NORTHEAST BANCORP /ME/
Form 10-K
September 28, 2012
Table of Contents

United States

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 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 (1-14588)

NORTHEAST BANCORP

(Exact name of registrant as specified in its charter)

Maine	**01-0425066**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**

500 Canal Street, Lewiston, Maine	**04240**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code:

(207) 786-3245

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

Title of each class:	**Name of each exchange on which registered:**
Voting Common Stock, $1.00 par value	NASDAQ

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 þ

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 þ

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 þ No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) 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. þ

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

Large Accelerated Filer ¨	Accelerated filer ¨
Non-accelerated filer ¨	Smaller Reporting Company þ

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

The aggregate market value of the registrant s voting and non-voting common stock held by non-affiliates, computed by reference to the last reported sales price of the registrant s voting common stock on the NASDAQ Global Market on December 31, 2011 was approximately $30,624,300.

As of September 1, 2012, the registrant had outstanding 9,307,127 shares of voting common stock, $1.00 par value per share, and 1,076,314 shares of non-voting common stock, $1.00 par value per share.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant s proxy statement for the 2012 Annual Meeting of Shareholders to be held on November 28, 2012 are incorporated by reference in Items 10, 11, 12, 13 and 14 of Part III of this Annual Report on Form 10-K. The registrant intends to file such proxy statement with the Securities and Exchange Commission no later than 120 days after the end of its fiscal year ended June 30, 2012.

Table of Contents

Table of Contents

A Note About Forward-Looking Statements

This report contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended and Section 21E of the Securities Exchange Act of 1934, as amended, such as statements relating to our financial condition, prospective results of operations, future performance or expectations, plans, objectives, prospects, loan loss allowance adequacy, simulation of changes in interest rates, capital spending, finance sources and revenue sources. These statements relate to expectations concerning matters that are not historical facts. Accordingly, statements that are based on management s projections, estimates, assumptions, and judgments constitute forward-looking statements. These forward looking statements, which are based on various assumptions (some of which are beyond the Company s control), may be identified by reference to a future period or periods, or by the use of forward-looking terminology such as believe , expect , estimate , anticipate , continue , plan , approximately , intend , objective , goal , project , or other similar terms or variations on those terms, or the conditional verbs such as will , may , should , could , and would . In addition, the Company may from time to time make such oral or written forward-looking statements in future filings with the Securities and Exchange Commission (including exhibits thereto), in its reports to shareholders, and in other communications made by or with the approval of the Company.

Such forward-looking statements reflect our current views and expectations based largely on information currently available to our management, and on our current expectations, assumptions, plans, estimates, judgments, and projections about our business and our industry, and they involve inherent risks and uncertainties. Although the Company believes that these forward-looking statements are based on reasonable estimates and assumptions, they are not guarantees of future performance and are subject to known and unknown risks, uncertainties, contingencies, and other factors. Accordingly, the Company cannot give you any assurance that our expectations will in fact occur or that our estimates or assumptions will be correct. The Company cautions you that actual results could differ materially from those expressed or implied by such forward-looking statements as a result of, among other factors, the factors referenced in this report under Item 1A. Risk Factors ; changes in interest rates; competitive pressures from other financial institutions; the effects of a continuing deterioration in general economic conditions on a national basis or in the local markets in which the Company operates, including changes which adversely affect borrowers ability to service and repay our loans; changes in loan defaults and charge-off rates; changes in the value of securities and other assets, adequacy of loan loss reserves, or deposit levels necessitating increased borrowing to fund loans and investments; increasing government regulation, such as the Dodd-Frank Wall Street Reform and Consumer Protection Act; the risk that we may not be successful in the implementation of our business strategy; the risk that intangibles recorded in the Company s financial statements will become impaired; and changes in assumptions used in making such forward-looking statements. These forward-looking statements speak only as of the date of this report and the Company does not undertake any obligation to update or revise any of these forward-looking statements to reflect events or circumstances occurring after the date of this report or to reflect the occurrence of unanticipated events.

Table of Contents

PART I

Item 1. Business
Overview

Northeast Bancorp (we, our, us, Northeast or the Company), a Maine corporation chartered in April 1987, is a bank holding company registe with the Board of Governors of the Federal Reserve System (Federal Reserve) under the Bank Holding Company Act of 1956, as amended. The Company s primary subsidiary and principal asset is its wholly-owned banking subsidiary, Northeast Bank (the Bank or Northeast Bank), which has ten banking branches. The Bank, which was originally organized in 1872 as a Maine-chartered mutual savings bank and was formerly known as Bethel Savings Bank F.S.B., is a Maine state-chartered bank and a member of the Federal Reserve System. As such, the Company and the Bank are currently subject to the regulatory oversight of the Federal Reserve and the State of Maine Bureau of Financial Institutions (the Bureau).

On December 29, 2010, the merger of the Company and FHB Formation LLC, a Delaware limited liability company (FHB), was consummated. As a result of the merger, the surviving company received a capital contribution of $16.2 million (in addition to the approximately $13.1 million in cash consideration paid to former shareholders), and the former members of FHB collectively acquired approximately 60% of the Company s outstanding common stock. The Company applied the acquisition method of accounting, as described in Accounting Standards Codification (ASC) 805, *Business Combinations* (ASC 805) to the merger, which represents an acquisition by FHB of Northeast, with Northeast as the surviving company.

In connection with the transaction, as part of the regulatory approval process, the Company and the Bank made certain commitments to the Federal Reserve and the Bureau, the most significant of which are (i) to maintain a Tier 1 leverage ratio of at least 10%, (ii) to maintain a total risk-based capital ratio of at least 15%, (iii) to limit purchased loans to 40% of total loans, (iv) to fund 100% of the Company s loans with core deposits (defined as non-maturity deposits and non-brokered insured time deposits), and (v) to hold commercial real estate loans (including owner-occupied commercial real estate) to within 300% of total risk-based capital. The Company and the Bank are currently in compliance with all commitments to the Federal Reserve and the Bureau.

As of June 30, 2012, the Company, on a consolidated basis, had total assets of $669.2 million, total deposits of $422.2 million, and stockholders equity of $119.1 million. The Company gathers retail deposits through its Community Banking Division s banking offices in Maine and through its online affinity deposit program, ableBanking; originates loans through its Community Banking Division; and purchases performing commercial real estate loans at a discount through its Loan Acquisition and Servicing Group (LASG). The Company operates the Community Banking Division, with ten full-service branches, investment centers in certain of those branches, and three loan production offices, from the Bank s headquarters in Lewiston, Maine. The Company operates ableBanking and the LASG from its offices in Boston, Massachusetts.

In August of 2011, the Company sold the customer lists and certain other assets of its insurance agency division. Refer to Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Business Strategy for additional information on the sale of insurance assets in August 2011.

In May of 2012, the Company raised net proceeds of $52.7 million through the sale of shares of its common stock. Refer to Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations Financial Condition for addition information on the common stock offering in May 2012.

Unless the context otherwise requires, references herein to the Company include the Company and its subsidiary on a consolidated basis.

Strategy

The Company s goal is to prudently grow its franchise, while maintaining sound operations and risk management, by implementing the following strategies:

Measured growth of the purchased loan portfolio. The Company s Loan Acquisition and Servicing Group purchases performing commercial real estate loans, on a nationwide basis, at a discount from their outstanding principal balances, producing yields higher than those normally achieved on our originated loan portfolio.

Loans are purchased on a nationwide basis from a variety of sources, including banks, insurance companies, investment funds and government agencies, either directly or indirectly through a broker. We expect that loans purchased by our Loan Acquisition and Servicing Group will, subject to compliance with applicable regulatory commitments, represent an increasing percentage of our total loan portfolio in the future.

Focus on core deposits. The Company offers a full line of deposit products to customers in the Community Banking Division s market area through its ten-branch network. In addition, we recently launched our online affinity deposit program, ableBanking, a division of Northeast Bank. One of the Company s strategic goals is for ableBanking to provide an additional channel through which to raise core deposits to fund the acquisition of loans by the Loan Acquisition and Servicing Group.

Continuing our community banking tradition. The Community Banking Division retains a high degree of local autonomy and operational flexibility to better serve its customers. The Community Banking Division s focus on sales and service is expected to allow us to attract and retain core deposits in support of balance sheet growth, and to continue to generate new loans, particularly through the efforts of the residential mortgage origination team.

Market Area and Competition

We operate our Community Banking Division, with ten full-service branches, four investment centers and three loan production offices, from our headquarters in Lewiston, Maine. We operate ableBanking and the Loan Acquisition and Servicing Group from our offices in Boston, Massachusetts. The Community Banking Division s primary market area, which covers the western and south central regions of the State of Maine, is characterized by a diverse economy that has experienced an economic decline in recent years. We encounter significant competition in our Community Banking Division market area in making loans, attracting deposits, and selling other customer products and services. Our Maine-based competitors include savings banks, commercial banks, credit unions, mutual funds, insurance companies, brokerage and investment banking companies, finance companies, and other financial intermediaries operating in Maine. Many of our primary competitors there have substantially greater resources, larger established customer bases, higher lending limits, extensive branch networks, numerous ATMs and greater advertising and marketing budgets. They may also offer services that we do not currently provide.

The Loan Acquisition and Servicing Group has a nationwide scope in its loan purchasing and servicing activities, and competes with regional banks, private equity funds operating nationwide and a limited number of community banks when bidding for performing commercial loans. ableBanking is currently focused on gathering deposits through its pilot program in the Greater Boston area of Massachusetts. ableBanking competes with banks and credit unions, as well as other, larger, online direct banks having a national reach.

Lending Activities

General

We conduct our loan-related activities through two primary channels: our Community Banking Division and our Loan Acquisition and Servicing Group. Our Community Banking Division originates loans directly to consumers

Table of Contents

and businesses located primarily in its market area in Maine and New Hampshire. Our Loan Acquisition and Servicing Group purchases primarily performing commercial real estate loans, on a nationwide basis, at a discount from their outstanding principal balances, producing yields higher than those normally achieved on the Company s originated loan portfolio. At June 30, 2012, of our total loan portfolio of $356.3 million, $271.8 million, or 76.3%, was originated in the Community Banking Division and $84.5 million, or 23.7%, was purchased by our Loan Acquisition and Servicing Group. We expect that loans purchased by our Loan Acquisition and Servicing Group will, subject to compliance with applicable regulatory commitments, represent an increasing percentage of our total loan portfolio in the future.

We individually underwrite the loans that we originate and all loans that we purchase. Our loan underwriting policies are reviewed and approved annually by our board of directors. Each loan, regardless of whether it is originated or purchased, must meet underwriting criteria set forth in our lending policies and the requirements of applicable lending regulations of our federal and state regulators. We typically retain servicing rights for all loans that we originate or purchase, except for residential loans that we originate and sell servicing released in the secondary market.

Community Banking Division

Originated Loan Portfolio. Our originated loan portfolio consists primarily of loans to consumers and businesses in our Community Banking Division s primary market area.

Residential Mortgage Loans. We originate single-family residential mortgage loans secured by owner-occupied property, and generally sell any such fixed rate loans into the secondary market. We also offer home equity loans and home equity lines of credit, which are secured by first or second mortgages on one- to four-family owner-occupied properties, and which are held on our balance sheet. At June 30, 2012, originated residential loans outstanding totaled $133.6 million, or 37.5% of total loans. Of the residential mortgages we held for investment at June 30, 2012, approximately 46.9% were adjustable rate. Included in residential loans are home equity lines of credit and other second mortgage loans aggregating approximately $42.7 million.

Commercial Real Estate Loans. We originate multi-family and other commercial real estate loans secured by property located primarily in our Community Banking Division s market area. At June 30, 2012, commercial real estate loans outstanding were $100.2 million, or 28.1% of total loans. Although the largest commercial real estate loan originated by our Community Banking Division had a principal balance of $3.0 million at June 30, 2012, the majority of the commercial real estate loans originated by our Community Banking Division had principal balances less than $500 thousand.

Commercial Business Loans. We originate commercial business loans, including term loans, lines of credit and equipment and receivables financing to businesses located primarily in our Community Banking Division s market area. At June 30, 2012, commercial business loans outstanding were $19.6 million, or 5.5% of total loans. At June 30, 2012, there were 235 commercial business loans outstanding with an average principal balance of $89 thousand. The largest of these commercial business loans had a principal balance of $1.9 million at June 30, 2012.

Consumer Loans. We originate, on a direct basis, automobile, boat and recreational vehicle loans. At June 30, 2012, consumer loans outstanding were $17.1 million, or 4.8% of total loans.

Construction Loans. From time to time, we originate residential construction loans to finance the construction of single-family, owner-occupied homes. At June 30, 2012, construction loans outstanding were $1.2 million, or 0.3% of total loans.

Underwriting of Originated Loans. Residential loans originated for sale in the secondary market are underwritten in accordance with the standards of the Federal National Mortgage Association, the Federal Home Loan

Table of Contents

Mortgage Corporation, or other purchasing agency. Our underwriting and approval process for all other loans originated by our Community Banking Division is as follows:

Most of our originated loans are sourced through a relationship between a loan officer at the Community Banking Division and the borrower.

After a loan officer has taken basic information from the borrower and structured a loan product, a written proposal is submitted to two senior managers, one from the lending department and one from the credit department. Each provide feedback to the loan officer and, if appropriate, authorize the officer to proceed with underwriting.

The Community Banking Division s credit department obtains comprehensive information from the borrower and third parties, and conducts a thorough verification and analysis of the borrower information, which is assembled into a single underwriting package that is submitted for final approval.

Loans of $500 thousand or more (determined on a relationship basis) require approval from the Community Banking Division Credit Committee, which is comprised of senior managers of the Community Banking Division and other senior managers of Northeast Bank. Loans of less than $500 thousand (determined on a relationship basis) require approval from two designated senior managers.

Loan Acquisition and Servicing Group

General. Our Loan Acquisition and Servicing Group purchases primarily performing commercial loans secured by income-producing collateral, and from time to time may also originate commercial loans on a nationwide basis. Although the Bank s legal lending limit was $15.2 million at June 30, 2012 (equal to 20% of Northeast Bank s capital plus surplus), our credit policy currently requires prior Board approval for the purchase of a loan with an initial investment greater than 10% of the Company s tier 1 capital, determined on a relationship basis. Since the merger, we have focused primarily on loans with balances between $1.0 million and $3.0 million. Loans are purchased on a nationwide basis from a variety of sources, including banks, insurance companies, investment funds and government agencies, either directly or indirectly through a broker. We seek to build a loan portfolio that is diverse with respect to geography, loan type and collateral type. Of the loans purchased by our Loan Acquisition and Servicing Group that were outstanding as of June 30, 2012, $80.5 million, or 95.3%, consisted of commercial real estate loans.

Since the inception of the Loan Acquisition and Servicing Group through June 30, 2012, we have purchased loans for an aggregate investment of $102.4 million, of which, $101.8 million was purchased during fiscal 2012. As of June 30, 2012, the unpaid principal balance of purchased loans (on a relationship basis) ranged from $37 thousand to $8.6 million, with an average of $1.1 million, and were secured by retail, industrial, mixed use, multi-family and office properties in 24 states.

The following table shows the composition of purchased loans from inception of the Loan Acquisition and Servicing Group through June 30, 2012 by the amount of our initial investment.

Investment size	Investment (Dollars in thousands)	Percent of Total
$0 - $500	$ 14,672	14.32%
$500 - $1,000	18,433	18.00%
$1,000 - $2,000	21,689	21.18%
$2,000 - $3,000	13,268	12.96%
$3,000 - $4,000	6,270	6.12%
Greater than $4,000	28,084	27.42%
	$ 102,416	100.00%

Table of Contents

The following tables show the composition of the Company s initial investments in purchased loans from inception of the LASG through June 30, 2012 by location and type of collateral.

Collateral Type	Investment (Dollars in thousands)	Percent of Total	State	Investment (Dollars in thousands)	Percent of Total
Retail	$ 26,462	25.84%	CA	$ 25,731	25.13%
Mixed Use	11,887	11.61%	FL	12,611	12.31%
Industrial	13,636	13.31%	NY	9,435	9.21%
Multifamily	10,109	9.87%	PA	7,022	6.86%
1-4 Family	3,958	3.86%	WI	6,800	6.64%
Office	12,559	12.26%	LA	5,644	5.51%
Self Storage	2,624	2.56%	IL	4,331	4.23%
Hospitality	15,390	15.03%	IN	3,196	3.12%
Other	5,791	5.66%	All other	27,646	26.99%
	$ 102,416	100.00%		$ 102,416	100.00%

Loan Purchase Strategies. Our Loan Acquisition and Servicing Group s loan purchasing strategy involves the acquisition of commercial loans, typically secured by real estate or other business assets located throughout the United States. The Loan Acquisition and Servicing Group includes a team of credit analysts, real estate analysts, servicing specialists and legal counsel with extensive experience in the loan acquisition business.

We acquire performing commercial loans typically at a discount to their unpaid principal balances. While we acquire loans on a nationwide basis, we seek to avoid significant concentration in any geographic region or in any one collateral type. We do not seek acquisition opportunities where the primary collateral is land, construction, or residential property, although in a very limited number of cases, loans secured by such collateral may be included in a pool of otherwise desirable loans.

We focus on servicing released, whole loan or lead participation transactions so that we can control the management of our portfolio through our experienced asset management professionals. Purchased loans can be acquired as a single relationship or combined with other borrowers in a larger pool. We generally avoid small average balance transactions (i.e. less than $250 thousand) due to the relatively higher operational and opportunity costs of managing and underwriting these assets. Loans are bid to a minimal acceptable yield to maturity based on the overall risk of the loan, including expected repayment terms and the underlying collateral value. Updated loan-to-value ratios and loan terms both influence the amount of discount the Bank requires in determining whether a loan meets the Bank s guidelines. We often achieve actual results in excess of our minimal acceptable yield to maturity when a loan is prepaid.

Since the inception of the Loan Acquisition and Servicing Group through June 30, 2012, we have purchased loans with unpaid principal balances of $125.5 million for aggregate purchase price of $102.4 million, representing an average discount across the portfolio of 18.4%.

Investment as a % of Unpaid Principal Balance	Investment (Dollars in thousands)	Percent of Total
0% - 60%	$ 1,961	1.91%
60% - 70%	6,936	6.77%
70% - 80%	21,088	20.59%
80% - 90%	32,381	31.62%
90% - 100%	40,050	39.11%
	$ 102,416	100.00%

Table of Contents

Secondary Market for Commercial Loans. Commercial whole loans are typically sold either directly by sellers or through loan sale advisors. Because a central database for commercial whole loans does not exist, we attempt to compile our own statistics by both polling major loan sale advisors to obtain their aggregate trading volume and tracking the deal flow that we see directly via a proprietary database. This data reflects only a portion of the total market, as commercial whole loans are sold in private direct sales or through other loan sale advisors not included in our surveys. In recent years, the ratio of performing loans to total loans in the market has increased, because, we believe, sellers have worked through their most troubled, non-performing loans or are looking to minimize the discount they would receive in a secondary transaction. While the recent economic crisis has led to a high level of trading volume, we expect the market to remain active in times of economic prosperity, as sellers tend to have additional reserve capacity to sell their unwanted and troubled assets. Furthermore, we believe that the continued consolidation of the banking industry will create secondary market activity as acquirers often sell non-strategic borrowing relationships or assets that create excess loan concentrations.

Underwriting of Purchased Loans. We review many loan purchase opportunities and commence underwriting on a relatively small percentage of them. During fiscal 2012, we reviewed approximately 123 transactions representing loans with $1.5 billion in unpaid principal balance. Of those transactions that we reviewed, we placed bids in 36 transactions representing loans with $211 million in unpaid principal balance. Ultimately, we closed 27 transactions in which we purchased a total of 105 loans with $124.6 million in unpaid principal balance for an aggregate purchase price of $101.8 million, or 81.6% of the unpaid principal balance.

Each of our purchased loans is individually underwritten by a team of in-house, seasoned analysts before being considered for approval. Prior to commencing underwriting, each loan or portfolio of loans is analyzed for its performance characteristics, loan terms, collateral quality, and price expectations. We also consider whether the loan or portfolio of loans would make our total purchased loan portfolio more or less diverse with respect to geography, loan type and collateral type. The opportunity is underwritten once it has been identified as fitting our investment parameters. While the extent of underwriting may vary based on investment size, procedures generally include the following:

- A loan analyst reviews and analyzes financial statements and third party research, including credit reports and other data with respect to the borrower, guarantors, corporate sponsors and any major tenants, in order to assess credit risk.

- An in-house attorney makes a determination regarding the quality of loan documentation and enforceability of loan terms.

- An in-house real estate specialist performs a detailed evaluation of all real estate collateral, including canvassing local market experts, conducting original market research for trends and sale and lease comparables, and creates a written valuation that is based on current data reflecting what we believe are recent trends.

- An environmental assessment is performed on real estate collateral.

- A property inspection is performed on all real estate collateral securing a loan, focusing on several characteristics, including, among other things, the physical quality of the property, current occupancy, general quality and occupancy within the neighborhood, market position and nearby property listings.

- A detailed underwriting package containing the results of all this analysis and information is assembled and reviewed by a separate credit analyst on our team before being submitted for approval by the Loan Acquisition and Servicing Group Credit Committee.

Collateral Valuation. The estimated value of the real property collateralizing the loan is determined by the Loan Acquisition and Servicing Group s in-house real estate group, which considers, among other factors, the type of property, its condition, location and its highest and best use in its marketplace. An inspection is conducted for the real property securing all loans bid upon, and for all loans that represent an investment in excess of $1.0 million, members of the Loan Acquisition and Servicing Group typically conduct a personal site inspection.

Table of Contents

We generally view cash flow from operations as the primary source of repayment on purchased loans. The Loan Acquisition and Servicing Group analyzes the current and likely future cash flows generated by the collateral to repay the loan. Also considered are minimum debt service coverage ratios, consisting of the ratio of net operating income to total principal and interest payments. For example, our credit policy provides that the debt service coverage ratio for a purchased commercial real estate loan generally should not be less than 120 percent of the monthly principal and interest payments resulting from a re-amortization of the Bank s basis, at a market interest rate.

Loan Pricing. In determining the amount that we are willing to bid to acquire individual loans or loan pools, the Loan Acquisition and Servicing Group considers the following:

- the collateral securing the loan;
- the geographic location;
- the financial resources of the borrower or guarantors, if any;
- the recourse nature of the loan;
- the age and performance of the loan;
- the length of time during which the loan has performance in accordance with its repayment term;
- the yield expected to be earned; and
- servicing restrictions, if any.

In addition to the factors listed above and despite the fact that purchased loans are typically performing loans, the Loan Acquisition and Servicing Group also estimates the amount that we may realize through collection efforts or foreclosure and sale of the collateral, net of expenses, and the length of time and costs required to complete the collection or foreclosure process in the event a loan becomes non-performing or is non-performing at the time of purchase.

Approvals. All loan purchases must be approved by the Loan Acquisition and Servicing Group Credit Committee. This committee is comprised of members of the executive management team and senior management from the Loan Acquisition and Servicing Group. The committee discusses all loans on an individual basis. Loan Acquisition and Servicing Group Credit Committee approval of a purchased loan with an initial investment greater of $500 thousand must include the approval of our Chief Executive Officer, Chief Financial Officer or the Chief Executive Officer s designee. Our credit policy currently requires prior Board approval for the purchase of a loan with an initial investment greater than 10% of the Company s tier 1 capital, determined on a relationship basis.

Loan Servicing. We conduct all loan servicing with an in-house team of experienced asset managers who actively manage the loan portfolio. Asset managers initiate and maintain regular borrower contact, and ensure that the loan credit analysis is accurate. Collateral valuations, property inspections, and other collateral characteristics are updated periodically as a result of our ongoing in-house real estate analysis. All asset management activity and analysis is contained within a central database.

Competition for Purchased of Loans. Our Loan Acquisition and Servicing Group competes primarily with a limited number of community banks, regional banks and private equity funds operating nationwide. We believe that we have a competitive advantage in bidding against private equity funds on performing loans because those funds generally have higher funding costs and, therefore, higher expectations for return on investment than we do. Furthermore, many private equity funds do not compete for small balance commercial loans and only pursue transactions where the investment amount would exceed $20 million or more.

We believe that we have a competitive advantage in bidding against many banks that purchase commercial loans in the secondary market because we have a specialized group with experience in purchasing commercial real

Table of Contents

estate loans. Most banks we compete against are community banks looking to acquire loans in their market; these banks usually have specific criteria for their acquisition activities and do not pursue pools with collateral or geographic diversity. We believe that there are a limited number of banks pursuing a similar, nationwide commercial loan acquisition strategy.

Brokerage and Investment Advisory Services

The Bank s investment brokerage division, Northeast Financial Services (Northeast Financial), offers an array of investment and financial planning products and services through the Bank s branch network. Working in partnership with *Commonwealth Financial Network, a registered investment adviser*, Northeast Financial s registered representatives offer customers a broad range of investment products.

Investment Activities

Our securities portfolio and short-term investments provide and maintain liquidity, assist in managing the interest rate sensitivity of our balance sheet, and serve as collateral for certain of our obligations. Individual investment decisions are made based on the credit quality of the investment, liquidity requirements, potential returns, cash flow targets, and consistency with our asset/liability management objectives.

Sources of Funds

Deposits have traditionally been the primary source of the Bank s funds for lending and other investment purposes. In addition to deposits, the Bank obtains funds from the amortization and prepayment of loans and mortg