good.

## Regulation and Supervision

**General.** First Federal of Hazard and First Federal of Frankfort are subject to extensive regulation, examination and supervision by the Office of the Comptroller of the Currency, as their primary federal regulator, and the Federal Deposit Insurance Corporation, as insurer of deposits. First Federal of Hazard and First Federal of Frankfort are each members of the Federal Home Loan Bank System and their deposit accounts are insured up to applicable limits by the Deposit Insurance Fund managed by the Federal Deposit Insurance Corporation. First Federal of Hazard and First Federal of Frankfort must each file reports with the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation concerning their activities and financial condition in addition to obtaining regulatory approvals before entering into certain transactions such as mergers with, or acquisitions of, other financial institutions. There are periodic examinations by the Office of the Comptroller of the Currency and, under certain circumstances, the Federal Deposit Insurance Corporation to evaluate First Federal of Hazard's and First Federal of Frankfort's safety and soundness and compliance with various regulatory requirements. This regulatory structure is intended primarily for the protection of the insurance fund and depositors. The Federal Reserve Board, the agency that regulates and supervises bank holding companies, now supervises and regulates Kentucky First Federal MHC. Kentucky First and First Federal MHC, as savings and loan holding companies, are required to file certain reports with, and are subject to examination by, and otherwise are required to comply with the rules and regulations of the Federal Reserve Board.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") made extensive changes in the regulation of federal savings banks such as First Federal of Hazard and First Federal of Frankfort. Under the Dodd-Frank Act, the Office of Thrift Supervision was eliminated and responsibility for the supervision and regulation of federal savings banks was transferred to the Office of the Comptroller of the Currency, the agency that is primarily responsible for the regulation and supervision of national banks, on July 21, 2011. The Office of the Comptroller of the Currency assumed responsibility for implementing and enforcing many of the laws and regulations applicable to federal savings 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, a function currently assigned to prudential regulators, and has authority to impose new requirements. However, institutions of less than \$10 billion in assets, such as First Federal of Hazard and First Federal of Frankfort, 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 regulator.

In addition, the Dodd-Frank Act, among other things, requires changes in the way that institutions are assessed for deposit insurance, mandates the imposition of consolidated capital requirements on savings and loan holding companies, requires that originators of securitized loans retain a percentage of the risk for the transferred loans,

reduces the federal preemption afforded to federal savings associations and contains a number of reforms related to mortgage origination. Many of the provisions of the Dodd-Frank Act require the issuance of regulations before their impact on operations can be assessed by management. However, there is a significant possibility that the Dodd-Frank Act will, at a minimum, result in increased regulatory burden and compliance costs for the Banks and the Company.

Certain of the regulatory requirements that are applicable to First Federal of Hazard, First Federal of Frankfort, Kentucky First and First Federal MHC are described below. This discussion does not purport to be a complete description of the laws and regulations involved, and is qualified in its entirety by the actual laws and regulations. Moreover, laws and regulations are subject to changes by the U.S. Congress or the regulatory agencies as applicable.

## Regulation of Federal Savings Institutions

**Business Activities.** Federal law and regulations, primarily the Home Owners' Loan Act and the regulations of the Office of the Comptroller of the Currency, govern the activities of federal savings institutions, such as First Federal of Hazard and First Federal of Frankfort. These laws and regulations delineate the nature and extent of the activities in which federal savings banks may engage. In particular, certain lending authority for federal savings institutions, *e.g.*, commercial, nonresidential real property loans and consumer loans, is limited to a specified percentage of the institution's capital or assets.

**Branching.** Federal savings institutions are authorized to establish branch offices in any state or states of the United States and its territories, subject to the approval of the Office of the Comptroller of the Currency.

**Capital Requirements.** The Office of the Comptroller of the Currency's capital regulations require federal savings institutions to meet three minimum capital standards: a 1.5% tangible capital to total assets ratio, a 4% leverage ratio (3% for institutions receiving the highest examination rating under 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 examination rating on the CAMELS system) and, together with the risk-based capital standard itself, a 4% Tier 1 risk-based capital standard. The Office of the Comptroller of the Currency 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 requires federal savings institutions to maintain 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 instruments) to risk-weighted assets of at least 4% and 8%, respectively. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet assets, recourse obligations, residual interests and direct credit substitutes, are multiplied by a risk-weight factor of 0% to 100% assigned by capital regulation based on the risks believed inherent in the type of asset. Core (Tier 1) capital is defined as common stockholders' equity (including retained earnings), certain noncumulative perpetual preferred stock and related surplus and minority interests in equity accounts of consolidated subsidiaries, less intangibles other than certain mortgage servicing rights and credit card relationships. The components of supplementary capital currently include cumulative preferred stock, long-term perpetual preferred stock, mandatory convertible 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 Office of the Comptroller of the Currency 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 June 30, 2012, First Federal of Hazard and First Federal of Frankfort each met each of these capital requirements.

**Prompt Corrective Regulatory Action.** The Office of the Comptroller of the Currency 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 institution 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 "under-capitalized." A savings institution that has a total risk-based capital ratio of 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 institution 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 Office of the Comptroller of the Currency is required to appoint a receiver or conservator within specified time frames for an institution that is "critically undercapitalized." An institution must file a capital restoration plan with the Office of the Comptroller of the Currency within 45 days of the date it receives 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 institution'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. "Significantly undercapitalized" and "critically undercapitalized" institutions are subject to more extensive mandatory regulatory actions. The Office of the Comptroller of the Currency 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.

***Loans to One Borrower.*** Federal law provides that savings institutions are generally subject to the limits on loans to one borrower applicable to national banks. Generally, subject to certain exceptions, a savings institution 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.

***Standards for Safety and Soundness.*** As required by statute, the federal banking agencies have adopted Interagency Guidelines prescribing Standards for Safety and Soundness. 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 Office of the Comptroller of the Currency determines that a savings institution fails to meet any standard prescribed by the guidelines, the Office of the Comptroller of the Currency may require the institution to submit an acceptable plan to achieve compliance with the standard.

***Limitation on Capital Distributions.*** Office of the Comptroller of the Currency regulations impose limitations upon all capital distributions by a savings institution, 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 the prior approval of the Office of the Comptroller of the Currency is required before any capital distribution if the institution does not meet the criteria for “expedited treatment” of applications under Office of the Comptroller of the Currency 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 Office of the Comptroller of the Currency. If an application is not required, the institution must still provide prior notice to the Federal Reserve Board of the capital distribution if, like First Federal of Hazard and First Federal of Frankfort, it is a subsidiary of a holding company as well as an informational notice to the Office of the Comptroller of the Currency. If First Federal of Hazard’s or First Federal of Frankfort’s capital were ever to fall below its regulatory requirements or the Office of the Comptroller of the Currency notified it that it was in need of increased supervision, its ability to make capital distributions could be restricted. In addition, the Office of the Comptroller of the Currency could prohibit a proposed capital distribution that would otherwise be permitted by the regulation, if the agency determines that such distribution would constitute an unsafe or unsound practice.

***Qualified Thrift Lender Test.*** Federal law requires savings institutions to meet a qualified thrift lender test. Under the test, a savings institution 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, education loans, credit card loans and small business loans) in at least 9 months out of each 12-month period.

A savings institution that fails the qualified thrift lender test is subject to certain operating restrictions. 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. At June 30, 2012, First Federal of Hazard and First Federal of Frankfort each met the qualified thrift lender test.

**Transactions with Related Parties.** Federal law limits the authority of First Federal of Hazard and First Federal of Frankfort to lend to, and engage in certain other transactions with (collectively, “covered transactions”), “affiliates” (e.g., any company that controls or is under common control with an institution, including Kentucky First, First Federal MHC and their non-savings institution subsidiaries). The aggregate amount of covered transactions with any individual affiliate is limited to 10% of the capital and surplus of the savings institution. The aggregate amount of covered transactions with all affiliates is limited to 20% of the savings institution’s capital and surplus. Loans and other specified transactions with affiliates are required to be secured by collateral in an amount and of a type described in federal law. The purchase of low quality assets from affiliates is generally prohibited. Transactions with affiliates must 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 institutions are prohibited from lending to any affiliate that is engaged in activities that are not permissible for bank holding companies and no savings institution may purchase the securities of any affiliate other than a subsidiary. Transactions between sister depository institutions that are 80% or more owned by the same holding company are exempt from the quantitative limits and collateral requirements.

The Sarbanes-Oxley Act of 2002 generally prohibits a company from making loans to its executive officers and directors. However, that 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, First Federal of Hazard’s and First Federal of Frankfort’s authority to extend credit to executive officers, directors and 10% shareholders (“insiders”), as well as entities such persons control, is limited. The law restricts both the individual and aggregate amount of loans First Federal of Hazard and First Federal of Frankfort may make to insiders based, in part, on First Federal of Hazard’s and First Federal of Frankfort’s respective capital positions and requires certain board approval procedures to be followed. Such loans must be made on terms, including rates and collateral, substantially the same as those offered to unaffiliated individuals prevailing at the time for comparable loans with persons not related to the lender and not involve more than the normal risk of repayment. There are additional restrictions applicable to loans to executive officers.

**Enforcement.** The Office of The Comptroller of the Currency has primary enforcement responsibility over federal savings institutions and has the 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 appointment of a receiver or conservator 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 Federal Deposit Insurance Corporation has authority to recommend to the Director of the Office of the Comptroller of the Currency that enforcement action to be taken with respect to a particular savings institution. If action is not taken by the Director, the Federal Deposit Insurance Corporation has authority to take such action under certain circumstances. Federal law also establishes criminal penalties for certain violations.

**Assessments.** Federal savings banks pay assessments to the Office of the Comptroller of the Currency to fund its operations. The general assessments, paid on a semi-annual basis, are based upon the savings institution’s total assets, including consolidated subsidiaries, its financial condition and the complexity of its portfolio.

***Insurance of Deposit Accounts.*** The deposits of both First Federal of Hazard and First Federal of Frankfort are insured up to applicable limits by the Deposit Insurance Fund administered by the Federal Deposit Insurance Corporation. Under the Federal Deposit Insurance Corporation's risk-based assessment system, insured institutions are assigned to one of four risk categories based on supervisory evaluations, regulatory capital levels and certain other factors, with less risky institutions paying lower assessments. An institution's assessment rate depends upon the category to which it is assigned. Effective April 1, 2009, assessment rates ranged from seven to 77.5 basis points. On February 7, 2011, the Federal Deposit Insurance Corporation issued final rules, effective April 1, 2011, implementing changes to the assessment rules resulting from the Dodd-Frank Act. Initially, the base assessment rates will range from two and one half to 45 basis points. The rate schedules will automatically adjust in the future when the Deposit Insurance Fund reaches certain milestones. No institution may pay a dividend if in default of the federal deposit insurance assessment.

The FDIC imposed on all insured institutions a special emergency assessment of five basis points of total assets minus Tier 1 capital, as of June 30, 2009 (capped at ten basis points of an institution's deposit assessment base), in order to cover losses to the Deposit Insurance Fund. That special assessment was collected on September 30, 2009. The FDIC provided for similar assessments during the final two quarters of calendar year 2009, if deemed necessary. However, in lieu of further special assessments, the Federal Deposit Insurance Corporation required insured institutions to prepay estimated quarterly risk-based assessments for the fourth quarter of 2009 through the fourth quarter of 2012. The estimated assessments, which include an assumed annual assessment base increase of 5%, were recorded as a prepaid expense asset as of December 30, 2009. As of December 31, 2009, and each quarter thereafter, a charge to earnings will be recorded for each regular assessment with an offsetting credit to the prepaid asset.

In addition, the Federal Deposit Insurance Corporation adopted an optional Temporary Liquidity Guarantee Program by which, for a fee, noninterest-bearing transaction accounts would receive unlimited insurance coverage to December 31, 2010, and certain senior unsecured debt issued by institutions and their holding companies between October 13, 2008 and December 31, 2009 would be guaranteed by the Federal Deposit Insurance Corporation through June 30, 2012, or in some cases, December 31, 2012. The Bank and the Company made the business decision to decline participation in both programs. The Dodd-Frank Act adopted unlimited coverage for certain noninterest-bearing transactions accounts for January 1, 2011 through December 31, 2012, with no apparent opt out option.

In addition to the assessment for deposit insurance, institutions are required to make payments on bonds issued in the late 1980s by the Financing Corporation to recapitalize a predecessor deposit insurance fund. That payment is established quarterly.

The Dodd-Frank Act increased the minimum target Deposit Insurance Fund ratio from 1.15% of estimated insured deposits to 1.35% of estimated insured deposits. The FDIC must seek to achieve the 1.35% ratio by September 30, 2020. Insured institutions with assets of \$10 billion or more are supposed to fund the increase. The Dodd-Frank Act eliminated the 1.5% maximum fund ratio, instead leaving it to the discretion of the FDIC.

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 Banks. Management cannot predict what insurance assessment rates will be in the future.

Insurance of deposits may be terminated by the Federal Deposit Insurance Corporation 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 condition imposed by the Federal Deposit Insurance Corporation or the Office of the Comptroller of the Currency. Management does not know of any practice, condition or violation that might lead to termination of deposit insurance.

***Federal Home Loan Bank System.*** First Federal of Hazard and First Federal of Frankfort are members 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. As members of the Federal Home Loan Bank of Cincinnati, First Federal of Hazard and First Federal of Frankfort are each required to acquire and hold shares of capital stock in that Federal Home Loan Bank. First Federal of Hazard and First Federal of Frankfort were in compliance with this requirement with investments in Federal Home Loan Bank of Cincinnati stock at June 30, 2012, of \$2.2 million and \$3.5 million, respectively.

***Community Reinvestment Act.*** All federal savings institutions have a continuing and affirmative obligation consistent with its safe and sound operation to help meet the credit needs of its entire community, including low and moderate income neighborhoods. The Community Reinvestment Act does not establish specific lending requirements or programs for financial institutions nor does it limit an institution's discretion to develop the types of products and services that it believes are best suited to its particular community, consistent with the Community Reinvestment Act. The Community Reinvestment Act requires the Office of the Comptroller of the Currency, in connection with its examination of a savings institution, to assess the institution's record of meeting the credit needs of its community and to take such record into account in its evaluation of certain applications by such institution.

The Community Reinvestment Act requires public disclosure of an institution's rating and requires the Office of the Comptroller of the Currency to provide a written evaluation of an institution's Community Reinvestment Act performance utilizing a four-tiered descriptive rating system. First Federal of Hazard and First Federal of Frankfort each received a "Satisfactory" rating as a result of their most recent Community Reinvestment Act assessments.

## **Holding Company Regulation**

**General.** Kentucky First and First Federal MHC are savings and loan holding companies within the meaning of federal law. As such, they are registered with the Federal Reserve Board and are subject to Federal Reserve Board regulations, examinations, supervision, reporting requirements and regulations concerning corporate governance and activities. In addition, the Federal Reserve Board has enforcement authority over Kentucky First and First Federal MHC and their non-savings institution subsidiaries. Among other things, this authority permits the Federal Reserve Board to restrict or prohibit activities that are determined to be a serious risk to First Federal of Hazard and/or First Federal of Frankfort.

**Restrictions Applicable to Mutual Holding Companies.** According to federal law and Federal Reserve Board regulations, a mutual holding company, such as First Federal MHC, may generally engage in the following activities: (1) investing in the stock of insured depository institutions and acquiring them by means of a merger or acquisition; (2) investing in a corporation the capital stock of which may be lawfully purchased by a savings association under federal law; (3) furnishing or performing management services for a savings association subsidiary of a savings and loan holding company; (4) conducting an insurance agency or escrow business; (5) holding, managing or liquidating assets owned or acquired from a savings association subsidiary of the savings and loan holding company; (6) holding or managing properties used or occupied by a savings association subsidiary of the savings and loan holding company; (7) acting as trustee under deed or trust; (8) any activity permitted for multiple savings and loan holding companies by Federal Reserve Board regulations; (9) any activity permitted by the Board of Governors of the Federal Reserve System for bank holding companies and financial holding companies; and (10) any activity permissible for service corporations. Legislation, which authorized mutual holding companies to engage in activities permitted for financial holding companies, expanded the authorized activities. Financial holding companies may engage in a broad array of financial services activities, including insurance and securities.

Federal law prohibits a savings and loan holding company, including a federal mutual holding company, from directly or indirectly, or through one or more subsidiaries, acquiring more than 5% of the voting stock of another savings institution, or its holding company, without prior written approval of the Federal Reserve Board. Federal law also prohibits a savings and loan holding company from acquiring or retaining control of a depository institution that is not insured by the Federal Deposit Insurance Corporation. In evaluating applications by holding companies to acquire savings institutions, the Federal Reserve Board must consider the financial and managerial resources and future prospects of the company and institution involved, the effect of the acquisition on the risk to the insurance funds, the convenience and needs of the community and competitive factors.

The Federal Reserve Board is prohibited from approving any acquisition that would result in a multiple savings and loan holding company controlling savings institutions in more than one state, except: (1) the approval of interstate supervisory acquisitions by savings and loan holding companies, and (2) the acquisition of a savings institution in another state if the laws of the state of the target savings institution specifically permit such acquisitions. The states vary in the extent to which they permit interstate savings and loan holding company acquisitions.

***Capital Requirements.*** 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. This will 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. There is a five-year transition period from the July 21, 2010 date of enactment 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 Dodd-Frank Act also requires the Federal Reserve Board to promulgate regulations implementing the “source of strength” policy that holding companies act as a source of strength to their subsidiary depository institutions by providing capital, liquidity and other support in times of financial stress.

Federal savings institutions must notify the Federal Reserve Board prior to paying a dividend to the Company. The Federal Reserve Board may disapprove a dividend if, among other things, the Federal Reserve Board determines that the federal savings institution would be undercapitalized on a pro forma basis or the dividend is determined to raise safety or soundness concerns.

**Stock Holding Company Subsidiary Regulation.** Federal Reserve Board regulations govern the two-tier mutual holding company form of organization and subsidiary stock holding companies that are controlled by mutual holding companies. Kentucky First is the stock holding company subsidiary of First Federal MHC. Kentucky First is only permitted to engage in activities that are permitted for First Federal MHC subject to the same restrictions and conditions.

**Waivers of Dividends by First Federal MHC.** Federal Reserve Board regulations require First Federal MHC to notify the Federal Reserve Board if it proposes to waive receipt of our dividends from Kentucky First. The Dodd-Frank Act addresses the issue of dividend waivers in the context of the transfer of the supervision of savings and loan holding companies to the Federal Reserve Board. The Dodd-Frank Act specified that dividends may be waived if certain conditions are met, including that the Federal Reserve Board does not object after being given written notice of the dividend and proposed waiver. The Dodd-Frank Act indicates that the Federal Reserve Board may not object to such a waiver (i) if the mutual holding company involved has, prior to December 1, 2009, reorganized into a mutual holding company structure, engaged in a minority stock offering and waived dividends; (ii) the board of directors of the mutual holding company expressly determines that a waiver of the dividend is consistent with its fiduciary duties to members and (iii) the waiver would not be detrimental to the safe and sound operation of the savings association subsidiaries of the holding company. The Federal Reserve has not previously permitted dividend waivers by mutual bank holding companies and may object to dividend waivers involving mutual savings and loan holding companies, notwithstanding the referenced language in the Dodd-Frank Act. The Federal Reserve Board will not consider the amount of dividends waived by the mutual holding company in determining an appropriate excha