

FEDERAL TRUST CORP  
Form 10-Q  
November 17, 2008  
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## U.S. SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

### FORM 10-Q

(Mark One)

Quarterly report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 for the quarterly period ended September 30, 2008.

Transition report pursuant to section 13 or 15(d) of the Securities Exchange Act of 1934 for the transition period from \_\_\_\_\_ to \_\_\_\_\_.

Commission file number: 001-31724.

## FEDERAL TRUST CORPORATION

(Exact name of registrant as specified in its charter)

Florida

59-2935028

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(State or other jurisdiction of  
incorporation or organization)

(I.R.S. Employer  
Identification No.)

312 West 1<sup>st</sup> Street

Sanford, Florida  
(Address of principal executive offices)

(407) 323-1833

32771  
(Zip Code)

Registrant's telephone number, including area code

Not applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES  NO

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

Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Act). YES  NO

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date:

Common stock, par value \$.01 per share  
(class)

9,436,305 Shares  
Outstanding at November 12, 2008

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**FEDERAL TRUST CORPORATION AND SUBSIDIARIES**

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**Table of Contents****FEDERAL TRUST CORPORATION AND SUBSIDIARIES****PART I. FINANCIAL INFORMATION****Item 1. Financial Statements****Condensed Consolidated Balance Sheets**

(\$ in thousands, except share information)

|   | At                                   |                                   |
|---|--------------------------------------|-----------------------------------|
|   | September 30,<br>2008<br>(Unaudited) | December 31,<br>2007<br>(Audited) |
| <b>Assets</b>   |                                      |                                   |
| Cash and due from banks   | \$ 38,916                            | \$ 8,046                          |
| Interest-earning deposits   | 1,421                                | 1,131                             |
| Cash and cash equivalents   | 40,337                               | 9,177                             |
| Securities available for sale   | 32,906                               | 52,449                            |
| Loans, less allowance for loan losses of \$21,252 in 2008 and \$13,869 in 2007  | 472,898                              | 563,234                           |
| Accrued interest receivable   | 3,002                                | 4,509                             |
| Premises and equipment, net   | 18,268                               | 18,814                            |
| Foreclosed assets   | 15,590                               | 9,522                             |
| Federal Home Loan Bank stock  | 8,505                                | 8,129                             |
| Mortgage servicing rights, net  | 404                                  | 444                               |
| Bank-owned life insurance   | 7,758                                | 7,504                             |
| Deferred tax asset, net of valuation allowance of \$16,674 in 2008 and \$0 in 2007  |                                      | 7,966                             |
| Other assets  | 2,073                                | 8,516                             |
| <b>Total assets</b>   | <b>\$ 601,741</b>                    | <b>\$ 690,264</b>                 |
| <b>Liabilities and Stockholders Equity</b>  |                                      |                                   |
| <b>Liabilities:</b>   |                                      |                                   |
| Noninterest-bearing demand deposits   | \$ 11,559                            | \$ 13,916                         |
| Interest-bearing demand deposits  | 34,131                               | 80,275                            |
| Money-market deposits   | 66,308                               | 57,608                            |
| Savings deposits  | 2,489                                | 2,422                             |
| Time deposits   | 296,172                              | 327,508                           |
| <b>Total deposits</b>   | <b>410,659</b>                       | <b>481,729</b>                    |
| Federal Home Loan Bank advances   | 161,500                              | 152,000                           |
| Other borrowings  |                                      | 16                                |
| Junior subordinated debentures  | 5,155                                | 5,155                             |
| Accrued interest payable  | 1,201                                | 2,597                             |
| Official checks   | 4,413                                | 2,238                             |
| Other liabilities   | 8,952                                | 6,843                             |
| <b>Total liabilities</b>  | <b>591,880</b>                       | <b>650,578</b>                    |
| <b>Stockholders equity:</b>   |                                      |                                   |
| Common stock, \$.01 par value, 65,000,000 shares authorized at September 30, 2008, and 15,000,000 shares authorized at December 31, 2007; 9,436,305 shares outstanding in 2008 and 2007 | 94                                   | 94                                |

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|  |            |            |
|--|------------|------------|
| Additional paid-in capital                               | 44,590     | 44,515     |
| Accumulated deficit                                      | (29,797)   | (3,755)    |
| Unallocated ESOP shares (42,386 shares in 2008 and 2007) | (440)      | (440)      |
| Accumulated other comprehensive loss                     | (4,586)    | (728)      |
| Total stockholders' equity                               | 9,861      | 39,686     |
| Total liabilities and stockholders' equity               | \$ 601,741 | \$ 690,264 |

See Accompanying Notes to Condensed Consolidated Financial Statements.

**Table of Contents****FEDERAL TRUST CORPORATION AND SUBSIDIARIES****Condensed Consolidated Statements of Operations (Unaudited)**

(\$ in thousands, except per share information)

|  | Three Months Ended<br>September 30, |                | Nine Months Ended<br>September 30, |                 |
|--|-------------------------------------|----------------|------------------------------------|-----------------|
|  | 2008                                | 2007           | 2008                               | 2007            |
| <b>Interest income:</b>  |                                     |                |                                    |                 |
| Loans  | \$ 6,370                            | \$ 9,729       | \$ 21,582                          | \$ 29,132       |
| Securities   | 534                                 | 801            | 1,734                              | 2,463           |
| Other  | 244                                 | 176            | 884                                | 519             |
| <b>Total interest income</b>   | <b>7,148</b>                        | <b>10,706</b>  | <b>24,200</b>                      | <b>32,114</b>   |
| <b>Interest expense:</b>   |                                     |                |                                    |                 |
| Deposits   | 3,969                               | 5,716          | 13,192                             | 16,659          |
| Other  | 1,811                               | 2,239          | 5,479                              | 6,406           |
| <b>Total interest expense</b>  | <b>5,780</b>                        | <b>7,955</b>   | <b>18,671</b>                      | <b>23,065</b>   |
| Net interest income  | 1,368                               | 2,751          | 5,529                              | 9,049           |
| Provision for loan losses  | 6,100                               | 5,115          | 10,265                             | 10,410          |
| <b>Net interest expense after provision for loan losses</b>            | <b>(4,732)</b>                      | <b>(2,364)</b> | <b>(4,736)</b>                     | <b>(1,361)</b>  |
| <b>Other income:</b>   |                                     |                |                                    |                 |
| Service charges and fees   | 121                                 | 107            | 371                                | 320             |
| Gains on sales of loans held for sale                                  | 27                                  | 14             | 226                                | 120             |
| Net gains (loss) on sales of securities available for sale             |                                     | (139)          | 6                                  | (104)           |
| Rental income  | 92                                  | 97             | 296                                | 266             |
| Increase in cash surrender value of bank-owned life insurance policies | 72                                  | 68             | 254                                | 204             |
| Other  | 112                                 | 158            | 223                                | 412             |
| <b>Total other income</b>  | <b>424</b>                          | <b>305</b>     | <b>1,376</b>                       | <b>1,218</b>    |
| <b>Other expenses:</b>   |                                     |                |                                    |                 |
| Salary and employee benefits   | 1,972                               | 4,782          | 5,827                              | 8,815           |
| Occupancy expense  | 693                                 | 565            | 2,072                              | 1,669           |
| Professional services  | 492                                 | 357            | 1,242                              | 990             |
| Deposit insurance premium  | 350                                 | 98             | 991                                | 145             |
| Data processing  | 261                                 | 279            | 838                                | 735             |
| Other-than-temporary impairment on securities available for sale       |                                     | 749            |                                    | 749             |
| Foreclosure expenses   | 120                                 | 30             | 391                                | 57              |
| Net loss (gain) on sale and write downs of foreclosed assets           | 214                                 | (36)           | 962                                | 318             |
| Offering expenses  | 1,330                               |                | 1,330                              |                 |
| Marketing and advertising  | 100                                 | 114            | 243                                | 345             |
| Other  | 387                                 | 868            | 1,255                              | 1,631           |
| <b>Total other expenses</b>  | <b>5,919</b>                        | <b>7,806</b>   | <b>15,151</b>                      | <b>15,454</b>   |
| <b>Loss before income taxes</b>  | <b>(10,227)</b>                     | <b>(9,865)</b> | <b>(18,511)</b>                    | <b>(15,597)</b> |

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|   |             |            |             |            |
|---|-------------|------------|-------------|------------|
| Income tax expense (benefit)                        | (3,794)     | 7,531      | (6,135)     |            |
| Net loss  | \$ (10,227) | \$ (6,071) | \$ (26,042) | \$ (9,462) |
| Loss per share:                                     |             |            |             |            |
| Basic   | \$ (1.09)   | \$ (.65)   | \$ (2.27)   | \$ (1.01)  |
| Diluted   | \$ (1.09)   | \$ (.65)   | \$ (2.27)   | \$ (1.01)  |
| Weighted-average shares outstanding (in thousands): |             |            |             |            |
| Basic   | 9,394       | 9,367      | 9,394       | 9,357      |
| Diluted   | 9,394       | 9,367      | 9,394       | 9,357      |
| Cash dividends per share                            | \$          | \$         | \$          | \$ .08     |

See Accompanying Notes to Condensed Consolidated Financial Statements.

**Table of Contents****FEDERAL TRUST CORPORATION AND SUBSIDIARIES****Condensed Consolidated Statements of Stockholders Equity****For the Nine Months Ended September 30, 2008 and 2007**

(\$ in thousands)

|   | Common Stock |        | Additional<br>Paid-In<br>Capital | Retained<br>Earnings<br>(Accumulated<br>Deficit) | Unallocated<br>ESOP<br>Shares | Accumulated<br>Other<br>Comprehensive<br>Loss | Total<br>Stockholders<br>Equity |
|---|--------------|--------|----------------------------------|--|-------------------------------|---|---------------------------------|
|   | Shares       | Amount |                                  |  |                               |   |                                 |
| Balance at December 31, 2006  | 9,351,542    | \$ 94  | \$ 43,858                        | \$ 11,160  | \$ (257)                      | \$ (235)                                      | \$ 54,620                       |
| Comprehensive income:   |              |        |                                  |  |                               |   |                                 |
| Net loss (unaudited)  |              |        |                                  | (9,462)  |                               |   | (9,462)                         |
| Change in unrealized loss on securities<br>available for sale, net of income taxes of<br>\$(346) (unaudited)                |              |        |                                  |  |                               | (572)   | (572)                           |
| Comprehensive loss (unaudited)  |              |        |                                  |  |                               |   | (10,034)                        |
| Issuance of common stock options exercised<br>(unaudited)   | 84,763       |        | 401                              |  |                               |   | 401                             |
| ESOP shares purchased (6,618 shares)<br>(unaudited)   |              |        | 183                              |  | (183)                         |   |                                 |
| Share based compensation (unaudited)  |              |        | 51                               |  |                               |   | 51                              |
| Dividends paid (unaudited)  |              |        |                                  | (752)  |                               |   | (752)                           |
| Balance at September 30, 2007 (unaudited)   | 9,436,305    | \$ 94  | \$ 44,493                        | \$ 946   | \$ (440)                      | \$ (807)                                      | \$ 44,286                       |
| Balance at December 31, 2007  | 9,436,305    | \$ 94  | \$ 44,515                        | \$ (3,755)                                       | \$ (440)                      | \$ (728)                                      | \$ 39,686                       |
| Comprehensive loss:   |              |        |                                  |  |                               |   |                                 |
| Net loss (unaudited)  |              |        |                                  | (26,042)   |                               |   | (26,042)                        |
| Change in unrealized loss on securities<br>available for sale, net of deferred tax asset<br>valuation allowance (unaudited) |              |        |                                  |  |                               | (3,858)                                       | (3,858)                         |
| Comprehensive loss (unaudited)  |              |        |                                  |  |                               |   | (29,900)                        |
| Share based compensation (unaudited)  |              |        | 75                               |  |                               |   | 75                              |
| Balance at September 30, 2008 (unaudited)   | 9,436,305    | \$ 94  | \$ 44,590                        | \$ (29,797)                                      | \$ (440)                      | \$ (4,586)                                    | \$ 9,861                        |

See Accompanying Notes to Condensed Consolidated Financial Statements.



**Table of Contents****FEDERAL TRUST CORPORATION AND SUBSIDIARIES****Condensed Consolidated Statements of Cash Flows (Unaudited)**

(\$ in thousands)

|  | <b>Nine Months Ended</b> |                 |
|--|--------------------------|-----------------|
|  | <b>September 30,</b>     |                 |
|  | <b>2008</b>              | <b>2007</b>     |
| <b>Cash flows from operating activities:</b>   |                          |                 |
| Net loss   | \$ (26,042)              | \$ (9,462)      |
| <b>Adjustments to reconcile net loss to net cash provided by operating activities:</b> |                          |                 |
| Depreciation and amortization  | 726                      | 658             |
| Provision for loan losses  | 10,265                   | 10,410          |
| Net loss on sale and write downs of foreclosed assets                                  | 962                      | 318             |
| Capitalized costs on foreclosed assets   | (277)                    | (25)            |
| Deferred tax expense (benefit)   | 7,527                    | (6,042)         |
| Net amortization of premiums and discounts on securities                               | 152                      | (84)            |
| Net amortization of loan origination fees, costs, premiums and discounts               | 868                      | 762             |
| Amortization of mortgage servicing rights  | 82                       | 142             |
| Increase in cash surrender value of life insurance policies                            | (254)                    | (204)           |
| Proceeds from sales of loans held for sale   | 2,315                    | 6,140           |
| Loans originated for resale  | (2,476)                  | (5,257)         |
| Gain on sale of loans held for sale  | (226)                    | (120)           |
| Market value adjustment on loans held for sale   |                          | 328             |
| Other-than-temporary impairment of securities held for sale                            |                          | 749             |
| Net (gain) loss on sales of securities available for sale                              | (6)                      | 104             |
| Share based compensation   | 75                       | 51              |
| <b>Cash provided by (used for) resulting from changes in:</b>                          |                          |                 |
| Accrued interest receivable  | 1,507                    | 254             |
| Other assets   | 6,337                    | 281             |
| Accrued interest payable   | (1,396)                  | 919             |
| Official checks  | 2,175                    | (52)            |
| Other liabilities  | 801                      | 4,483           |
| <b>Net cash provided by operating activities</b>                                       | <b>2,811</b>             | <b>4,353</b>    |
| <b>Cash flows from investing activities:</b>   |                          |                 |
| Purchase of securities available for sale  | (1,005)                  | (15,301)        |
| Proceeds from principal repayments and sales of securities available for sale          | 17,287                   | 22,631          |
| Loan principal repayments, net of originations   | 55,971                   | 28,196          |
| Purchase of loans  |                          | (47,901)        |
| Proceeds from sales of loans transferred to held for sale                              | 12,051                   | 2,491           |
| Purchase of premises and equipment   | (74)                     | (2,997)         |
| (Purchase) redemption of Federal Home Loan Bank stock                                  | (376)                    | 157             |
| Net proceeds from sales of foreclosed assets   | 4,773                    | 269             |
| <b>Net cash provided by (used in) investing activities</b>                             | <b>88,627</b>            | <b>(12,455)</b> |
| <b>Cash flows from financing activities:</b>   |                          |                 |
| Net increase (decrease) in deposits  | (71,070)                 | 8,613           |
| Net increase in Federal Home Loan Bank advances  | 9,500                    | 1,300           |
| Net decrease in other borrowings   | (16)                     | (323)           |
| Principal repayments under capital lease obligation                                    |                          | (2,504)         |

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|   |           |          |
|---|-----------|----------|
| Net increase in advance payments from borrowers for taxes and insurance | 1,308     | 1,790    |
| Dividends paid  |           | (752)    |
| Net proceeds from the exercise of options on common stock               |           | 401      |
| Net cash provided by (used in) financing activities                     | (60,278)  | 8,525    |
| Net increase in cash and cash equivalents                               | 31,160    | 423      |
| Cash and cash equivalents at beginning of period                        | 9,177     | 8,680    |
| Cash and cash equivalents at end of period                              | \$ 40,337 | \$ 9,103 |

(Continued)

**Table of Contents****FEDERAL TRUST CORPORATION AND SUBSIDIARIES****Condensed Consolidated Statements of Cash Flows (Unaudited), Continued**

(\$ in thousands)

|   | <b>Nine Months Ended<br/>September 30,</b> |             |
|---|--|-------------|
|   | <b>2008</b>                                | <b>2007</b> |
| <b>Supplemental disclosure of cash flow information:</b>  |  |             |
| Cash paid during the period for interest  | \$ 20,067                                  | \$ 22,146   |
| Cash received during the period for income tax recoveries   | \$ 4,071                                   | \$          |
| <b>Noncash transactions:</b>  |  |             |
| Foreclosed assets acquired in settlement of loans   | \$ 11,526                                  | \$ 5,649    |
| Accumulated other comprehensive loss, net change in unrealized loss on securities available for sale, net of deferred tax asset valuation allowance | \$ (3,858)                                 | \$ (572)    |
| Mortgage servicing rights recognized upon sale of loans held for sale   | \$ 42                                      | \$ 25       |
| ESOP shares purchased   | \$   | \$ 183      |
| Transfer from other assets to premises and equipment  | \$ 106                                     | \$          |
| Transfer of premises and equipment to other assets  | \$   | \$ 882      |

See Accompanying Notes to Condensed Consolidated Financial Statements.

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**FEDERAL TRUST CORPORATION AND SUBSIDIARIES**

**Notes to Condensed Consolidated Financial Statements (Unaudited)**

**(1) Description of Business and Basis of Presentation**

**Organization.** Federal Trust Corporation ( Federal Trust ) is the sole shareholder of Federal Trust Bank (the Bank ) and Federal Trust Mortgage Company (the Mortgage Company ). Federal Trust operates as a unitary savings and loan holding company. Federal Trust's primary business activity is the operation of the Bank and the Mortgage Company. The Bank is a federally-chartered stock savings bank. The Bank's deposits are insured up to applicable limits by the Federal Deposit Insurance Corporation. The Bank provides a wide range of banking services to individual and corporate customers through its 11 full-service branch offices located in Orange, Seminole, Volusia, Lake and Flagler Counties, Florida. Until April 2008, we operated a residential mortgage company, Federal Trust Mortgage Company, where the Company originated residential mortgage loans, purchased and sold mortgage loans in the secondary market, and serviced residential mortgage loans, including loans in Federal Trust Bank's loan portfolio. In April 2008, Federal Trust Bank assumed the staff and operations of Federal Trust Mortgage Company.

The condensed consolidated financial statements include the accounts of Federal Trust, the Bank and the Mortgage Company (collectively referred to herein as, the Company ). All significant intercompany accounts and transactions have been eliminated in consolidation.

In the opinion of management, the accompanying condensed consolidated financial statements contain all adjustments (principally consisting of normal recurring accruals) necessary to present fairly the financial position as of September 30, 2008, and the results of operations and cash flows for the three- and nine-month periods ended September 30, 2008 and 2007. The results of operations for the nine-month period ended September 30, 2008, are not necessarily indicative of the results to be expected for the entire year ending December 31, 2008. These statements should be read in conjunction with the condensed consolidated financial statements included in the Company's Annual Report on Form 10-K for the year ended December 31, 2007.

**Going Concern**

If the Company is not able to raise additional capital or sell control of all or part of the Company in a merger or other transaction, management believes that there is substantial doubt about the Company's and the Bank's ability to continue as a going concern. The Bank's operating and capital requirements, the recurring losses due to recent increases in nonperforming loans, declining net interest margin and continuing high levels of operating expenses are contributing factors for this concern. In order to comply with its regulatory capital requirements, the Bank needs to raise substantial additional capital. There is no guarantee that a merger or similar transaction or that sufficient capital will be available at acceptable terms, if at all.

**Recent Accounting Pronouncements.**

In October 2008, the Financial Accounting Standards Board ( FASB ) issued FASB Staff Position No. 157-3 *Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active*. This FASB Staff Position clarifies the application of Statement of Financial Accounting Standards (SFAS) No. 157, *Fair Value Measurements* ( SFAS 157 ), in a market that is not active and provides an example to illustrate key considerations in determining the fair value of a financial asset when the market for that financial asset is not active. This FASB Staff Position is effective upon issuance, including prior periods for which financial statements have not been issued. The Company has used this guidance, along with earlier guidance in the joint press release issued September 30, 2008, by The Office of the Chief Accountant of the Securities and Exchange Commission ( SEC ) and FASB that addresses similar SFAS 157 application issues, in preparing the financial statements and related disclosures contained herein.

In May 2008, the FASB issued (SFAS) No. 162 *The Hierarchy of Generally Accepted Accounting Principles* ( SFAS 162 ). This statement identifies the sources of accounting principals and the framework for selecting the principals to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with generally accepted accounting principals GAAP in the United States. This Statement is effective 60 days following the SEC approval of the Public Company Accounting Oversight Board amendments to AU Section 411, *The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles*. Adoption of SFAS 162 will not be a change in the Company's current practice and therefore, will not have a material impact on the Company's consolidated financial condition or the results of operations.

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In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* ( SFAS 161 ). This standard requires enhanced disclosures regarding derivative instruments and hedging activities so as to enable investors to better understand their effects on an entity's financial position, financial performance, and cash flows. This statement is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The adoption of SFAS 161 will have no impact on the Company's financial condition and results of operations.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements* ( SFAS 160 ) and SFAS No. 141(R), *Business Combinations* ( SFAS 141(R) ). The Standards will improve, simplify, and converge internationally the accounting for business combinations and the reporting of noncontrolling interests in consolidated financial statements. The statements are effective for fiscal years, and interim periods within those years, beginning on or after December 15, 2008. Earlier adoption is prohibited. Management does not anticipate that SFAS 160 and SFAS 141(R) will have a material effect on the Company's financial condition or results of operations.

**(2) Loans**

The components of loans are summarized as follows (\$ in thousands):

|  | At September 30,<br>2008<br>(unaudited) | At December 31,<br>2007 |
|--|---|-------------------------|
| <b>Residential lending:</b>                      |   |                         |
| Mortgages (1)                                    | \$ 321,496                              | \$ 359,954              |
| Lot  | 39,157                                  | 39,994                  |
| Construction                                     | 4,749                                   | 21,926                  |
| <b>Total residential lending</b>                 | <b>365,402</b>                          | <b>421,874</b>          |
| <b>Commercial lending:</b>                       |   |                         |
| Real estate secured                              | 53,987                                  | 85,492                  |
| Land, development and construction               | 54,078                                  | 73,752                  |
| Commercial loans                                 | 33,763                                  | 15,866                  |
| <b>Total commercial lending</b>                  | <b>141,828</b>                          | <b>175,110</b>          |
| <b>Consumer loans</b>                            | <b>141</b>                              | <b>214</b>              |
| <b>Total loans</b>                               | <b>507,371</b>                          | <b>597,198</b>          |
| <b>Add (deduct):</b>                             |   |                         |
| Allowance for loan losses                        | (21,252)                                | (13,869)                |
| Net premiums, discounts, deferred fees and costs | 2,189                                   | 3,033                   |
| Loans in process                                 | (15,410)                                | (23,128)                |
| <b>Loans, net</b>                                | <b>\$ 472,898</b>                       | <b>\$ 563,234</b>       |

(1) Includes approximately \$155,000 and \$7.6 million of loans held for sale at September 30, 2008, and December 31, 2007, respectively.

(Continued)

**Table of Contents****FEDERAL TRUST CORPORATION AND SUBSIDIARIES****Notes to Condensed Consolidated Financial Statements (Unaudited), Continued****(2) Loans, Continued**

During the third quarter of 2008, we continued to experience weakness in the real estate market throughout Florida and increases in loan delinquencies. As a result, we recorded a provision for loan losses in the 2008 third quarter of \$6.1 million. Our loan charge-offs during the 2008 third quarter were \$1.7 million, we recognized \$344,000 in recoveries from the liquidation of Transland Financial Services, Inc. in settlement of the fraud loss we recognized in 2007. Our allowance for loan losses increased from \$13.9 million at December 31, 2007, to \$21.3 million at September 30, 2008.

The activity in the allowance for loan losses is as follows (\$ in thousands):

|                                | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|--------------------------------|-------------------------------------|-----------|------------------------------------|-----------|
|                                | 2008                                | 2007      | 2008                               | 2007      |
| Balance at beginning of period | \$ 16,557                           | \$ 10,292 | \$ 13,869                          | \$ 5,098  |
| Provision for loan losses      | 6,100                               | 5,115     | 10,265                             | 10,410    |
| Charge-offs                    | (1,749)                             | (4,902)   | (3,282)                            | (5,004)   |
| Recoveries                     | 344                                 | 1         | 400                                | 2         |
| Balance at end of period       | \$ 21,252                           | \$ 10,506 | \$ 21,252                          | \$ 10,506 |

The following is a summary of information regarding nonaccrual and collateral dependent impaired loans (\$ in thousands):

|   | At September 30,<br>2008 | At December 31,<br>2007 |
|---|--------------------------|-------------------------|
| Non-accrual loans   | \$ 59,707                | \$ 38,223               |
| Accruing loans past due ninety days or more   | \$                       | \$                      |
| Recorded investment in impaired loans for which there is a related allowance for loan losses  | \$ 16,650                | \$ 15,299               |
| Allowance for loan losses related to impaired loans   | \$ (8,138)               | \$ (5,556)              |
| Recorded investment in impaired loans for which there is no related allowance for loan losses | \$ 42,397                | \$ 22,903               |
| Net investment in impaired loans  | \$ 50,909                | \$ 32,646               |

|  | Three Months Ended<br>September 30, |      | Nine Months Ended<br>September 30, |      |
|--|-------------------------------------|------|------------------------------------|------|
|  | 2008                                | 2007 | 2008                               | 2007 |

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|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| Interest income recognized and received on impaired loans | \$ 111    | \$        | \$ 1,774  | \$        |
| Average net recorded investment in impaired loans         | \$ 62,393 | \$ 20,041 | \$ 57,543 | \$ 13,076 |

(Continued)

**Table of Contents****FEDERAL TRUST CORPORATION AND SUBSIDIARIES****Notes to Condensed Consolidated Financial Statements (Unaudited), Continued****(2) Loans, Continued**

|  | September 30,<br>2008 | December 31,<br>2007 |
|--|-----------------------|----------------------|
| Non-accrual loans:   |                       |                      |
| Residential loans:   |                       |                      |
| Mortgages  | \$ 17,150             | \$ 4,993             |
| Lot  | 10,995                | 6,578                |
| Construction   | 4,051                 | 7,317                |
| Total residential loans                                    | 32,196                | 18,888               |
| Commercial loans:  |                       |                      |
| Real estate secured  | 5,662                 | 7,520                |
| Land, development and construction                         | 16,693                | 11,063               |
| Commercial business  | 5,124                 | 752                  |
| Total commercial loans                                     | 27,479                | 19,335               |
| Consumer loans   | 32                    |                      |
| Total non-accrual loans                                    | 59,707                | 38,223               |
| Foreclosed assets  | 15,590                | 9,522                |
| Total non-performing assets                                | \$ 75,297             | \$ 47,745            |
| Total non-accrual loans to total loans                     | 11.8%                 | 6.4%                 |
| Total non-accrual loans to total assets                    | 9.9%                  | 5.5%                 |
| Total allowance for loan losses to total non-accrual loans | 35.6%                 | 36.3%                |
| Total non-performing assets to total assets                | 12.5%                 | 6.9%                 |

Total non-performing assets, which includes non-accrual loans and foreclosed properties, increased from \$47.7 million at December 31, 2007, to \$75.3 million at September 30, 2008. The increase in non-performing assets during 2008 included net increases of \$8.1 million in commercial loans, \$13.3 million in residential loans, of which \$8.9 million was to foreign national borrowers secured by investment homes in central Florida. Foreclosed properties also increased \$6.1 million from December 2007 to September 2008. In addition to our non-performing assets, at September 30, 2008, we had \$37.6 million in performing loans that exhibited weakness or concerns and were graded as classified or special mention; this total decreased \$19.0 million from \$56.6 million at December 31, 2007, due primarily to the loans transferred to non-accrual status and foreclosed properties.

Compared to June 2008, total non-performing assets increased by \$6.3 million at September 2008. Residential loans to foreign national borrowers experienced the largest increase of \$3.9 million to a total of \$11.6 million at the end of September 30, 2008. Non-accruing residential lot loans increased \$1.4 million to \$11.0 million and non-accruing commercial loans decreased \$2.0 million to \$27.5 million at September 30,



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2008. The decrease in non-accruing commercial loans during the 2008 third quarter was primarily due to a \$3.0 million loan on vacant property that was transferred to foreclosed assets. This loan was also the primary reason for the increase in foreclosed assets from \$12.2 million at June 30, 2008, to \$15.6 million at September 30, 2008.

The increase in non-performing assets during the 2008 third quarter reflects the continuing weakness in the real estate market. The Bank completed foreclosure on 15 properties during the quarter for a total of \$4.4 million, including the \$3.0 million loan noted above. Partially offsetting these additions to the foreclosed properties was the sales of 11 residential properties totaling \$1.1 million. Throughout 2008, the Bank has been actively engaged in the resolution efforts relating to problem assets. During the year, loan originations have decreased and our total loan portfolio has been reduced \$90.3 million to \$507.4 million.

**Table of Contents****FEDERAL TRUST CORPORATION AND SUBSIDIARIES****Notes to Condensed Consolidated Financial Statements (Unaudited), Continued****(3) Deferred Tax Asset**

Federal Trust Corporation assessed the loss and trends over the prior six quarters and the estimated future earnings of the Company, and determined that it is more likely than not that the deferred tax asset may not be realized. Accordingly, a valuation allowance of \$16.7 million has been recorded on the deferred tax asset as of September 30, 2008. Accordingly, the Company recognized no income tax benefit for the loss incurred during the three months ended September 30, 2008.

**(4) Regulatory Capital**

The Bank is required to maintain certain minimum regulatory capital requirements. The following is a summary at September 30, 2008, of the Bank's actual capital on a percentage basis and the regulatory capital requirements for a financial institution to be classified as adequately capitalized or well capitalized. As a result of the 2008 third quarter loss and the failure to successfully complete the sale of additional common stock, the Bank's capital ratios at September 30, 2008, fell below the level to satisfy minimum adequate capital requirements for regulatory capital purposes.

|   | <b>Actual</b> | <b>For Minimum<br/>Capital<br/>Adequacy<br/>Purposes</b> | <b>To Be Well<br/>Capitalized<br/>Under Prompt<br/>Corrective Action<br/>Provisions</b> |
|---|---------------|--|---|
| Total capital to risk-weighted assets         | 6.30%         | 8.00%  | 10.00%  |
| Tier I capital to risk-weighted assets        | 3.36%         | 4.00%  | 6.00%   |
| Tier I capital to total assets-leverage ratio | 5.03%         | 4.00%  | 5.00%   |

**(5) Loss Per Share of Common Stock**

The Company follows the provisions of SFAS No. 128, *Earnings Per Share* ( SFAS No. 128 ). SFAS No. 128 provides accounting and reporting standards for calculating loss per share. Basic loss per share of common stock has been computed by dividing the net loss for the period by the weighted-average number of shares outstanding. Shares of common stock purchased by the Company's Employee Stock Ownership Plan ( ESOP ) are considered outstanding when the shares are allocated to participants. Diluted loss per share is computed by dividing net loss by the weighted-average number of shares outstanding including the dilutive effect of stock options computed using the treasury stock method and the restricted stock units. Outstanding stock options and restricted stock units are not considered dilutive securities for the three- and nine-month periods ended September 30, 2008 and 2007, due to the net loss incurred by the Company.

(Continued)

**Table of Contents****FEDERAL TRUST CORPORATION AND SUBSIDIARIES****Notes to Condensed Consolidated Financial Statements (Unaudited), Continued****(5) Loss Per Share of Common Stock, Continued**

The following table presents the calculation of basic and diluted loss per share for the three- and nine-month periods ending September 30, 2008 and 2007.

|  | <b>Three Months Ended</b> |              | <b>Nine Months Ended</b> |              |
|--|---------------------------|--------------|--------------------------|--------------|
|  | <b>September 30,</b>      |              | <b>September 30,</b>     |              |
|  | <b>2008</b>               | <b>2007</b>  | <b>2008</b>              | <b>2007</b>  |
| Weighted-average shares outstanding before adjustment for unallocated ESOP shares  | 9,436                     | 9,418        | 9,436                    | 9,399        |
| Adjustment to reflect the effect of unallocated ESOP shares  | (42)                      | (51)         | (42)                     | (42)         |
| <b>Weighted-average shares outstanding for basic earnings per share</b>  | <b>9,394</b>              | <b>9,367</b> | <b>9,394</b>             | <b>9,357</b> |
| Basic loss per share   | \$ (1.09)                 | \$ (.65)     | \$ (2.27)                | \$ (1.01)    |
| <b>Total weighted-average shares outstanding for basic earnings per share computation</b>  | <b>9,394</b>              | <b>9,367</b> | <b>9,394</b>             | <b>9,357</b> |
| Additional dilutive shares using the average market value for the period utilizing the treasury stock method regarding stock options |                           |              |                          |              |
| <b>Weighted-average shares and equivalents outstanding for diluted earnings per share</b>  | <b>9,394</b>              | <b>9,367</b> | <b>9,394</b>             | <b>9,357</b> |
| Diluted loss per share   | \$ (1.09)                 | \$ (.65)     | \$ (2.27)                | \$ (1.01)    |

**(6) Stock Compensation Plans**

The Company has three stock benefit plans. The Key Employee Stock Compensation Program (the Employee Plan) is authorized to issue up to 10% of the issued shares up to a maximum of 1,020,000 shares through the exercise of incentive stock options, compensatory stock options, stock appreciation rights or performance shares. All awards granted under the Employee Plan have been incentive stock options. These options have five to ten year terms and vest over various terms up to five years. At September 30, 2008, the Company had 432,417 options available for future grants under the Employee Plan.

The Directors Stock Option Plan (the Directors Plan) is authorized to issue up to 141,337 shares through the exercise of stock options. All options granted under the Directors Plan have five to ten-year terms, and vest over various terms up to five years. At September 30, 2008, the Company had 29,680 options available for future grants under the Directors Plan.

The 2005 Directors Stock Plan (2005 Directors Plan) is authorized to issue up to 91,800 shares through the exercise of stock options and the issuance of restricted stock shares. Awards made under the 2005 Directors Plan may be in the form of restricted shares, restricted stock units, or stock options. A restricted stock unit is the right to receive a share of common stock, after vesting, on a date selected by the director. While any restricted stock unit is outstanding the director holding the restricted stock unit will be entitled to receive a dividend in the form of additional restricted stock units, if cash or stock dividends are declared on outstanding shares of common stock. Each restricted stock unit, including fractional restricted stock units, will be converted to one share of common stock, after vesting, on the date which has been selected by the director or when the director no longer serves on the Board.



**Table of Contents****FEDERAL TRUST CORPORATION AND SUBSIDIARIES****Notes to Condensed Consolidated Financial Statements (Unaudited), Continued****(6) Stock Compensation Plans, Continued**

Awards of restricted shares or restricted stock units may be granted to a director as an annual stock retainer, which is dependent upon the amount of the director's annual cash retainer. Under terms of those respective agreements, the units vest over periods from three to four years, unless there is a change in control, at which point the units vest immediately.

Options are granted to certain employees and directors at a price equal to the market value of the stock on the dates the options were granted. In accordance with SFAS No. 123, *Share-Based Payment* (SFAS 123(R)), the fair value of each option is amortized using the straight-line method over the requisite service period of each option. We have estimated the fair value of all option awards as of the grant date by applying the Black-Scholes pricing valuation model. The application of this valuation model involves assumptions that are judgmental and sensitive in the determination of compensation expense. There were no stock options issued during the third quarter of 2007 or 2008. The weighted average amounts for key assumptions used in determining the fair value of options granted during the nine-months ended September 30, 2008 and 2007 are as follows:

|  | Nine Months Ended<br>September 30,<br>2008 | Nine Months Ended<br>September 30,<br>2007 |
|--|--|--|
| Expected stock price volatility  | 32.67%                                     | 47.95%                                     |
| Risk-free interest rate  | 2.64%                                      | 4.66%                                      |
| Weighted average expected life in years  | 4.0  | 6.5  |
| Expected dividend yield  | 0.00%                                      | 1.58%                                      |
| Per share weighted-average grant date fair value of options issued during the period | \$ 0.64                                    | \$ 4.66                                    |

As part of its adoption of SFAS 123(R), the Company examined its historical pattern of option exercises in an effort to determine if there was any pattern based on certain employee populations. From this analysis, the Company could not identify any patterns in the exercise of options. As such, the Company used the guidance in Staff Accounting Bulletin No. 110, issued by the Securities and Exchange Commission to determine the estimated life of options issued. Historical information was the primary basis for the selection of expected volatility and expected dividend yield. The risk-free rate was selected based upon yields of U.S. Treasury issues with a term equal to the expected life of the option being valued.

A summary of stock option transactions for the nine-month period ended September 30, 2008, follows: (\$ in thousands, except per share data):

|   | Number<br>of<br>Options | Weighted<br>Avg. Per Option<br>Exercise Price | Weighted<br>Avg. Remaining<br>Contract Term<br>(in years) | Aggregate<br>Intrinsic<br>Value |
|---|-------------------------|---|---|---------------------------------|
| <b>Options Under the Employee Plan:</b> |                         |   |   |                                 |
| Outstanding at December 31, 2007        | 374,283                 | \$ 7.87                                       |   |                                 |
| Options exercised                       |                         |   |   |                                 |
| Options forfeited                       | (205,716)               | \$ 9.46                                       |   |                                 |
| Outstanding at September 30, 2008       | 168,567                 | \$ 5.94                                       | 4.18  | \$                              |

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|                                   |        |    |      |      |    |
|-----------------------------------|--------|----|------|------|----|
| Exercisable at September 30, 2008 | 79,611 | \$ | 7.50 | 4.36 | \$ |
|-----------------------------------|--------|----|------|------|----|

(Continued)

**Table of Contents****FEDERAL TRUST CORPORATION AND SUBSIDIARIES****Notes to Condensed Consolidated Financial Statements (Unaudited), Continued****(6) Stock Compensation Plans, Continued**

|  | Number<br>of<br>Options | Weighted<br>Avg. Per Option<br>Exercise Price | Weighted<br>Avg. Remaining<br>Contract Term<br>(in years) | Aggregate<br>Intrinsic<br>Value |
|--|-------------------------|---|---|---------------------------------|
| <i>Options Under the Directors Plans:</i>                        |                         |   |   |                                 |
| <i>(includes the Directors Plan and the 2005 Directors Plan)</i> |                         |   |   |                                 |
| Outstanding at December 31, 2007                                 | 144,146                 | \$ 7.17                                       |   |                                 |
| Options granted  | 5,000                   | \$ 2.15                                       |   |                                 |
| Options forfeited  | (35,292)                | \$ 4.98                                       |   |                                 |
| Outstanding at September 30, 2008                                | 113,854                 | \$ 7.62                                       | 8.77  | \$                              |
| Exercisable at September 30, 2008                                | 46,054                  | \$ 7.13                                       | 5.20  | \$                              |

As of September 30, 2008, the Company had 156,756 nonvested options outstanding resulting in approximately \$222,000 of total unrecognized compensation expense related to these nonvested options. This expense is expected to be recognized monthly over the related vesting periods using the straight-line method through December 2011.

A summary of the Restricted Stock Unit transactions follows:

|  | Number<br>of<br>Units |
|--|-----------------------|
| <i>Restricted Stock Units under the 2005 Directors Plan:</i> |                       |
| Outstanding at December 31, 2007                             | 11,815                |
| Stock unit dividends earned                                  |                       |
| Stock units forfeited  |                       |
| Stock issued   |                       |
| Outstanding at September 30, 2008                            | 11,815                |

A summary of the status of the Company's nonvested restricted stock units as of December 31, 2007, and changes during the nine-months ended September 30, 2008, is presented below:

| Nonvested Shares | Number<br>of<br>Units | Weighted-Average<br>Grant-Date<br>Fair Value |
|------------------|-----------------------|--|
|------------------|-----------------------|--|

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|                                 |       |    |       |
|---------------------------------|-------|----|-------|
| Nonvested at December 31, 2007  | 6,471 | \$ | 10.54 |
| Dividends credited              |       |    |       |
| Forfeited                       |       |    |       |
| Vested                          | (774) | \$ | 11.26 |
| Nonvested at September 30, 2008 | 5,697 | \$ | 10.12 |

(Continued)



**Table of Contents****FEDERAL TRUST CORPORATION AND SUBSIDIARIES****Notes to Condensed Consolidated Financial Statements (Unaudited), Continued****(7) Fair Value Measurements**

In the first quarter of 2008, we adopted SFAS No. 157, for financial assets and liabilities. This standard defines fair value, provides guidance for measuring fair value and requires certain disclosures. This standard does not require any new fair value measurements, but rather applies to all other accounting pronouncements that require or permit fair value measurements. This standard does not apply measurements related to share-based payments.

SFAS 157 discusses valuation techniques, such as the market approach (comparable market prices), the income approach (present value of future cash flows), and the cost approach (cost to replace the service capacity of an asset or replacement cost), focusing on the price that would be received when selling an asset or paid to transfer a liability (exit price). The statement utilizes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value into three broad levels. The following is a brief description of those three levels:

Level 1: Observable inputs such as quoted prices (unadjusted) in active markets for identical assets or liabilities.

Level 2: Inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities that are not active; and model-driven valuations whose inputs are observable or whose significant value drivers are observable. Valuations may be obtained from, or corroborated by, third-party pricing services.

Level 3: Unobservable inputs to measure fair value of assets and liabilities for which there is little, if any market activity at the measurement date, using reasonable inputs and assumptions based upon the best information at the time, to the extent that inputs are available without undue cost and effort.

Our listing of financial assets and liabilities subject to fair value measurements on a recurring basis are as follows (in thousands):

|                               | Fair Value<br>as of<br>9/30/08 | Fair Value Measurements at Reporting Date Using<br>Quoted Prices |   |  |
|-------------------------------|--------------------------------|--|---|--|
|                               |                                | in Active<br>Markets for<br>Identical<br>Assets<br>(Level 1)     | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Available for sale securities | \$ 32,906                      | \$   | \$ 30,600   | \$ 2,306   |
| Loans Held for Sale           | 155                            |  | 155   |  |

**Table of Contents****FEDERAL TRUST CORPORATION AND SUBSIDIARIES****Notes to Condensed Consolidated Financial Statements (Unaudited), Continued****(7) Fair Value Measurements**

The fair values of our securities available for sale are determined by a third-party pricing service utilizing various methods dependent upon the specific type of investment.

*Securities available for sale:* Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is provided by independent third-party pricing services based upon quoted prices, if available. If quoted prices are not available, fair values are obtained from independent third party pricing services using computerized models or indicative values provided by their trading desk. Level 2 securities include government sponsored agency notes, collateralized mortgage obligations, corporate debt securities, and municipal bonds. Level 3 securities are asset-backed securities and other investments priced using computerized models heavily influenced by unobservable inputs or consensus pricing heavily influenced by unobservable inputs provided by the trading desk at our independent third-party pricing service.

*Loans held for sale:* Loans held for sale are carried at the lower of cost or market value. The fair value of loans held for sale is based on what secondary markets are currently offering for portfolios or loans with similar characteristics. As such, the Company classifies loans subjected to nonrecurring fair value adjustments as Level 2.

The table below presents a reconciliation of all assets and liabilities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) during the three and nine months ended September 30, 2008 (in thousands):

Three months ended September 30, 2008:

|  | <b>Available-<br/>For-Sale<br/>Securities</b> |
|--|---|
| Balance, July 1, 2008                  | \$ 3,635                                      |
| Included in earnings                   |   |
| Included in other comprehensive income | (1,328)                                       |
| Purchases, issuances and settlements   | (1)   |
| Transfers in to (out of) Level 3       |   |
| Balance, September 30, 2008            | 2,306   |

Nine months ended September 30, 2008:

|  | <b>Available-<br/>For-Sale<br/>Securities</b> |
|--|---|
| Balance, January 1, 2008               | \$ 4,784                                      |
| Included in earnings                   |   |
| Included in other comprehensive income | (2,475)                                       |
| Purchases, issuances and settlements   | (3)   |

Transfers in to (out of) Level 3

Balance, September 30, 2008

2,306

**Table of Contents****FEDERAL TRUST CORPORATION AND SUBSIDIARIES****Notes to Condensed Consolidated Financial Statements (Unaudited), Continued****(7) Fair Value Measurements, Continued**

Our listing of assets and liabilities subject to carrying value measurements on a non-recurring basis are as follows (in thousands):

|                | Carrying Value at September 30, 2008 |           |           |           | Total losses included in operations as of Sept. 30, 2008 |
|----------------|--------------------------------------|-----------|-----------|-----------|--|
|                | Carrying Value as of                 |           |           |           |  |
|                | Sept. 30, 2008                       | (Level 1) | (Level 2) | (Level 3) |  |
| Impaired loans | \$ 50,909                            | \$        | \$        | \$ 50,909 | \$ 6,999   |

SFAS No. 157 applies to loans measured for impairment using the practical expedients permitted by SFAS 114, *Accounting by Creditors for Impairment of a Loan*, including impaired loans measured by an observable market price or at the fair value of the loans collateral if the loan is collateral dependent. If a loan is determined to be collateral dependent, the fair value of the collateral is determined by appraisals or independent valuation adjusted for costs related to the liquidation of the collateral.

**(8) Legal Contingencies**

Various legal claims arise from time to time in the normal course of business. In the opinion of management of the Company, none have occurred that will have a material effect on the Company's condensed consolidated financial statements.

**(9) Reclassification**

Certain amounts in the prior period consolidated financial statements have been reclassified to conform with the 2008 presentation.

As of September 30, 2007, \$2.5 million of proceeds from sales of loans transferred to loans held for sale were incorrectly reported on the Condensed Consolidated Statement of Cash Flows as net cash flows from operating activities rather than net cash flows from investing activities as required by generally accepted accounting standards in the United States of America. These loan sale proceeds were reclassified to cash flows from investing activities for the nine months ended September 30, 2008. This change did not affect the previously reported amount of net decrease in cash and cash equivalents.

**(10) Subsequent Events**

On November 3, 2008 Federal Trust announced that on October 29, 2008, it received notice from the staff of the NYSE Alternext US (the Exchange) indicating the Exchange's intent to delist Federal Trust common stock from the Exchange. The letter from the Exchange indicated that Federal Trust no longer complies with the Exchange's continued listing standards. Specifically, the staff of the Exchange determined that Federal Trust is in violation of Section 1003(a)(iv) of the NYSE Alternext US LLC Company Guide (the Company Guide). The letter noted the issues raised by the Cease and Desist Order that has previously been issued to Federal Trust by the Office of Thrift Supervision, as well as Federal Trust's inability to raise capital by the September 30, 2008 deadline previously established by the Office of Thrift Supervision. The Exchange has also determined that Federal Trust has become subject to Section 1002(b) of the Company Guide, which states that the Exchange will consider removal from listing of a security when, in the opinion of the Exchange, it appears that the extent of public distribution or the aggregate market value of the security has become so reduced as to make further dealings on the Exchange inadvisable.

Federal Trust does not intend to appeal the Exchange's intention to delist the common stock from the Exchange, will seek to have one or more market makers quote the common stock for trading through the OTC Bulletin Board or the Pink Sheets.



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**FEDERAL TRUST CORPORATION AND SUBSIDIARIES**

**Item 2. Management's Discussion and Analysis of**

**Financial Condition and Results of Operations**

**Forward Looking Statements**

This quarterly report contains forward-looking statements within the meaning of Section 21E of the Securities Exchange Act of 1934, as amended. Forward-looking statements can be identified by the use of words such as estimate, project, believe, intend, anticipate, plan, expect and words of similar meaning. These forward-looking statements include, but are not limited to:

statements of our goals, intentions and expectations;

statements regarding our business plans, prospects, growth and operating strategies;

statements regarding the asset quality of our loan and investment portfolios; and

estimates of our risks and future costs and benefits.

These forward-looking statements are based on current beliefs and expectations of our management and are inherently subject to significant business, economic and competitive uncertainties and contingencies, many of which are beyond our control. In addition, these forward-looking statements are subject to assumptions with respect to future business strategies and decisions that are subject to change.

The following factors, among others, could cause actual results to differ materially from the anticipated results or other expectations expressed in the forward-looking statements:

general economic conditions and real estate values, either nationally or in our market areas, that are worse than expected;

competition among depository and other financial institutions;

inflation and adverse changes in the securities markets;

changes in laws or government regulations or policies affecting financial institutions, including changes in regulatory fees and capital requirements;

our ability to enter new markets successfully and capitalize on growth opportunities;

changes in consumer spending, borrowing and savings habits;

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changes in demand for new housing in our market area;

unfavorable changes in economic conditions affecting housing markets, credit markets, real estate values or oil and gas prices, either nationally or locally;

changes in accounting policies and practices, as may be adopted by the bank regulatory agencies and the Financial Accounting Standards Board; and

changes in our organization, compensation and benefit plans.

Because of these and other uncertainties, our actual future results may be materially different from the results indicated by these forward-looking statements.

### Critical Accounting Policies

Critical accounting policies are defined as those that are reflective of significant judgments and uncertainties, and could potentially result in materially different results under different assumptions and conditions. We believe that the critical accounting policies upon which our financial condition and results of operation depend, and that involve the most complex subjective decisions or assessments, are included in Item 7,

Management's Discussion and Analysis of Financial Condition and Results of Operations, in the Company's Amendment No. 2 to the Annual Report on Form 10-K/A for the fiscal year ended December 31, 2007, as filed with the Securities and Exchange Commission.

### Allowance for Loan Losses

While we did not change our methodology for calculating the adequacy of the allowance for loan losses in 2008, we added \$7.4 million to the allowance during the first nine months of 2008 due to the continuing weakness in the Florida real estate market and the increases in our past due and non-accrual loans.

The activity in the allowance for loan losses is as follows (\$ in thousands):

|                                | Three Months Ended |           | Nine Months Ended |           |
|--------------------------------|--------------------|-----------|-------------------|-----------|
|                                | September 30,      |           | September 30,     |           |
|                                | 2008               | 2007      | 2008              | 2007      |
| Balance at beginning of period | \$ 16,557          | \$ 10,272 | \$ 13,869         | \$ 5,098  |
| Provision for loan losses      | 6,100              | 5,115     | 10,265            | 10,410    |
| Charge-offs                    | (1,749)            | (4,902)   | (3,282)           | (5,004)   |
| Recoveries                     | 344                | 1         | 400               | 2         |
| Balance at end of period       | \$ 21,252          | \$ 10,506 | \$ 21,252         | \$ 10,506 |

We anticipate recognizing additional charge-offs during the remainder of 2008, but cannot predict the amount and timing of such charge-offs, if any. In early July 2008, we received a \$344,000 recovery from the liquidation of Transland Financial Services, Inc. in settlement of the fraud loss we recognized in 2007. This amount will be recorded as a recovery to our allowance for loan losses in the 2008 third quarter.

At September 30, 2008, the allowance for loan losses was \$21.3 million, or 35.6% of non-performing loans and 4.19% of total loans outstanding at that date. At December 31, 2007, the allowance for loan losses was \$13.9 million, or 36.3% of non-performing loans and 1.72% of total loans outstanding at that date. The allowance at September 30, 2008, consisted of reserves for performing loans in the portfolio and reserves against certain impaired loans based on management's evaluation of these individual loans.

Weakening economic conditions in the residential real estate sector have adversely affected, and may continue to adversely affect our loan portfolio. Our percentage of non-performing assets relating to total assets, continued to increase in 2008 to 12.5% at September 30, 2008, as compared to 6.9% at December 31, 2007. If loans that are currently non-performing further deteriorate or loans that are currently performing become non-performing loans, we may need to increase our allowance for loan losses. Such an increase would have an adverse impact on our financial condition and results of operations.

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Based on our analysis, management believes that the allowance for loan losses was adequate to absorb estimated loan losses inherent in the loan portfolio at September 30, 2008. Actual results could differ from these estimates. However, since the allowance is affected by management's judgments and uncertainties, there is the likelihood that materially different amounts would be reported under different conditions or assumptions. To the extent that the economy, collateral values, reserve factors or the nature and volume of problem loans change, we may need to adjust the provision for loan losses. In addition, federal regulatory agencies, as an integral part of the examination process, periodically review our allowance for loan losses. Such agencies may require us to recognize additions to the allowance level based upon their judgment of the information available to them at the time of their examination. As we experienced in the nine months of 2008, material additions to our provision for loan losses for the remainder of the year could result in an increase in our operating losses and adversely effect capital.



**Table of Contents****Liquidity and Capital Resources**

Like other financial institutions, we must ensure that sufficient funds are available to meet deposit withdrawals, loan commitments, investment needs and expenses. Control of our cash flow requires the anticipation of deposit flows and loan payments. Our primary sources of funds are deposits accounts, principal and interest payments on loans, maturities and calls of investment securities and sales of loans and investments. Historically, we have also relied on brokered deposits and Federal Home Loan Bank advances as funding sources, but we currently have no ability to renew, replace or accept brokered deposits without the prior approval of the Federal Deposit Insurance Corporation. In addition, we are not able to draw additional advances from the Federal Home Loan Bank.

We require funds in the short-term to finance ongoing operating expenses, pay liquidating deposits, and originate loans. We have changed our business strategy from purchasing pools of loans to focusing on originating in-market retail and small business loans to transition our asset and liability mix to that of a traditional community bank and to reduce our reliance on wholesale funding sources, such as brokered deposits and Federal Home Loan Bank advances. We believe this focus will build core relationships with our deposit and loan customers. As such, in the short-term, we anticipate our cash flow requirements for in-market retail and business loan originations to be less than the cash used historically for purchases of pooled residential real estate loans.

On August 7, 2008, we received conditional approval from the Federal Deposit Insurance Corporation ( FDIC ) to replace up to \$25.2 million of the \$30.2 million of brokered deposits maturing through November 30, 2008. The FDIC approval was contingent upon the Bank maintaining its regulatory capital ratios above the minimum threshold for capital adequacy. At September 30, 2008, the Bank's capital ratio fell below the adequately capitalized level so we will not be able to renew or extend any additional brokered deposits until the capital level is raised above the minimum amount required and a new waiver is received from the FDIC. As of September 30, 2008, we had a total of \$33.5 million of brokered deposits. The following table sets forth the maturities of those deposits (\$ in thousands):

| <b>Maturity Date</b> | <b>Amount</b> |
|----------------------|---------------|
| November 28, 2008    | \$ 5,013      |
| March 5, 2009        | 5,000         |
| April 22, 2009       | 3,004         |
| May 29, 2009         | 2,364         |
| August 11, 2009      | 1,500         |
| November 30, 2009    | 12,000        |
| June 15, 2010        | 4,599         |
|                      | \$ 33,480     |

Long-term funds are required to invest in loans for our portfolio, purchase fixed assets and provide for the liquidation of deposits maturing in the future. Long-term funding requirements are obtained from principal payments from maturing loans and investments, and the sale of loans investments. We have no plans to significantly change long-term funding requirements.

Our most liquid assets are cash and cash equivalents. The levels of these assets depend on our operating, financing and investing activities during any given period. At September 30, 2008, cash and cash equivalents totaled \$40.3 million. Also, at September 30, 2008, we had investment securities with a market value of \$10.1 million held at a correspondent bank that were available to secure short-term borrowings. In addition, principal and interest payments on loans will also be used for our short-term funding needs to cover shortfalls in the event our operating cash flows are not sufficient to satisfy short-term emergencies, such as significant withdrawals of customer deposits.

During the nine months ended September 30, 2008, our sources of funds came primarily from net loan principal repayments of \$56.0 million, proceeds from the sale of loans of \$12.1 million, proceeds from the sale and repayments of securities of \$17.3 million and an increase of \$9.5 million in Federal Home Loan Bank advances.

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We used \$71.0 million for brokered and other deposit maturities and withdrawals and \$31.2 million was retained in cash and cash equivalents for liquidity purposes. Management believes that, over the next 12 months, funds will primarily be obtained from deposit growth and principal and interest payments on loans.

At September 30, 2008, loans-in-process, or closed loans scheduled to be funded over a future period of time, totaled \$15.4 million. Available lines of credit totaled \$12.1 million, and standby letters of credit totaled \$831,000. Funding for these amounts is expected to be provided by the sources described above (other than Federal Home Loan Bank advances).

For the month of September 2008, Federal Trust Bank's average liquidity ratio was 9.19%. This ratio is generally calculated by dividing average cash and other short-term investment securities by average borrowings and savings accounts. Federal Trust Bank's 11 Central Florida branches are expected to generate deposits along with loan principal and interest payments to provide liquidity for new loan originations and other investments. The Asset/Liability Management Committee meets regularly and reviews liquidity levels to ensure that funds are available as needed.

**Off-Balance-Sheet Arrangements**

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit, unused lines of credit, standby letters of credit and loans in process. These instruments involve, to varying degrees, elements of credit and interest-rate risk in excess of the amounts recognized in the Condensed Consolidated Balance Sheet. The contract amounts of those instruments reflect the extent of the Company's involvement in particular classes of financial instruments.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit, unused lines of credit, standby letters of credit and loans in process is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments as it does for on-balance sheet instruments.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total committed amounts do not necessarily represent future cash requirements. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if it is deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the counter party.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers.

A summary of the amounts of the Company's financial instruments with off-balance-sheet risk at September 30, 2008, follows (\$ in thousands):

|                              | <b>Contract<br/>Amount</b> |
|------------------------------|----------------------------|
| Commitments to extend credit | \$                         |
| Unused lines of credit       | \$ 12,114                  |
| Standby letters of credit    | \$ 831                     |
| Loans in process             | \$ 15,409                  |

Management believes the Company has adequate resources to fund its commitments. At September 30, 2008, the Company had approximately \$240.8 million in time deposits maturing in one year or less. Management also believes that, if so desired, it can adjust the rates on time deposits to retain or obtain new deposits in a changing interest rate environment.



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The following tables set forth the average balance sheets, the total dollar amount of interest income and expense and the resulting average yields for the periods indicated (\$ in thousands):

|   | Three Months Ended September 30, |                 |                               |                    |                 |                               |
|---|----------------------------------|-----------------|-------------------------------|--------------------|-----------------|-------------------------------|
|   | 2008                             |                 |                               | 2007               |                 |                               |
|   | Average<br>Balance               | Interest        | Average<br>Yield/<br>Cost (7) | Average<br>Balance | Interest        | Average<br>Yield/<br>Cost (7) |
| <b>Interest-earning assets:</b>   |                                  |                 |                               |                    |                 |                               |
| Loans (1)   | \$ 517,980                       | \$ 6,370        | 4.92%                         | \$ 604,602         | \$ 9,729        | 6.44%                         |
| Securities  | 38,224                           | 534             | 5.59                          | 63,445             | 801             | 5.05                          |
| Other interest-earning assets (2)   | 42,164                           | 244             | 2.31                          | 10,702             | 176             | 6.58                          |
| <b>Total interest-earning assets</b>  | <b>598,368</b>                   | <b>7,148</b>    | <b>4.78</b>                   | <b>678,749</b>     | <b>10,706</b>   | <b>6.31</b>                   |
| Other noninterest-earning assets  | 33,073                           |                 |                               | 43,480             |                 |                               |
| <b>Total assets</b>   | <b>\$ 631,444</b>                |                 |                               | <b>\$ 722,229</b>  |                 |                               |
| Noninterest-bearing demand deposits   | \$ 13,102                        |                 |                               | \$ 12,260          |                 |                               |
| <b>Interest-bearing liabilities:</b>  |                                  |                 |                               |                    |                 |                               |
| Interest-bearing demand and money-market deposits                                       | 110,085                          | 643             | 2.34                          | 126,365            | 1,359           | 4.30                          |
| Savings deposits  | 2,610                            | 4               | 0.61                          | 2,780              | 11              | 1.58                          |
| Time deposits   | 307,756                          | 3,322           | 4.32                          | 333,630            | 4,346           | 5.21                          |
| <b>Total deposit accounts</b>   | <b>433,553</b>                   | <b>3,969</b>    | <b>3.66</b>                   | <b>475,035</b>     | <b>5,716</b>    | <b>4.81</b>                   |
| FHLB advances and other borrowings (3)  | 169,244                          | 1,811           | 4.28                          | 188,682            | 2,239           | 4.75                          |
| <b>Total interest-bearing liabilities (4)</b>   | <b>589,695</b>                   | <b>5,780</b>    | <b>3.92</b>                   | <b>651,457</b>     | <b>7,955</b>    | <b>4.88</b>                   |
| Other noninterest-bearing liabilities   | 12,784                           |                 |                               | 7,338              |                 |                               |
| Stockholders' equity  | 15,860                           |                 |                               | 51,174             |                 |                               |
| <b>Total liabilities and stockholders' equity</b>                                       | <b>\$ 631,441</b>                |                 |                               | <b>\$ 722,229</b>  |                 |                               |
| <b>Net interest/dividend income</b>   |                                  | <b>\$ 1,368</b> |                               |                    | <b>\$ 2,751</b> |                               |
| <b>Net interest margin (5)</b>  |                                  |                 | <b>0.91%</b>                  |                    |                 | <b>1.62%</b>                  |
| <b>Interest-rate spread (6)</b>   |                                  |                 | <b>0.86%</b>                  |                    |                 | <b>1.42%</b>                  |
| <b>Ratio of average interest-earning assets to average interest-bearing liabilities</b> | <b>1.01</b>                      |                 |                               | <b>1.04</b>        |                 |                               |

(1) Includes nonaccrual loans.

(2) Includes Federal Home Loan Bank stock and interest-earning deposits.

(3) Includes Federal Home Loan Bank advances, other borrowings and junior subordinated debentures.

(4) Total interest-bearing liabilities exclude noninterest-bearing demand deposits.

(5) Net interest margin is annualized net interest income divided by average interest-earning assets.

(6) Interest-rate spread represents the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities.

(7) Annualized

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|  | Nine Months Ended September 30, |                 |                               |                    |                 |                               |
|--|---------------------------------|-----------------|-------------------------------|--------------------|-----------------|-------------------------------|
|  | 2008                            |                 |                               | 2007               |                 |                               |
|  | Average<br>Balance              | Interest        | Average<br>Yield/<br>Cost (7) | Average<br>Balance | Interest        | Average<br>Yield/<br>Cost (7) |
| <b>Interest-earning assets:</b>  |                                 |                 |                               |                    |                 |                               |
| Loans (1)  | \$ 530,254                      | \$ 21,582       | 5.43%                         | \$ 601,693         | \$ 29,132       | 6.46%                         |
| Securities   | 40,330                          | 1,734           | 5.73                          | 63,789             | 2,463           | 5.15                          |
| Other interest-earning assets (2)  | 40,251                          | 884             | 2.93                          | 10,633             | 519             | 6.51                          |
| <b>Total interest-earning assets</b>   | <b>610,835</b>                  | <b>24,200</b>   | <b>5.28</b>                   | <b>676,115</b>     | <b>32,114</b>   | <b>6.33</b>                   |
| Other noninterest-earning assets   | 42,262                          |                 |                               | 42,504             |                 |                               |
| <b>Total assets</b>  | <b>\$ 653,097</b>               |                 |                               | <b>\$ 718,619</b>  |                 |                               |
| Noninterest-bearing demand deposits  | \$ 13,697                       |                 |                               | \$ 12,474          |                 |                               |
| <b>Interest-bearing liabilities:</b>   |                                 |                 |                               |                    |                 |                               |
| Interest-bearing demand and money-market deposits                                | 116,619                         | 2,400           | 2.74                          | 121,620            | 3,571           | 3.91                          |
| Savings deposits   | 2,517                           | 12              | 0.64                          | 2,916              | 36              | 1.65                          |
| Time deposits  | 310,654                         | 10,780          | 4.63                          | 335,363            | 13,052          | 5.19                          |
| <b>Total deposit accounts</b>  | <b>443,487</b>                  | <b>13,192</b>   | <b>3.97</b>                   | <b>472,373</b>     | <b>16,659</b>   | <b>4.70</b>                   |
| FHLB advances and other borrowings (3)   | 169,889                         | 5,479           | 4.30                          | 186,084            | 6,406           | 4.59                          |
| <b>Total interest-bearing liabilities (4)</b>                                    | <b>599,679</b>                  | <b>18,671</b>   | <b>4.15</b>                   | <b>645,983</b>     | <b>23,065</b>   | <b>4.76</b>                   |
| Other noninterest-bearing liabilities  | 12,544                          |                 |                               | 7,366              |                 |                               |
| Stockholders' equity   | 27,177                          |                 |                               | 52,796             |                 |                               |
| <b>Total liabilities and stockholders' equity</b>                                | <b>\$ 653,097</b>               |                 |                               | <b>\$ 718,619</b>  |                 |                               |
| <b>Net interest/dividend income</b>  |                                 | <b>\$ 5,529</b> |                               |                    | <b>\$ 9,049</b> |                               |
| Net interest margin (5)  |                                 |                 | 1.21%                         |                    |                 | 1.78%                         |
| Interest-rate spread (6)   |                                 |                 | 1.13%                         |                    |                 | 1.57%                         |
| Ratio of average interest-earning assets to average interest-bearing liabilities | 1.02                            |                 |                               | 1.05               |                 |                               |

(1) Includes nonaccrual loans.

(2) Includes Federal Home Loan Bank stock and interest-earning deposits.

(3) Includes Federal Home Loan Bank advances, other borrowings, junior subordinated debentures and capital lease obligation.

(4) Total interest-bearing liabilities exclude noninterest-bearing demand deposits.

(5) Net interest margin is annualized net interest income divided by average interest-earning assets.

(6) Interest-rate spread represents the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities.

(7) Annualized

**Table of Contents****Comparison of Financial Condition at September 30, 2008 and December 31, 2007**

Total assets at September 30, 2008 were \$601.7 million, a decrease of \$88.6 million, or 13%, from \$690.3 million at December 31, 2007. This decrease in total assets during 2008 was part of our strategy to improve our liquidity and shrink the balance sheet due to our operating losses and the need to strengthen our regulatory capital ratios, combined with our efforts to change our asset/liability mix through a reduction in wholesale loan purchases and borrowed funds. Our portfolio of securities available for sale decreased by \$19.5 million, or 37%, to \$32.9 million at September 30, 2008, from \$52.4 million at December 31, 2007. Total loans declined \$90.3 million, or 16%, to \$472.9 million at September 30, 2008, from \$563.2 million at December 31, 2007. Residential mortgage loans and residential construction loans declined \$38.5 million and \$17.2 million, or 11% and 78%, respectively, from December 31, 2007. In addition, commercial real estate secured loans and land, development and construction loans declined \$31.5 million and \$19.7 million, or 37% and 27%, respectively, while commercial loans increased \$17.9 million or 113% from December 31, 2007. The primary cause of the change in balances within the commercial loan portfolio is the result of the reclassification of certain individual loans to more accurately reflect the current classification of loans which comprise the portfolio. The funds provided by the sales and payoffs of loans and investments were used to repay brokered deposits and increase our liquidity. Cash and cash equivalents increased from \$9.2 million at December 31, 2007 to \$40.3 million at September 30, 2008.

Total deposits at September 30, 2008 were \$410.7 million, a decrease of \$71.0 million, or 15%, from \$481.7 million at December 31, 2007. This decrease was primarily the result of a \$46.2 million, or 58%, decrease in interest-bearing demand deposits from \$80.3 million at December 31, 2007, to \$34.1 million at September 30, 2008. Time deposits declined \$31.3 million, or 10%, to \$296.2 million at September 30, 2008, from \$327.5 million at December 31, 2007, primarily due to \$45.1 million in brokered deposits that matured and were not renewed. Federal Home Loan Bank advances increased \$9.5 million, or 6%, during 2008 to \$161.5 million at September 30, 2008. Total stockholders' equity decreased \$29.8 million in 2008 due primarily to the \$26.0 million loss for the nine months ended September 30, 2008.

**Comparison of the Three-Month Periods Ended September 30, 2008 and 2007**

**General.** The Company had a net loss for the three-month period ended September 30, 2008, of \$10.2 million, or \$1.09 per basic and fully diluted share, compared to a net loss of \$6.1 million or \$.65 per basic and fully diluted share for the same period in 2007. The loss for the three months ended September 30, 2008, is primarily attributable to a \$6.1 million provision for loan losses, together with interest income foregone as a result of the increase in nonperforming loans and the \$1.3 million write-off of the costs associated with our unsuccessful efforts to raise additional equity capital.

**Interest Income.** Interest income decreased \$3.6 million to \$7.1 million for the 2008 third quarter, from \$10.7 million for the quarter ended September 30, 2007. The decrease in interest income was primarily due to a decrease in market interest rates from the third quarter of 2007 to the third quarter of 2008, foregone interest on non-performing loans for the three months ended September 30, 2008 and a decrease in average interest-earning assets. The average yield on earning assets for the third quarter of 2008 was 4.78%, compared to 6.31% for the 2007 third quarter. Similarly, the average balance of interest-earning assets decreased to \$598.4 million from \$678.7 million.

**Interest Expense.** Interest expense decreased \$2.2 million, or 27%, due to a decrease in the average rate paid on interest-bearing liabilities from 4.88% in the quarter ending September 2007 to 3.92% for the 2008 third quarter. In addition, average interest bearing liabilities decreased from \$651.5 million for the 2007 third quarter to \$589.7 million for the third quarter of 2008.

**Provision for Loan Losses.** A provision for loan losses is charged to operations based upon management's evaluation of the loan portfolio. During the quarter ended September 30, 2008, the Bank recorded a provision for loan losses of \$6.1 million based on its evaluation of the loan portfolio, compared to a provision of \$5.1 million for the same period in 2007. The provision for the 2008 third quarter was due to the decline in real estate collateral values and an increase in nonaccrual loans.

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**Comparison of the Three-Month Periods Ended September 30, 2008 and 2007, Continued**

**Other Income.** Other income increased 39% to \$424,000 for the quarter ended September 30, 2008, from \$305,000 for the 2007 third quarter due primarily to \$139,000 in losses on the sale of securities available for sale recognized during the third quarter of 2007 compared to no sales of securities available for sale during the third quarter of 2008.

**Other Expenses.** Total other expenses for the 2008 third quarter were \$5.9 million, down \$1.9 million, or 24%, from the third quarter of 2007. The decrease was primarily due to a \$2.8 million decrease in employee compensation and benefits during the 2008 third quarter, compared to the third quarter of 2007 partially offset by \$1.3 million in costs associated with the stock offering that was terminated during the quarter. The large decline in employee compensation is primarily the result of recognizing a \$2.6 million charge associated with the termination of a former Chief Executive Officer during the third quarter of 2007, along with staff reductions during 2008. Other increases in operating expenses during the 2008 third quarter compared to the second quarter of 2007 were, a \$252,000 increase in the Bank's FDIC insurance premium, an \$128,000 increase in occupancy expense resulting from our two new branches opened in the second half of 2007, and a \$340,000 increase in expenses related to legal and foreclosure costs associated with our problem asset resolution efforts.

**Income Taxes.** The Company established a valuation allowance for the full amount of the deferred tax asset of \$9.1 million as of March 31, 2008, and therefore recognized no tax benefit relating to the operating loss for the three-months ended September 30, 2008. For the 2008 third quarter, the tax benefit was offset by a \$1.6 million addition to the valuation allowance on our deferred tax assets because management believes that it is more likely than not that the Company will not have sufficient future earnings to realize the deferred tax asset. A tax benefit of \$3.8 million (an effective rate of 38.5%) was recognized during the same period in 2007.



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**Table of Contents****Comparison of the Nine-Month Periods Ended September 30, 2008 and 2007**

**General.** The Company had a net loss for the nine-month period ended September 30, 2008, of \$26.0 million, or \$2.27 per basic and diluted share, compared to a net loss of \$9.5 million, or \$1.01 per basic and diluted share, for the same period in 2007. The 2008 loss was the result of a \$16.7 million valuation allowance on our deferred tax asset due to our assessment that it is more likely than not that the Company will not have sufficient future earnings to realize the deferred tax asset. Also included in the 2008 nine-month loss, was a \$10.3 million provision for loan losses and interest income foregone as a result of the increase of \$33.2 million in non-performing assets from \$42.1 million at September 30, 2007 to \$75.3 million at September 30, 2008.

**Interest Income.** Interest income decreased by \$7.9 million or 25% to \$24.2 million for the nine-month period ended September 30, 2008, from \$32.1 million for the same period in 2007. Interest income on loans decreased \$7.6 million or 26% to \$21.6 million in 2008 from \$29.1 million in 2007, as a result of a decrease in the average yield earned on loans from 6.46% for the nine-month period ended September 30, 2007, to 5.43% for the comparable period in 2008 and the negative effect of the \$59.7 million of non-accrual loans at September 30, 2008, in addition to a decrease in the average amount of loans outstanding from \$601.7 million in 2007 to \$530.3 million in 2008. Interest income on securities decreased by \$729,000 for the nine-month period ended September 30, 2008, from the same period in 2007, primarily as a result of a decrease in the average balance of securities owned partially offset by an increase in the average yield. Interest income on other interest-earning assets increased \$365,000 to \$884,000 from \$519,000 primarily as a result of an increase in average balances of our short-term liquid assets from \$10.6 million for the nine-month period ended September 30, 2007, to \$40.3 million for the comparable period in 2008. Management expects the rates earned on the portfolio to fluctuate with general market conditions.

**Interest Expense.** Interest expense decreased by \$4.4 million or 19% during the nine-month period ended September 30, 2008, compared to the same period in 2007. Interest on deposits decreased \$3.5 million or 21% to \$13.2 million in 2008 from \$16.7 million in 2007, as a result of a decrease in the average cost of deposits from 4.70% for the nine-month period ended September 30, 2007, to 3.97% for the comparable period in 2008 and a decrease in average deposits outstanding from \$472.4 million in 2007 to \$443.5 million in 2008. Interest on other borrowings decreased to \$5.5 million in 2008 from \$6.4 million in 2007, primarily as a result of a decrease in the average balance of other borrowings from \$186.1 million for the nine-month period ended September 30, 2007 to \$169.9 million for the comparable 2008 period and a decrease in the average rate paid on other borrowings from 4.76% in 2007 to 4.15% in 2008.

**Provision for Loan Losses.** During the nine months ended September 30, 2008, a \$10.3 million provision for loan losses was recorded, compared to \$10.4 million recorded for the same period in 2007. The allowance for loan losses at September 30, 2008, was \$21.3 million or 4.19% of total loans outstanding, up from \$10.5 million, or 1.72% of total loans outstanding at September 30, 2007. The increase in the provision for loan losses was due to the continuing weakness in the Florida real estate market and the increases in our past due and non-accrual loans.

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**Comparison of the Nine-Month Periods Ended September 30, 2008 and 2007, Continued**

**Other Income.** Other income increased \$158,000, or 13%, from the nine-month period ended September 30, 2007, to the same period in 2008. The increase in other income was primarily due to an increase of \$106,000 in gains on sales of loans, a \$110,000 increase in gains on sales of securities available for sale, a \$51,000 increase in cash surrender values of life insurance policies and a \$51,000 increase in service charges and fees, partially offset by a decrease in other income of \$190,000, primarily caused by lower mortgage loan origination volumes and a decline in mortgage prepayment fees.

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**Comparison of the Three-Month Periods Ended September 30, 2008 and 2007, Continued**

**Other Expense.** Other expense decreased \$303,000, or 2%, to \$15.2 million for the nine-month period ended September 30, 2008, from \$15.5 million for the same period in 2007. The decline in other expense was primarily the result of a decline of \$3.0 million or 34% in employee compensation and benefits to \$5.8 million in 2008, from \$8.8 million in 2007, primarily the result of recognizing a \$2.6 million charge associated with the termination of a former Chief Executive Officer during the nine months ended September 30, 2007. In addition, during the third quarter 2007, the Company recognized a \$749,000 other-than-temporary charge to adjust for the market value decline on a single investment security. These savings were partially offset by \$1.3 million in costs associated with the proposed stock offering terminated in August 2008, which we recognized during the third quarter of 2008. Other year-over-year expense growth was due to an increase in our deposit insurance premium of \$846,000; net losses and writedowns on foreclosed assets of \$644,000; occupancy expense of \$403,000; foreclosure related expenses of \$334,000; professional fees of \$252,000; data processing of \$103,000.

**Income Taxes.** The Company's consolidated tax position resulted in a tax expense of \$7.5 million for the nine months ending September 30, 2008, compared to a benefit of \$6.1 million (an effective rate of 39.3%) for the same period in 2007. Included in the tax expense for the first nine months of 2008, was an \$16.7 million valuation allowance on our deferred tax assets because management believes it is more likely than not that the Company will not have sufficient future earnings to realize the deferred tax asset.

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**Item 3. Quantitative and Qualitative Disclosures about Market Risk**

Not applicable, as the Company is a smaller reporting company.

**Item 4. Controls and Procedures**

*Evaluation of Disclosure Controls and Procedures.* Management, including the Company's Chief Executive Officer and Chief Financial Officer, has made an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of the end of the period covered by this quarterly report pursuant to Exchange Act Rule 13(a)-15. Based upon the evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded, as of the end of the period covered by this report, that the Company's disclosure controls and procedures are effective to ensure that the information required to be disclosed by Federal Trust in the reports that it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms.

*Changes in Internal Controls.* During the period covered by this report, there was no change in internal controls over financial reporting that has materially affected, or is reasonably likely to materially affect the Company's internal controls over financial reporting.

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**PART II. OTHER INFORMATION**

**Item 1A. Risk Factors**

*In addition to the other information contained this Quarterly Report on Form 10-Q and the exhibits hereto, the following risk factors represent material changes from those previously disclosed in the Company's Amendment No. 2 to the Annual Report on Form 10-K/A, filed with the Securities and Exchange Commission on June 27, 2008. The risks disclosed below, either alone or in combination, could materially adversely affect our business, financial condition or results of operations. Additional risks not presently known to us, or that we currently deem immaterial, may also adversely affect our business, financial condition or results of operations. Further, to the extent that any of the information contained in this Quarterly Report on Form 10-Q constitutes forward-looking statements, the risk factors set forth below also are cautionary statements identifying important factors that could cause our actual results to differ materially from those expressed in any forward-looking statements made by or on behalf of us.*

**We have terminated our proposed stock offering. We may not be able to raise capital or sell control of part or all of the Company in a merger or other transaction.**

Effective August 8, 2008, the Company terminated its proposed stock offering. In accordance with the terms of the previously disclosed Cease and Desist Order issued to the Company by the Office of Thrift Supervision, the Company is seeking to capitalize the Bank in a private transaction, or otherwise sell control of part or all of the Company in a merger or other transaction.

If the Company is not able to raise additional capital or sell control of all or part of the Company in a merger or other transaction, management believes that there is substantial doubt about the Company's ability to continue as a going concern. The Company's operating and capital requirements and recurring losses due to increases in non-performing loans are contributing factors for this concern. There is no guarantee that the Company will be able to raise additional capital or sell control of part or all of the Company in a merger or other transaction, either on terms and conditions acceptable to the Company or the Office of Thrift Supervision, or at all.

**Our Expenses Will Increase as a Result of Increases in FDIC Insurance Premiums**

The Federal Deposit Insurance Corporation ( FDIC ) imposes an assessment against institutions for deposit insurance. This assessment is based on the risk category of the institution and ranges from five to 43 basis points of the institution's deposits. Federal law requires that the designated reserve ratio for the deposit insurance fund be established by the FDIC at 1.15% to 1.50% of estimated insured deposits. If this reserve ratio drops below 1.15% or the FDIC expects it to do so within six months, the FDIC must, within 90 days, establish and implement a plan to restore the designated reserve ratio to 1.15% of estimated insured deposits within five years (absent extraordinary circumstances).

Recent bank failures coupled with deteriorating economic conditions have significantly reduced the deposit insurance fund's reserve ratio. As of June 30, 2008, the designated reserve ratio was 1.01% of estimated insured deposits at March 31, 2008. As a result of this reduced reserve ratio, on October 16, 2008, the FDIC published a proposed rule that would restore the reserve ratios to its required level. The proposed rule would raise the current deposit insurance assessment rates uniformly for all institutions by seven basis points (to a range from 12 to 50 basis points) for the first quarter of 2009. The proposed rule would also alter the way the FDIC calculates federal deposit insurance assessment rates beginning in the second quarter of 2009 and thereafter.

Under the proposed rule, the FDIC would first establish an institution's initial base assessment rate. This initial base assessment rate would range, depending on the risk category of the institution, from 10 to 45 basis points. The FDIC would then adjust the initial base assessment (higher or lower) to obtain the total base assessment rate.

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The adjustments to the initial base assessment rate would be based upon an institution's levels of unsecured debt, secured liabilities, and brokered deposits. The total base assessment rate would range from eight to 77.5 basis points of the institution's deposits. There can be no assurance that the proposed rule will be implemented by the FDIC or implemented in its proposed form.

In addition, the Emergency Economic Stabilization Act of 2008 (EESA) temporarily increased the limit on FDIC insurance coverage for deposits to \$250,000 through December 31, 2009, and the FDIC took action to provide coverage for newly issued senior unsecured debt and non-interest bearing transaction accounts in excess of the \$250,000 limit, for which institutions will be assessed additional premiums.

These actions will significantly increase the Company's non-interest expense in 2009 and in future years as long as the increased premiums are in place.

### **Our common stock was recently delisted from trading on the New York Stock Exchange. An active and liquid trading market for the stock may not develop.**

Effective November 11, 2008, our common stock was delisted from trading on the New York Stock Exchange. An active market for the stock is not expected to exist. If a market in our stock does not develop, shareholders wishing to sell will be required to seek out willing buyers and negotiate a transaction price for each sale. This may make it difficult to buy or sell the stock, which may negatively affect the price of the stock or cause significant volatility in the price of our stock.

## **Item 6. Exhibits**

- 31.1 Certification of Chief Executive Officer, pursuant to Rule 13a-14(a)
- 31.2 Certification of Chief Financial Officer, pursuant to Rule 13a-14(a)
- 32.1 Certification of Chief Executive Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
- 32.2 Certification of Chief Financial Officer, pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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**FEDERAL TRUST CORPORATION AND SUBSIDIARIES**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**FEDERAL TRUST CORPORATION**

(Registrant)

Date: November 14, 2008

By: /s/ Dennis T. Ward  
Dennis T. Ward  
President and Chief Executive Officer

Date: November 14, 2008

By: /s/ Gregory E. Smith  
Gregory E. Smith  
Executive Vice President and Chief Financial Officer