SI Financial Group, Inc.
Form 10-K
March 29, 2007

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

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

For the Fiscal Year Ended December 31, 2006

£ **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: 0-50801

SI FINANCIAL GROUP, INC.
(Exact name of registrant as specified in its charter)

United States **(State or other jurisdiction of incorporation or organization)**	**84-1655232** **(I.R.S. Employer Identification No.)**
803 Main Street, Willimantic, Connecticut **(Address of principal executive offices)**	**06226** **(Zip Code)**

(860) 423-4581
(Registrant's telephone number, including area code)

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

Title of each class	**Name of Exchange on which registered**
Common stock, par value $0.01 per share	Nasdaq Stock Market LLC

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

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

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 S

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 S 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 or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.

Large accelerated filer £	Accelerated filer £	Non-accelerated filer S

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

The aggregate market value of the voting and non-voting common equity held by non-affiliates was $54.1 million, which was computed by reference to the closing price of $11.00, at which the common equity was sold as of June 30, 2006. Solely for the purposes of this calculation, the shares held by SI Bancorp, MHC and the directors and officers of the registrant are deemed to be affiliates.

As of March 13, 2007, there were 12,421,920 shares of the registrant's common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the 2007 Annual Meeting of Stockholders are incorporated by reference in Part III of this Form 10-K.

Table of Contents

SI FINANCIAL GROUP, INC.
TABLE OF CONTENTS

		Page No.
PART I.		
Item 1.	Business	1
Item 1A.	Risk Factors	35
Item 1B.	Unresolved Staff Comments	39
Item 2.	Properties	39
Item 3.	Legal Proceedings	41
Item 4.	Submission of Matters to a Vote of Security Holders	41
PART II.		
Item 5.	Market for the Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	41
Item 6.	Selected Financial Data	43
Item 7.	Management's Discussion and Analysis of Financial Condition and Results of Operations	45
Item 7A.	Quantitative and Qualitative Disclosures About Market Risk	58
Item 8.	Financial Statements and Supplementary Data	60
Item 9.	Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	60
Item 9A.	Controls and Procedures	61
Item 9B.	Other Information	61
PART III.		
Item 10.	Directors, Executive Officers and Corporate Governance	61
Item 11.	Executive Compensation	62
Item 12.	Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters	62
Item 13.	Certain Relationships and Related Transactions and Director Independence	62
Item 14.	Principal Accountant Fees and Services	63
PART IV.		
Item 15.	Exhibits and Financial Statement Schedules	63

Signatures 65

Table of Contents

Forward-Looking Statements

This report contains forward-looking statements that are based on assumptions and may describe future plans, strategies and expectations of SI Financial Group, Inc. (the "Company"). These forward-looking statements are generally identified by the use of the words "believe," "expect," "intend," "anticipate," "estimate," "project" or similar expressions. The Company's ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors that could have a material adverse effect on the operations of the Company and its subsidiaries include, but are not limited to, changes in interest rates, national and regional economic conditions, legislative and regulatory changes, monetary and fiscal policies of the United States government, including policies of the United States Treasury and the Federal Reserve Board, the quality and composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in the Company's market area, changes in real estate market values in the Company's market area and changes in relevant accounting principles and guidelines. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Except as required by applicable law or regulation, the Company does not undertake, and specifically disclaims any obligation, to release publicly the result of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of the statements or to reflect the occurrence of anticipated or unanticipated events.

PART I.

Item 1. Business.

General

In certain instances where appropriate, the terms "we," "us" and "our" refer to SI Financial Group, Inc. and Savings Institute Bank and Trust Company or both.

SI Financial Group, Inc. was established on August 6, 2004 to become the parent holding company for Savings Institute Bank and Trust Company (the "Bank" or "Savings Institute") upon the conversion of the Bank's former parent, SI Bancorp, Inc., from a state-chartered to a federally-chartered mutual holding company. At the same time, the Bank also converted from a state-chartered to a federally-chartered savings bank. The Bank is a wholly-owned subsidiary of the Company and management of the Company and the Bank are substantially similar. The Company neither owns nor leases any property, but instead uses the premises, equipment and other property of the Bank. Thus, the financial information and discussion contained herein primarily relates to the activities of the Bank.

The Bank was incorporated by an act of the Connecticut legislature in 1842 under the name Willimantic Savings Institute. It was shortened to Savings Institute in 1991 to reflect the Bank's expanded geographic territory. In 2000, the Bank converted to stock form and became the wholly-owned subsidiary of SI Bancorp, Inc., a Connecticut-chartered mutual holding company. On August 6, 2004, Savings Institute converted to a federal charter and now operates under the name Savings Institute Bank and Trust Company. At that time, SI Bancorp, Inc. converted to a federal charter operating under the name SI Bancorp, MHC and transferred all of the common stock of the Bank to SI Financial Group, Inc. On September 30, 2004, the Company completed its minority stock offering with the sale of 5,025,500 shares of its common stock to the public, 251,275 shares contributed to SI Financial Group Foundation and 7,286,975 issued to SI Bancorp, MHC.

The Bank operates as a community-oriented financial institution offering a full range of financial services to consumers and businesses in its market area, including insurance, trust and investment services. The Bank attracts deposits from the general public and uses those funds to originate one- to four-family residential, multi-family and commercial real estate, commercial business and consumer loans, which it holds primarily for investment.

1

Table of Contents

Definitive Agreement Signed

On September 5, 2006, the Bank signed a definitive agreement to purchase Fairfield Financial Mortgage Group, Inc. ("FFMG"). FFMG has branch offices in Texas, Massachusetts, New Hampshire, New Jersey, New York and Pennsylvania and is also a licensed mortgage banker in South Carolina, Florida, Georgia, Michigan, Rhode Island, Maryland, Delaware and California.

Availability of Information

The Company's annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K and any amendments to such reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, are made available free of charge on the Company's website, *www.mysifi.com*, as soon as reasonably practicable after the Company electronically files such material with, or furnishes it to, the Securities and Exchange Commission (the "SEC"). The information on the Company's website shall not be considered as incorporated by reference into this Form 10-K.

Market Area

The Company is headquartered in Willimantic, Connecticut, which is located in eastern Connecticut approximately 30 miles east of Hartford. The Bank operates nineteen offices in Windham, New London, Tolland and Hartford Counties, which the Bank considers its primary market area. The economy in its market area is primarily oriented to the educational, service, entertainment, manufacturing and retail industries.

The major employers in the area include several institutions of higher education, the Mohegan Sun and Foxwoods casinos, General Dynamics Defense Systems and Pfizer, Inc. According to published statistics, Windham County's population in 2006 was approximately 116,000 and consisted of 43,000 households. The population increased approximately 6.7% from 2000. Median household income in Windham County is $49,000, compared to $60,000 for Connecticut as a whole and $43,000 nationally. The surrounding counties of Hartford, New London and Tolland Counties have median household incomes of $56,000, $55,000 and $65,000, respectively.

Competition

The Bank faces significant competition for the attraction of deposits and origination of loans. The most direct competition for deposits has historically come from the several financial institutions operating in the Bank's market area and, to a lesser extent, from other financial service companies, such as brokerage firms, credit unions and insurance companies. The Bank also faces competition for investors' funds from money market funds and other corporate and government securities. At June 30, 2006, which is the most recent date for which data is available from the Federal Deposit Insurance Corporation ("FDIC"), the Bank held approximately 18.95% of the deposits in Windham County, which is the largest market share out of 11 financial institutions with offices in this county. Also, at June 30, 2006, the Bank held approximately 0.97% of the deposits in Hartford, New London and Tolland Counties, which is the 15th market share out of 36 financial institutions with offices in these counties. Banks owned by Bank of America Corp., Webster Bank Financial Corporation, TD Banknorth Group, Inc., Sovereign Bancorp., Inc. and Citizens Financial Group, Inc., all of which are large regional bank holding companies, also operate in the Bank's market area. These institutions are significantly larger and, therefore, have significantly greater resources than the Bank does and may offer products and services that the Bank does not provide.

Table of Contents

The Bank's competition for loans comes primarily from financial institutions in its market area, and to a lesser extent from other financial service providers, such as mortgage companies and mortgage brokers. Competition for loans also comes from the increasing number of non-depository financial service companies entering the mortgage market, such as insurance companies, securities companies and specialty finance companies.

The Bank expects 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 barriers to entry, 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 the Company's growth in the future.

Lending Activities

General. The Bank's loan portfolio consists primarily of one- to four-family residential mortgage loans, multi-family and commercial real estate loans and commercial business loans. To a much lesser extent, the loan portfolio includes construction and consumer loans. The Bank historically and currently originates loans primarily for investment purposes. At December 31, 2006, the Bank had $135,000 in loans that were held for sale.

The following table summarizes the composition of the Bank's loan portfolio in dollar amounts and as a percentage of the respective portfolio at the dates indicated.

	At December 31,									
(Dollars in Thousands)	**2006**		**2005**		**2004**		**2003**		**2002**	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
Real estate loans:										
Residential - 1 to 4 family	$ 309,695	53.65%	$ 266,739	51.66%	$ 252,180	55.99%	$ 226,881	58.29%	$ 213,831	63.29%
Multi-family and commercial	118,600	20.55	100,926	19.54	82,213	18.25	73,428	18.87	61,214	18.12
Construction	44,647	7.73	47,325	9.16	35,773	7.94	20,652	5.30	21,104	6.25
Total real estate loans	472,942	81.93	414,990	80.36	370,166	82.18	320,961	82.46	296,149	87.66
Consumer loans:										
Home equity	18,489	3.20	20,562	3.98	18,335	4.07	14,411	3.70	10,786	3.19
Other	10,616	1.84	3,294	0.64	2,790	0.62	3,107	0.80	3,936	1.16
Total consumer loans	29,105	5.04	23,856	4.62	21,125	4.69	17,518	4.50	14,722	4.35
	75,171	13.03	77,552	15.02	59,123	13.13	50,746	13.04	27,003	7.99

Commercial business loans										
Total loans	577,218	100.00%	516,398	100.00%	450,414	100.00%	389,225	100.00%	337,874	100.00%
Deferred loan origination costs, net of fees	1,258		1,048		743		387		(209)	
Allowance for loan losses	(4,365)		(3,671)		(3,200)		(2,688)		(3,067)	
Loans receivable, net	$ 574,111		$ 513,775		$ 447,957		$ 386,924		$ 334,598	

Table of Contents

One- to Four-Family Residential Loans. The Bank's primary lending activity is the origination of mortgage loans to enable borrowers to purchase or refinance existing homes or to construct new residential dwellings in its market area. The Bank offers fixed-rate and adjustable-rate mortgage loans with terms up to 30 years. Borrower demand for adjustable-rate loans versus fixed-rate loans is a function of the level of interest rates, the expectations of changes in the level of interest rates, the difference between the interest rates and loan fees offered for fixed-rate mortgage loans and the initial period interest rates and loan fees for adjustable-rate loans. The relative amount of fixed-rate mortgage loans and adjustable-rate mortgage loans that can be originated at any time is largely determined by the demand for each in a competitive environment and the effect each has on the Bank's interest rate risk. The loan fees charged, interest rates and other provisions of mortgage loans are determined on the basis of the Bank's own pricing criteria and competitive market conditions. Additionally, the Bank offers reverse mortgages to its customers, through a correspondent relationship with another institution, in response to increasing demand for this type of product.

The Bank offers fixed-rate loans with terms of 10, 15, 20 or 30 years. The Bank's adjustable-rate mortgage loans are based on 15, 20 or 30 year amortization schedules. Interest rates and payments on adjustable-rate mortgage loans adjust annually after a one, three, five, seven or 10-year initial fixed period. Interest rates and payments on adjustable-rate loans are adjusted to a rate typically equal to 2.75% (2.875% for jumbo loans) above the one-year constant maturity Treasury index. The maximum amount by which the interest rate may be increased or decreased is generally 2% per adjustment period and the lifetime interest rate cap is generally 6% over the initial interest rate of the loan.

While the Bank anticipates that adjustable-rate loans will better offset the adverse effects of an increase in interest rates as compared to fixed-rate mortgages, the increased mortgage payments required of adjustable-rate loan borrowers in a rising interest rate environment could cause an increase in delinquencies and defaults. The marketability of the underlying property also may be adversely affected in a high interest rate environment. In addition, although adjustable-rate mortgage loans help make the Bank's asset base more responsive to changes in interest rates, the extent of this interest sensitivity is limited by the annual and lifetime interest rate adjustment limits.

Generally, the Bank does not originate conventional loans with loan-to-value ratios exceeding 95% and generally originates loans with a loan-to-value ratio in excess of 80% only when secured by first liens on owner-occupied one- to four-family residences. Loans with loan-to-value ratios in excess of 80% generally require private mortgage insurance or additional collateral. The Bank requires all properties securing mortgage loans to be appraised by a board approved independent licensed appraiser and requires title insurance on all first mortgage loans. Borrowers must obtain hazard insurance and flood insurance for loans on property located in a flood zone, before closing the loan.

In an effort to provide financing for moderate income and first-time buyers, the Bank offers Federal Housing Authority, Veterans Administration and Connecticut Housing Finance Agency loans and a first-time home buyers program. The Bank offers fixed-rate residential mortgage loans through these programs to qualified individuals and originates the loans using modified underwriting guidelines.

Multi-Family and Commercial Real Estate Loans. The Bank offers fixed-rate and adjustable-rate mortgage loans secured by multi-family and commercial real estate. The Bank's multi-family and commercial real estate loans are generally secured by condominiums, apartment buildings, single-family subdivisions as well as owner-occupied properties located in its market area and used for businesses. The Bank intends to continue to emphasize this segment of its loan portfolio.

Table of Contents

The Bank originates adjustable-rate multi-family and commercial real estate loans for terms up to 25 years. Interest rates and payments on these loans typically adjust every five years after a five-year initial fixed-rate period. Interest rates and payments on adjustable-rate loans are adjusted to a rate typically 2.0-3.0% above the classic advance rates offered by the Federal Home Loan Bank of Boston (the "FHLB"). There are no adjustment period or lifetime interest rate caps. Loans are secured by first mortgages that generally do not exceed 75% of the property's appraised value. At December 31, 2006, the largest outstanding multi-family or commercial real estate loan was $3.0 million. This loan is secured by office and retail space and was performing according to its terms at December 31, 2006.

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, the Bank requires borrowers and loan guarantors, if any, to provide annual financial statements on multi-family and commercial real estate loans. In reaching a decision on whether to make a multi-family or commercial real estate loan, consideration is given to the net operating income of the property, the borrower's expertise, credit history and profitability and the value of the underlying property. In addition, with respect to commercial real estate rental properties, the Bank will also consider the term of the lease and the quality of the tenants. The Bank generally requires that the properties securing these real estate loans have debt service coverage ratios of at least 1.20. The debt service coverage ratio is equal to cash flows before interest, depreciation and required principal payments. Appropriate environmental assessments are generally required for commercial real estate loans over $100,000, based upon the environmental risk factors for the subject collateral property.

Construction and Land Loans. The Bank originates loans to individuals, and to a lesser extent, builders, to finance the construction of residential dwellings. The Bank also originates construction loans for commercial development projects, including condominiums, apartment buildings, single-family subdivisions as well as owner-occupied properties used for businesses. Residential construction loans generally provide for the payment of interest only during the construction phase, which is usually twelve months. At the end of the construction phase, the loan generally converts to a permanent mortgage loan. Commercial construction loans generally provide for the payment of interest only during the construction phase which may range from three months to a maximum of twenty-four months as allowed by the Bank's Loan Policy. Generally, commercial loans on owner-occupied properties would convert to a permanent mortgage as the construction loan is repaid from the sale of individual units or houses. Loans generally can be made with a maximum loan-to-value ratio of 90% on residential construction and 75% on commercial construction for nonresidential properties and 80% on commercial multi-family construction of the lower of appraised value or cost of the project, whichever is less. At December 31, 2006, the largest outstanding residential construction loan commitment was for $1.0 million, of which $392,000 was outstanding. At December 31, 2006, the largest outstanding commercial construction loan commitment was $7.3 million, of which $4.7 million was outstanding. These loans were performing according to their terms at December 31, 2006. Primarily all commitments to fund construction loans require an appraisal of the property by a board approved independent licensed appraiser. Also, inspections of the property are required before the disbursement of funds during the term of the construction loan.

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

Table of Contents

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, the Bank 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 the Bank is forced to foreclose on a project before or at completion due to a default, there can be no assurance that the Bank will be able to recover all of the unpaid balance of, and accrued interest on, the loan as well as related foreclosure and holding costs.

The Bank also originates land loans to individuals and local contractors and developers only for the purpose of making improvements on approved building lots, subdivisions and condominium projects within two years of the date of the loan. Such loans to individuals generally are written with a maximum loan-to-value ratio based upon the appraised value or purchase price of the land. Maximum loan-to-value ratio on raw land is 50%, while the maximum loan-to-value ratio for land development loans involving approved projects is 65%. The Bank offers fixed-rate land loans and variable-rate land loans that adjust annually. Interest rates and payments on adjustable-rate land loans are adjusted to a rate typically equal to the then current *The Wall Street Journal* prime rate plus a 1.0 - 2.0% margin. The maximum amount by which the interest rate may be increased or decreased is generally 2% annually and the lifetime interest rate cap is generally 6% over the initial rate of the loan.

Commercial Business Loans. The Bank originates commercial business loans to a variety of professionals, sole proprietorships and small businesses primarily in its market area. The Bank offers a variety of commercial lending products, the maximum amount of which is limited by the Bank's in-house loans to one borrower limit. At December 31, 2006, the largest commercial loan was a $1.5 million loan, which is secured by a business asset consisting of a waste processing system. This loan was performing according to its terms at December 31, 2006.

The Bank offers loans secured by business assets other than real estate, such as business equipment and inventory. These loans are originated with maximum loan-to-value ratios of 75% of the value of the personal property. The Bank originates lines of credit to finance the working capital needs of businesses to be repaid by seasonal cash flows or to provide a period of time during which the business can borrow funds for planned equipment purchases. These loans convert to a term loan at the expiration of a draw period, which is not to exceed twelve months and will be paid over a pre-defined amortization period. Additional products such as time notes, letters of credit and Small Business Administration guaranteed loans are offered.

When originating commercial business loans, the Bank considers the financial statements of the borrower, the borrower's payment history of both corporate and personal debt, the debt service capabilities of the borrower, the projected cash flows of the business, viability of the industry in which the customer operates and the value of the collateral.

Unlike residential mortgage loans, which generally are made on the basis of the borrower's ability to make repayment from his or her employment or other income, and which are secured by real property whose value tends to be more easily ascertainable, commercial loans are of higher risk and typically are made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business. As a result, the availability of funds for the repayment of commercial loans may depend

Table of Contents

substantially on the success of the business itself. Further, any collateral securing such loans may depreciate over time, may be difficult to appraise and may fluctuate in value.

The Bank offers equipment lease financing to its commercial customers. Financing is available up to 100% of the leased equipment and amortized over a period of one to three years. All commercial leasing loans, totaling $1.3 million, were performing according to terms at December 31, 2006.

Consumer Loans. The Bank offers a variety of consumer loans, primarily home equity lines of credit, and, to a lesser extent, loans secured by marketable securities, passbook or certificate accounts, motorcycles, automobiles and recreational vehicles as well as unsecured loans. Unsecured loans generally have a maximum borrowing limit of $15,000 and a maximum term of five years.

In February 2006, the Bank purchased a participation interest in a pool of automobile loans from UnitedOne Credit Union, which are serviced by Flatiron Financial Services, Inc. (formerly Centrix Financial, LLC), for a total purchase price of $10.3 million. These loans are secured by new and used automobiles. The indirect automobile loans have fixed interest rates and generally have terms up to seven years. Generally, the Bank offers automobile loans with a maximum loan-to-value ratio of 100% of the purchase price for new vehicles.

The procedures for underwriting consumer loans include an assessment of the applicant's payment history on other debts and their ability to meet existing obligations and payments on the proposed loans. Although the applicant's creditworthiness is a primary consideration, the underwriting process also includes a comparison of the value of the collateral, if any, to the proposed loan amount. Home equity lines of credit have adjustable rates of interest that are indexed to the prime rate as reported in *The Wall Street Journal.* The Bank will offer home equity loans with maximum combined loan-to-value ratios of 100%, provided that loans in excess of 80% will be charged a higher rate of interest. A home equity line of credit may be drawn down by the borrower for an initial period of five years from the date of the loan agreement. During this period, the borrower has the option of paying, on a monthly basis, either principal and interest or only interest. If not renewed, the borrower has to pay back the amount outstanding under the line of credit over a term not to exceed ten years, beginning at the end of the five-year period.

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

Loan Originations, Purchases, Sales and Servicing. Loan originations come from a number of sources. The primary source of loan originations are the Bank's in-house loan originators, and to a lesser extent, local mortgage brokers, advertising and referrals from customers.

From time to time, the Bank will purchase whole participations in loans fully guaranteed by the United States Department of Agriculture and the Small Business Administration. The loans are primarily for commercial and agricultural properties located throughout the United States. The Bank purchased

Table of Contents

$675,000 and $22.2 million of these loans in fiscal 2006 and 2005, respectively. Additionally, the Bank purchased $10.3 million of indirect automobile loans during 2006.

The Bank generally originates loans for portfolio but from time to time will sell loans in the secondary market, primarily fixed-rate one- to four-family residential mortgage loans with servicing retained, based on prevailing market interest rate conditions, an analysis of the composition and risk of the loan portfolio, liquidity needs and interest rate risk management. Generally, loans are sold without recourse. The Bank utilizes the proceeds from these sales primarily to meet liquidity needs and manage interest rate risk. The Bank sold $11.0 million, $35.5 million and $15.5 million of loans in the years ended December 31, 2006, 2005 and 2004, respectively.

At December 31, 2006, the Bank retained the servicing rights on $72.5 million of loans for others, consisting primarily of fixed-rate mortgage loans sold with or without recourse to third parties. Loan repurchase commitments are agreements to repurchase loans previously sold upon the occurrence of conditions established in the contract, including default by the underlying borrower. Loans sold with recourse totaled $59,000 at December 31, 2006. Loan servicing includes collecting and remitting loan payments, accounting for principal and interest, contacting delinquent mortgagors, processing insurance and tax payments on behalf of borrowers, assisting in foreclosures and property dispositions when necessary and general administration of loans. The gross servicing fee income from loans sold with servicing rights retained is typically 25.0 or 37.5 basis points of the total balance of serviced loans. The servicing rights related to these loans was $392,000 and $373,000 at December 31, 2006 and 2005, respectively. Amortization of mortgage servicing rights totaled $78,000, $64,000 and $24,000 for the years ended December 31, 2006, 2005 and 2004, respectively.

The following table sets forth the Bank's loan originations, loan purchases, loan sales, principal repayments, charge-offs and other reductions on loans for the years indicated.

	Years Ended December 31,		
(Dollars in Thousands)	**2006**	**2005**	**2004**
Loans at beginning of year	$ 516,398	$ 450,414	$ 389,225
Originations:			
Real estate loans	144,533	154,166	147,899
Commercial business loans	11,094	12,635	14,465
Consumer loans	13,096	17,011	16,063
Total loan originations	168,723	183,812	178,427
Purchases	11,007	22,211	12,152
Deductions:			
Principal loan repayments, prepayments and other, net	107,672	104,126	113,766
Loan sales	11,039	35,534	15,549
Loan charge-offs	199	29	75
Transfers to other real estate owned	-	350	-
Total deductions	118,910	140,039	129,390
Net increase in loans	60,820	65,984	61,189
Loans at end of year	$ 577,218	$ 516,398	$ 450,414