

Kentucky First Federal Bancorp
Form 10-K
September 28, 2009

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 1934
For the fiscal year ended June 30, 2009

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
(State or other jurisdiction of
incorporation or organization)

61-1484858
(I.R.S. Employer
Identification No.)

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

41702
(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)
(Title of each class)

Nasdaq Stock Market, LLC
(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

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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):

Large accelerated filer

Non-accelerated filer

(Do not check if smaller reporting company)

Accelerated filer

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 \$31.2 million as of June 30, 2009.

Number of shares of common stock outstanding as of September 20, 2009: 7,905,120.

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, 2009. (Part II)
2. Portions of Proxy Statement for the 2009 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	21
Item 3. Legal Proceedings	21
Item 4. Submission of Matters to a Vote of Security Holders	21
PART II	
Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities	22
Item 6. Selected Financial Data	22
Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation	22
Item 7A. Quantitative and Qualitative Disclosures About Market Risk	22
Item 8. Financial Statements and Supplementary Data	23
Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure	23
Item 9A(T). Controls and Procedures	23
Item 9B. Other Information	25
PART III	
Item 10. Directors, Executive Officers and Corporate Governance	25
Item 11. Executive Compensation	25
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	26
Item 14. Principal Accountant Fees and Services	26
PART IV	

Item 15.	Exhibits and Financial Statement Schedules	27
SIGNATURES		29

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”). Under the terms of the agreement of merger, shareholders of Frankfort First Bancorp received approximately 1,740,554 shares of Kentucky First’s common stock and approximately \$13.7 million in cash (including payments to holders of Frankfort First stock options). Following the Reorganization and Merger, 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 their main telephone number is (606) 436-3860.

At June 30, 2009, Kentucky First had total assets of \$240.9 million, deposits of \$139.7 million and stockholders’ equity of \$58.4 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.

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First Federal of Hazard and First Federal of Frankfort are subject to examination and comprehensive regulation by the Office of Thrift Supervision 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.”

1

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, 2009, First Federal of Hazard had total assets of \$114.2 million, net loans receivable of \$86.4 million, total mortgage-backed and investment securities of \$17.1 million, deposits of \$77.7 million and total capital of \$22.9 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, 2009, First Federal of Frankfort had total assets of \$130.4 million, net loans receivable of \$103.3 million, deposits of \$66.4 million and total capital of \$32.3 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.

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), per capita personal income in Perry County averaged \$26,175 in 2007, compared to personal income of \$31,826 in Kentucky and \$39,751 in the United States. Total population in Perry County has remained stable over the last five years at approximately 30,000. 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 services sector, including health care (34.8%), trade, transportation and utilities industry (21.3%), state and local government (17.6%) and the mining industry (16.2%). During the last five years, the unemployment rate has exceeded 6% and in June 2009, was 12.7%, compared to 6.4% in Kentucky and 5.8% in the United States at June 2008.

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 48,000, 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 47% 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 9.6% in June 2009 after having experienced a generally stable unemployment rate which had ranged from 3 to 6% 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, although there is little demand for such loans in our market areas. 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, 2009, residential mortgage loans totaled \$163.1 million, or 85.8% 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, 2009, the Company's loan portfolio included \$113.0 million in adjustable-rate one- to four-family residential mortgage loans, or 69.3%, of the Company's one- to four-family 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 offers 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. On limited occasions we have made construction loans to builders for the construction of a single-family residence for subsequent sale. At June 30, 2009, construction loans totaled \$735,000, or 0.4%, 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.

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, 2009, multi-family and nonresidential loans totaled \$7.3 million and \$11.5 million, respectively, or 3.8% and 6.1%, 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, 2009, our consumer loan balance totaled \$7.4 million, or 3.9%, of our total loan portfolio. Of the consumer loan balance at June 30, 2009, \$4.5 million were home equity loans and \$2.9 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 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, 2009, the total outstanding home equity loans amounted to 2.4% 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, 2009, loans on savings accounts totaled 1.5% 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 began selling fixed-rate loans in April 2004 to the Federal Home Loan Bank of Cincinnati ("FHLB-Cincinnati"). Loan servicing rights are retained on such loans. At June 30, 2009, \$10.4 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, 2009, the regulatory limit on loans to one borrower was \$3.5 million for First Federal of Hazard and \$2.6 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, 2009, 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.

5

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, 2009, our investment portfolio consisted primarily of U.S. Government agency securities with maturities of five years or less and 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 \$2.4 million at June 30, 2009. 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.