# OCEANFIRST FINANCIAL CORP

## FORM 10-K405
(Annual Report (Regulation S-K, item 405))

## Filed 3/25/1998 For Period Ending 12/31/1997

| | |
|---|---|
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| CIK | 0001004702 |
| Industry | S&Ls/Savings Banks |
| Sector | Financial |
| Fiscal Year | 12/31 |

# SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549

# FORM 10-K

Annual report pursuant to Section 13 of the
Securities Exchange Act of 1934, as amended

For the fiscal year ended DECEMBER 31, 1997
*Commission File No.: 0-27428*

# OCEAN FINANCIAL CORP.
(exact name of registrant as specified in its charter)

| | |
|---|---|
| DELAWARE | 22-3412577 |
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer I.D. No.) |

**975 HOOPER AVENUE, TOMS RIVER, NEW JERSEY 08753**
(Address of principal executive offices)

Registrant's telephone number, including area code: (732) 240-4500
**Securities registered pursuant to Section 12(b) of the Act: NONE Securities registered pursuant to Section 12(g) of the Act:**

**COMMON STOCK, PAR VALUE $0.01 PER SHARE**
(Title of class)

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 X No .

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

The aggregate market value of the voting stock held by non-affiliates of the registrant, i.e., persons other than the directors and executive officers of the registrant, was $261,336,000, based upon the last sales price as quoted on The Nasdaq Stock Market for March 18, 1998.

The number of shares of Common Stock outstanding as of March 18, 1998 is 7,767,067.

**DOCUMENTS INCORPORATED BY REFERENCE**

**THE ANNUAL REPORT TO STOCKHOLDERS FOR THE YEAR ENDED DECEMBER 31, 1997, IS**

**INCORPORATED BY REFERENCE INTO PART II OF THIS FORM 10-K.**

THE PROXY STATEMENT FOR THE 1998 ANNUAL MEETING OF SHAREHOLDERS IS INCORPORATED BY REFERENCE INTO PART III OF THIS FORM 10-K.

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## SIGNATURES

**PART I**

## ITEM 1. BUSINESS

### GENERAL

Ocean Financial Corp. (the "Company") was organized by the Board of Directors of Ocean Federal Savings Bank (the "Bank") for the purpose of acquiring all of the capital stock of the Bank issued in connection with the Bank's conversion from mutual to stock form, which was completed on July 2, 1996. At December 31, 1997, the Company had consolidated total assets of $1,510.9 million and total equity of $215.5 million. The Company was incorporated under Delaware law and is a savings and loan holding company subject to regulation by the Office of Thrift Supervision ("OTS"), the Federal Deposit Insurance Corporation ("FDIC") and the Securities and Exchange Commission ("SEC"). Currently, the Company does not transact any material business other than through its subsidiary, the Bank.

The Bank was originally founded as a state-chartered building and loan association in 1902, and converted to a federal savings and loan association in 1945. The Bank became a federally chartered mutual savings bank in 1989. The Bank's principal business has been and continues to be attracting retail deposits from the general public in the communities surrounding its branch offices and investing those deposits, together with funds generated from operations and borrowings, primarily in single-family, owner-occupied residential mortgage loans within its market area. To a significantly lesser extent, the Bank invests in commercial real estate, multi-family, construction, consumer and commercial loans. The Bank also invests in mortgage-backed securities, securities issued by the U.S. Government and agencies thereof, and other investments permitted by applicable law and regulations. The Bank may periodically sell newly originated 30-year, fixed-rate mortgage loans to the secondary market. Loan sales come from loans held in the Bank's portfolio designated as being held for sale or originated during the period and being so designated. The Bank retains all of the servicing rights of loans sold. The Bank's revenues are derived principally from interest on its mortgage loans, and to a lesser extent, interest on its investment and mortgage-backed securities and income from loan servicing. The Bank's primary sources of funds are deposits, principal and interest payments on loans, Federal Home Loan Bank ("FHLB") and other borrowings and to a lesser extent, investment maturities and proceeds from the sale of loans.

In addition to historical information, this Form 10-K may include certain forward looking statements based on current management expectations. The Company's actual results could differ materially from those management expectations. Factors that could cause future results to vary from current management expectations include, but are not limited to, general economic conditions, legislative and regulatory changes, monetary and fiscal policies of the federal government, changes in tax policies, rates and regulations of federal and state tax authorities, changes in interest rates, deposit flows, the cost of funds, demand for loan products, demand for financial services, competition, changes in the quality or composition of the Bank's loan and investment portfolios, changes in accounting principles, policies or guidelines, and other economic, competitive, governmental and technological factors affecting the Company's operations, markets, products, services and prices. Further description of the risks and uncertainties to the business are included in detail herein and in the Company's Annual Report to Stockholders.

### MARKET AREA AND COMPETITION

The Bank is a community-oriented financial institution, offering a wide variety of financial services to meet the needs of the communities it serves. The Bank conducts its business through an administrative and branch office located in Toms River, Ocean County, New Jersey, and nine additional branch offices, eight of which are located in Ocean County and one of which is located in Middlesex County, New Jersey. The Bank's deposit gathering base is concentrated in the communities surrounding its offices. While its lending area extends throughout New Jersey, most of the Bank's mortgage loans are secured by properties located in Ocean County and Southern Monmouth County.

The Bank is the oldest and largest community-based financial institution headquartered in Ocean County, New Jersey, which is located along the central New Jersey shore. Ocean County is among the fastest growing population areas in New Jersey and has a significant number of retired residents who have traditionally provided the Bank with a stable source of deposit funds. The economy in the Bank's primary market area is based upon a mixture of service and retail trade. Other employment is provided by a variety of wholesale trade, manufacturing, federal, state and local government, hospitals and utilities. The area is also home to commuters working in New Jersey suburban areas around New York and Philadelphia.

In the late 1980's and early 1990's, due in part to the effects of a prolonged decline in the national and regional economy, layoffs in the financial services industry and corporate relocations, New Jersey experienced reduced levels of employment. These events, in conjunction with a surplus of available commercial and residential properties, resulted in an overall decline during this period in the underlying values of properties located in New Jersey. However, New Jersey's real estate market has stabilized in recent years. Whether such stabilization will continue is dependent, in large part, upon the general economic health of the United States and New Jersey, and other factors beyond the Bank's control and, therefore, cannot be estimated.

The Bank faces significant competition both in making loans and in attracting deposits. The State of New Jersey has a high density of financial institutions, many of which are branches of significantly larger institutions which have greater financial resources than the Bank, all of which are competitors of the Bank to varying degrees. The Bank's competition for loans comes principally from commercial banks, savings banks, savings and loan associations, credit unions, mortgage banking companies and insurance companies. Its most direct competition for deposits has historically come from commercial banks, savings banks, savings and loan associations and credit unions. The Bank faces additional competition for deposits from short-term money market funds, other corporate and government securities funds and from other financial service institutions such as brokerage firms and insurance companies.

**LENDING ACTIVITIES**

Loan Portfolio Composition. The Bank's loan portfolio consists primarily of conventional first mortgage loans secured by one- to four-family residences. At December 31, 1997, the Bank had total loans outstanding of $794.3 million, of which $711.6 million or 89.57 % of total loans, were one- to four-family, residential mortgage loans. The remainder of the portfolio consisted of $45.4 million of consumer loans, primarily home equity loans and lines of credit, equaling 5.72% of total loans; $25.7 million of commercial real estate, multi- family and land loans, or 3.24% of total loans; $8.7 million of real estate construction loans, or 1.10% of total loans; and $2.9 million of commercial loans, or .37% of total loans. The Bank had no loans held for sale at December 31, 1997. At that same date, 59.87% of the Bank's total loans had adjustable interest rates.

The types of loans that the Bank may originate are subject to federal and state law and regulations. Interest rates charged by the Bank on loans are affected by the demand for such loans and the supply of money available for lending purposes and the rates offered by competitors. These factors are, in turn, affected by, among other things, economic conditions, monetary policies of the federal government, including the Federal Reserve Board, and legislative tax policies.

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

| | At December 31, | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1997 | | 1996 | | 1995 | | 1994 | | 1993 | |
| | AMOUNT | PERCENT OF TOTAL | AMOUNT | PERCENT OF TOTAL | AMOUNT | PERCENT OF TOTAL | AMOUNT | PERCENT OF TOTAL | AMOUNT | PERCENT OF TOTAL |
| | (DOLLARS IN THOUSANDS) | | | | | | | | | |
| Real estate: | | | | | | | | | | |
| One- to four-family | $711,548 | 89.57% | $628,525 | 91.05% | $575,010 | 92.01% | $552,401 | 91.63% | $505,984 | 91.66% |
| Commercial real estate, multi-family and land | 25,699 | 3.24 | 15,634 | 2.26 | 14,939 | 2.39 | 13,885 | | | |
| Construction | 8,748 | 1.10 | 9,287 | 1.35 | 8,153 | 1.30 | 10,474 | 1.74 | 8,123 | 1.47 |
| Consumer (1) | 45,417 | 5.72 | 36,860 | 5.34 | 26,867 | 4.30 | 26,100 | 4.33 | 26,427 | 4.79 |
| Commercial loans | 2,904 | .37 | - | - | - | - | - | - | - | - |
| Total loans | 794,316 | 100.00% | 690,306 | 100.00% | 624,969 | 100.00% | 602,860 | 100.00% | 552,006 | 100.00% |
| Less: | | | | | | | | | | |
| Undisbursed loan funds | 2,867 | | 3,517 | | 2,687 | | 2,661 | | 2,341 | |
| Unamortized discounts, net | 9 | | 11 | | 12 | | 13 | | 27 | |
| Deferred loan fees | 1,133 | | 1,302 | | 1,679 | | 2,263 | | 3,286 | |
| Allowance for loan losses | 6,612 | | 6,021 | | 6,001 | | 5,608 | | 5,504 | |
| Total loans, net | 783,695 | | 679,455 | | 614,590 | | 592,315 | | 540,848 | |
| Less: | | | | | | | | | | |
| Mortgage loans held for sale | - | | 727 | | 1,894 | | - | | 963 | |
| Loans receivable, net | $783,695 | | $678,728 | | $612,696 | | $592,315 | | $539,885 | |
| Total loans: | | | | | | | | | | |
| Adjustable rate | $475,533 | 59.87% | $437,706 | 63.41% | $405,485 | 64.88% | $386,424 | 64.10% | $332,487 | 60.23% |
| Fixed rate | 318,783 | 40.13 | 252,600 | 36.59 | 219,484 | 35.12 | 216,436 | 35.90 | 219,519 | 39.77 |
| Total loans | $794,316 | 100.00% | $690,306 | 100.00% | $624,969 | 100.00% | $602,860 | 100.00% | $552,006 | 100.00% |

(1) Consists primarily of home equity loans and lines of credit, and to a lesser extent, loans on savings accounts, automobile and student loans.

Loan Maturity. The following table shows the contractual maturity of the Bank's total loans at December 31, 1997. There were no loans held for sale at December 31, 1997. The table does not include principal repayments. Principal repayments, including prepayments, on total loans was $120.9 million, $103.5 million and $89.6 million for the years ended December 31, 1997, 1996 and 1995, respectively.

| | AT DECEMBER 31, 1997 | | | | | |
|---|---|---|---|---|---|---|
| | ONE- TO FOUR-FAMILY | COMMERCIAL REAL ESTATE, MULTI-FAMILY AND LAND | CONSTRUCTION | CONSUMER | COMMERCIAL LOANS | TOTAL LOANS RECEIVABLE |
| | (IN THOUSANDS) | | | | | |
| One year or less | $ 23,692 | $ 6,526 | $8,748 | $ 5,309 | $1,099 | $ 45,374 |
| After one year: | | | | | | |
| More than one year to three years | 51,973 | 763 | - | 8,304 | 290 | 61,330 |
| More than three years to five years | 56,870 | 6,290 | - | 7,821 | 1,324 | 72,305 |
| More than five years to 10 years | 134,274 | 1,628 | - | 16,304 | 191 | 152,397 |
| More than 10 years to 20 years | 235,045 | 6,569 | - | 7,679 | - | 249,293 |
| More than 20 years | 209,694 | 3,923 | - | - | - | 213,617 |
| Total due after December 31, 1998 | 687,856 | 19,173 | - | 40,108 | 1,805 | 748,942 |
| Total amount due | $711,548 | $25,699 | $8,748 | $45,417 | $2,904 | 794,316 |
| Less: | | | | | | |
| Undisbursed loan funds | | | | | | 2,867 |
| Unamortized discounts, net | | | | | | 9 |
| Deferred loan fees | | | | | | 1,133 |
| Allowance for loan losses | | | | | | 6,612 |
| Total loans, net | | | | | | 783,695 |
| Less: Mortgage loans held for sale | | | | | | - |
| Loans receivable, net | | | | | | $783,695 |

The following table sets forth at December 31, 1997, the dollar amount of total loans receivable contractually due after December 31, 1998, and whether such loans have fixed interest rates or adjustable interest rates.

| | DUE AFTER DECEMBER 31, 1998 | | |
|---|---|---|---|
| | Fixed | ADJUSTABLE | Total |
| | (In thousands) | | |
| Real estate loans: | | | |
| One- to four-family | $266,606 | $421,250 | $687,856 |
| Commercial real estate, multi-family and land | 9,763 | 9,410 | 19,173 |
| Consumer | 15,775 | 24,333 | 40,108 |
| Commercial loans | 1,697 | 108 | 1,805 |
| Total loans receivable | $293,841 | $455,101 | $748,942 |

Origination, Sale, Servicing and Purchase of Loans. The Bank's residential mortgage lending activities are conducted primarily by commissioned loan representatives in the exclusive employment of the Bank and through the Bank's branch offices. The Bank originates both adjustable-rate and fixed-rate mortgage loans. The Bank's ability to originate loans is dependent upon the relative customer demand for fixed-rate or adjustable-rate mortgage loans, which is affected by the current and expected future level of interest rates. The Bank may periodically sell part of the 30-year, fixed-rate mortgage loans that it originates and retain for portfolio ARM loans and shorter term fixed-rate loans with maturities of 15 years or less. The Bank retains all servicing of the loans sold. See "- Loan Servicing." At December 31, 1997 there were no loans categorized as held for sale. In the past, the Bank has also originated loans through commitments negotiated with correspondent mortgage origination firms.

The following tables set forth the Bank's loan originations, purchases, sales, principal repayments and loan activity for the periods indicated.

| | FOR THE YEAR DECEMBER 31, | | |
|---|---|---|---|
| | 1997 | 1996 | 1995 |
| | (IN THOUSANDS) | | |
| Total loans: | | | |
| Beginning balance | $690,306 | $624,969 | $602,860 |
| Loans originated: | | | |
| One- to four-family | 182,519 | 170,381 | 112,283 |
| Commercial real estate, multi-family and land | 16,709 | 2,031 | 4,058 |
| Construction | 4,743 | 1,537 | 6,010 |
| Consumer | 22,982 | 21,829 | 11,007 |
| Commercial | 3,177 | - | - |
| Total loans originated | 230,130 | 195,778 | 133,358 |
| Total | 920,436 | 820,747 | 736,218 |
| Less: | | | |
| Principal repayments | 120,905 | 103,546 | 89,596 |
| Sales of loans | 2,752 | 24,711 | 18,861 |
| Transfer to REO | 2,463 | 2,184 | 2,792 |
| Total loans | $794,316 | $690,306 | $624,969 |

One- to Four-Family Mortgage Lending. The Bank offers both fixed-rate and adjustable-rate mortgage loans secured by one- to four-family residences with maturities up to 30 years. Substantially all of such loans are secured by property located in the Bank's primary market area. Loan originations are generally obtained from the Bank's existing or past customers, members of the local communities and commissioned loan representatives and their contacts with the local real estate industry. In the past, the Bank has also originated loans through commitments negotiated with correspondent mortgage origination firms.

At December 31, 1997, the Bank's total loans outstanding were $794.3 million, of which $711.6 million, or 89.57%, were one- to four-family residential mortgage loans, primarily single-family and owner-occupied. To a lesser extent, the Bank also makes mortgage loans secured by seasonal second homes. The average size of the Bank's one- to four-family mortgage loan was approximately $82,000 at December 31, 1997. The Bank currently offers a number of ARM loan programs with interest rates which adjust every one-, three-, or five-years. The Bank's ARM loans generally provide for periodic (not less than 2%) and overall (not more than 6%) caps on the increase or decrease in the interest rate at any adjustment date and over the life of the loan. The interest rate on these loans is indexed to the applicable one-, three-, five- or ten-year U.S. Treasury constant maturity yield, with a repricing margin which ranges generally from 2.75% to 3.25% above the index. The Bank also offers three-, five-, and seven-year ARM loans which operate as fixed-rate loans for three, five or seven years and then convert to one-year ARM loans for the remainder of the term. The ARM loans are then indexed to a margin of generally 2.75% to 3.25% above the one-year U.S. Treasury constant maturity yield.

Generally, ARM loans pose credit risks different than risks inherent in fixed- rate loans, primarily because as interest rates rise, the payments of the borrower rise, thereby increasing the potential for delinquency and default. At the same time, the marketability of the underlying property may be adversely affected by higher interest rates. In order to minimize risks, borrowers of one- year ARM loans with a loan-to-value ratio of 75% or less are qualified at the fully-indexed rate (the applicable U.S. Treasury index plus the margin, rounded to the nearest one-eighth of one percent), and borrowers of one-year ARM loans with a loan-to-value ratio over 75% are qualified at the higher of the fully indexed rate or the initial rate plus the 2% annual interest rate cap. The Bank does not originate ARM loans which provide for negative amortization.

The Bank's fixed-rate mortgage loans currently are made for terms from 10 to 30 years. At December 31, 1997, the Bank had commitments for the origination of fixed-rate mortgage loans totaling $24.5 million. The normal terms for such commitments provide for a maximum of 90 days rate lock upon receipt of a 1.0% fee charged on the mortgage amount. The Bank may periodically sell part of the 30-year, fixed-rate residential mortgage loans that it originates. The Bank retains the servicing on all loans sold. The Bank generally retains for its portfolio shorter term, fixed-rate loans with maturities of 15 years or less, and certain longer term fixed-rate loans, generally consisting of loans to facilitate the sale of REO, loans to officers, directors or employees of the Bank and "jumbo", non-conforming loans as determined by applicable FNMA and FHLMC guidelines. The Bank may retain all or most of its longer term fixed rate loans after considering volume and yield and after evaluating interest rate risk and capital management considerations.

The Bank's policy is to originate one- to four-family residential mortgage loans in amounts up to 80% of the lower of the appraised value or the selling price of the property securing the loan and up to 95% of the appraised value or selling price if private mortgage insurance is obtained. Mortgage loans originated by the Bank include due-on-sale clauses which provide the Bank with the contractual right to deem the loan immediately due and payable in the event the borrower transfers ownership of the property without the Bank's consent. Due-on-sale clauses are an important means of adjusting the rates on the Bank's fixed-rate mortgage loan portfolio and the Bank has generally exercised its rights under these clauses.

Commercial Real Estate, Multi-Family and Land Lending. The Bank originates commercial real estate loans that are secured by properties generally used for business purposes such as small office buildings or retail facilities located in the Bank's primary market area. The Bank's underwriting procedures provide that commercial real estate loans may be made in amounts up to 80% of the appraised value of the property. The Bank currently originates commercial real estate loans with terms of up to twenty five years with fixed or adjustable rates which are indexed to a margin above the one-, three-, or five-year U.S. Treasury constant maturity yield. In reaching its decision on whether to make a commercial real estate loan, the Bank considers the net operating income of the property and the borrower's expertise, credit history, profitability and the term and quantity of leases. The Bank has generally required that the properties securing commercial real estate loans have debt service coverage ratios of at least 120%. Generally, properties securing a loan are appraised by an independent appraiser and title insurance is required on all first mortgage loans. The Bank typically requires the personal guarantee of the principal borrowers for all commercial real estate loans. The Bank's commercial real estate loan portfolio at

December 31, 1997 was $21.5 million, or 2.71% of total loans. The largest commercial real estate loan in the Bank's portfolio at December 31, 1997 was a performing loan for which the Bank had an outstanding carrying balance of $2.7 million, which was secured by a first mortgage on an owner-occupied 38,000 square foot commercial building.

The Bank originates multi-family mortgage loans generally secured by buildings with five or more housing units located in the Bank's primary market area. As a result of market conditions in its primary market area, the Bank currently originates multi-family loans on a limited and highly selective basis. In reaching its decision on whether to make a multi-family loan, the Bank considers the qualifications of the borrower as well as the underlying property. Some of the factors to be considered are: the net operating income of the mortgaged premises before debt service and depreciation; the debt service ratio; and the ratio of loan amount to appraised value. Pursuant to the Bank's current underwriting policies, a multi-family adjustable-rate mortgage loan may only be made in an amount up to 75% of the appraised value of the underlying property to a maximum amount of generally $4 million. In addition, the Bank generally requires a debt service ratio of 120%. Properties securing a loan are appraised by an independent appraiser and title insurance is required on all loans. The Bank's multi-family loan portfolio at December 31, 1997, totaled $4.0 million. The Bank's largest multi-family loan at December 31, 1997, had an outstanding balance of $2.2 million and was secured by a 125-unit affordable-housing apartment complex located in Toms River, New Jersey. To a significantly lesser extent, the Bank also originates land loans. Such loans totaled $153,000 at December 31, 1997.

Loans secured by commercial real estate and multi-family residential properties are generally larger and involve a greater degree of risk than one- to four- family residential mortgage loans. Because payments on loans secured by multi- family properties are often dependent on successful operation or management of the properties, repayment of such loans may be subject to a greater extent to adverse conditions in the real estate market or the economy. The Bank seeks to minimize these risks through its underwriting policies, which require such loans to be qualified at origination on the basis of the property's income and debt coverage ratio.

Construction Lending. At December 31, 1997, construction loans totaled $8.7 million, or 1.10%, of the Bank's total loans outstanding. The Bank originates single-family construction loans primarily on a construction/permanent basis with such loans converting to an amortizing loan following the completion of the construction phase. Most of the Bank's construction loans are made to individuals building their primary residence, while, to a lesser extent, loans are made to developers known to the Bank in order to build single-family houses under contract for sale, which loans become due and payable over terms not exceeding 18 months. The current policy of the Bank is to charge interest rates on its construction loans which float at margins which are generally 2.0% above the prime rate (as published in the Wall Street Journal). The Bank's construction loans increase the interest rate sensitivity of its earning assets. At December 31, 1997, the Bank had 44 construction loans, with the largest loan balance being approximately $825,000. At December 31, 1997, all of the Bank's construction lending portfolio consisted of loans secured by property located in the State of New Jersey, for the purpose of constructing one- to four-family homes. The Bank may originate construction loans to individuals and contractors on approved building lots in amounts up to 75% of the appraised value of the land and the building. The terms to maturity of the Bank's construction/permanent loans are similar to the Bank's other one- to four-family mortgage products. The Bank requires an appraisal of the property, credit reports, and financial statements on all principals and guarantors, among other items, for all construction loans.

Construction lending, by its nature, entails additional risks compared to one-to four-family mortgage lending, attributable primarily to the fact that funds are advanced upon the security of the project under construction prior to its completion. As a result, construction lending often involves the disbursement of substantial funds with repayment dependent on the success of the ultimate project and the ability of the borrower or guarantor to repay the loan. Because of these factors, the analysis of prospective construction loan projects requires an expertise that is different in significant respects from that which is required for residential mortgage lending. The Bank has attempted to address these risks through its underwriting procedures.

Consumer Loans. The Bank also offers consumer loans. At December 31, 1997, the Bank's consumer loans totaled $45.4 million, or 5.72% of the Bank's total loan portfolio. Of that amount, home equity loans comprised $23.1 million, or 50.9%; home equity lines of credit comprised $18.7 million, or 41.2%; loans on savings accounts totaled $1.6 million, or 3.5%; and automobile and student loans totaled $2.0 million, or 4.4%.

The Bank originates home equity loans secured by one- to four-family residences. These loans are originated as either adjustable-rate or fixed-rate loans with terms ranging from 10 to 20 years. Home equity loans are typically made on owner-occupied, one- to four-family residences and generally to the Bank's first mortgage customers. These loans are subject to a 80% loan-to-value limitation, including any other outstanding mortgages or liens.

The Bank also offers a variable rate home equity line of credit which extends a credit line based on the applicant's income and equity in the home. Generally, the credit line, when combined with the balance of the first mortgage lien, may not exceed 80% of the appraised value of the property at the time of the loan commitment. Home equity lines of credit are secured by a mortgage on the underlying real estate. The Bank presently charges no origination fees for these loans, but may in the future charge origination fees for its home equity lines of credit. A borrower is required to make monthly payments of principal and interest, at a minimum of $50, based upon a 10 or 15 year amortization period. Generally, the adjustable rate of interest charged is the prime rate of interest (as published in the Wall Street Journal) plus a range of 0.0% to 1.25%. The loans have an 18% lifetime cap on interest rate adjustments. The Bank's home equity lines of credit outstanding at December 31, 1997 totaled $18.7 million.

Commercial Lending. At December 31, 1997, commercial loans totaled $2.9 million, or .37% of the Bank's total loans outstanding. During 1996, a Commercial Lending group was established within the Bank. The group's primary function is to service the business communities' banking and financing needs in the Bank's primary market area. The Commercial Lending group originates both commercial loans (including loans for working capital; fixed asset purchases; and acquisition, receivable and inventory financing) and commercial mortgage loans (including acquisition, construction, expansion and refinancing of owner occupied and investment properties). Credit facilities such as lines of credit and term loans will be used to facilitate these requests. In all cases, the Bank will review and analyze financial history and capacity, collateral value, strength and character of the principals, and general payment history of the borrower and principals in coming to a credit decision.

A well-defined credit policy has been approved by the Bank's Board of Directors. This policy discourages high risk credits, while focusing on quality underwriting, sound financial strength, and close management and Board monitoring. Commercial business lending, both secured and unsecured, is generally considered to involve a higher degree of risk than secured residential real estate lending. Risk of loss on a commercial business loan is dependent largely on the borrower's ability to remain financially able to repay the loan out of ongoing operations. If the Bank's estimate of the borrower's financial ability is inaccurate, the Bank may be confronted with a loss of principal on the loan.

Loan Approval Procedures and Authority. The Board of Directors establishes the loan approval policies of the Bank. The Board of Directors has authorized the approval of loans secured by real estate up to $1 million and unsecured loans up to $500,000 by various employees of the Bank, on a scale which requires approval by personnel with progressively higher levels of responsibility as the loan amount increases. A minimum of two employees' signatures are required to approve residential loans over $150,000. Loans secured by real estate in amounts over $1 million and unsecured loans over $500,000 require approval by the Loan Committee of the Board of Directors. Loans in excess of $2 million require approval by the Board of Directors. Pursuant to OTS regulations, loans to one borrower generally cannot exceed 15% of the Bank's unimpaired capital, which at December 31, 1997 amounted to $26.8 million. At December 31, 1997, the Bank's maximum loan exposure to a single borrower was $4.4 million.

Loan Servicing. Loan servicing includes collecting and remitting loan payments, accounting for principal and interest, making inspections as required of mortgaged premises, contacting delinquent mortgagors, supervising foreclosures and property dispositions in the event of unremedied defaults, making certain insurance and tax payments on behalf of the borrowers and generally administering the loans. The Bank also services mortgage loans for others. All of the loans currently being serviced for others are loans which have been sold by the Bank. At December 31, 1997, the Bank was servicing $144.2 million of loans for others. For the years ended December 31, 1997, 1996 and 1995, loan servicing fees totaled $529,000, $543,000 and $522,000, respectively.

Delinquencies and Classified Assets. The Board of Directors performs a monthly review of all delinquent loan totals which includes loans sixty days or more past due, and the detail of each loan thirty days or more past due that were originated within the past year. In addition, management prepares a quarterly list of all classified loans and a narrative report of classified commercial, commercial real estate, multi-family, land and construction loans. The procedures taken by the Bank with respect to delinquencies vary depending on the nature of the loan and period of delinquency. When a borrower fails to make a required payment on a loan, the Bank takes a number of steps to have the borrower cure the delinquency and restore the loan to current status. The Bank generally sends the borrower a written notice of non-payment after the loan is first past due. In the event payment is not then received, additional letters and phone calls generally are made. If the loan is still not brought current and it becomes necessary for the Bank to take legal action, which typically occurs after a loan is delinquent at least 90 days or more, the Bank will commence foreclosure proceedings against any real property that secures the loan. If a foreclosure action is instituted and the loan is not brought current, paid in full, or an acceptable workout accommodation is not agreed upon before the foreclosure sale, the real property securing the loan generally is sold at foreclosure.

The Bank's Internal Asset Classification Committee, which is chaired by an officer who reports directly to the Audit Committee of the Board of Directors, reviews and classifies the Bank's assets quarterly and reports the results of its review to the Board of Directors. The Bank classifies assets in accordance with certain regulatory guidelines established by the OTS which are applicable to all savings associations. At December 31, 1997, the Bank had $7.0 million of assets, including all REO, classified as Substandard, $3,000 of assets classified as Doubtful and no assets classified as Loss. Loans and other assets may also be placed on a watch list as "Special Mention" assets. Assets which do not currently expose the insured institution to sufficient risk to warrant classification in one of the aforementioned categories but possess weaknesses are required to be designated "Special Mention." Special Mention assets totaled $3.6 million at December 31, 1997, and consisted primarily of loans secured by single-family, owner-occupied residences. These loans are classified as Special Mention due to past delinquencies or other identifiable weaknesses. At December 31, 1997, the largest loan classified as Special Mention had a balance of $552,000 and the largest loan classified as Substandard had a balance of $250,000.

**Non-Accrual Loans and REO**

The following table sets forth information regarding non-accrual loans and REO. The Bank had no troubled-debt restructured loans within the meaning of SFAS 114, and 16 REO properties at December 31, 1997. It is the policy of the Bank to cease accruing interest on loans 90 days or more past due or in the process of foreclosure. For the years ended December 31, 1997, 1996, 1995, 1994 and 1993, respectively, the amount of interest income that would have been recognized on nonaccrual loans if such loans had continued to perform in accordance with their contractual terms was $278,000, $345,000, $428,000, $607,000 and $642,000 none of which was recognized.

| | December 31, | | | | |
|---|---|---|---|---|---|
| | 1997 | 1996 | 1995 | 1994 | 1993 |
| Non-accrual loans: | | | | | |
| Real estate: | | | | | |
| One- to four-family.................. | $ 5,062 | $7,148 | $ 8,296 | $10,280 | $ 9,705 |
| Commercial real estate, multi-family and land.............. | 382 | 122 | 154 | 96 | 315 |
| Construction.......................... | - | 314 | -- | 265 | 250 |
| Consumer................................. | 110 | 113 | 221 | 298 | 224 |
| Total............................. | 5,554 | 7,697 | 8,671 | 10,939 | 10,494 |
| REO, net(1)............................... | 1,198 | 1,555 | 1,367 | 1,580 | 3,056 |
| Total non-performing assets............ | $ 6,752 | $9,252 | $10,038 | $12,519 | $13,550 |
| Allowance for loan losses as a percent of total loans receivable (2).. | .83% | .88% | .97% | .94% | 1.01% |
| Allowance for loan losses as a percent of total non-performing loans (3)............................. | 119.03 | 78.23 | 69.21 | 51.27 | 52.45 |
| Non-performing loans as a percent of total loans receivable(2)(3).......... | .70 | 1.12 | 1.40 | 1.83 | 1.92 |
| Non-performing assets as a percent of total assets(3)........ | .45 | .71 | .97 | 1.29 | 1.45 |

(1) REO balances are shown net of related loss allowances.
(2) Total loans includes loans receivable and mortgage loans held for sale, less undisbursed loan funds, deferred loan fees and unamortized premiums and discounts.
(3) Non-performing assets consist of non-performing loans and REO. Non- performing loans consist of all loans 90 days or more past due and other loans in the process of foreclosure.

Allowance for Loan Losses. The allowance for loan losses is established through a provision for loan losses based on management's evaluation of the risks inherent in its loan portfolio and the general economy. The allowance for loan losses is maintained at an amount management considers sufficient to provide for estimated losses based on evaluating known and inherent risks in the loan portfolio based upon management's continuing analysis of the factors underlying the quality of the loan portfolio. These factors include changes in the size and composition of the loan portfolio, actual loan loss experience, current and anticipated economic conditions, detailed analysis of individual loans for which full collectibility may not be assured, and the determination of the existence and realizable value of the collateral and guarantees securing the loan. Additions to the allowance are charged to earnings. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require the Bank to make additional provisions for loan losses based upon information available to them at the time of their examination. Although management uses the best information available, future adjustments to the allowance may be necessary due to economic, operating, regulatory and other conditions beyond the Company's control. As of December 31, 1997 and 1996, the Bank's allowance for loan losses was .83% and .88%, respectively, of total loans. The Bank had non-accrual loans of $5.6 million and $7.7 million at December 31, 1997 and 1996, respectively. The Bank will continue to monitor and modify its allowances for loan losses as conditions dictate.

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The following table sets forth activity in the Bank's allowance for estimated loan losses for the periods set forth in the table.

| | AT OR FOR THE YEAR ENDED | | | | |
|---|---|---|---|---|---|
| | 1997 | 1996 | 1995 | 1994 | 1993 |
| | (IN THOUSANDS) | | | | |
| Balance at beginning of year | $6,021 | $6,001 | $5,608 | $5,504 | $5,737 |
| Charge-offs: | | | | | |
| Real Estate: | | | | | |
| One- to four-family | 328 | 599 | 510 | 907 | 1,080 |
| Commercial real estate, multi-family and land | -- | 30 | 28 | 141 | 334 |
| Construction | -- | -- | -- | -- | 11 |
| Consumer | 9 | 63 | 30 | 5 | 122 |
| Total | 337 | 692 | 568 | 1,053 | 1,547 |
| Recoveries | 28 | 12 | 11 | 28 | 14 |
| Net charge-offs | 309 | 680 | 557 | 1,025 | 1,533 |
| Provision for loan losses | 900 | 700 | 950 | 1,129 | 1,300 |
| Balance at end of year | $6,612 | $6,021 | $6,001 | $5,608 | $5,504 |
| Ratio of net charge-offs during the year to average net loans outstanding during the year | .05% | .11% | .09% | .18% | .29% |

The following tables set forth the Bank's percent of allowance for loan losses to total allowance and the percent of loans to total loans in each of the categories listed at the dates indicated.

| | At December 31, | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 1997 | | | 1996 | | | 1995 | | |
| | Amount | Percent of Allowance to Total Allowance | Percent of Loans in Each Category to Total Loans | Amount | Percent of Allowance to Total Allowance | Percent of Loans in Each Category to Total Loans | Amount | Percent of Allowance to Total Allowance | Percent of Loans in Each Category to Total Loans |
| One- to four-family | $2,485 | 37.58% | 89.57% | $2,659 | 44.16% | 91.05% | $2,790 | 46.49% | 92.01% |
| Commercial real estate, multi-family and land | 591 | 8.94 | 3.24 | 330 | 5.48 | 2.26 | 556 | 9.27 | 2.39 |
| Construction | 44 | .67 | 1.10 | 75 | 1.25 | 1.35 | 41 | .68 | 1.30 |
| Consumer | 471 | 7.12 | 5.72 | 324 | 5.38 | 5.34 | 273 | 4.55 | 4.30 |
| Commercial | 58 | .88 | .37 | -- | -- | -- | -- | -- | -- |
| Unallocated | 2,963 | 44.81 | - | 2,633 | 43.73 | -- | 2,341 | 39.01 | -- |
| Total | $6,612 | 100.00% | 100.00% | $6,021 | 100.00% | 100.00% | $6,001 | 100.00% | 100.00% |

| | At December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 1994 | | | 1993 | | |
| | Amount | Percent of Allowance to Total Allowance | Percent of Loans in Each Category to Total Loans | Amount | Percent of Allowance to Total Allowance | Percent of Loans in Each Category to Total Loans |
| One- to four-family | $2,809 | 50.09% | 91.63% | $2,941 | 53.43% | 91.66% |
| Commercial real estate, multi-family and land | 483 | 8.61 | 2.30 | 506 | 9.19 | 2.08 |
| Construction | 79 | 1.41 | 1.74 | 49 | .89 | 1.47 |
| Consumer | 268 | 4.78 | 4.33 | 275 | 5.00 | 4.79 |
| Commercial | -- | -- | -- | -- | -- | -- |
| Unallocated | 1,969 | 35.11 | -- | 1,733 | 31.49 | -- |
| Total | $5,608 | 100.00% | 100.00% | $5,504 | 100.00% | 100.00% |

**INVESTMENT ACTIVITIES**

Federally chartered savings institutions have the authority to invest in various types of liquid assets, including United States Treasury obligations, securities of various federal agencies, certificates of deposit of insured banks and savings institutions, bankers' acceptances, repurchase agreements and federal funds. Subject to various restrictions, federally chartered savings institutions may also invest their assets in commercial paper, investment-grade corporate debt securities and mutual funds whose assets conform to the investments that a federally chartered savings institution is otherwise authorized to make directly. Additionally, the Bank must maintain minimum levels of investments that qualify as liquid assets under OTS regulations. See "Regulation and Supervision - Federal Savings Institution Regulation -Liquidity." Historically, the Bank has maintained liquid assets above the minimum OTS requirements and at a level considered to be adequate to meet its normal daily activities.

The investment policy of the Bank as established by the Board of Directors attempts to provide and maintain liquidity, generate a favorable return on investments without incurring undue interest rate and credit risk, and complement the Bank's lending activities. Specifically, the Bank's policies generally limit investments to government and federal agency-backed securities and other non-government guaranteed securities, including corporate debt obligations, that are investment grade. The Bank's policies provide that all investment purchases must be approved by two officers (either the Senior Vice President/Treasurer, Executive Vice President/Chief Financial Officer or the President and Chief Executive Officer) and be ratified by the Board of Directors. In December 1995, the Bank reassessed its investment portfolio and reclassified all of its investment and mortgage-backed securities, totaling in the aggregate $382.7 million, from held-to-maturity to available for sale.

Mortgage-backed Securities. Mortgage-backed securities represent a participation interest in a pool of single-family or multi-family mortgages, the principal and interest payments on which, in general, are passed from the mortgage originators, through intermediaries that pool and repackage the participation interests in the form of securities, to investors such as the Bank. Such intermediaries may be private issuers, or agencies including FHLMC, FNMA and GNMA that guarantee the payment of principal and interest to investors. Mortgage-backed securities typically are issued with stated principal amounts, and the securities are backed by pools of mortgages that have loans with interest rates that are within a range and have varying maturities. The underlying pool of mortgages can be composed of either fixed- or ARM loans.

The actual maturity of a mortgage-backed security varies, depending on when the mortgagors repay or prepay the underlying mortgages. Prepayments of the underlying mortgages may shorten the life of the security, thereby affecting its yield to maturity and the related market value of the mortgage-backed security. The prepayments of the underlying mortgages depend on many factors, including the type of mortgages, the coupon rates, the age of mortgages, the geographical location of the underlying real estate collateralizing the mortgages, general levels of market interest rates, and general economic conditions. GNMA mortgage- backed securities that are backed by assumable Federal Housing Authority ("FHA") or the Department of Veterans Affairs ("VA") loans generally have a longer life than conventional non-assumable loans underlying FHLMC and FNMA mortgage-backed securities. During periods of falling mortgage interest rates, prepayments generally increase, as opposed to periods of increasing interest rates when prepayments generally decrease. If the interest rate of underlying mortgages significantly exceeds the prevailing market interest rates offered for mortgage loans, refinancing generally increases and accelerates the prepayment of the underlying mortgages. Prepayment experience is more difficult to estimate for adjustable-rate mortgage-backed securities.

The Bank has significant investments in mortgage-backed securities and has utilized such investments to complement its mortgage lending activities. At December 31, 1997, mortgage-backed securities totaled $457.1 million, or 30.2% of total assets, all of which were classified as available for sale. The Bank invests in a large variety of mortgage-backed securities, including ARM, balloon and fixed-rate mortgage-backed securities, the majority of which are directly insured or guaranteed by FHLMC, GNMA and FNMA. At such date, the mortgage-backed securities portfolio had a weighted average interest rate of 6.73%.

The Bank generally purchases short-term, straight sequential or planned amortization class collateralized mortgage obligations ("CMOs"). CMOs are securities created by segregating or portioning cash flows from mortgage pass-through securities or from pools of mortgage loans. CMOs provide a broad range of mortgage investment vehicles by tailoring cash flows from mortgages to meet the varied risk and return preferences of investors. These securities enable the issuer to "carve up" the cash flows from the underlying securities and thereby create multiple classes of securities with different maturity and risk characteristics. The Bank invests in U.S. Government and agency-backed CMOs and, to a lesser extent, privately issued CMOs, all of which have agency-backed collateral. All of the Bank's CMOs and mortgage-backed securities are currently rated "AAA". Prior to purchasing mortgage-backed securities, each security is tested for Federal Financial Institutions Examination Council ("FFIEC") qualification. At December 31, 1997, the Bank's investment in CMOs had an amortized cost of $3.4 million, and a market value of $3.4 million.

The following table sets forth the Bank's mortgage-backed securities activities for the periods indicated.

| | FOR THE YEAR ENDED DECEMBER 31, | | |
|---|---|---|---|
| | 1997 | 1996 | 1995 |
| | | (IN THOUSANDS) | |
| Beginning balance | $ 395,542 | $ 265,113 | $224,569 |
| Mortgage-backed securities purchased | 248,917 | 251,004 | 88,490 |
| Less: Principal repayments | (164,291) | (117,048) | (50,193) |
| Mortgage-backed securities sold | (19,149) | - | - |
| (Amortization of premium) | (3,504) | (1,804) | (612) |
| Change in net unrealized gain (loss) on mortgage-backed securities available for sale | (367) | (1,723) | 2,859 |
| Ending balance | $ 457,148 | $ 395,542 | $265,113 |

The following table sets forth certain information regarding the amortized cost and market value of the Bank's mortgage-backed securities at the dates indicated.

| | At December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 1997 | | 1996 | | 1995 | |
| | AMORTIZED COST | MARKET VALUE | AMORTIZED COST | MARKET VALUE | AMORTIZED COST | MARKET VALUE |
| | (IN THOUSANDS) | | | | | |
| Mortgage-backed securities: | | | | | | |
| FHLMC.................. | $245,414 | $245,559 | $316,773 | $317,735 | $221,822 | $223,884 |
| FNMA................... | 109,873 | 109,991 | 69,190 | 69,108 | 27,307 | 27,624 |
| GNMA................... | 97,714 | 98,172 | 2,800 | 2,931 | 3,561 | 3,763 |
| | 3,378 | 3,426 | 5,643 | 5,768 | 9,564 | 9,842 |
| Total mortgage-backed securities............. | $456,379 | $457,148 | $394,406 | $395,542 | $262,254 | $265,113 |

Investment Securities. Investment securities identified as held to maturity are carried at cost, adjusted for amortization of premium and accretion of discount, which are recognized as adjustments to interest income. Management determines the appropriate classification of securities at the time of purchase. If management has the intent and the Bank has the ability at the time of purchase to hold securities until maturity, they are classified as held to maturity. Debt securities to be held for indefinite periods of time and not intended to be held to maturity are classified as available for sale. Securities available for sale include securities that management intends to use as part of its asset/liability management strategy. Such securities are carried at fair value and unrealized gains and losses, net of related tax effect, are excluded from earnings, but are included as a separate component of stockholders' equity. At December 31, 1997, the Bank had investment securities with an amortized cost of $206.6 million, and a market value of $207.4 million, all of which were classified as available for sale.

The following table sets forth certain information regarding the amortized cost and market values of the Bank's investment securities at the dates indicated.

| | AT DECEMBER 31, | | | | | |
|---|---|---|---|---|---|---|
| | 1997 | | 1996 | | 1995 | |
| | AMORTIZED COST | MARKET VALUE | AMORTIZED COST | MARKET VALUE | AMORTIZED COST | MARKET VALUE |
| | (IN THOUSANDS) | | | | | |
| Investment securities: | | | | | | |
| U.S. Government and agency obligations..... | $204,992 | $205,648 | $175,003 | $173,327 | $112,956 | $113,302 |
| State and municipal obligations............ | 393 | 400 | 693 | 701 | 1,549 | 1,579 |
| Equity investments............ | 1,170 | 1,309 | --- | --- | --- | --- |
| Total investment securities............. | $206,555 | $207,357 | $175,696 | $174,028 | $114,505 | $114,881 |

The table below sets forth certain information regarding the amortized cost, weighted average yields and contractual maturities of the Bank's investment and mortgage-backed securities as of December 31, 1997.

| AT DECEMBER 31, 1997 (DOLLARS IN THOUSANDS) | ONE YEAR OR LESS AMORTIZED COST | ONE YEAR OR LESS WEIGHTED AVERAGE YIELD | MORE THAN ONE YEAR TO FIVE YEARS AMORTIZED COST | MORE THAN ONE YEAR TO FIVE YEARS WEIGHTED AVERAGE YIELD |
|---|---|---|---|---|
| Investment securities: | | | | |
| U.S. Government and agency obligations | $ 5,000 | 5.75% | $ 85,000 | 6.31% |
| State and municipal obligations (1) | 60 | 9.66 | 197 | 9.27 |
| Equity investments | 1,170 | --- | --- | --- |
| Total investment securities | $ 6,230 | 4.71 | $ 85,197 | 6.32 |
| Mortgage-backed securities: | | | | |
| FHLMC | 12,898 | 5.55 | 29,428 | 6.42 |
| FNMA | 836 | 8.66 | 4,016 | 6.31 |
| GNMA | --- | --- | 205 | 8.00 |
| CMOs | 519 | 6.27 | 2,227 | 8.98 |
| Total mortgage-backed securities | $ 14,253 | 5.76 | $ 35,876 | 6.58 |

| AT DECEMBER 31, 1997 (DOLLARS IN THOUSANDS) | MORE THAN FIVE YEAR TO TEN YEARS AMORTIZED COST | MORE THAN FIVE YEAR TO TEN YEARS WEIGHTED AVERAGE YIELD | MORE THAN TEN YEARS AMORTIZED COST | MORE THAN TEN YEARS WEIGHTED AVERAGE YIELD |
|---|---|---|---|---|
| Investment securities: | | | | |
| U.S. Government and agency obligations | $ 114,992 | 7.10% | $ --- | ---% |
| State and municipal obligations (1) | 136 | 8.71 | --- | --- |
| Equity investments | --- | --- | --- | --- |
| Total investment securities | $ 115,128 | 7.10 | $ --- | --- |
| Mortgage-backed securities: | | | | |
| FHLMC | 40,823 | 6.76 | 162,265 | 6.52 |
| FNMA | 52,326 | 6.61 | 52,695 | 6.21 |
| GNMA | 1,433 | 8.96 | 96,076 | 7.62 |
| CMOs | 632 | 6.28 | --- | --- |
| Total mortgage-backed securities | $ 95,214 | 6.71 | $ 311,036 | 6.81 |

| AT DECEMBER 31, 1997 (DOLLARS IN THOUSANDS) | AMORTIZED COST | MARKET VALUE | WEIGHTED AVERAGE YIELD |
|---|---|---|---|
| Investment securities: | | | |
| U.S. Government and agency obligations | $ 204,992 | $ 205,648 | 6.74% |
| State and municipal obligations (1) | 393 | 400 | 9.14 |
| Equity investments | 1,170 | 1,309 | --- |
| Total investment securities | $ 206,555 | $ 207,357 | 6.70 |
| Mortgage-backed securities: | | | |
| FHLMC | 245,414 | 245,559 | 6.50 |
| FNMA | 109,873 | 109,991 | 6.42 |
| GNMA | 97,714 | 98,172 | 7.64 |
| CMOs | 3,378 | 3,426 | 8.06 |
| Total mortgage-backed securities | $ 456,379 | $ 457,148 | 6.73 |

(1) Tax equivalent yield.

**SOURCES OF FUNDS**

General. Deposits, loan repayments and prepayments, proceeds from sales of loans, investment maturities, cash flows generated from operations and FHLB and other borrowings are the primary sources of the Bank's funds for use in lending, investing and for other general purposes.

Deposits. The Bank offers a variety of deposit accounts with a range of interest rates and terms. The Bank's deposits consist of savings accounts, NOW accounts, money market accounts and time deposits. For the year ended December 31, 1997, time deposits constituted 66.3% of total average deposits. The flow of deposits is influenced significantly by general economic conditions, changes in money market rates, prevailing interest rates and competition. The Bank's deposits are obtained predominantly from the areas in which its branch offices are located. The Bank relies primarily on customer service and long-standing relationships with customers to attract and retain these deposits; however, market interest rates and rates offered by competing financial institutions significantly affect the Bank's ability to attract and retain deposits. Time deposits in excess of $100,000 are not actively solicited by the Bank, nor does the Bank use brokers to obtain deposits.

The following table presents the deposit activity of the Bank for the periods indicated:

| | FOR THE YEAR ENDED DECEMBER 31, | | |
|---|---|---|---|
| | 1997 | 1996 | 1995 |
| | | (IN THOUSANDS) | |
| Net deposits (withdrawals) | $ 2,946 | $(29,111) | $23,097 |
| Interest credited on deposit accounts | 39,088 | 37,283 | 36,041 |
| Total increase in deposit accounts | $42,034 | $ 8,172 | $59,138 |

At December 31, 1997, the Bank had $59.5 million in certificate accounts in amounts of $100,000 or more maturing as follows:

| MATURITY PERIOD | AMOUNT | WEIGHTED AVERAGE RATE |
|---|---|---|
| | (DOLLARS IN THOUSANDS) | |
| Three months or less | $21,158 | 5.48% |
| Over three through six months | 6,633 | 5.55 |
| Over six through 12 months | 12,538 | 5.73 |
| Over 12 months | 19,175 | 6.20 |
| Total | $59,504 | 5.77% |

The following table sets forth the distribution of the Bank's average deposit accounts for the periods indicated and the weighted average interest rates at the end of each period, on each category of deposits presented.

| | AT OR FOR THE YEARS ENDED 31, | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 1997 | | | 1996 | | | 1995 | | |
| | AVERAGE BALANCE | PERCENT OF TOTAL AVERAGE DEPOSITS | WEIGHTED AVERAGE YIELD | AVERAGE BALANCE | PERCENT OF TOTAL AVERAGE DEPOSITS | WEIGHTED AVERAGE YIELD | AVERAGE BALANCE | PERCENT OF TOTAL AVERAGE DEPOSITS | WEIGHTED AVERAGE YIELD |
| | (DOLLARS IN THOUSANDS) | | | | | | | | |
| Money market deposit accounts.. | $ 68,972 | 7.18% | 2.94% | $ 70,209 | 7.52% | 2.90% | $ 68,987 | 7.71% | 2.93% |
| Savings accounts............... | 168,733 | 17.56 | 2.30 | 175,060 | 18.75 | 2.28 | 178,973 | 20.00 | 2.53 |
| NOW accounts................... | 77,785 | 8.09 | 1.78 | 72,265 | 7.74 | 1.84 | 69,330 | 7.74 | 2.14 |
| Non-interest-bearing accounts.. | 8,115 | .84 | - | 6,425 | .69 | -- | 2,902 | .32 | -- |
| Total......................... | 323,605 | 33.67 | 2.25 | 323,959 | 34.70 | 2.27 | 320,192 | 35.77 | 2.49 |
| Time deposits: | | | | | | | | | |
| Six months or less............ | 78,724 | 8.19 | 5.32 | 71,353 | 7.64 | 4.95 | 78,455 | 8.77 | 4.84 |
| Over Six through 12 months.... | 146,951 | 15.29 | 5.37 | 151,485 | 16.23 | 5.23 | 131,795 | 14.73 | 5.44 |
| Over 12 through 24 months..... | 178,440 | 18.57 | 5.55 | 150,085 | 16.08 | 5.49 | 123,825 | 13.83 | 5.59 |
| Over 24 months................ | 120,709 | 12.56 | 5.92 | 124,056 | 13.29 | 6.09 | 127,205 | 14.21 | 6.19 |
| IRA/KEOGH..................... | 112,602 | 11.72 | 5.84 | 112,641 | 12.06 | 5.86 | 113,564 | 12.69 | 6.39 |
| Total time deposits.......... | 637,425 | 66.33 | 5.60 | 609,620 | 65.30 | 5.55 | 574,844 | 64.23 | 5.70 |
| Total average deposits...... | $961,030 | 100.00% | 4.47% | $933,579 | 100.00% | 4.44% | $895,036 | 100.00% | 4.59% |

**Borrowings**

From time to time the Bank has obtained advances from the FHLB as an alternative to retail deposit funds and may do so in the future as part of its operating strategy. FHLB advances may also be used to acquire certain other assets as may be deemed appropriate for investment purposes. These advances are collateralized primarily by certain of the Bank's mortgage loans and mortgage-backed securities and secondarily by the Bank's investment in capital stock of the FHLB. The Bank has an available overnight line of credit with the FHLB-NY for $50.0 million which expires November 25, 1998. When utilized, the line bears a floating interest rate of 1/8% over the current federal funds rate and is secured by the Bank's mortgage loans, mortgage-backed securities and U.S. Government securities. The maximum amount that the FHLB will advance to member institutions, including the Bank, fluctuates from time to time in accordance with the policies of the OTS and the FHLB. At December 31, 1997, the Bank had borrowed $20.4 million against the FHLB line of credit.

The Bank also borrows funds using securities sold under agreements to repurchase. Under this form of borrowing specific U.S. Government agency and/or mortgage-backed securities are pledged as collateral to secure the borrowing. These securities are not under the Bank's control. At December 31, 1997, the Bank had borrowed $288.2 million through securities sold under agreements to repurchase. (See note 11 to the consolidated financial statements in the 1997 Annual Report to Stockholders.)

## SUBSIDIARY ACTIVITIES

The Bank owns two subsidiaries - Ocean Investment Services Corp. (formerly Dome Financial Services, Inc.) and Ocean Federal Realty Inc.

Ocean Investment Services Corp. was originally organized in 1982 to engage in the sale of all-savers life insurance. For the past several years the subsidiary has been inactive, however, beginning in 1998, the Bank plans to sell non- deposit investment products (annuities and mutual funds) to Bank customers through this subsidiary, recognizing fee income from such sales.

Ocean Federal Realty Inc. was established in 1997 and is intended to qualify as a real estate investment trust, which may, among other things, be utilized by the Company to raise capital in the future. Upon formation of Ocean Federal Realty Inc., the Bank transferred $668 million of mortgage loans to this subsidiary.

## PERSONNEL

As of December 31, 1997, the Bank had 210 full-time employees and 47 part-time employees. The employees are not represented by a collective bargaining unit and the Bank considers its relationship with its employees to be good.

## REGULATION AND SUPERVISION

### GENERAL

The Company, as a savings and loan holding company, is required to file certain reports with, and otherwise comply with the rules and regulations of the Office of Thrift Supervision ("OTS") under the Home Owners' Loan Act, as amended (the "HOLA"). In addition, the activities of savings institutions, such as the Bank, are governed by the HOLA and the Federal Deposit Insurance Act ("FDI Act").

The Bank is subject to extensive regulation, examination and supervision by the OTS, as its primary federal regulator, and the FDIC, as the deposit insurer. The Bank is a member of the Federal Home Loan Bank ("FHLB") System and its deposit accounts are insured up to applicable limits by the Savings Association Insurance Fund ("SAIF") managed by the FDIC. The Bank must file reports with the OTS and the FDIC concerning its activities and financial condition in addition to obtaining regulatory approvals prior to entering into certain transactions such as mergers with, or acquisitions of, other savings institutions. The OTS and/or the FDIC conduct periodic examinations to test the Bank's safety and soundness and compliance with various regulatory requirements. This regulation and supervision establishes a comprehensive framework of activities in which an institution can engage and is intended primarily for the protection of the insurance fund and depositors. The regulatory structure also gives the regulatory authorities extensive discretion in connection with their supervisory and enforcement activities and examination policies, including policies with respect to the classification of assets and the establishment of adequate loan loss reserves for regulatory purposes. Any change in such regulatory requirements and policies, whether by the OTS, the FDIC or the Congress, could have a material adverse impact on the Company, the Bank and their operations. Certain of the regulatory requirements applicable to the Bank and to the Company are referred to below or elsewhere herein. The description of statutory provisions and regulations applicable to savings institutions and their holding companies set forth in this Form 10-K does not purport to be a complete description of such statutes and regulations and their effects on the Bank and the Company.

**HOLDING COMPANY REGULATION**

The Company is a nondiversified unitary savings and loan holding company within the meaning of the HOLA. As a unitary savings and loan holding company, the Company generally is not restricted under existing laws as to the types of business activities in which it may engage, provided that the Bank continues to be a qualified thrift lender ("QTL"). See "Federal Savings Institution Regulation - QTL Test." Upon any non-supervisory acquisition by the Company of another savings institution or savings bank that meets the QTL test and is deemed to be a savings institution by the OTS, the Company would become a multiple savings and loan holding company (if the acquired institution is held as a separate subsidiary) and would be subject to extensive limitations on the types of business activities in which it could engage. The HOLA limits the activities of a multiple savings and loan holding company and its non-insured institution subsidiaries primarily to activities permissible for bank holding companies under Section 4(c)(8) of the Bank Holding Company Act ("BHC Act"), subject to the prior approval of the OTS, and certain activities authorized by OTS regulation, and no multiple savings and loan holding company may acquire more than 5% of the voting stock of a company engaged in impermissible activities.

The HOLA prohibits a savings and loan holding company, directly or indirectly, or through one or more subsidiaries, from acquiring more than 5% of the voting stock of another savings institution or holding company thereof, without prior written approval of the OTS; or acquiring or retaining control of a depository institution that is not insured by the FDIC. In evaluating applications by holding companies to acquire savings institutions, the OTS must consider the financial and managerial resources and future prospects of the company and institution involved, the effect of the acquisition on the risk to the insurance funds, the convenience and needs of the community and competitive factors.

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

Although savings and loan holding companies are not subject to specific capital requirements or specific restrictions on the payment of dividends or other capital distributions, HOLA does prescribe such restrictions on subsidiary savings institutions as described below. The Bank must notify the OTS 30 days before declaring any dividend to the Company. In addition, the financial impact of a holding company on its subsidiary institution is a matter that is evaluated by the OTS and the agency has authority to order cessation of activities or divestiture of subsidiaries deemed to pose a threat to the safety and soundness of the institution.

**FEDERAL SAVINGS INSTITUTION REGULATION**

Capital Requirements. The OTS capital regulations require savings institutions to meet three minimum capital standards: a 1.5% tangible capital ratio, a 3% leverage (core) capital ratio and an 8% risk-based capital ratio. In addition, the prompt corrective action standards discussed below also establish, in effect, a minimum 2% tangible capital standard, a 4% leverage (core) capital ratio (3% for institutions receiving the highest rating on the CAMEL financial institution rating system), and, together with the risk-based capital standard itself, a 4% Tier I risk-based capital standard. Core capital is defined as common stockholders' equity (including retained earnings), certain noncumulative perpetual preferred stock and related surplus, and minority interests in equity accounts of consolidated subsidiaries less intangibles other than certain purchased mortgage servicing rights and credit card relationships. The OTS regulations also require that, in meeting the tangible, leverage (core) and risk-based capital standards, institutions must generally deduct investments in and loans to subsidiaries engaged in activities not permissible for a national bank.

The risk-based capital standard for savings institutions requires the maintenance of Tier I (core) and total capital (which is defined as core capital and supplementary capital) to risk-weighted assets of 4% and 8%, respectively. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet assets, are multiplied by a risk-weight factor of 0% to 100%, as assigned by the OTS capital regulation based on the risks OTS believes are inherent in the type of asset. The components of Tier I (core) capital are equivalent to those discussed earlier. The components of supplementary capital currently include cumulative preferred stock, long-term perpetual preferred stock, mandatory convertible securities, subordinated debt and intermediate preferred stock and the allowance for loan and lease losses limited to a maximum of 1.25% of risk-weighted assets. Overall, the amount of supplementary capital included as part of total capital cannot exceed 100% of core capital.

The OTS regulatory capital requirements also incorporate an interest rate risk component. Savings institutions with "above normal" interest rate risk exposure are subject to a deduction from total capital for purposes of calculating their risk-based capital requirements. A savings institution's interest rate risk is measured by the decline in the net portfolio value of its assets (i.e., the difference between incoming and outgoing discounted cash flows from assets, liabilities and off-balance sheet contracts) that would result from a hypothetical 200 basis point increase or decrease in market interest rates divided by the estimated economic value of the institution's assets. In calculating its total capital under the risk-based capital rule, a savings institution whose measured interest rate risk exposure exceeds 2% must deduct an amount equal to one-half of the difference between the institution's measured interest rate risk and 2%, multiplied by the estimated economic value of the institution's assets. The Director of the OTS may waive or defer a savings institution's interest rate risk component on a case-by-case basis. A savings institution with assets of less than $300 million and risk-based capital ratios in excess of 12% is not subject to the interest rate risk component, unless the OTS determines otherwise. For the present time, the OTS has deferred implementation of the interest rate risk component. At December 31, 1997, the Bank met each of its capital requirements, in each case on a fully phased-in basis. Although the Bank may be subject to the interest rate risk component, the effect on the Bank's capital compliance is not expected to be significant.

The following table presents the Bank's capital position at December 31, 1997 relative to fully phased-in regulatory requirements.

| | | | | CAPITAL | |
|---|---|---|---|---|---|
| | ACTUAL CAPITAL | REQUIRED CAPITAL | EXCESS (DEFICIENCY) AMOUNT | ACTUAL PERCENT | REQUIRED PERCENT |
| | | (Dollars in thousands) | | | |
| Tangible.............. | $178,592 | $22,491 | $156,101 | 11.91% | 1.50% |
| Core (Leverage)....... | 178,592 | 44,982 | 133,610 | 11.91% | 3.00% |
| Risk-based............ | 184,970 | 49,525 | 135,445 | 29.88% | 8.00% |

Prompt Corrective Regulatory Action. Under the OTS prompt corrective action regulations, the OTS is required to take certain supervisory actions against undercapitalized institutions, the severity of which depends upon the institution's degree of undercapitalization. Generally, a savings institution is considered "well capitalized" if its ratio of total capital to risk-weighted assets is at least 10%, its ratio of Tier I (core) capital to risk-weighted assets is at least 6%, its ratio of core capital to total assets is at least 5%, and it is not subject to any order or directive by the OTS to meet a specific capital level. A savings institution generally is considered "adequately capitalized" if its ratio of total capital to risk-weighted assets is at least 8%, its ratio of Tier I (core) capital to risk-weighted assets is at least 4%, and its ratio of core capital to total assets is at least 4% (3% if the institution receives the highest CAMEL rating). A savings institution that has a ratio of total capital to risk weighted assets of less than 8%, a ratio of Tier I (core) capital to risk-weighted assets of less than 4% or a ratio of core capital to total assets of less than 4% (3% or less for institutions with the highest examination rating) is considered to be "undercapitalized." A savings institution that has a total risk-based capital ratio less than 6%, a Tier 1 capital ratio of less than 3% or a leverage ratio that is less than 3% is considered to be "significantly undercapitalized" and a savings institution that has a tangible capital to assets ratio equal to or less than 2% is deemed to be "critically undercapitalized." Subject to a narrow exception, the banking regulator is required to appoint a receiver or conservator for an institution that is "critically undercapitalized." The regulation also provides that a capital restoration plan must be filed with the OTS within 45 days of the date a savings institution receives notice that it is "undercapitalized," "significantly undercapitalized" or "critically undercapitalized." Compliance with the plan must be guaranteed by any parent holding company. In addition, numerous mandatory supervisory actions become immediately applicable to an undercapitalized institution, including, but not limited to, increased monitoring by regulators and restrictions on growth, capital distributions and expansion. The OTS could also take any one of a number of discretionary supervisory actions, including the issuance of a capital directive and the replacement of senior executive officers and directors.

Insurance of Deposit Accounts. Deposits of the Bank are presently insured by the SAIF. Both the SAIF and the Bank Insurance Fund ("BIF"), (the deposit insurance fund that covers most commercial bank deposits), are statutorily required to be recapitalized to a 1.25% of insured reserve deposits ratio. Until recently, members of the SAIF and BIF were paying average deposit insurance premiums of between 24 and 25 basis points. The BIF met the required reserve in 1995, whereas the SAIF was not expected to meet or exceed the required level until 2002 at the earliest. This situation was primarily due to the statutory requirement that SAIF members make payments on bonds issued in the late 1980s by the Financing Corporation ("FICO") to recapitalize the predecessor to the SAIF.

In view of the BIF's achieving the 1.25% ratio, the FDIC ultimately adopted a new assessment rate schedule of from 0 to 27 basis points under which 92% of BIF members paid an annual premium of only $2,000. With respect to SAIF member institutions, the FDIC adopted a final rule retaining the previously existing assessment rate schedule applicable to SAIF member institutions of 23 to 31 basis points. As long as the premium differential continued, it may have had adverse consequences for SAIF members, including reduced earnings and an impaired ability to raise funds in the capital markets. In addition, SAIF members, such as the Bank could have been placed at a substantial competitive disadvantage to BIF members with respect to pricing of loans and deposits and the ability to achieve lower operating costs.

On September 30, 1996, the President signed into law the Deposit Insurance Funds Act of 1996 (the "Funds Act") which, among other things, imposed a special one- time assessment on SAIF member institutions, including the Bank, to recapitalize the SAIF. As required by the Funds Act, the FDIC imposed a special assessment of 65.7 basis points on SAIF assessable deposits held as of March 31, 1995, payable November 27, 1996 (the "SAIF Special Assessment"). The SAIF Special Assessment was recognized by the Bank as an expense in the quarter ended September 30, 1996 and is generally tax deductible. The SAIF Special Assessment recorded by the Bank amounted to $5.7 million on a pre-tax basis and $3.6 million on an after- tax basis.

The Funds Act also spreads the obligations for payment of the FICO bonds across all SAIF and BIF members. Beginning on January 1, 1997, BIF deposits will be assessed for FICO payment of 1.3 basis points, while SAIF deposits will pay approximately 6.5 basis points. Full pro rata sharing of the FICO payments between BIF and SAIF members will occur on the earlier of January 1, 2000 or the date the BIF and SAIF are merged. The Funds Act specifies that the BIF and SAIF will be merged on January 1, 1999, provided no savings associations remain as of that time.

As a result of the Funds Act, the FDIC voted to effectively lower SAIF assessments to 0 to 27 basis points as of January 1, 1997, a range comparable to that of BIF members. However, SAIF members will continue to make the FICO payments described above. The FDIC also lowered the SAIF assessment schedule for the fourth quarter of 1996 to 18 to 27 basis points. Management cannot predict the level of FDIC insurance assessments on an on-going basis, whether the savings association charter will be eliminated or whether the BIF and SAIF will eventually be merged.

The Bank's assessment rate for fiscal 1997 was 6.5 basis points and the premium paid for this period was $482,000. A significant increase in SAIF insurance premiums would likely have an adverse effect on the operating expenses and results of operations of the Bank.

Under the FDI Act, insurance of deposits may be terminated by the FDIC upon a finding that the institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC or the OTS. The management of the Bank does not know of any practice, condition or violation that might lead to termination of deposit insurance.

Thrift Rechartering Legislation. The Funds Act provides that the BIF and SAIF will merge on January 1, 1999, if there are no more savings associations as of that date. Various proposals to eliminate the federal thrift charter, create a uniform financial institutions charter and abolish the OTS have been introduced in Congress. Some bills would require federal savings institutions to convert to a national bank or some type of state charter by a specified date or they would automatically become national banks. Under some proposals, converted federal thrifts would generally be required to conform their activities to those permitted for the charter selected and divestiture of nonconforming assets would be required over a two year period, subject to two possible one year extensions. State chartered thrifts would become subject to the same federal regulation as applies to state commercial banks. A more recent bill passed by the House Banking Committee would allow savings institutions to continue to exercise activities being conducted when they convert to a bank regardless of whether a national bank could engage in the activity. Holding companies for savings institutions would become subject to the same regulation as holding companies that control commercial banks, with a limited grandfather provision for unitary savings and loan holding company activities. The grandfathering would be lost under certain circumstances such as a change in control of the Company. The Bank is unable to predict whether such legislation would be enacted or the extent to which legislation would restrict or disrupt its operations.

Loans to One Borrower. Under the HOLA, savings institutions are generally subject to the limits on loans to one borrower applicable to national banks. Generally, savings institutions may not make a loan or extend credit to a single or related group of borrowers in excess of 15% of its unimpaired capital and surplus. An additional amount may be lent, equal to 10% of unimpaired capital and surplus, if such loan is secured by readily-marketable collateral, which is defined to include certain financial instruments and bullion. At December 31, 1997, the Bank's limit on loans to one borrower as provided under the HOLA was $26.8 million. At December 31, 1997, the Bank's largest aggregate outstanding balance of loans to one borrower was $4.4 million.

QTL Test. The HOLA requires savings institutions to meet a QTL test. Under the QTL test, a savings and loan association is required to maintain at least 65% of its "portfolio assets" (total assets less: (i) specified liquid assets up to 20% of total assets; (ii) intangibles, including goodwill; and (iii) the value of property used to conduct business) in certain "qualified thrift investments" (primarily residential mortgages and related investments, including certain mortgage-backed securities) in at least 9 months out of each 12 month period.

A savings institution that fails the QTL test is subject to certain operating restrictions and may be required to convert to a bank charter. As of December 31, 1997, the Bank maintained 95% of its portfolio assets in qualified thrift investments and, therefore, met the QTL test. Recent legislation has expanded the extent to which education loans, credit card loans and small business loans may be considered "qualified thrift investments."

Limitation on Capital Distributions. OTS regulations impose limitations upon all capital distributions by savings institutions, such as cash dividends, payments to repurchase or otherwise acquire its shares, payments to shareholders of another institution in a cash-out merger and other distributions charged against capital. The rule establishes three tiers of institutions, which are based primarily on an institution's capital level. An institution that exceeds all fully phased-in capital requirements before and after a proposed capital distribution ("Tier 1 Bank") and has not been advised by the OTS that it is in need of more than normal supervision, could, after prior notice but without obtaining approval of the OTS, make capital distributions during a calendar year equal to the greater of (i) 100% of its net earnings to date during the calendar year plus the amount that would reduce by one-half its "surplus capital ratio" (the excess capital over its fully phased-in capital requirements) at the beginning of the calendar year or (ii) 75% of its net income for the previous four quarters. Any additional capital distributions would require prior regulatory approval. In the event the Bank's capital fell below its regulatory requirements or the OTS notified it that it was in need of more than normal supervision, the Bank's ability to make capital distributions could be restricted. In addition, the OTS could prohibit a proposed capital distribution by any institution, which would otherwise be permitted by the regulation, if the OTS determines that such distribution would constitute an unsafe or unsound practice. In December 1994, the OTS proposed amendments to its capital distribution regulation that would generally authorize the payment of capital distributions without OTS approval provided that the payment does not cause the institution to be undercapitalized within the meaning of the prompt corrective action regulation. However, institutions in a holding company structure would still have a prior notice requirement. At December 31, 1997, the Bank was a Tier 1 Bank.

Liquidity. The Bank is required to maintain an average daily balance of specified liquid assets equal to a monthly average of not less than a specified percentage of its net withdrawable deposit accounts plus short-term borrowings. This liquidity requirement is currently 4% but may be changed from time to time by the OTS to any amount within the range of 4% to 10% depending upon economic conditions and the savings flows of member institutions. Monetary penalties may be imposed for failure to meet the liquidity requirement. The Bank's liquidity ratio for December 31, 1997 was 9.82%, which exceeded the applicable requirement. The Bank has never been subject to monetary penalties for failure to meet its liquidity requirement.

Assessments. Savings institutions are required to pay assessments to the OTS to fund the agency's operations. The general assessments, paid on a semi-annual basis, are computed upon the savings institution's total assets, including consolidated subsidiaries, as reported in the Bank's latest quarterly thrift financial report. The assessments paid by the Bank for the fiscal year ended December 31, 1997 totaled $237,000.

Branching. OTS regulations permit nationwide branching by federally chartered savings institutions to the extent allowed by federal statute. This permits federal savings institutions to establish interstate networks and to geographically diversify their loan portfolios and lines of business. The OTS authority preempts any state law purporting to regulate branching by federal savings institutions.

Transactions with Related Parties. The Bank's authority to engage in transactions with related parties or "affiliates" (e.g.., any company that controls or is under common control with an institution, including the Company and its non-savings institution subsidiaries) is limited by Sections 23A and 23B of the Federal Reserve Act ("FRA"). Section 23A limits the aggregate amount of covered transactions with any individual affiliate to 10% of the capital and surplus of the savings institution. The aggregate amount of covered transactions with all affiliates is limited to 20% of the savings institution's capital and surplus. Certain transactions with affiliates are required to be secured by collateral in an amount and of a type described in Section 23A and the purchase of low quality assets from affiliates is generally prohibited. Section 23B generally provides that certain transactions with affiliates, including loans and asset purchases, must be on terms and under circumstances, including credit standards, that are substantially the same or at least as favorable to the institution as those prevailing at the time for comparable transactions with non-affiliated companies. In addition, savings institutions are prohibited from lending to any affiliate that is engaged in activities that are not permissible for bank holding companies and no savings institution may purchase the securities of any affiliate other than a subsidiary.

The Bank's authority to extend credit to executive officers, directors and 10% shareholders ("insiders"), as well as entities such persons control, is governed by Sections 22(g) and 22(h) of the FRA and Regulation O thereunder. Among other things, such loans are required to be made on terms substantially the same as those offered to unaffiliated individuals and to not involve more than the normal risk of repayment. In accordance with recently modified federal regulations, the Bank's Loans to Insiders Policy now permits loans to be made to Executive Officers on terms available to all Bank employees under the "Loan Program." This Program allows loans to eligible employees at a discount of 1% below the prevailing interest rates at time of loan approval, subject to certain conditions. Regulation O also places individual and aggregate limits on the amount of loans the Bank may make to insiders based, in part, on the Bank's capital position and requires certain board approval procedures to be followed.

Enforcement. Under the FDI Act, the OTS has primary enforcement responsibility over savings institutions and has the authority to bring actions against the institution and all institution-affiliated parties, including stockholders, and any attorneys, appraisers and accountants who knowingly or recklessly participate in wrongful action likely to have an adverse effect on an insured institution. Formal enforcement action may range from the issuance of a capital directive or cease and desist order to removal of officers and/or directors to institution of receivership, conservatorship or termination of deposit insurance. Civil penalties cover a wide range of violations and can amount to $25,000 per day, or even $1 million per day in especially egregious cases. Under the FDI Act, the FDIC has the authority to recommend to the Director of the OTS enforcement action to be taken with respect to a particular savings institution. If action is not taken by the Director, the FDIC has authority to take such action under certain circumstances. Federal law also establishes criminal penalties for certain violations.

Standards for Safety and Soundness. The federal banking agencies have adopted Interagency Guidelines Prescribing Standards for Safety and Soundness ("Guidelines") and a final rule to implement safety and soundness standards required under the FDI Act. The Guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. The standards set forth in the Guidelines address internal controls and information systems; internal audit system; credit underwriting; loan documentation; interest rate risk exposure; asset growth; and compensation, fees and benefits. If the appropriate federal banking agency determines that an institution fails to meet any standard prescribed by the Guidelines, the agency may require the institution to submit to the agency an acceptable plan to achieve compliance with the standard, as required by the FDI Act. The final rule establishes deadlines for the submission and review of such safety and soundness compliance plans when such plans are required.

**FEDERAL RESERVE SYSTEM**

The Federal Reserve Board regulations require savings institutions to maintain non-interest earning reserves against their transaction accounts (primarily NOW and regular checking accounts). The Federal Reserve Board regulations generally required for most of 1997 that reserves be maintained against aggregate transaction accounts as follows: for accounts aggregating $49.3 million or less (subject to adjustment by the Federal Reserve Board) the reserve requirement was 3%; and for accounts aggregating greater than $49.3 million, the reserve requirement was $1.48 million plus 10% (subject to adjustment by the Federal Reserve Board between 8% and 14%) against that portion of total transaction accounts in excess of $49.3 million. The first $4.4 million of otherwise reservable balances (subject to adjustments by the Federal Reserve Board) are exempted from the reserve requirements. The Bank is in compliance with the foregoing requirements. For 1998, the Federal Reserve Bond has decreased from $49.3 to $47.8 million the amount of transaction accounts subject to the 3% reserve requirement and increased the amount of exempt reservable balances from $4.4 million to $4.7 million. The balances maintained to meet the reserve requirements imposed by the Federal Reserve Board may be used to satisfy liquidity requirements imposed by the OTS.

**FEDERAL AND STATE TAXATION**

**FEDERAL TAXATION**

General. The Company and the Bank report their income on a calendar year basis using the accrual method of accounting, and are subject to federal income taxation in the same manner as other corporations with some exceptions, including particularly the Bank's reserve for bad debts discussed below. The following discussion of tax matters is intended only as a summary and does not purport to be a comprehensive description of the tax rules applicable to the Bank or the Company. The Bank has not been audited by the IRS in over 10 years. For its 1997 taxable year, the Bank is subject to a maximum federal income tax rate of 34.5%.

Bad Debt Reserves. For fiscal years beginning prior to December 31, 1995, thrift institutions which qualified under certain definitional tests and other conditions of the Internal Revenue Code of 1986 (the "Code") were permitted to use certain favorable provisions to calculate their deductions from taxable income for annual additions to their bad debt reserve. A reserve could be established for bad debts on qualifying real property loans (generally secured by interests in real property improved or to be improved) under (i) the Percentage of Taxable Income Method (the "PTI Method") or (ii) the Experience Method. The reserve for nonqualifying loans was computed using the Experience Method.

The Small Business Job Protection Act of 1996 (the "1996 Act"), which was enacted on August 20, 1996, requires savings institutions to recapture (i.e., take into taxable income) certain portions of their accumulated bad debt reserves. The 1996 Act repeals the reserve method of accounting for bad debts effective for tax years beginning after 1995. Thrift institutions that would be treated as small banks are allowed to utilize the Experience Method applicable to such institutions, while thrift institutions that are treated as large banks (those generally exceeding $500 million in assets) are required to use only the specific charge-off method. Thus, the PTI Method of accounting for bad debts is no longer available for any financial institution.

Use of the PTI Method had the effect of reducing the marginal rate of federal tax on the Bank's income to 32.2%, exclusive of any minimum or environmental tax, as compared to the maximum corporate federal income tax rate of 35%.

A thrift institution required to change its method of computing reserves for bad debts will treat such change as a change in method of accounting, initiated by the taxpayer, and having been made with the consent of the IRS. Any Section 481(a) adjustment required to be taken into income with respect to such change generally will be taken into income ratably over a six-taxable year period, beginning with the first taxable year beginning after 1995, subject to the residential loan requirement.

Under the residential loan requirement provision, the recapture required by the 1996 Act will be suspended for each of two successive taxable years, beginning with the Bank's current taxable year, in which the Bank originates a minimum of certain residential loans based upon the average of the principal amounts of such loans made by the Bank during its six taxable years preceding its current taxable year.

Under the 1996 Act, for its current and future taxable years, the Bank is not permitted to make additions to its tax bad debt reserves. In addition, the Bank is required to recapture (i.e., take into taxable income) over a six year period the excess of the balance of its tax bad debt reserves as of December 31, 1995 over the balance of such reserves as of December 31, 1987. As a result of such recapture, the Bank will incur an additional tax liability of approximately $2.3 million. The Bank has accrued for this liability in the consolidated financial statements.

Distributions. Under the 1996 Act, if the Bank makes "non-dividend distributions" to the Company, such distributions will be considered to have been made from the Bank's unrecaptured tax bad debt reserves (including the balance of its reserves as of December 31, 1987) to the extent thereof, and then from the Bank's supplemental reserve for losses on loans, to the extent thereof, and an amount based on the amount distributed (but not in excess of the amount of such reserves) will be included in the Bank's income. Non-dividend distributions include distributions in excess of the Bank's current and accumulated earnings and profits, as calculated for federal income tax purposes, distributions in redemption of stock, and distributions in partial or complete liquidation. Dividends paid out of the Bank's current or accumulated earnings and profits will not be so included in the Bank's income.

The amount of additional taxable income triggered by a non-dividend is an amount that, when reduced by the tax attributable to the income, is equal to the amount of the distribution. Thus, if the Bank makes a non-dividend distribution to the Company, approximately one and one-half times the amount of such distribution (but not in excess of the amount of such reserves) would be includable in income for federal income tax purposes, assuming a 35% federal corporate income tax rate. The Bank does not intend to pay dividends that would result in a recapture of any portion of its bad debt reserves.

SAIF Recapitalization Assessment. The Funds Act levied a 65.7-cent fee on every $100 of thrift deposits held on March 31, 1995. For financial statement purposes, this assessment was reported as an expense for the quarter ended September 30, 1996. The Funds Act includes a provision which states that the amount of any special assessment paid to capitalize SAIF under this legislation is deductible under Section 162 of the Code in the year of payment.

Corporate Alternative Minimum Tax. The Internal Revenue Code of 1986, as amended (the "Code") imposes a tax on alternative minimum taxable income ("AMTI") at a rate of 20%. The excess of the bad debt reserve deduction using the percentage of taxable income method over the deduction that would have been allowable under the experience method is treated as a preference item for purposes of computing the AMTI. Only 90% of AMTI can be offset by net operating loss carryovers of which the Bank currently has none. AMTI is increased by an amount equal to 75% of the amount by which the Bank's adjusted current earnings exceeds its AMTI (determined without regard to this preference and prior to reduction for net operating losses). In addition, for taxable years beginning after December 31, 1986 and before January 1, 1996, an environmental tax of .12% of the excess of AMTI. (with certain modifications) over $2.0 million is imposed on corporations, including the Bank, whether or not an Alternative Minimum Tax ("AMT") is paid. The Bank does not expect to be subject to the AMT.

Dividends Received Deduction and Other Matters. The Company may exclude from its income 100% of dividends received from the Bank as a member of the same affiliated group of corporations. The corporate dividends received deduction is generally 70% in the case of dividends received from unaffiliated corporations with which the Company and the Bank will not file a consolidated tax return, except that if the Company or the Bank own more than 20% of the stock of a corporation distributing a dividend then 80% of any dividends received may be deducted.

**STATE AND LOCAL TAXATION**

New Jersey Taxation. The Bank files New Jersey income tax returns. For New Jersey income tax purposes, savings institutions are presently taxed at a rate equal to 3% of taxable income. For this purpose, "taxable income" generally means federal taxable income, subject to certain adjustments (including addition of interest income on State and municipal obligations).

The Company is required to file a New Jersey income tax return because it will be doing business in New Jersey. For New Jersey tax purposes, regular corporations are presently taxed at a rate equal to 9% of taxable income. For this purpose, "taxable income" generally means Federal taxable income, subject to certain adjustments (including addition of interest income on state and municipal obligations). However, if the Company meets certain requirements, it may be eligible to elect to be taxed as a New Jersey Investment Company at a tax rate presently equal to 2.25% (25% of 9%) of taxable income.

Delaware Taxation. As a Delaware holding company not earning income in Delaware, the Company is exempted from Delaware corporate income tax but is required to file an annual report with and pay an annual franchise tax to the State of Delaware.

**ITEM 2. PROPERTIES**

The Bank currently conducts its business through its administrative office, which was recently relocated to Toms River and which includes a branch office, and nine other full service offices located in Ocean and Middlesex Counties. The Company believes that the Bank's current facilities will be adequate to meet the present and immediately foreseeable needs of the Bank and the Company.

**ITEM 3. LEGAL PROCEEDINGS**

The Company and the Bank are not involved in any pending legal proceedings other than routine legal proceedings occurring in the ordinary course of business. Such other routine legal proceedings in the aggregate are believed by management to be immaterial to the Company's financial condition or results of operations.

**ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS**

None.

## PART II

**ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS**

Information relating to the market for Registrant's common equity and related stockholder matters appears under "Shareholder Information" on the Inside Back Cover in the Registrant's 1997 Annual Report to Stockholders and is incorporated herein by reference.

**ITEM 6. SELECTED FINANCIAL DATA**

The above-captioned information appears under "Selected Consolidated Financial and Other Data of the Company" in the Registrant's 1997 Annual Report to Stockholders on pages 11 and 12 and is incorporated herein by reference.

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The above-captioned information appears under "Management's Discussion and Analysis of Financial Condition and Results of Operations" in the Registrant's 1997 Annual Report to Stockholders on pages 13 through 21 and is incorporated herein by reference.

**ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The above captioned information appears under "Management Discussion and Analysis of Financial Condition and Results of Operations - Management of Interest Rate Risk" in the Registrant's 1997 Annual Report to Stockholders on pages 14 to 16.

**ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA**

The Consolidated Financial Statements of Ocean Financial Corp. and its subsidiary, together with the report thereon by KPMG Peat Marwick LLP and the "Selected Consolidated Quarterly Financial Data (Unaudited)" appears in the Registrant's 1997 Annual Report to Stockholders on pages 22 through 37 and are incorporated herein by reference.

**ITEM 9. CHANGE IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE**

None.

**PART III**

**ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT**

The information relating to Directors and Executive Officers of the Registrant is incorporated herein by reference to the Registrant's Proxy Statement for the Annual Meeting of Stockholders to be held on April 23 , 1998, at pages 5 through 7.

**ITEM 11. EXECUTIVE COMPENSATION**

The information relating to directors' compensation and executives' compensation is incorporated herein by reference to the Registrant's Proxy Statement for the Annual Meeting of Stockholders to be held on April 23, 1998, at pages 8 and 9 and pages 14 through 20 (excluding the Executive Compensation Committee Report and Stock Performance Graph).

**ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT**

The information relating to security ownership of certain beneficial owners and management is incorporated herein by reference to the Registrant's Proxy Statement for the Annual Meeting of Stockholders to be held on April 23, 1998, at pages 3 through 4 and 6 through 7.

**ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS**

The information relating to certain relationships and related transactions is incorporated herein by reference to the Registrant's Proxy Statement for the Annual Meeting of Stockholders to be held on April 23, 1998, at page 20.

**PART IV**

**ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES, AND REPORTS ON FORM 8-K**

(a) The following documents are filed as a part of this report:

(1) Consolidated Financial Statements of the Company are incorporated by reference to the following indicated pages of the 1997 Annual Report to Stockholders.

The remaining information appearing in the 1997 Annual Report to Stockholders is not deemed to be filed as part of this report, except as expressly provided herein.

(2) All schedules are omitted because they are not required or applicable, or the required information is shown in the consolidated financial statements or the notes thereto.

(3) Exhibits

(a) The following exhibits are filed as part of this report.

| | |
|---|---|
| 3.1 | Certificate of Incorporation of Ocean Financial Corp.* |
| 3.2 | Bylaws of Ocean Financial Corp.* |
| 4.0 | Stock Certificate of Ocean Financial Corp.* |
| 10.1 | Form of Ocean Federal Savings Bank Employee Stock Ownership Plan* |
| 10.1(a) | Amendment to Ocean Federal Savings Bank Employee Stock Ownership Plan (filed previously) |
| 10.2 | Ocean Federal Savings Bank Employees' Savings and Profit Sharing Plan* |
| 10.3 | Ocean Federal Savings Bank 1995 Supplemental Executive Retirement Plan* |
| 10.4 | Ocean Federal Savings Bank Deferred Compensation Plan for Directors* |
| 10.5 | Ocean Federal Savings Bank Deferred Compensation Plan for Officers* |
| 10.6 | Ocean Federal Savings Bank Long-Term Award Program* |
| 10.7 | Ocean Federal Savings Bank Performance Achievement Awards Program* |
| 10.8 | Amended and Restated Ocean Financial Corp. 1997 Incentive Plan** |
| 10.9 | Form of Employment Agreement between Ocean Federal Savings Bank and certain executive officers, including Michael J. Fitzpatrick and John R. Garbarino* |
| 10.10 | Form of Employment Agreement between Ocean Financial Corp. and certain executive officers, including Michael J. Fitzpatrick and John R. Garbarino* |
| 10.11 | Form of Change in Control Agreement between Ocean Federal Savings Bank and certain executive officers, including Michael E. Barrett, John K. Kelly and Karl E. Reinheimer* |
| 10.12 | Form of Change in Control Agreement between Ocean Financial Corp. and certain executive officers, including Michael E. Barrett, John K. Kelly and Karl E. Reinheimer* |
| 11.0 | Computation of earnings per share (filed herewith) |
| 13.0 | Portions of 1997 Annual Report to Stockholders (filed herewith) |
| 21.0 | Subsidiary information is incorporated herein by reference to "Part I - Subsidiaries" |
| 23.0 | Consent of KPMG Peat Marwick LLP (filed herewith) |
| 27.0 | Financial Data Schedule (filed herewith) |

(b) Reports on Form 8-K

None.

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* Incorporated herein by reference into this document from the Exhibits to Form S-1, Registration Statement, effective May 13, 1996 as amended, Registration No. 33-80123. ** Incorporated herein by reference into this document from the Proxy Statement for the Annual Meeting of Shareholders of Ocean Financial Corp. to be held on April 23, 1998.

## CONFORMED SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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.

## OCEAN FINANCIAL CORP.

*By: /s/ John R. Garbarino*
*---------------------*
*John R. Garbarino*
*Chairman of the Board,*
*President and*
*Chief Executive Officer and*
*Director*

*Date: March 18, 1998*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed by the following persons in the capacities and on the dates indicated.

| Name | Date |
| --- | --- |
| /s/ John R. Garbarino<br>John R. Garbarino<br>Chairman of the Board, President and<br>Chief Executive Officer<br>(principal executive officer) | March 18, 1998 |
| /s/ Michael J. Fitzpatrick<br>Michael J. Fitzpatrick<br>Executive Vice President and<br>Chief Financial Officer<br>(principal accounting and financial officer) | March 18, 1998 |
| /s/ Michael E. Barrett<br>Michael E. Barrett<br>Director | March 18, 1998 |
| /s/ Thomas F. Curtin<br>Thomas F. Curtin<br>Director | March 18, 1998 |
| /s/ Carl Feltz, Jr.<br>Carl Feltz, Jr.<br>Director | March 18, 1998 |
| /s/ Robert E. Knemoller<br>Robert E. Knemoller<br>Director | March 18, 1998 |

*/s/ Donald E. McLaughlin* *March 18, 1998*
*-----------------------*
*Donald E. McLaughlin*
*Director*

*/s/ Diane F. Rhine* *March 18, 1998*
*-----------------------*
*Diane F. Rhine*
*Director*

*/s/ Frederick E. Schlosser* *March 18, 1998*
*-------------------------*
*Frederick E. Schlosser*
*Director*

*/s/ James T. Snyder* *March 18, 1998*
*-------------------*
*James T. Snyder*
*Director*

**Exhibit 11**

**OCEAN FINANCIAL CORP.**

**STATEMENT REGARDING COMPUTATION OF EARNINGS PER SHARE**

**FOR THE YEAR ENDED DECEMBER 31, 1997 AND FOR THE PERIOD FROM JULY 2, 1996 TO DECEMBER 31, 1996**

(dollars and shares in thousands, except per share amounts)

| | Year Ended December 31, 1997 | For the period from July 2, 1996 to December 31, 1997 |
|---|---|---|
| Net income (loss) | $13,825 | $(6,612) |
| Weighted average shares outstanding: | | |
| Weighted average shares issued net of Treasury shares | 8,556 | 9,059 |
| Less: Unallocated ESOP shares | (580) | (629) |
| Unallocated Incentive award shares | (304) | - |
| Average basic shares outstanding | 7,672 | 8,430 |
| Add: Effect of dilutive securities: | | |
| Stock options | 72 | - |
| Incentive awards | 75 | - |
| Average diluted shares outstanding | 7,819 | 8,430 |
| Basic earnings (loss) per share | $ 1.80 | $(.78) |
| Diluted earnings (loss) per share | $ 1.77 | $(.78) |

## SELECTED CONSOLIDATED FINANCIAL AND OTHER DATA OF THE COMPANY

The selected consolidated financial and other data of the Company set forth below is derived in part from, and should be read in conjunction with the Consolidated Financial Statements of the Company and Notes thereto presented elsewhere in this Annual Report.

| At December 31, | 1997 | 1996 | 1995 | 1994 | 1993 |
|---|---|---|---|---|---|
| (dollars in thousands) | | | | | |
| SELECTED FINANCIAL CONDITION DATA: | | | | | |
| Total assets | $1,510,947 | $1,303,865 | $1,036,445 | $ 971,651 | $ 937,214 |
| Investment securities held to maturity | - | - | - | 127,451 | 126,999 |
| Investment securities available for sale | 207,357 | 174,028 | 114,881 | - | - |
| FHLB-NY stock | 14,980 | 8,457 | 7,723 | 7,323 | 6,680 |
| Mortgage-backed securities held to maturity | - | - | - | 224,569 | 241,188 |
| Mortgage-backed securities available for sale | 457,148 | 395,542 | 265,113 | - | - |
| Loans receivable, net | 783,695 | 678,728 | 612,696 | 592,315 | 539,885 |
| Mortgage loans held for sale | - | 727 | 1,894 | - | 963 |
| Deposits | 976,764 | 934,730 | 926,558 | 867,420 | 858,461 |
| Federal Home Loan Bank borrowings | 20,400 | 8,800 | 10,400 | - | - |
| Securities sold under agreements to repurchase | 288,200 | 99,322 | - | - | - |
| Stockholders' equity | 215,544 | 252,789 | 92,351 | 82,334 | 72,605 |

| For the Year Ended December 31, | 1997 | 1996 | 1995 | 1994 | 1993 |
|---|---|---|---|---|---|
| (dollars in thousands except per share amounts) | | | | | |
| SELECTED OPERATING DATA: | | | | | |
| Interest income | $ 98,656 | $ 80,236 | $ 70,210 | $ 63,683 | $ 64,853 |
| Interest expense | 55,608 | 43,857 | 40,004 | 32,373 | 33,975 |
| Net interest income | 43,048 | 36,379 | 30,206 | 31,310 | 30,878 |
| Provision for loan losses | 900 | 700 | 950 | 1,129 | 1,300 |
| Net interest income after provision for loan losses | 42,148 | 35,679 | 29,256 | 30,181 | 29,578 |
| Other income | 2,509 | 2,881 | 1,356 | 2,057 | 2,740 |
| Operating expenses | 23,145 | 39,206 | 18,006 | 17,104 | 16,626 |
| Income (loss) before provision for income taxes | 21,512 | (646) | 12,606 | 15,134 | 15,692 |
| Provision for income taxes | 7,687 | 1,083 | 4,659 | 5,405 | 5,556 |
| Net income (loss) | $ 13,825 | $ (1,729) | $ 7,947 | $ 9,729 | $ 10,136 |
| Basic earnings (loss) per share | $ 1.80 | $ (.78) | N/A | N/A | N/A |
| Diluted earnings (loss) per share | $ 1.77 | $ (.78) | N/A | N/A | N/A |
| Net income before non-recurring items (2) | $ 13,825 | $ 11,576 | $ 7,947 | $ 9,729 | $ 10,136 |

Earnings (loss) per share for 1996 is for the period from July 2, 1996 (date of conversion) to December 31, 1996

**Selected Consolidated Financial and Other Data (continued)**

| At or for the Year Ended December 31, | 1997 | 1996 | 1995 | 1994 | 1993 |
|---|---|---|---|---|---|
| SELECTED FINANCIAL RATIOS AND OTHER DATA (1): | | | | | |
| PERFORMANCE RATIOS: | | | | | |
| Return on average assets | 0.97% | (.15%) | 0.80% | 1.02% | 1.10% |
| Return on average assets, as adjusted (2) | 0.97 | 1.00 | 0.80 | 1.02 | 1.10 |
| Return on average stockholders' equity | 6.00 | (1.03) | 9.44 | 12.54 | 14.85 |
| Return on average stockholders' equity, as adjusted (2) | 6.00 | 6.91 | 9.44 | 12.54 | 14.85 |
| Average stockholders' equity to average assets | 16.25 | 14.42 | 8.51 | 8.11 | 7.41 |
| Stockholders' equity to total assets at end of year | 14.27 | 19.39 | 8.91 | 8.47 | 7.75 |
| Average interest rate spread (3) | 2.39 | 2.61 | 2.79 | 3.07 | 3.20 |
| Net interest margin (4) | 3.12 | 3.22 | 3.13 | 3.34 | 3.44 |
| Average interest-earning assets to average interest-bearing liabilities | 117.95 | 115.84 | 107.98 | 107.71 | 106.42 |
| Operating expenses to average assets | 1.63 | 3.37 | 1.82 | 1.79 | 1.81 |
| Operating expenses to average assets, as adjusted (2) | 1.63 | 1.73 | 1.82 | 1.79 | 1.81 |
| Operating Efficiency Ratio (5) | 50.80 | 99.86 | 57.05 | 51.26 | 49.46 |
| Operating Efficiency Ratio, as adjusted (2)(5) | 50.80 | 51.11 | 57.05 | 51.26 | 49.46 |
| REGULATORY CAPITAL RATIOS (BANK ONLY): | | | | | |
| Tangible capital | 11.91 | 12.69 | 8.72 | 8.43 | 7.73 |
| Core capital | 11.91 | 12.69 | 8.72 | 8.43 | 7.73 |
| Risk-based capital | 29.88 | 32.04 | 21.34 | 20.34 | 18.59 |
| ASSET QUALITY RATIOS: | | | | | |
| Non-performing loans as a percent of total loans receivable (6)(7) | 0.70 | 1.12 | 1.40 | 1.83 | 1.92 |
| Non-performing assets as a percent of total assets (7) | 0.45 | 0.71 | 0.97 | 1.29 | 1.45 |
| Allowance for loan losses as a percent of total loans receivable (6) | 0.83 | 0.88 | 0.97 | 0.94 | 1.01 |
| Allowance for loan losses as a percent of total non-performing loans (7) | 119.03 | 78.23 | 69.21 | 51.27 | 52.45 |
| NUMBER OF FULL-SERVICE CUSTOMER FACILITIES | 10 | 9 | 8 | 8 | 8 |

(1) With the exception of end of year ratios, all ratios are based on average daily balances for 1997, 1996 and 1995 and average monthly balances for 1994 and 1993.

(2) Performance ratios are calculated to exclude the effect of non-recurring charges in 1996 for charitable donation and the special Savings Association Insurance Fund assessment.

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

(4) The net interest margin represents net interest income as a percentage of average interest-earning assets.

(5) Operating efficiency ratio represents the ratio of operating expenses to the aggregate of other income and net interest income.

(6) Total loans receivable includes loans receivable and loans held for sale, less undisbursed loan funds, deferred loan fees and unamortized discounts/premiums.

(7) Non-performing assets consist of non-performing loans and real estate acquired through foreclosure ("REO"). Non-performing loans consist of all loans 90 days or more past due and other loans in the process of foreclosure. It is the Company's policy to cease accruing interest on all such loans.

## MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

### General

Ocean Financial Corp. (the "Company") was incorporated on November 21, 1995, and is the holding company for Ocean Federal Savings Bank (the "Bank"). On August 17, 1995, the Board of Directors of the Bank adopted a Plan of Conversion, as amended, to convert from a federally chartered mutual savings bank to a federally chartered capital stock savings bank with the concurrent formation of a holding company ("the Conversion").

The Conversion was completed on July 2, 1996 with the issuance by the Company of 8,388,078 shares of its common stock in a public offering to the Bank's eligible depositors and the Bank's employee stock ownership plan (the "ESOP"). The purchase of 671,046 shares of common stock (8% of the total shares offered) by the ESOP was funded by a loan of $13.4 million from the Company.

In exchange for 50% of the net conversion proceeds ($81.6 million), the Company acquired 100% of the stock of the Bank and retained the remaining net conversion proceeds at the holding company level.

Concurrent with the close of the Conversion, an additional 671,046 shares of common stock (8% of the offering) were issued and donated by the Company to the Ocean Federal Foundation (the "Foundation"), a private foundation dedicated to charitable purposes within Ocean County, New Jersey and its neighboring communities. The fair market value of the contribution of $13.4 million was reflected as an expense in the Company's 1996 operating results and as an increase to capital stock and paid in capital for the same amount.

The Company had no operations prior to July 2, 1996 and, accordingly, the results of operations prior to that date reflect only those of the Bank and its subsidiaries.

The Company conducts business, primarily through its ownership of the Bank which operates its administrative/branch office located in Toms River and nine other branch offices. Nine of the ten branch offices are located in Ocean County, New Jersey.

The Company has historically operated as a consumer-oriented federal savings bank, with a focus on offering traditional savings deposit and loan products to its local community. In recent years, the Company's strategy has been to maintain profitability while limiting its credit and interest rate risk exposure. To accomplish these objectives, the Company has sought to: (1) control credit risk by emphasizing the origination of single-family, owner-occupied residential mortgage loans and consumer loans, consisting primarily of home equity loans and lines of credit; (2) offer superior service and competitive rates to increase the core deposit base consistent with its capital management goals; (3) invest funds in excess of loan demand in mortgage-backed and investment securities; (4) reduce exposure to interest rate risk by originating for the portfolio first mortgage loans having terms to maturity of not more than 15 years and adjustable-rate mortgage ("ARM") loans, selling most fixed-rate 30- year mortgage loans, and investing in shorter term or adjustable-rate mortgage- backed securities; and (5) control operating expenses.

The Company expects to continue to capitalize on its strengths - the delivery of traditional thrift products and services (primarily single-family mortgages) with a high level of customer service, thereby maintaining its community orientation. Despite this emphasis, the Company took steps during 1996 and 1997 to modify its historical operating strategy. With industry consolidation eliminating most locally headquartered competitors, the Company saw an opportunity to fill a perceived void for locally delivered commercial loan and deposit services. As such, in the second half of 1996 the Company assembled an experienced team of commercial lending professionals and began offering commercial loan and deposit services and merchant credit card services to businesses in Ocean County and surrounding communities.

Management believes that the diversification of the Company's loan products may expose the Company to a higher degree of credit risk than is involved in the Company's one- to four-family residential mortgage lending activity. As a consequence of this strategy, management has developed a well-defined credit policy focusing on quality underwriting and close management and Board monitoring.

With the significant increase in capital arising from the stock conversion, the Company adopted a leverage strategy in late 1996 to improve returns on capital. The strategy included the retention of most 30-year fixed rate mortgage loans and the use of wholesale borrowings to fund purchases of investment and mortgage-backed securities. The adoption of this strategy may increase the Company's interest rate risk exposure. As noted below, management seeks to carefully monitor and assess the Company's interest rate risk exposure while actively managing the balance sheet composition.

Management is also seeking to increase the Company's market share in its primary market area by expanding the Bank's branch network. During 1996, the Company opened a branch office in Toms River at the site of its new administrative offices. In February 1997, a new branch opened in Lacey Township. In 1998, the Company expects to open an additional branch office in Toms River during the second quarter. A branch in Wall Township, in Southern Monmouth County, is expected to open at year end. The Company is also evaluating additional office sites within its existing market area.

Management also intends to diversify its retail product line. In 1998, the Company expects to offer alternative investment products (annuities and mutual funds) for sale through its retail branch network. The products will be non-proprietary, sold through a third party vendor, and provide the Company with fee income opportunities.

The Company's results of operations are dependent primarily on net interest income, which is the difference between the interest income earned on the Company's interest-earning assets, such as loans and investments, and the interest expense on its interest-bearing liabilities, such as deposits and borrowings. The Company also generates non-interest income such as income from secondary marketing activities, loan servicing and other fees. The Company's operating expenses primarily consist of compensation and employee benefits, general and administrative expenses, federal deposit insurance premiums, occupancy and equipment expenses, marketing expenses and other operating expenses. The Company's results of operations are also significantly affected by general economic and competitive conditions, particularly changes in market interest rates, government policies and actions of regulatory agencies.

**Management of Interest Rate Risk**

Market risk is the risk of loss from adverse changes in market prices and rates. The Company's market risk arises primarily from interest rate risk inherent in its lending, investment and deposit taking activities. The Company's profitability is affected by fluctuations in interest rates. A sudden and substantial increase in interest rates may adversely impact the Company's earnings to the extent that the interest rates borne by assets and liabilities do not change at the same speed, to the same extent or on the same basis. To that end, management actively monitors and manages its interest rate risk exposure.

The principal objectives of the Company's interest rate risk management function are to evaluate the interest rate risk included in certain balance sheet accounts; determine the level of risk appropriate given the Company's business focus, operating environment, capital and liquidity requirements and performance objectives; and manage the risk consistent with Board approved guidelines. Through such management, the Company seeks to reduce the vulnerability of its operations to changes in interest rates. The Company monitors its interest rate risk as such risk relates to its operating strategies. The Company's Board of Directors has established an Asset/Liability Committee ("ALCO Committee") consisting of members of the Company's management, responsible for reviewing the Company's asset/liability policies and interest rate risk position. The ALCO Committee meets monthly and reports trends and the Company's interest rate risk position to the Board of Directors on a quarterly basis. The extent of the movement of interest rates, higher or lower, is an uncertainty that could have a negative impact on the earnings of the Company.

In recent years, the Company has utilized the following strategies to manage interest rate risk: (i) emphasizing the origination for portfolio of fixed-rate mortgage loans having terms to maturity of not more than fifteen years, adjustable-rate loans, and consumer loans consisting primarily of home equity loans and lines of credit; (ii) selling most 30-year fixed-rate mortgage loans originated to the secondary market; (iii) holding primarily short-term and/or adjustable-rate mortgage-backed and investment securities; and (iv) attempting to reduce the overall interest rate sensitivity of liabilities by emphasizing core and longer-term deposits. In late 1996 and throughout 1997, however, the Company began retaining most of its 30-year fixed rate mortgage loan production in order to improve yields and increase balance sheet leverage. Management felt that the significant capital position of the Company resulting from the Conversion, mitigated the additional interest rate risk associated with retaining these mortgages.

The matching of assets and liabilities may be analyzed by examining the extent to which such assets and liabilities are "interest rate sensitive" and by monitoring an institution's interest rate sensitivity "gap." An asset or liability is said to be interest rate sensitive within a specific time period if it will mature or reprice within that time period. The interest rate sensitivity gap is defined as the difference between the amount of interest-earning assets maturing or repricing within a specific time period and the amount of interest- bearing liabilities maturing or repricing within that time period. A gap is considered positive when the amount of interest rate sensitive assets exceeds the amount of interest rate sensitive liabilities. A gap is considered negative when the amount of interest rate sensitive liabilities exceeds the amount of interest rate sensitive assets. Accordingly, during a period of rising interest rates, an institution with a negative gap position generally would not be in as favorable a position, compared to an institution with a positive gap, to invest in higher yielding assets. This may result in the yield on the institution's assets increasing at a slower rate than the increase in its cost of interest- bearing liabilities. Conversely, during a period of falling interest rates, an institution with a negative gap might experience a repricing of its assets at a slower rate than its interest-bearing liabilities, which, consequently, may result in its net interest income growing at a faster rate than an institution with a positive gap position.

The following table sets forth the amounts of interest-earning assets and interest-bearing liabilities outstanding at December 31, 1997, which are anticipated by the Company, based upon certain assumptions, to reprice or mature in each of the future time periods shown. Except as stated below, the amount of assets and liabilities shown which reprice or mature during a particular period were determined in accordance with the earlier of term to repricing or the contractual maturity of the asset or liability. The table is intended to provide an approximation of the projected repricing of assets and liabilities at December 31, 1997, on the basis of contractual maturities, anticipated prepayments, and scheduled rate adjustments within a three month period and subsequent selected time intervals. The loan amounts in the table reflect principal balances expected to be redeployed and/or repriced as a result of contractual amortization and anticipated prepayments of adjustable-rate loans and fixed-rate loans, and as a result of contractual rate adjustments on adjustable-rate loans. For loans on residential properties, adjustable-rate loans and fixed-rate loans are projected to repay at rates between 11% and 30% annually. Mortgage-backed securities are projected to prepay at rates between 11% and 30% annually. Passbook accounts, negotiable order of withdrawal ("NOW") and money market accounts are assumed to decay at 9.66%, 8.73%, 15.01%, 37.05%, 16.44%, 11.39% and 1.72%, for the periods of three months or less, three to six months, six to 12 months, one to three years, three to five years, five to ten years and more than ten years, respectively. Prepayment and decay rates can have a significant impact on the Company's estimated gap. There can be no assurance that projected prepayment rates for loans and mortgage-backed securities will be achieved or that projected decay rates will be realized.

| At December 31, 1997 | 3 Months or Less | More than 3 Months to 6 Months | More than 6 Months to 1 Year | More than 1 Year to 3 Years | More than 3 Years to 5 Years | More than 5 Years to 10 Years | More than 10 Years | Total |
|---|---|---|---|---|---|---|---|---|
| (dollars in thousands) | | | | | | | | |
| INTEREST-EARNING ASSETS (1): | | | | | | | | |
| Interest-earning deposits and short-term investments | $ 1,603 | $ -- | $ -- | $ -- | $ -- | $ -- | $ -- | $ 1,603 |
| Investment securities | 6,268 | -- | 60 | 50,198 | 35,014 | 115,817 | -- | 207,357 |
| Loans receivable (2) | 101,159 | 60,504 | 115,684 | 244,319 | 133,599 | 95,848 | 43,203 | 794,316 |
| Mortgage-backed securities | 135,993 | 60,868 | 83,405 | 69,770 | 52,216 | 34,088 | 20,808 | 457,148 |
| FHLB stock | 14,980 | -- | -- | -- | -- | -- | -- | 14,980 |
| Total interest-earning assets | 260,003 | 121,372 | 199,149 | 364,287 | 220,829 | 245,753 | 64,011 | 1,475,404 |
| INTEREST-BEARING LIABILITIES: | | | | | | | | |
| Money market deposit accounts | 6,568 | 5,933 | 10,202 | 25,191 | 11,175 | 7,742 | 1,168 | 67,979 |
| Savings accounts | 15,755 | 14,245 | 24,494 | 60,484 | 26,831 | 18,589 | 2,804 | 163,202 |
| NOW accounts | 7,655 | 6,918 | 11,894 | 29,360 | 13,027 | 9,026 | 1,363 | 79,243 |
| Time deposits | 138,589 | 115,995 | 185,153 | 147,872 | 56,734 | 10,097 | -- | 654,440 |
| FHLB borrowings | 20,400 | -- | -- | -- | -- | -- | -- | 20,400 |
| Securities sold under agreements to repurchase | 148,700 | -- | 50,000 | 24,500 | 30,000 | 35,000 | -- | 288,200 |
| Total interest-bearing liabilities | 337,667 | 143,091 | 281,743 | 287,407 | 137,767 | 80,454 | 5,335 | 1,273,464 |
| Interest sensitivity gap (3) | $ (77,664) | $ (21,719) | $ (82,594) | $ 76,880 | $ 83,062 | $165,299 | $ 58,676 | $ 201,940 |
| Cumulative interest sensitivity gap | $ (77,664) | $ (99,383) | $(181,977) | $(105,097) | $ (22,035) | $143,264 | $201,940 | |
| Cumulative interest sensitivity gap as a percent of total assets | (5.14%) | (6.58%) | (12.04%) | (6.95%) | 1.46% | 9.48% | 13.36% | |
| Cumulative interest-earning assets as a percent of cumulative interest-bearing liabilities | 77.00% | 79.33% | 76.13% | 89.99% | 98.14% | 111.30% | 115.86% | |

(1) Interest-earning assets are included in the period in which the balances are expected to be redeployed and/or repriced as a result of anticipated prepayments, scheduled rate adjustments, and contractual maturities.

(2) For purposes of the gap analysis, loans receivable includes loans held for sale and non-performing loans gross of the allowance for loan losses, undisbursed loan funds, unamortized discounts and deferred loan fees.

(3) Interest sensitivity gap represents the difference between net interest-earning assets and interest-bearing liabilities.

Certain shortcomings are inherent in the method of analysis presented in the foregoing table. For example, although certain assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets, such as adjustable-rate loans, have features which restrict changes in interest rates both on a short-term basis and over the life of the asset. Further, in the event of a change in interest rates, prepayment and decay rates would likely deviate significantly from those assumed in calculating the table. Finally, the ability of many borrowers to service their adjustable-rate loans may be impaired in the event of an interest rate increase.

Another method of analyzing an institution's exposure to interest rate risk is by measuring the change in the institution's net portfolio value ("NPV") under various interest rate scenarios. NPV is the difference between the net present value of assets, liabilities and off-balance sheet contracts. The NPV ratio, in any interest rate scenario, is defined as the NPV in that scenario divided by the market value of assets in the same scenario. The Sensitivity Measure is the decline in the NPV ratio, in basis points, caused by a 2% increase or decrease in rates, whichever produces a larger decline. The higher an institution's Sensitivity Measure is, the greater its exposure to interest rate risk is considered to be. The Company's interest rate sensitivity is monitored by management through the use of an interest rate risk ("IRR") model which measures IRR by modeling the change in NPV over a range of interest rate scenarios. The Office of Thrift Supervision ("OTS") also produces a similar analysis using its own model, based upon data submitted on the Bank's quarterly Thrift Financial Reports, the results of which may vary from the results provided by the Company's model, primarily due to differences in the assumptions utilized including estimated loan prepayment rates, reinvestment rates and deposit decay rates. The following table sets forth the Company's NPV as of December 31, 1997, as calculated by the Company.

| Change in Interest Rates in Basis Points (Rate Shock) | Net Portfolio Value | | | NPV as % of Portfolio Value of Assets | |
|---|---|---|---|---|---|
| | Amount | $ Change | % Change | NPV Ratio | % Change (1) |
| (dollars in thousands) | | | | | |
| 400 | $ 148,630 | $(102,067) | (40.7)% | 10.9% | (33.9)% |
| 300 | 181,482 | (69,215) | (27.6) | 12.9 | (21.8) |
| 200 | 213,613 | (37,084) | (14.8) | 14.7 | (10.9) |
| 100 | 234,059 | (16,638) | (6.6) | 15.8 | (4.2) |
| Static | 250,697 | - | - | 16.5 | - |
| (100) | 255,243 | 4,546 | 1.8 | 16.5 | - |
| (200) | 256,799 | 6,102 | 2.4 | 16.3 | (1.2) |
| (300) | 258,282 | 7,585 | 3.0 | 16.1 | (2.4) |
| (400) | 258,579 | 7,882 | 3.1 | 15.8 | (4.2) |

(1) Based on the portfolio value of the Company's assets assuming no change in interest rates.

As is the case with the gap table, certain shortcomings are inherent in the methodology used in the NPV IRR measurements. Modeling changes in NPV requires the making of certain assumptions which may tend to oversimplify the manner in which actual yields and costs respond to changes in market interest rates. First, the models assume that the composition of the Company's interest sensitive assets and liabilities existing at the beginning of a period remains constant over the period being measured. Second, the models assume that a particular change in interest rates is reflected uniformly across the yield curve regardless of the duration to maturity or repricing of specific assets and liabilities. Third, the model does not take into account the Company's business or strategic plans. Accordingly, although the NPV measurements do provide an indication of the Company's IRR exposure at a particular point in time, such measurements are not intended to provide a precise forecast of the effect of changes in market interest rates on the Company's net interest income and can be expected to differ from actual results.

**Analysis of Net Interest Income**

Net interest income represents the difference between income on interest-earning assets and expense on interest-bearing liabilities. Net interest income also depends upon the relative amounts of interest-earning assets and interest- bearing liabilities and the interest rate earned or paid on them.

The following table sets forth certain information relating to the Company at December 31, 1997 and for each of the years ended December 31, 1997, 1996 and 1995. The yields and costs are derived by dividing income or expense by the average balance of assets or liabilities, respectively, for the periods shown except where noted otherwise. Average balances are derived from average daily balances. The yields and costs include fees which are considered adjustments to yields.

| | At December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 1997 | | | 1997 | | |
| | Balance | Average Yield/ Cost | Average Balance | Interest | Average Yield/ Cost | Average Balance |
| Assets: | | | | | | |
| Interest-earning assets: | | | | | | |
| Interest earning deposits and short-term investments | $ 1,603 | 2.65% | $ 2,852 | $ 155 | 5.43% | $ 4,872 |
| Investment securities (1) | 207,357 | 6.70 | 196,650 | 13,302 | 6.76 | 148,378 |
| Loans receivable, net (2) | 783,695 | 7.81 | 725,866 | 57,540 | 7.93 | 637,453 |
| Mortgage-backed securities (3) | 457,148 | 6.73 | 442,500 | 26,907 | 6.08 | 331,669 |
| FHLB stock | 14,980 | 7.05 | 11,271 | 752 | 6.67 | 8,323 |
| Total interest-earning assets | 1,464,783 | 7.30 | 1,379,139 | 98,656 | 7.15 | 1,130,695 |
| Non-interest-earning assets | 46,164 | | 38,829 | | | 31,810 |
| Total assets | $1,510,947 | | $1,417,968 | | | $1,162,505 |
| Liabilities and Equity: | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Money market deposit accounts | $ 67,979 | 2.90% | $ 68,972 | 2,028 | 2.94% | $ 70,209 |
| Savings accounts | 163,202 | 2.28 | 168,733 | 3,877 | 2.30 | 175,060 |
| NOW accounts | 77,994 | 1.84 | 77,785 | 1,388 | 1.78 | 72,265 |
| Time deposits | 654,440 | 5.69 | 637,425 | 35,667 | 5.60 | 609,620 |
| Total | 963,615 | 4.60 | 952,915 | 42,960 | 4.51 | 927,154 |
| FHLB borrowings | 20,400 | 6.38 | 7,207 | 414 | 5.74 | 39,135 |
| Securities sold under agreements to repurchase | 288,200 | 6.01 | 209,089 | 12,234 | 5.85 | 9,803 |
| Total interest-bearing liabilities | 1,272,215 | 4.95 | 1,169,211 | 55,608 | 4.76 | 976,092 |
| Non-interest-bearing liabilities | 23,188 | | 18,395 | | | 18,778 |
| Total liabilities | 1,295,403 | | 1,187,606 | | | 994,870 |
| Stockholders' equity | 215,544 | | 230,362 | | | 167,635 |
| Total liabilities and equity | $1,510,947 | | $1,417,968 | | | $1,162,505 |
| Net interest income | | | | $ 43,048 | | |
| Net interest rate spread (4) | | 2.35% | | | 2.39% | |
| Net interest margin (5) | | 3.00% | | | 3.12% | |
| Ratio of interest-earning assets to interest-bearing liabilities | 115.14% | | 117.95% | | | 115.84% |

| | Years Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 1996 | | | 1995 | |
| | | Average Yield/ | Average | | Average Yield/ |

| | Interest | Cost | Balance | Interest | Cost |
|---|---|---|---|---|---|
| Assets: | | | | | |
| Interest-earning assets: | | | | | |
| Interest earning deposits and short-term investments | $ 251 | 5.15% | $ 5,245 | $ 331 | 6.31% |
| Investment securities (1) | 9,710 | 6.54 | 126,792 | 7,166 | 5.65 |
| Loans receivable, net (2) | 50,324 | 7.89 | 612,431 | 48,323 | 7.89 |
| Mortgage-backed securities (3) | 19,413 | 5.85 | 214,348 | 13,799 | 6.44 |
| FHLB stock | 538 | 6.46 | 7,679 | 591 | 7.70 |
| Total interest-earning assets | 80,236 | 7.10 | 966,495 | 70,210 | 7.26 |
| Non-interest-earning assets | | | 22,212 | | |
| Total assets | | | $ 988,707 | | |
| Liabilities and Equity: | | | | | |
| Interest-bearing liabilities: | | | | | |
| Money market deposit accounts | 1,994 | 2.84% | $ 68,987 | 2,083 | 3.02% |
| Savings accounts | 4,069 | 2.32 | 178,973 | 4,537 | 2.54 |
| NOW accounts | 1,371 | 1.90 | 69,330 | 1,483 | 2.14 |
| Time deposits | 33,555 | 5.50 | 574,844 | 31,723 | 5.52 |
| Total | 40,989 | 4.42 | 892,134 | 39,826 | 4.46 |
| FHLB borrowings | 2,298 | 5.87 | 2,933 | 178 | 6.07 |
| Securities sold under agreements to repurchase | 570 | 5.81 | -- | -- | -- |
| Total interest-bearing liabilities | 43,857 | 4.49 | 895,067 | 40,004 | 4.47 |
| Non-interest-bearing liabilities | | | 9,457 | | |
| Total liabilities | | | 904,524 | | |
| Stockholders' equity | | | 84,183 | | |
| Total liabilities and equity | | | $ 988,707 | | |
| Net interest income | $ 36,379 | | | $ 30,206 | |
| Net interest rate spread (4) | | 2.61% | | | 2.79% |
| Net interest margin (5) | | 3.22% | | | 3.13% |
| Ratio of interest-earning assets to interest-bearing liabilities | | | 107.98% | | |

(1) Includes investment securities available for sale.

(2) Amount is net of deferred loan fees, undisbursed loan funds, discounts and premiums and estimated loan loss allowances and includes loans held for sale and non-performing loans.

(3) Includes mortgage-backed securities available for sale.

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

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

Rate Volume Analysis. The following table presents the extent to which changes in interest rates and changes in the volume of interest-earning assets and interest-bearing liabilities have affected the Company's interest income and interest expense during the periods indicated. Information is provided in each category with respect to: (i) changes attributable to changes in volume (changes in volume multiplied by prior rate); (ii) changes attributable to changes in rate (changes in rate multiplied by prior volume); and (iii) the net change. The changes attributable to the combined impact of volume and rate have been allocated proportionately to the changes due to volume and the changes due to rate.

| | Year Ended December 31, 1997 Compared to Year Ended December 31, 1996 | | | Year Ended December 31, 1996 Compared to Year Ended December 31, 1995 | | |
|---|---|---|---|---|---|---|
| | Increase (Decrease) Due to | | | Increase (Decrease) Due to | | |
| | Volume | Rate | Net | Volume | Rate | Net |
| INTEREST-EARNING ASSETS: | | | | | | |
| Interest-earning deposits and short-term investments | $ (109) | $ 13 | $ (96) | $ (22) | $ (58) | $ (80) |
| Investment securities | 3,256 | 336 | 3,592 | 1,321 | 1,223 | 2,544 |
| Loans receivable, net | 6,962 | 254 | 7,216 | 2,001 | - | 2,001 |
| Mortgage-backed securities | 6,705 | 789 | 7,494 | 6,976 | (1,362) | 5,614 |
| FHLB stock | 196 | 18 | 214 | 47 | (100) | (53) |
| Total interest-earning assets | 17,010 | 1,410 | 18,420 | 10,323 | (297) | 10,026 |
| INTEREST-BEARING LIABILITIES: | | | | | | |
| Money market deposit accounts | (35) | 69 | 34 | 37 | (126) | (89) |
| Savings accounts | (155) | (37) | (192) | (94) | (374) | (468) |
| NOW accounts | 104 | (87) | 17 | 61 | (173) | (112) |
| Time deposits | 1,510 | 602 | 2,112 | 1,945 | (113) | 1,832 |
| Total | 1,424 | 547 | 1,971 | 1,949 | (786) | 1,163 |
| FHLB borrowings | (1,834) | (50) | (1,884) | 2,126 | (6) | 2,120 |
| Securities sold under agreements to repurchase | 11,660 | 4 | 11,664 | 570 | - | 570 |
| Total interest-bearing liabilities | 11,250 | 501 | 11,751 | 4,645 | (792) | 3,853 |
| Net change in net interest income | $ 5,760 | $ 909 | $ 6,669 | $ 5,678 | $ 495 | $ 6,173 |

**Comparison of Financial Condition at December 31, 1997 and December 31, 1996**

Total assets at December 31, 1997 were $1.511 billion, an increase of $207.1 million, or 15.9%, compared to $1.304 billion at December 31, 1996.

Investment securities available for sale increased by $33.3 million, to a balance of $207.3 million at December 31, 1997, compared to a balance of $174.0 million at December 31, 1996, and mortgage-backed securities available for sale increased by $61.6 million, to $457.1 million at December 31, 1997, from $395.5 million at December 31, 1996. The increase in investment and mortgage-backed securities available for sale was due to the continued deployment of a wholesale leverage strategy adopted in late 1996, designed to improve returns on invested capital. Wholesale leverage growth was funded through securities sold under agreements to repurchase, which increased to $288.2 million at December 31, 1997 from $99.3 at December 31, 1996. The strategy primarily involves the purchase of adjustable and fixed-rate mortgage-backed securities funded by short and medium-term repurchase agreements and the purchase of medium-term callable agency securities funded by repurchase agreements with maturities through the call date. Loans receivable, net, increased by $105.0 million, or 15.5%, to a balance of $783.7 million at December 31, 1997, compared to a balance of $678.7 million at December 31, 1996. The increase was largely attributable to robust residential loan growth in the Bank's market area, as well as commercial lending initiatives which accounted for $14.4 million of this growth.

Total deposits at December 31, 1997 were $976.8 million, an increase of $42.1 million, compared to $934.7 million at December 31, 1996. Stockholders' equity at December 31, 1997 was $215.5 million, compared to $252.8 million at December 31, 1996. The reduction was due to the award of 335,523 shares of common stock to directors and officers of the Company and the Bank under the Company's 1997 Incentive Plan. The fair market value of the shares on February 4, 1997 (the date of shareholder approval) was initially recorded as a reduction to stockholders' equity and is being amortized to expense. Additionally, through December 31, 1997, the Company has completed the repurchase of 1,206,264 shares, or 13.3%, of outstanding common stock. These shares were held as treasury stock at December 31, 1997.

**Results of Operations**

**General**

Net income increased to $13.8 million for the year ended December 31, 1997, as compared to a net loss of $1.7 million for the year ended December 31, 1996. Prior year amounts were adversely affected by a charge of $5.7 million ($3.7 million after tax) representing the Bank's share of a special assessment to recapitalize the Savings Association Insurance Fund ("SAIF") of the FDIC. Additionally, concurrent with the close of the Company's stock offering on July 2, 1996, the Company funded The Ocean Federal Foundation with a one-time donation of 671,046 shares of common stock, resulting in a charge of $13.4 million ($9.7 million after tax).

**Interest Income**

Interest income for the year ended December 31, 1997 was $98.6 million, compared to $80.2 million for the year ended December 31, 1996, an increase of $18.4 million, or 23.0%. The increase in interest income was the result of increases in the average size of the investment and mortgage-backed securities available for sale portfolios, due to the investment, in 1997, of funds received from wholesale borrowings. Also, the average balance of loans receivable increased $88.4 million for the year ended December 31, 1997, as compared to the same prior year period. The increase in interest income was further augmented by an increase in the yield on average interest earning assets, which improved to 7.15% on average in 1997, from 7.10% on average in 1996.

**Interest Expense**

Interest expense for the year ended December 31, 1997 was $55.6 million, compared to $43.9 million for the year ended December 31, 1996, an increase of $11.7 million or 26.8%. The increase in interest expense was primarily the result of an increase in the average outstanding balance of total borrowings, as previously discussed, and a smaller average increase in deposits. The average cost of interest-bearing liabilities also increased to 4.76% for the year ended December 31, 1997, as compared to 4.49% for the same prior year period due to a greater percentage increase in higher cost wholesale funding over retail deposit funding.

**Provision for Loan Losses**

For the year ended December 31, 1997, the Company's provision for loan losses was $900,000, compared to $700,000 for the same prior year period. The increase was due to overall loan growth and the introduction of commercial business loans which generally carry greater credit risk than the 1-4 family mortgage loans which have been the Bank's historical focus.

Management of the Company is responsible for the determination of the level of the allowance for loan losses. The allowance for loan losses is maintained at a level sufficient to provide for estimated losses based on evaluating known and inherent risks in the loan portfolio and upon management's continuing analysis of the factors underlying the quality of the loan portfolio. These factors include changes in the size and composition of the loan portfolio, actual loan loss experience, current and anticipated economic conditions, detailed analysis of individual loans for which full collectability may not be assured, and determination of the existence and realizable value of the collateral and guarantees securing the loan. Additions to this allowance are charged to earnings. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require the Bank to provide additions to the allowance based upon information available to them at the time of their examination. Although management uses the best information available, future adjustments to the allowance may be necessary due to economic, operating, regulatory and other conditions beyond the Company's control.

**Other Income**

Other income was $2.5 million for the year ended December 31, 1997, compared to $2.9 million for the same prior year period. Income from the net gain (loss) on sales of loans and securities decreased $410,000 for the year ended December 31, 1997, compared to the same prior year period. The decrease was due to the recognition of a loss of $142,000 in 1997 on the sale of a mortgage-backed security. Additionally, the Company sold $2.7 million of 30-year fixed rate mortgage loans in 1997, a decrease of $21.5 million as compared to $24.2 million sold in 1996. Management determined that the significant capital position of the Company mitigated the additional interest rate risk associated with retaining these mortgages.

**Operating Expenses**

Operating expenses were $23.1 million and $39.2 million for the year ended December 31, 1997, a decrease of $16.1 million compared to the same prior year period. The charitable donation to The Ocean Federal Foundation in the third quarter of 1996 accounted for $13.4 million of the decrease. Additionally, federal deposit insurance expense declined by $7.3 million for the year ended December 31, 1997, compared to the same prior year period due to the special SAIF assessment of $5.7 million recorded in the third quarter of 1996. As a result of the special assessment insurance premiums on SAIF-insured deposits declined to 6.5 basis points per $100 of deposits effective January 1, 1997, as compared to 23 basis points in 1996.

The increase in compensation and employee benefits expense of $3.7 million for the year ended December 31, 1997, as compared to the same prior year period, was due to the expense associated with the amortization, beginning in February 1997, of incentive stock awards and the higher expense associated with the Bank's Employee Stock Ownership Plan as a result of the increase in the Company's stock price over its initial $20 per share cost. The ESOP expense was partly offset by eliminating matching contributions under the Bank's 401K Plan.

Equipment expense increased by $426,000 for the year ended December 31, 1997, compared to the same prior year period due to the establishment of two new branch offices and the upgrade of computer equipment. General and administrative expenses increased by $386,000 for the year ended December 31, 1997, compared to the same prior year period due to expenses associated with operating as a publicly-owned holding company.

**Provision for Income Taxes**

Income tax expense was $7.7 million for the year ended December 31, 1997, compared to $1.1 million for the year ended December 31, 1996 due to the significant increase in income before income taxes.

Comparison of Operating Results for the Years Ended December 31, 1996 and December 31, 1995

**General**

The Company incurred a net loss of $1.7 million for the year ended December 31, 1996, as compared to net income of $7.9 million for the year ended December 31, 1995. The 1996 loss was caused by the charitable donation to The Ocean Federal Foundation of 671,046 shares of common stock which resulted in expense recognition of $13.4 million ($9.7 million net of tax), the fair market value of the stock at the time of the donation. Operating results for the year ended December 31, 1996 were further reduced by a special one-time assessment imposed on institutions such as the Bank insured by SAIF. The special assessment was 65.7 basis points on SAIF assessable deposits as of March 31, 1995. The Company's assessment was $5.7 million ($3.7 million net of taxes).

**Interest Income**

Interest income for the year ended December 31, 1996 was $80.2 million, compared to $70.2 million for the year ended December 31, 1995, an increase of $10.0 million, or 14.3%. The increase in interest income was the result of increases in the average size of the investment and mortgage-backed securities available for sale portfolios, which together increased $138.9 million on average, due to the 1996 purchases relating to the investment of net Conversion proceeds. Many of these purchases were made early in 1996 as the Company prefunded expected Conversion proceeds by increasing Federal Home Loan Bank ("FHLB") borrowings and investing the borrowed funds in investment and mortgage-backed securities. The FHLB borrowings were then repaid upon consummation of the Conversion. Additionally, the average balance of loans receivable increased by $25.0 million during 1996 as compared to 1995. The overall increase in interest-earning assets was partially offset by the effects of a lower average interest-earning asset yield which decreased to 7.10% for the year ended December 31, 1996, as compared to 7.26% for the year ended December 31, 1995.

**Interest Expense**

Interest expense for the year ended December 31, 1996 was $43.9 million, compared to $40.0 million for the year ended December 31, 1995, an increase of $3.9 million, or 9.6%. The increase in interest expense for the year ended December 31, 1996, as compared to the same period in 1995 was the result of an increase in the average outstanding balance of both deposits (to $927.2 million for the year ended December 31, 1996, from $892.1 million for the same period in 1995) and FHLB borrowings (to $39.1 million for the year ended December 31, 1996, from $2.9 million for the same period in 1995.

**Provision for Loan Losses**

For the year ended December 31, 1996, the Company's provision for loan losses was $700,000, compared to $950,000 for the same prior year period. The decrease was partly due to the decline in non-performing loans, which decreased $1.0 million, to $7.7 million at December 31, 1996, from $8.7 million at December 31, 1995.

**Other Income**

Other income was $2.9 million for the year ended December 31, 1996, an increase of $1.5 million, or 112.5%, compared to the same prior year period. Income from the net gain on sales of loans and securities available for sale increased $618,000 for the year ended December 31, 1996, compared to the same prior year period. The increase was primarily due to the recognition of a $587,000 loss in 1995 on the sale of investment securities available for sale. The net gain from real estate owned increased $396,000 for the year ended December 31, 1996, compared to the same prior year period due to the recognition of $311,000 in gains on the sale of two properties in late 1996. Other income increased $295,000 for the year ended December 31, 1996, compared to the same prior year period due to the recovery of $101,000 from the previous charge off of a financial asset and due to the recognition of $232,000 of income in 1996 relating to increases in the cash surrender value of life insurance policies on Bank officers.

**Operating Expenses**

Operating expenses were $39.2 million for the year ended December 31, 1996, an increase of $21.2 million compared to the same prior year period. The charitable donation to The Ocean Federal Foundation accounted for $13.4 million of the increase. The Bank's share of the special assessment imposed by the FDIC on SAIF-insured institutions of $5.7 million accounted for the increase in federal deposit insurance for the year ended December 31, 1996, as compared to the same prior year period. The increase in compensation and employee benefits expense of $1.6 million for the year ended December 31, 1996, as compared to the same prior year period, was due to the expense associated with the adoption, effective January 1,1996, of the ESOP. This expense was partly offset by freezing the future accrual of benefits under the Bank's defined benefit pension plan.

**Provision for Income Taxes**

Income tax expense was $1.1 million for the year ended December 31, 1996, compared to $4.7 million for the year ended December 31, 1995.

The Company has been advised by its independent accountants that the Company's contribution of common stock to The Ocean Federal Foundation is tax deductible, subject to a limitation based on 10% of the Company's annual taxable income. The Company, however, is able to carry forward any unused portion of the deduction for five years following the year in which the contribution is made. Based on the Company's estimate of annual taxable income for 1996 and for the next successive five years (the carry forward period), the Company recognized a tax benefit of $3.7 million on the $13.4 million charitable donation. An additional $1.2 million of tax benefit was unrecognized due to the limitations imposed by the tax code. The unrecognized tax benefit relating to the charitable donation caused the Company to recognize an income tax expense for 1996 despite a pre-tax book loss.

**Liquidity and Capital Resources**

The Company's primary sources of funds are deposits, principal and interest payments on loans and mortgage-backed securities, FHLB and other borrowings and, to a lesser extent, investment maturities and proceeds from the sale of loans. While scheduled amortization of loans are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition. The Company has other sources of liquidity if a need for additional funds arises, including an overnight line of credit and advances from the FHLB. At December 31, 1997, the Company had $20.4 million of outstanding overnight borrowings from the FHLB, representing an increase from $8.8 million at December 31, 1996. The Company utilizes the overnight line from time to time to fund short-term liquidity needs. The Company also borrowed $288.2 million at December 31, 1997 through securities sold under agreements to repurchase, an increase from $99.3 million at December 31, 1996. These borrowings were used to fund a wholesale leverage strategy designed to improve returns on invested capital.

The Company's cash needs for the year ended December 31, 1997, were principally provided by principal payments on loans and mortgage-backed securities, deposit flows, and borrowings through securities sold under agreements to repurchase. The cash provided was principally used for investing activities, which included the purchase of investment and mortgage-backed securities and the origination of loans. The Company also used funds to purchase outstanding common stock, either to fund incentive awards or to hold as treasury stock. For the year ended December 31, 1996, the cash needs of the Company were primarily satisfied by investment maturities, principal payments on loans and mortgage-backed securities, borrowings through securities sold under agreements to repurchase and proceeds from common stock subscriptions. The cash was principally utilized for loan originations and purchases of investment and mortgage-backed securities.

Federal regulations require the Bank to maintain minimum levels of liquid assets. The required percentage has varied from time to time based upon economic conditions and savings flows and is currently 4% (a decrease from 5% at December 31, 1996) of net withdrawable savings deposits and borrowings payable on demand or in one year or less during the preceding calendar month. Liquid assets for purposes of this ratio include cash, accrued interest receivable, certain time deposits, U.S. Treasury and Government agencies and other securities and obligations generally having remaining maturities of less than five years. The levels of these assets are dependent on the Bank's operating, financing, lending and investing activities during any given period. As of December 31, 1997 and 1996, the Bank's liquidity ratios were 9.8% and 17.5%, respectively, both in excess of the minimum regulatory requirement.

At December 31, 1997, the Bank exceeded all of its regulatory capital requirements with tangible capital of $178.6 million, or 11.9%, of total adjusted assets, which is above the required level of $22.5 million or 1.5%; core capital of $178.6 million or 11.9% of total adjusted assets, which is above the required level of $45.0 million, or 3.0%; and risk-based capital of $185.0 million, or 29.9% of risk-weighted assets, which is above the required level of $49.5 million or 8.0%. The Bank is considered a "well capitalized" institution under the Office of Thrift Supervision's prompt corrective action regulations.

**Impact of Year 2000**

The Company is conducting a comprehensive review of its computer systems and third party vendors to identify the systems that could be affected by the "Year 2000" issue. The Year 2000 problem is the result of computer programs being written using two digits rather than four to define the applicable year. Any of the Company's programs that have time-sensitive software may recognize a date using "00" as the year 1900 rather than the Year 2000. This could result in system failure or miscalculations. The Company is devoting the necessary internal and external resources in the development of an implementation plan to address Year 2000. Management anticipates that all Year 2000 initiatives and testing will be completed in a timely manner and will meet all regulatory milestones. Expenditures in future years are not expected to have a material impact on the Company.

**Impact of Inflation and Changing Prices**

The consolidated financial statements and notes thereto presented herein have been prepared in accordance with GAAP, which require the measurement of financial position and operating results in terms of historical dollar amounts without considering the changes in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of the Company's operations. Unlike industrial companies, nearly all of the assets and liabilities of the Company are monetary in nature. As a result, interest rates have a greater impact on the Company's performance than do the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the price of goods and services.

**Impact of New Accounting Standards**

Statement of Financial Accounting Standards No. 129, "Disclosure of Information about Capital Structure" (SFAS 129) was issued in February 1997. SFAS 129 is effective for periods ending after December 15, 1997. SFAS 129 lists required disclosures about capital structure that had been included in a number of separate statements and opinions of authoritative accounting literature. As such, the adoption of SFAS 129 is not expected to have a significant impact on the disclosures in financial statements of the Company.

In June 1997, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income" (SFAS 130). SFAS 130 establishes standards for reporting and display of comprehensive income and its components in a full set of general purpose financial statements. Under SFAS 130, comprehensive income is divided into net income and other comprehensive income. Other comprehensive income includes items previously recorded directly in equity, such as unrealized gains or losses on securities available for sale. SFAS 130 is effective for interim and annual periods beginning after December 15, 1997. Comparative financial statements provided for earlier periods are required to be reclassified to reflect application of the provisions of the Statement. The adoption of SFAS 130 is not expected to have a significant impact on the Company.

In June 1997, the FASB issued Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information" (SFAS 131). SFAS 131 establishes standards for the way public business enterprises are to report information about operating segments in annual financial statements and requires those enterprises to report selected financial information about operating segments in interim financial reports to shareholders. SFAS 131 is effective for financial statements for periods beginning after December 15, 1997. The adoption of SFAS 131 is not expected to have a significant impact on the Company.

**Private Securities Litigation Reform Act Safe Harbor Statement**

In addition to historical information, this annual report may include certain forward looking statements based on current management expectations. The Company's actual results could differ materially from those management expectations. Factors that could cause future results to vary from current management expectations include, but are not limited to, general economic conditions, legislative and regulatory changes, monetary and fiscal policies of the federal government, changes in tax policies, rates and regulations of federal and state tax authorities, changes in interest rates, deposit flows, the cost of funds, demand for loan products, demand for financial services, competition, changes in the quality or composition of the Bank's loan and investment portfolios, changes in accounting principles, policies or guidelines, and other economic, competitive, governmental and technological factors affecting the Company's operations, markets, products, services and prices. Further description of the risks and uncertainties to the business are included in Item 1, BUSINESS of the Company's 1997 Form 10-K.

## CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

| December 31, 1997 and 1996 | 1997 | 1996 |
|---|---|---|
| (dollars in thousands, except per share amounts) | | |
| ASSETS | | |
| Cash and due from banks | $ 2,225 | $ 5,372 |
| Investment securities available for sale (notes 4, 11 and 15) | 207,357 | 174,028 |
| Federal Home Loan Bank of New York stock, at cost | 14,980 | 8,457 |
| Mortgage-backed securities available for sale (notes 5, 11 and 15) | 457,148 | 395,542 |
| Loans receivable, net (notes 6 and 15) | 783,695 | 678,728 |
| Mortgage loans held for sale | - | 727 |
| Interest and dividends receivable (note 7) | 11,064 | 9,757 |
| Real estate owned, net (note 9) | 1,198 | 1,555 |
| Premises and equipment, net (note 8) | 14,279 | 14,100 |
| Other assets (note 12) | 19,001 | 15,599 |
| Total assets | $ 1,510,947 | $ 1,303,865 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Deposits (note 10) | $ 976,764 | $ 934,730 |
| Federal Home Loan Bank borrowings | 20,400 | 8,800 |
| Securities sold under agreements to repurchase (note 11) | 288,200 | 99,322 |
| Advances by borrowers for taxes and insurance | 4,773 | 3,832 |
| Other liabilities (notes 12 and 13) | 5,266 | 4,392 |
| Total liabilities | 1,295,403 | 1,051,076 |
| Stockholders' Equity (notes 2, 3, 12, 13 and 14): | | |
| Preferred stock, $.01 par value, 5,000,000 shares authorized, no shares issued | - | - |
| Common stock, $.01 par value, 55,000,000 shares authorized, 9,059,124 shares issued and 7,852,860 and 9,059,124 shares outstanding at December 31, 1997 and 1996, respectively | 91 | 91 |
| Additional paid-in capital | 177,223 | 176,812 |
| Retained earnings-substantially restricted | 97,577 | 88,552 |
| Net unrealized gain (loss) on securities available for sale, net of tax | 989 | (335) |
| Less: Unallocated common stock held by Employee Stock Ownership Plan | (10,903) | (12,331) |
| Unearned Incentive Awards | (7,897) | - |
| Treasury stock (1,206,264 shares at December 31, 1997) | (41,536) | |
| Total stockholders' equity | 215,544 | 252,789 |
| Commitments and contingencies (note 15) | | |
| Total liabilities and stockholders' equity | $ 1,510,947 | $ 1,303,865 |

See accompanying notes to consolidated financial statements.

## CONSOLIDATED STATEMENTS OF INCOME

| Years Ended December 31, 1997, 1996 and 1995 | 1997 | 1996 | 1995 |
|---|---|---|---|
| (dollars in thousands, except per share amounts) | | | |
| INTEREST INCOME: | | | |
| Loans | $ 57,540 | $ 50,324 | $ 48,323 |
| Mortgage-backed securities | 26,907 | 19,413 | 13,799 |
| Investment securities and other | 14,209 | 10,499 | 8,088 |
| Total interest income | 98,656 | 80,236 | 70,210 |
| INTEREST EXPENSE: | | | |
| Deposits (note 10) | 42,960 | 40,989 | 39,826 |
| Borrowed funds | 12,648 | 2,868 | 178 |
| Total interest expense | 55,608 | 43,857 | 40,004 |
| Net interest income | 43,048 | 36,379 | 30,206 |
| Provision for loan losses (note 6) | 900 | 700 | 950 |
| Net interest income after provision for loan losses | 42,148 | 35,679 | 29,256 |
| OTHER INCOME: | | | |
| Fees and service charges (note 6) | 1,905 | 1,819 | 1,603 |
| Net (loss) gain on sales of loans and securities available for sale (notes 4 and 6) | (132) | 278 | (340) |
| Net income from (cost of) other real estate operations | 223 | 355 | (41) |
| Other | 513 | 429 | 134 |
| Total other income | 2,509 | 2,881 | 1,356 |
| OPERATING EXPENSES: | | | |
| Compensation and employee benefits (notes 13 and 14) | 13,969 | 10,296 | 8,707 |
| Occupancy (note 15) | 1,919 | 1,882 | 1,721 |
| Equipment | 1,288 | 862 | 879 |
| Marketing | 684 | 818 | 836 |
| Federal deposit insurance (note 18) | 719 | 8,051 | 2,199 |
| Data processing | 1,243 | 941 | 737 |
| General and administrative | 3,323 | 2,937 | 2,927 |
| Charitable donation (notes 2 and 12) | - | 13,419 | - |
| Total operating expenses | 23,145 | 39,206 | 18,006 |
| Income (loss) before provision for income taxes | 21,512 | (646) | 12,606 |
| Provision for income taxes (note 12) | 7,687 | 1,083 | 4,659 |
| Net income (loss) | $ 13,825 | $ (1,729) | $ 7,947 |
| Basic earnings (loss) per share | $ 1.80 | $ (.78) | N/A |
| Diluted earnings (loss) per share | $ 1.77 | $ (.78) | N/A |
| Average basic shares outstanding (note 1) | 7,672 | 8,430 | N/A |
| Average diluted shares outstanding (note 1) | 7,819 | 8,430 | N/A |

Earnings (loss) per share and shares outstanding for 1996 cover the period from July 2, 1996 (date of conversion) to December 31, 1996

See accompanying notes to consolidated financial statements.

## CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

| For The Years Ended 31, 1997, 1996 and 1995 | Common Stock | Additional Paid-In Capital | Retained Earnings | Net Unrealized Gain (Loss) On Securities Available For Sale, Net of Tax |
|---|---|---|---|---|
| (dollars in thousands, except per share amounts) | | | | |
| Balance at December 31, 1994 | $ -- | $ -- | $ 82,334 | $ -- |
| Net income for the year ended December 31, 1995 | -- | -- | 7,947 | -- |
| Change in net unrealized gain (loss) on securities available for sale, net of tax | -- | -- | -- | 2,070 |
| Balance at December 31, 1995 | -- | -- | 90,281 | 2,070 |
| Sale of 8,388,078 shares of common stock in conversion | 84 | 163,216 | -- | -- |
| Donation of 671,046 shares of common stock to the Ocean Federal Foundation at par value | 7 | 13,414 | -- | -- |
| Acquisition of 671,046 shares of stock by ESOP | -- | -- | -- | -- |
| Allocation of ESOP stock | -- | -- | -- | -- |
| ESOP adjustment | -- | 182 | -- | -- |
| Change in net unrealized gain (loss) on securities available for sale, net of tax | -- | -- | -- | (2,405) |
| Net loss for the year ended December 31, 1996 | -- | -- | (1,729) | -- |
| Balance at December 31, 1996 | 91 | 176,812 | 88,552 | (335) |
| Acquisition of 335,523 shares of common stock for Incentive Awards | -- | (506) | -- | -- |
| Earned Incentive Awards | -- | -- | -- | -- |
| Purchase 1,206,264 shares of common stock | -- | -- | -- | -- |
| Allocation of ESOP stock | -- | -- | -- | -- |
| ESOP adjustment | -- | 917 | -- | -- |
| Cash dividend - $.60 per share | -- | -- | (4,800) | -- |
| Change in net unrealized gain (loss) on securities available for sale, net of tax | -- | -- | -- | 1,324 |
| Net income for the year ended December 31, 1997 | -- | -- | 13,825 | -- |
| Balance at December 31, 1997 | $ 91 | $ 177,223 | $ 97,577 | $ 989 |

| For The Years Ended 31, 1997, 1996 and 1995 | Employee Stock Ownership Plan | Unearned Incentive Awards | Treasury Stock | Total |
|---|---|---|---|---|
| (dollars in thousands, except per share amounts) | | | | |
| Balance at December 31, 1994 | $ -- | $ -- | $ -- | $ 82,334 |
| Net income for the year ended December 31, 1995 | -- | -- | -- | 7,947 |
| Change in net unrealized gain (loss) on securities available for sale, net of tax | -- | -- | -- | 2,070 |
| Balance at December 31, 1995 | -- | -- | -- | 92,351 |
| Sale of 8,388,078 shares of common stock in conversion | -- | -- | -- | 163,300 |
| Donation of 671,046 shares of common stock to the Ocean Federal Foundation at par value | -- | -- | -- | 13,421 |
| Acquisition of 671,046 shares of stock by ESOP | (13,421) | -- | -- | (13,421) |
| Allocation of ESOP stock | 1,090 | -- | -- | 1,090 |

| | | | | |
|---|---|---|---|---|
| ESOP adjustment | -- | -- | -- | 182 |
| Change in net unrealized gain (loss) on securities available for sale, net of tax | -- | -- | -- | (2,405) |
| Net loss for the year ended December 31, 1996 | -- | -- | -- | (1,729) |
| Balance at December 31, 1996 | (12,331) | -- | -- | 252,789 |
| Acquisition of 335,523 shares of common stock for Incentive Awards | -- | (9,670) | -- | (10,176) |
| Earned Incentive Awards | -- | 1,773 | -- | 1,773 |
| Purchase 1,206,264 shares of common stock | -- | -- | (41,536) | (41,536) |
| Allocation of ESOP stock | 1,428 | -- | -- | 1,428 |
| ESOP adjustment | -- | -- | -- | 917 |
| Cash dividend - $.60 per share | -- | -- | -- | (4,800) |
| Change in net unrealized gain (loss) on securities available for sale, net of tax | -- | -- | -- | 1,324 |
| Net income for the year ended December 31, 1997 | -- | -- | -- | 13,825 |
| Balance at December 31, 1997 | $(10,903) | $(7,897) | $(41,536) | $ 215,544 |

See accompanying notes to consolidated financial statements.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

| Years Ended December 31, 1997, 1996 and 1995 | 1997 | 1996 | 1995 |
|---|---|---|---|
| (dollars in thousands) | | | |
| CASH FLOWS FROM OPERATING ACTIVITIES: | | | |
| Net income (loss) | $ 13,825 | $ (1,729) | $ 7,947 |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: | | | |
| Donation of 671,046 shares of common stock to the Ocean Federal Foundation | - | 13,419 | - |
| Depreciation and amortization of premises and equipment | 1,354 | 760 | 810 |
| Amortization of Incentive Awards | 1,773 | - | - |
| Amortization of ESOP | 1,428 | 1,090 | - |
| ESOP adjustment | 917 | 182 | - |
| Amortization of servicing asset | 197 | 204 | 106 |
| Net premium amortization in excess of discount accretion on securities | 3,498 | 1,761 | 585 |
| Net accretion of deferred fees and discounts in excess of premium amortization on loans | (382) | (487) | (535) |
| Provision for loan losses | 900 | 700 | 950 |
| Deferred taxes | 818 | (3,263) | 385 |
| Net gain on sales of real estate owned | (457) | (507) | (256) |
| Net loss (gain) on sales of loans and securities available for sale | 132 | (278) | 340 |
| Proceeds from sales of mortgage loans held for sale | 2,705 | 24,173 | 19,108 |
| Mortgage loans originated for sale | (2,008) | (23,453) | (21,264) |
| Increase in interest and dividends receivable | (1,307) | (2,277) | (251) |
| Increase in other assets | (5,154) | (830) | (4,160) |
| Increase in other liabilities | 874 | 577 | 1,371 |
| Total adjustments | 5,288 | 11,771 | (2,811) |
| Net cash provided by operating activities | 19,113 | 10,042 | 5,136 |
| CASH FLOWS FROM INVESTING ACTIVITIES: | | | |
| Net increase in loans receivable | (107,948) | (68,429) | (23,588) |
| Proceeds from sales of investment and mortgage-backed securities available for sale | 19,006 | - | 63,713 |
| Purchase of investment securities available for sale | (51,154) | (105,006) | (29,976) |
| Purchase of mortgage-backed securities available for sale | (248,917) | (251,004) | (34,575) |
| Purchase of investment securities held to maturity | - | - | (54,975) |
| Purchase of mortgage-backed securities held to maturity | - | - | (53,915) |
| Proceeds from maturities of investment securities available for sale | 20,300 | 43,858 | - |
| Principal payments on mortgage-backed securities available for sale | 164,291 | 117,048 | - |
| Principal payments on mortgage-backed securities held to maturity | - | - | 50,193 |
| Proceeds from maturities of investment securities held to maturity | - | - | 33,624 |
| Purchases of Federal Home Loan Bank of New York stock | (6,523) | (734) | (400) |
| Proceeds from sales of real estate owned | 3,277 | 2,503 | 3,261 |
| Purchases of premises and equipment | (1,533) | (7,219) | (4,121) |
| Net cash used in investing activities | (209,201) | (268,983) | (50,759) |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | | |
| Increase in deposits | 42,034 | 8,172 | 59,138 |
| Increase (decrease) increase in Federal Home Loan Bank borrowings | 11,600 | (1,600) | (5,900) |
| Increase in securities sold under agreements to repurchase | 188,878 | 99,322 | - |
| Increase in advances by borrowers for taxes and insurance | 941 | 511 | 168 |
| Net proceeds of common stock issuance | - | 149,886 | - |
| Purchase of Incentive Award shares | (10,176) | - | - |
| Dividends paid | (4,800) | - | - |
| Purchase of treasury stock | (41,536) | - | - |

| | | | |
|---|---|---|---|
| Net cash provided by financing activities | 186,941 | 256,291 | 53,406 |
| Net (decrease) increase in cash and due from banks | (3,147) | (2,650) | 7,783 |
| Cash and due from banks at beginning of year | 5,372 | 8,022 | 239 |
| Cash and due from banks at end of year | $ 2,225 | $ 5,372 | $ 8,022 |
| SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION: | | | |
| Cash paid during the year for: | | | |
| Interest | $ 54,863 | $ 43,624 | $ 39,849 |
| Income taxes | 7,246 | 4,231 | 3,873 |
| Non cash investing activities: | | | |
| Transfer of loans receivable to real estate owned | 2,463 | 2,184 | 2,792 |
| Transfer of investment and mortgage-backed securities from held-to-maturity to available for sale | - | - | 382,713 |
| Mortgage loans securitized into mortgage-backed securities | $ 2,025 | $ 23,392 | $ 17,180 |

See accompanying notes to consolidated financial statements.

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**December 31, 1997 and 1996**

(1) Summary of Significant Accounting Policies

As more fully described in note 2, Ocean Federal Savings Bank (the "Bank") converted from a mutual savings bank to a capital stock savings bank on July 2, 1996. As part of the conversion, Ocean Financial Corp. (the "Company") was formed, acquired all of the Bank's conversion stock, and issued its common stock in a subscription offering. The acquisition of the Bank's conversion stock was accounted for similar to a pooling of interests and, therefore, the financial condition and results of operations of the Bank prior to July 2, 1996 became the financial condition and results of operations of the Company.

**Principles of Consolidation**

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, Ocean Federal Savings Bank, and its wholly-owned subsidiaries, Ocean Federal Realty, Inc. and Ocean Investment Services, Corp. All significant intercompany accounts and transactions have been eliminated in consolidation.

**Business**

The Bank provides a range of banking services to customers through a network of branches in Ocean and Middlesex counties in New Jersey. The Bank is subject to competition from other financial institutions; it is also subject to the regulations of certain regulatory agencies and undergoes periodic examinations by those regulatory authorities.

**Basis of Financial Statement Presentation**

The consolidated financial statements have been prepared in conformity with generally accepted accounting principles. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the consolidated statement of financial condition and revenues and expenses for the period then ended. Actual results could differ significantly from those estimates and assumptions.

Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and the valuation of real estate acquired in connection with foreclosures or in settlement of loans. In connection with the determination of the allowances for loan losses and Real Estate Owned (REO), management obtains independent appraisals for significant properties.

**Cash Equivalents**

Cash equivalents consist of interest-bearing deposits in other financial institutions and loans of Federal funds. For purposes of the consolidated statements of cash flows, the Company considers all highly liquid debt instruments with original maturities of three months or less to be cash equivalents.

**Investment and Mortgage-Backed Securities**

Investment and mortgage-backed securities identified as held to maturity are carried at cost, adjusted for amortization of premiums and accretion of discounts, which are recognized as adjustments to interest income using a method which approximates a level yield over the estimated average life of the security. Management determines the appropriate classification of securities at the time of purchase. If management has the intent and the Company has the ability at the time of purchase to hold securities until maturity, they are classified as held to maturity.

Debt securities not intended to be held to maturity are classified as available for sale. Securities available for sale include securities that management intends to use as part of its asset/liability management strategy. Such securities are carried at fair value and unrealized gains and losses, net of related tax effect, are excluded from earnings, but are included as a separate component of stockholders' equity. Gains or losses on the sale of such securities are included in other income using the specific identification method.

**Loans Receivable**

Loans receivable, other than loans held for sale, are stated at unpaid principal balance, plus unamortized premiums less unearned discounts, net deferred loan origination and commitment fees, and the allowance for loan losses. Discounts and premiums are recognized in income using the level-yield method over the estimated lives of the loans.

Loan origination and commitment fees and certain direct loan origination costs are deferred and the net fee or cost is recognized in interest income using the level-yield method over the contractual life of the specifically identified loans, adjusted for actual prepayments.

Loans in which interest is more than 90 days past due, including impaired loans, and other loans in the process of foreclosure are placed on nonaccrual status. Interest income previously accrued on these loans, but not yet received, is reversed in the current period. Any interest subsequently collected is credited to income in the period of recovery. A loan is returned to accrual status when all amounts due have been received and the remaining principal balance is deemed collectible.

A loan is considered impaired when it is deemed probable that the Company will not collect all amounts due according to the contractual terms of the loan agreement. The Company has defined the population of impaired loans to be all non-accrual commercial real estate, multi-family and land loans. Impaired loans are individually assessed to determine that the loan's carrying value is not in excess of the fair value of the collateral or the present value of the loan's expected future cash flows. Smaller balance homogeneous loans that are collectively evaluated for impairment, such as residential mortgage loans and installment loans, are specifically excluded from the impaired loan portfolio.

**Mortgage Loans Held for Sale**

The Company may periodically sell all or part of its conforming loan originations. Mortgage loans intended for sale are carried at the lower of unpaid principal balance, net, or market value on an aggregate basis.

**Allowance for Loan Losses**

The adequacy of the allowance for loan losses is based on management's evaluation of the Company's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and current economic conditions. Additions to the allowance arise from charges to operations through the provision for loan losses or from the recovery of amounts previously charged off. The allowance is reduced by loan charge-offs. Loans are charged-off when management believes such loans are uncollectible.

Management believes that the allowance for losses on loans is adequate. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in economic conditions in the Company's market area. In addition, various regulatory agencies, as an integral part of their routine examination process, periodically review the Bank's allowance for losses on loans. Such agencies may require the Bank to recognize additions to the allowances based on their judgments about information available to them at the time of their examination.

**Real Estate Owned**

Real estate owned is carried at the lower of cost or fair value, less estimated costs to sell. When a property is acquired, the excess of the loan balance over fair value is charged to the allowance for loan losses. A reserve for real estate owned has been established to provide for subsequent declines in the fair values of properties. Real estate owned is carried net of the related reserve. Operating results from real estate owned, including rental income, operating expenses, and gains and losses realized from the sales of real estate owned are recorded as incurred.

**Premises and Equipment**

Land is carried at cost and premises and equipment, including leasehold improvements, are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are computed using the straight-line method over the estimated useful lives of the assets or leases. Repair and maintenance items are expensed and improvements are capitalized. Gains and losses on dispositions are reflected in current operations.

**Income Taxes**

The Company utilizes the asset and liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases.

Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

**Pension Plan**

Pension plan costs based on actuarial computation of current and future benefits for employees are charged to expense. The Company funds the Plan based on the maximum amount that can be deducted for Federal income tax purposes.

**Stock Based Compensation**

Effective January 1, 1997, the Company adopted Statement of Financial Accounting Standards No. 123, Accounting for Stock Based Compensation (SFAS 123) which allows an entity to choose between the intrinsic value method, as defined in Accounting Principles Board Opinion No. 25, and the fair value method of accounting for stock based compensation described in SFAS 123. An entity using the intrinsic value method must show the pro forma net income and earnings per share as if the stock based compensation had been determined using the fair value method. The Company has elected to account for stock based compensation using the intrinsic value method under APB No. 25 and has recognized no compensation expense under this method. The pro forma disclosures required by SFAS 123 are included in note 14 - 1997 Incentive Plan.

**Contributions**

Contributions made are recognized as expenses in the period made and as decreases of assets or increases of liabilities depending on the form of the benefits given. Contributions made are measured at the fair values of the asset given or, if made in the form of a settlement or cancellation of a donee's liabilities, at the fair value of the liabilities canceled.

**Earnings (Loss) Per Share**

Effective December 31, 1997 the Company adopted the provisions of Statement of Financial Accounting Standards No. 128 "Earnings per Share". All prior share amounts have been restated to conform with the provisions of this statement. Basic earnings (loss) per share is computed by dividing net income (loss) by the weighted average number of shares of common stock outstanding. Diluted earnings (loss) per share is calculated by dividing net income (loss) by the weighted average number of shares of common stock outstanding plus potential common stock, utilizing the treasury stock method. All share amounts exclude unallocated shares of stock held by the Employee Stock Ownership Plan (ESOP). Loss per share for 1996 was computed on net loss and average shares outstanding for the period from July 2, 1996 (conversion date) through December 31, 1996. Per share amounts are not presented for periods prior to conversion to stock from, as no stock was outstanding.

The following reconciles shares outstanding for basic and diluted earnings per share for the year ended December 31, 1997 (in thousands):

| | |
|---|---|
| Weighted average shares net of Treasury shares | 8,556 |
| Less: Unallocated ESOP shares | (580) |
| Unallocated incentive award shares | (304) |

| | |
|---|---|
| Average basic shares outstanding | 7,672 |
| Add: Effect of dilutive securities: | |
| Stock options | 72 |
| Incentive awards | 75 |
| Average diluted shares outstanding | 7,819 |

(2) Stock Form of Ownership

On August 17, 1995, the Board of Directors of the Bank adopted a Plan of Conversion to convert from a federally chartered mutual savings bank to a federally chartered stock savings bank with the concurrent formation of a holding company. As part of the conversion, the Company was incorporated under Delaware law on November 21, 1995. The Company completed its initial public offering on July 2, 1996 with the issuance of 8,388,078 shares of common stock to the Bank's eligible depositors and the Bank's Employee Stock Ownership Plan (the "ESOP"), resulting in proceeds of $163.3 million (net of $4.5 million in costs). The Company retained $81.6 million of the net proceeds and used the remaining net proceeds to purchase all of the outstanding stock of the Bank.

Concurrent with the close of the conversion, an additional 671,046 shares of common stock (8% of the offering) were issued and donated by the Company to The Ocean Federal Foundation (the "Foundation"), a private foundation dedicated to charitable purposes within Ocean County, New Jersey and its neighboring communities. The fair market value of the contribution of $13.4 million was reflected as a current expense and as an increase to capital stock and paid in capital for the same amount. The Company also recorded a related tax benefit of $3.7 million with a corresponding increase to the Company's deferred tax assets.

At the time of the conversion, the Bank established a liquidation account with a balance equal to its retained earnings at March 31, 1996. The balance in the liquidation account at December 31, 1997 was approximately $30.8 million. The liquidation account will be maintained for the benefit of eligible account holders who continue to maintain their accounts at the Bank after the conversion. The liquidation account will be reduced annually to the extent that the eligible account holders have reduced their qualifying deposits as of each anniversary date. Subsequent increases will not restore an eligible account holder's interest in the liquidation account. In the event of a complete liquidation, each eligible account holder will be entitled to receive a distribution from the liquidation account in an amount proportionate to the current adjusted qualifying balances for accounts then held.

The Company may not declare or pay cash dividends on or repurchase any of its shares of common stock if the effect thereof would cause stockholders' equity to be reduced below applicable regulatory capital maintenance requirements, the amount required for the liquidation account, or if such declaration and payment would otherwise violate regulatory requirements.

(3) Regulatory Matters

Office of Thrift Supervision (OTS) regulations require savings institutions to maintain minimum levels of regulatory capital. Under the regulations in effect at December 31, 1997, the Bank was required to maintain a minimum ratio of tangible capital to total adjusted assets of 1.5%; a minimum ratio of Tier 1
(core) capital to total adjusted assets of 3.0%; and a minimum ratio of total (core and supplementary) capital to risk-weighted assets of 8.0%.

Under its prompt corrective action regulations, the OTS is required to take certain supervisory actions (and may take additional discretionary actions) with respect to an undercapitalized institution. Such actions could have a direct material effect on the institution's financial statements. The regulations establish a framework for the classification of savings institutions into five categories: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. Generally an institution is considered well-capitalized if it has a Tier 1 ratio of at least 6.0%; and a total risk-based capital ratio of at least 10.0%. At December 31, 1997 and 1996 the Bank was considered well-capitalized.

The following is a summary of the Bank's actual capital amounts and ratios as of December 31, 1997 and 1996, compared to the OTS minimum capital adequacy requirements and the OTS requirements for classification as a well-capitalized institution (in thousands).

| | Actual | | For capital adequacy purposes | | To be well capitalized under prompt corrective action | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| As of December 31, 1997: | | | | | | |
| Tangible capital | $178,592 | 11.9% | $22,491 | 1.5% | $ -- | --% |
| Core capital | 178,592 | 11.9 | 44,982 | 3.0 | 74,969 | 5.0 |
| Tier 1 risk-based capital | 178,592 | 28.8 | 24,763 | 4.0 | 37,144 | 6.0 |
| Risk-based capital | 184,970 | 29.9 | 49,525 | 8.0 | 61,906 | 10.0 |
| As of December 31, 1996: | | | | | | |
| Tangible capital | $165,537 | 12.7% | $19,563 | 1.5 | $ -- | --% |
| Core capital | 165,537 | 12.7 | 39,126 | 3.0 | 65,210 | 5.0 |
| Tier 1 risk-based capital | 165,537 | 31.0 | 21,386 | 4.0 | 32,080 | 6.0 |
| Risk-based capital | 171,199 | 32.0 | 42,773 | 8.0 | 53,466 | 10.0 |

OTS regulations impose limitations upon all capital distributions by savings institutions, like the Bank, such as dividends and payments to repurchase or otherwise acquire shares. Based on these limitations, approximately $91,865,000 of the Bank's retained earnings is unavailable for distribution to the Company.

(4) Investment Securities

The amortized cost and estimated market value of investment securities at December 31, 1997 and December 31, 1996 are as follows (in thousands):

December 31, 1997

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Market Value |
|---|---|---|---|---|

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Market Value |
|---|---|---|---|---|
| Investment Securities Available for Sale: | | | | |
| United States Government and agency obligations | $204,992 | $ 948 | $ (292) | $205,648 |
| State and municipal obligations | 393 | 7 | -- | 400 |
| Equity investments | 1,170 | 139 | -- | 1,309 |
| | $206,555 | $1,094 | $ (292) | $207,357 |

December 31, 1996

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Market Value |
|---|---|---|---|---|
| Investment Securities Available For Sale: | | | | |
| United States Government and agency obligations | $175,003 | $ 172 | $ (1,848) | $ 173,327 |
| State and municipal obligations | 693 | 8 | -- | 701 |
| | $175,696 | $ 180 | $ (1,848) | $ 174,028 |

The amortized cost and estimated market value of investment securities at December 31, 1997 by contractual maturity, are shown below (in thousands). Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

December 31, 1997

| | Amortized Cost | Estimated Market Value |
|---|---|---|
| Investment Securities Available For Sale: | | |
| Due in one year or less | $ 6,230 | $ 6,328 |
| Due after one year through five years | 85,197 | 85,212 |
| Due after five years through ten years | 115,128 | 115,817 |
| Due after 10 years | -- | -- |
| | $206,555 | $207,357 |

Gross losses on the sale of investment securities available for sale of $587,000 were realized in 1995.

(5) Mortgage-Backed Securities

The amortized cost and estimated market value of mortgage-backed securities at December 31, 1997 and December 31, 1996 are as follows (in thousands):

| December 31, 1997 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Market Value |
|---|---|---|---|---|
| Mortgage-Backed Securities Available for Sale: | | | | |
| FHLMC | $ 245,414 | $ 1,549 | $ (1,404) | $ 245,559 |
| FNMA | 109,873 | 719 | (601) | 109,991 |
| GNMA | 97,714 | 465 | (7) | 98,172 |
| Collaterized mortgage obligations | 3,378 | 48 | - | 3,426 |
| | $ 456,379 | $ 2,781 | $ (2,012) | $ 457,148 |

| December 31, 1996 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Market Value |
|---|---|---|---|---|
| Mortgage-Backed Securities Available For Sale: | | | | |
| FHLMC | $ 316,773 | $ 2,084 | $ (1,122) | $ 317,735 |
| FNMA | 69,190 | 480 | (562) | 69,108 |
| GNMA | 2,800 | 131 | - | 2,931 |
| Collaterized mortgage obligations | 5,643 | 126 | (1) | 5,768 |
| | $ 394,406 | $ 2,821 | $ (1,685) | $ 395,542 |

Gross losses on the sale of mortgage-backed securities available for sale of $142,000 were realized in 1997.

Collateralized mortgage obligations issued by FHLMC, FNMA and private interests amounted to $2,274,000, $519,000 and $633,000, respectively at December 31, 1997 and $4,143,000, $697,000 and $928,000, respectively at December 31, 1996.

The contractual maturities of mortgage-backed securities generally exceed 20 years; however, the effective lives are expected to be shorter due to anticipated prepayments.

(6) Loans Receivable, Net

A summary of loans receivable at December 31, 1997 and 1996 follows (in thousands):

| December 31, | 1997 | 1996 |
|---|---|---|
| Real estate mortgage: | | |
| One to four-family | $ 710,880 | $ 626,857 |
| Commercial real estate, multi-family and land | 25,699 | 15,613 |
| FHA insured & VA guaranteed | 668 | 941 |
| | 737,247 | 643,411 |
| Real estate construction | 8,748 | 9,287 |
| Consumer | 45,417 | 36,860 |

| | | |
|---|---|---|
| Commercial | 2,904 | 21 |
| Total loans | 794,316 | 689,579 |
| Loans in process | (2,867) | (3,517) |
| Deferred fees | (1,133) | (1,302) |
| Unearned discount | (9) | (11) |
| Allowance for loan losses | (6,612) | (6,021) |
| | (10,621) | (10,851) |
| | $ 783,695 | $ 678,728 |

At December 31, 1997, 1996 and 1995, loans in the amount of $5,554,000, $7,697,000, and $8,671,000, respectively, were three or more months delinquent or in the process of foreclosure and the Company was not accruing interest income. If these loans had continued to realize interest in accordance with their contractual terms, approximately $278,000, $345,000 and $428,000 of additional interest income would have been recognized for the years ended December 31, 1997, 1996 and 1995, respectively. The Company was not committed to lend additional funds on any nonaccrual loans at December 31, 1997.

An analysis of the allowance for loan losses for the years ended December 31, 1997, 1996 and 1995 is as follows (in thousands):

| Year Ended December 31, | 1997 | 1996 | 1995 |
|---|---|---|---|
| Balance at beginning of year | $ 6,021 | $ 6,001 | $ 5,608 |
| Provision charged to operations | 900 | 700 | 950 |
| Charge-offs | (337) | (692) | (568) |
| Recoveries | 28 | 12 | 11 |
| Balance at end of year | $ 6,612 | $ 6,021 | $ 6,001 |

At December 31, 1997, 1996 and 1995, the Company serviced loans for others in the amount of $144,230,000, $152,717,000 and $143,115,000, respectively.

(7) Interest and Dividends Receivable

A summary of interest and dividends receivable at December 31, 1997 and 1996 follows (in thousands):

| December 31, | 1997 | 1996 |
|---|---|---|
| Loans | $ 4,018 | $ 3,567 |
| Investment securities | 3,190 | 2,811 |
| Mortgage-backed securities | 3,856 | 3,379 |
| | $ 11,064 | $ 9,757 |

(8) Premises and Equipment, Net

Premises and equipment at December 31, 1997 and 1996 are summarized as follows (in thousands):

| December 31, | 1997 | 1996 |
|---|---|---|
| Land | $ 3,195 | $ 3,195 |
| Buildings and improvements | 10,922 | 10,260 |
| Leasehold improvements | 1,322 | 1,101 |
| Furniture and equipment | 5,613 | 4,448 |
| Automobiles | 150 | 130 |
| Construction in progress | 181 | 735 |
| Total | 21,383 | 19,869 |
| Accumulated depreciation and amortization | (7,104) | (5,769) |
| | $ 14,279 | $ 14,100 |

(9) Real Estate Owned, Net

An analysis of the allowance for losses on real estate owned for the years ended December 31, 1997, 1996 and 1995 is as follows (in thousands):

| Year Ended December 31, | 1997 | 1996 | 1995 |
|---|---|---|---|
| Balance at beginning of year | $ 402 | $ 411 | $ 476 |
| Losses charged off | (35) | (9) | (65) |
| Balance at end of year | $ 367 | $ 402 | $ 411 |

(10) Deposits

Deposits, including accrued interest payable of $175,000 and $105,000 at December 31, 1997 and 1996, respectively, are summarized as follows (in thousands):

| December 31, | 1997 | | 1996 | |
|---|---|---|---|---|
| | Amount | Weighted Average Cost | Amount | Weighted Average Cost |
| Non-interest bearing accounts | $ 13,149 | -% | $ 6,354 | -% |
| NOW accounts | 77,994 | 1.84 | 71,168 | 1.84 |
| Money market deposit accounts | 67,979 | 2.90 | 70,021 | 2.90 |

| | | | | |
|---|---|---|---|---|
| Savings accounts | 163,202 | 2.28 | 169,527 | 2.28 |
| Time deposits | 654,440 | 5.69 | 617,660 | 5.55 |
| | $976,764 | 4.52% | $934,730 | 4.44% |

Included in time deposits at December 31, 1997 and 1996, respectively, is $59,504,000 and $43,841,000 in deposits of $100,000 and over.

Time deposits at December 31, 1997 mature as follows (in thousands):

| December 31, | 1997 |
|---|---|
| 1998 | $ 439,777 |
| 1999 | 121,832 |
| 2000 | 26,039 |
| 2001 | 38,614 |
| 2002 | 18,119 |
| Thereafter | 10,059 |
| | $ 654,440 |

Interest expense on deposits for the years ended December 31, 1997, 1996 and 1995 was as follows (in thousands):

| Year ended December 31, | 1997 | 1996 | 1995 |
|---|---|---|---|
| NOW accounts | $ 1,388 | $ 1,371 | $ 1,483 |
| Money market deposit accounts | 2,028 | 1,994 | 2,083 |
| Savings accounts | 3,877 | 4,069 | 4,537 |
| Time deposits | 35,667 | 33,555 | 31,723 |
| | $ 42,960 | $40,989 | $39,826 |

(11) Securities Sold Under Agreements to Repurchase

Securities sold under agreements to repurchase are as follows (in thousands):

| | 1997 | 1996 |
|---|---|---|
| Balance at December 31 | $ 288,200 | $ 99,322 |
| Average Balance | 209,089 | 9,803 |
| Maximum amount outstanding at any month end | 294,826 | 99,322 |
| Average interest rate: During the year | 5.85% | 5.81% |
| At December 31 | 6.01 | 5.69 |

At December 31, 1997, securities sold under agreements to repurchase matured as follows: $198,700,000 in 1998; $24,500,000 in 1999; $30,000,000 in 2002; and $35,000,000 in 2004. Securities sold under agreements to repurchase are collateralized by U.S. Government agency and mortgage-backed securities with an amortized cost and a market value of $301,117,000 and $301,231,000, respectively, at December 31, 1997 and $102,943,000 and $102,974,000, respectively, at December 31, 1996. The securities underlying the agreements are not under the Company's control.

(12) Income Taxes

Under tax law that existed prior to 1996, the Company was generally allowed a special bad debt deduction in determining income for Federal income tax purposes. The deduction was based on either specified experience formulas or a percentage of taxable income before such deduction (previously 8%). For the year ended December 31, 1995, the Company used the percentage of taxable income method. Legislation was enacted in August 1996 which repealed for tax purposes the percentage of taxable income bad debt reserve method. As a result, the Company must instead use the direct charge-off method to compute its bad debt deduction. The legislation also requires the Company to recapture its post-1987 additions to the tax bad debt reserve of $2,333,000. The Company has accrued for this liability in the consolidated financial statements.

Retained earnings at December 31, 1997 includes approximately $10,750,000 for which no provision for income tax has been made. This amount represents an allocation of income to bad debt deductions for tax purposes only. Events that would result in taxation of these reserves include failure to qualify as a bank for tax purposes, distributions in complete or partial liquidation, stock redemptions and excess distributions to shareholders. At December 31, 1997 the Company had an unrecognized deferred tax liability of $3,870,000 with respect to this reserve.

The provision for income taxes for the years ended December 31, 1997, 1996 and 1995 consists of the following (in thousands):

| Year Ended December 31, | 1997 | 1996 | 1995 |
|---|---|---|---|
| Current: | | | |
| Federal | $ 6,648 | $ 4,001 | $ 3,936 |
| State | 221 | 345 | 338 |
| Total Current | 6,869 | 4,346 | 4,274 |
| Deferred: | | | |
| Federal | 857 | (2,992) | 353 |
| State | (39) | (271) | 32 |
| Total Deferred | 818 | (3,263) | 385 |
| | $ 7,687 | $ 1,083 | $ 4,659 |

A reconciliation between the provision for income taxes and the expected amount computed by multiplying income before provision for income taxes times the applicable statutory Federal income tax rate for the years ended December 31, 1997, 1996 and 1995 is as follows (in thousands):

| Year Ended December 31, | 1997 | 1996 | 1995 |
|---|---|---|---|
| Income (loss) before provision for income taxes | $ 21,512 | $ (646) | $ 12,606 |
| Applicable statutory Federal income tax rate | 34.5% | 34.1% | 34.1% |
| Computed "expected" Federal income tax expense (benefit) | $ 7,422 | $ (220) | $ 4,299 |
| Increase (decrease) in Federal income tax expense resulting from: | | | |
| Valuation allowance | - | 1,166 | - |
| ESOP adjustment | 316 | 62 | - |
| State income taxes net of Federal benefit | 119 | 49 | 253 |
| Other items, net | (170) | 26 | 107 |
| | $ 7,687 | $ 1,083 | $ 4,659 |
| Effective tax rate | 35.7% | N/A | 37.0% |

Included in other assets at December 31, 1997 and 1996 is a net deferred tax asset of $3,962,000 and $5,550,000, respectively. In addition, included in other liabilities at December 31, 1997 and 1996 is a current tax payable of $259,000 and $409,000, respectively.

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities at December 31, 1997 and 1996 are presented below (in thousands).

| December 31, | 1997 | 1996 |
|---|---|---|
| Deferred tax assets: | | |
| Allowance for loan and real estate owned losses per books | $ 2,430 | $ 2,319 |
| Reserve for uncollected interest | 113 | 188 |
| Deferred compensation | 297 | 247 |
| Accrued pension expense | 194 | 191 |
| Premises and equipment, differences in depreciation | 286 | 202 |
| Other reserves | 173 | 199 |
| Stock awards | 652 | - |
| Charitable donation | 3,599 | 4,321 |
| Unrealized loss on securities available for sale | - | 192 |
| Total gross deferred tax assets | 7,744 | 7,859 |
| Less valuation allowance | (1,166) | (1,166) |
| Deferred tax assets, net | 6,578 | 6,693 |
| Deferred tax liabilities: | | |
| Allowance for loan and real estate owned losses for tax purposes | (858) | (842) |
| Unrealized gain on securities available for sale | (578) | - |
| Excess servicing on sale of mortgage loans | (94) | (95) |
| Investments, discount accretion | (26) | (24) |
| Deferred loan and commitment fees | (371) | (182) |
| Fair market value adjustment on loans available for sale | (19) | - |
| Undistributed income of real estate investment trust subsidiary | (670) | - |
| Total deferred tax liabilities | (2,616) | (1,143) |
| Net deferred tax assets | $ 3,962 | $ 5,550 |

As disclosed in footnote 2, the Company, as part of the conversion, recorded a charitable donation expense of $13,419,000. Under the Internal Revenue Code, charitable donations are tax deductible subject to a limitation based on 10% of the Company's annual taxable income. The Company, however, is able to carry forward any unused portion of the deduction for five years following the year in which the contribution is made. Based on the Company's estimate of taxable income for 1997 and the succeeding four years, $3,419,000 of the charitable donation expense was considered non tax deductible as it was unlikely that the Company would realize sufficient earnings over the six year period to take the full deduction. As a result, the Company has established a deferred tax valuation allowance of $1,166,000 relating to the nondeductible expense.

The Company has determined that it is not required to establish a valuation reserve for the remaining deferred tax asset account since it is "more likely than not" that the remaining deferred tax assets will be realized through future reversals of existing taxable temporary differences, future taxable income and tax planning strategies. The conclusion that it is "more likely than not" that the remaining deferred tax assets will be realized is based on the history of earnings and the prospects for continued growth. Management will continue to review the tax criteria related to the recognition of deferred tax assets.

(13) Employee Benefit Plans

**Employee Stock Ownership Plan**

As part of the conversion, the Bank established an ESOP to provide retirement benefits for eligible employees. All full-time employees are eligible to participate in the ESOP after they attain age 21 and complete one year of service during which they work at least 1,000 hours. Beginning April 1, 1997, ESOP shares are first allocated to employees who also participate in the Bank's Incentive Savings (401K) Plan in an amount equal to 50% of the first 6% of the employee's contribution. During 1997, 3,345 shares were either released or committed to be released under this formula. The remaining ESOP shares are allocated among participants on the basis of compensation earned during the year. Employees are fully vested in their ESOP account after the completion of five years of credited service or completely if service was terminated due to death, retirement, disability, or change in control of the Company. ESOP participants are entitled to receive distributions from the ESOP account only upon termination of service, which includes retirement and death.

The ESOP borrowed $13,421,000 from the Company to purchase 671,046 shares of common stock issued in the conversion. This loan is to be repaid from discretionary contributions by the Bank to the ESOP trust. The Bank intends to make contributions to the ESOP in amounts at least equal to the principal and interest requirement of the debt, assuming a twelve year term and at a fixed interest rate of 8.25%. The Bank's obligation to make such contributions is reduced to the extent of any dividends paid by the Company on unallocated shares and any investment earnings realized on such dividends. As of December 31, 1997 and 1996, contributions to the ESOP, which were used to fund principal and interest payments on the ESOP debt, totaled $2,133,000 and $1,666,000, respectively. During 1997, $368,000 of dividends paid on unallocated ESOP shares were used for debt service. At December 31, 1997 and 1996, the loan had an outstanding balance of $11,184,000 and $12,302,000, respectively, and the ESOP had unallocated shares of 543,942 and 615,314, respectively. At December 31, 1997 and 1996, the unallocated shares had a fair value of $20,262,000 and $15,691,000, respectively. The unamortized balance of the ESOP is shown as unallocated common stock held by the ESOP and is reflected as a reduction of stockholders' equity.

For the years ended December 31, 1997 and 1996, the Bank recorded compensation expense related to the ESOP of $2,345,000 and $1,272,000, respectively, including $917,000 and $182,000, respectively, representing adjustments to expense to reflect the increase in the average fair value of allocated shares in excess of cost. As of December 31, 1997, 58,029 shares had been allocated to participants and 69,075 shares were committed to be released.

**Pension Plan**

The Bank has a qualified noncontributory defined benefit pension plan (the Plan) covering all eligible employees. Retirement benefits are based upon a formula utilizing years of service and average monthly compensation.

It is the Company's practice to fund the Plan for the maximum amount that can be deducted for Federal income tax purposes subject to the minimum funding requirements of ERISA.

Effective June 7, 1996, the Company froze benefit accruals under the Plan. The Company further expects to terminate the Plan upon receipt of approval by the Internal Revenue Service. As a result of this action, the Company recognized a curtailment gain in 1996 of $24,000.

The following table sets forth the Plan's latest available funded status and amounts recognized at December 31, 1997 and 1996 in the Company's consolidated statements of financial condition (in thousands):

| | 1997 | 1996 |
|---|---|---|
| Actuarial present value of benefit obligations | | |
| - accumulated benefit obligation: | | |
| Vested | $(1,625) | $(1,657) |
| Non-vested | (106) | (114) |
| Projected benefit obligation for service rendered to date | (1,731) | (1,771) |
| Plan assets at fair value, primarily a group annuity contract | 1,456 | 1,476 |
| Plan assets less than projected benefit obligation | (275) | (295) |
| Unrecognized net loss | 120 | 165 |
| Unrecognized net transition asset | (311) | (343) |
| Accrued pension cost (included in other liabilities) | $ (466) | $ (473) |

The components of net pension expense for the years ended December 31, 1997, 1996 and 1995 are as follows (in thousands):

| | 1997 | 1996 | 1995 |
|---|---|---|---|
| Service cost - benefits earned during the year | $ -- | $ 98 | $ 209 |
| Interest cost on projected benefit obligation | 113 | 136 | 137 |
| Actual return on plan assets | (81) | (89) | (79) |
| Net amortization and deferral | (39) | (42) | (40) |
| Net pension (benefit) expense | $ (7) | $ 103 | $ 227 |
| Assumptions used to develop the net periodic pension cost are: | | | |
| Discount rate | 6.51% | 6.51% | 8.00% |
| Expected long-term rate of return on assets | 6.75 | 6.75 | 6.75 |
| Rate of increase in compensation level | N/A | 5.00 | 5.00 |

The Bank also maintains an incentive savings plan for eligible employees. An employee may make contributions to the plan of 1% to 15% of his or her compensation. Prior to July 1, 1996, the Bank contributed 75% of the first 6% of the employee's contribution to the employee's account. From to July 1, 1996 through March 31, 1997, the Bank contributed 50% of the first 6% of the employees contribution to the employee's account. Effective March 31, 1997, the Bank eliminated their matching obligation under this plan. The Bank's contributions under this plan were $53,000, $161,000 and $242,000 for the years ended December 31, 1997, 1996 and 1995, respectively.

**Executive Officer Employment Agreements**

The Company and Bank entered into employment agreements with its President and Chief Executive Officer and Executive Vice President and Chief Financial Officer. The employment agreements generally provide for the continued payment (either lump-sum or periodic) of specified compensation and benefits for three years and provide payments for the remaining term of the agreement after the officers are terminated, unless the termination is for "cause" as defined in the employment agreements. The agreements also provide for payments to the officer upon voluntary or involuntary termination of the officer following a change in control, as defined in the agreements. In addition, the Company and the Bank entered into change in control agreements with three other executives, which provide that in the event of voluntary or involuntary termination following a change in control of the Bank or the Company, the executive would be entitled to receive a severance payment equal to two times the executive's average annual compensation for the five years preceding termination.

**Employee Severance Compensation Plan**

The Company established an Employee Severance Compensation Plan. The Plan will provide eligible employees with severance pay benefits in the event of a change in control of the Bank or Company. Generally, employees are eligible to participate in the Plan unless eligible to receive benefits under the executive officer employment agreements. The Plan would provide for the payment, under certain circumstances, of lump-sum amounts up to 100% of annual compensation upon termination following change of control, as defined in the Plan.

(14)1997 Incentive Plan

On February 4, 1997, a special meeting of the Company's shareholders ratified the Ocean Financial Corp. 1997 Incentive Plan (the "Incentive Plan"). The Incentive Plan authorizes the granting of options to purchase Common Stock, option-related awards and awards of Common Stock. The purpose of the Incentive Plan is to attract and retain qualified personnel in key positions, provide officers, employees and non-employee directors ("Outside Directors") with a proprietary interest in the Company as an incentive to contribute to the success of the Company, promote the attention of management to other stockholder's concerns and reward employees for outstanding performance. All officers, other employees and Outside Directors of the Company and its affiliates are eligible to receive awards under the Incentive Plan.

During 1997, the Company acquired 335,523 shares in the open market at a cost of $10,176,000. At December 31, 1997, 312,676 of these shares have been awarded to officers and directors. Such amounts represent deferred compensation and have been accounted for as a reduction of stockholders' equity. Awards vest at the rate of 20% per year except that the Company has determined that certain awards are also contingent upon attainment of certain performance goals by the Company, which performance goals would be established by a committee of outside directors ("Committee"). The first and second annual installments will vest on the first and second anniversary dates of the date of grant. Vesting of 25% of the third annual installment, and 50% of each of the fourth and fifth annual installments, will be subject to the attainment of performance goals established by the Committee. The performance goals may be set by the Committee on an individual basis, for all stock awards made during a given period of time, or for all stock awards for indefinite periods. No stock award that is subject to a performance goal is to be distributed to an employee until the Committee confirms that the underlying performance goal has been achieved. No stock award that is subject to a performance goal is to be distributed to an Outside Director until an independent third party confirms that the underlying performance goal has been achieved. The Company recorded compensation expense relating to stock awards of $1,773,000 for the year ended December 31, 1997.

Under the 1997 Incentive Plan, the Company is authorized to issue up to 838,807 shares, subject to option. All options expire 10 years from the date of grant and vest at the rate of 20% per year.

The company accounts for stock option awards using the intrinsic value method and has recognized no compensation expense in 1997. SFAS 123 permits the use of the intrinsic value method; however, requires the Company to disclose the pro forma net income and earnings per share as if the stock based compensation had been accounted for using the fair value method. Had the compensation costs for the Company's stock option plan been determined based on the fair value method, the Company's net income and earnings per share would have been reduced to the pro forma amounts indicated below (in thousands except per share data):

| | |
|---|---|
| Net income: | |
| As reported | $ 13,825 |
| Pro forma | 13,000 |
| Basic earnings per share: | |
| As reported | $ 1.80 |
| Pro forma | 1.69 |
| Diluted earnings per share: | |
| As reported | $ 1.77 |
| Pro forma | 1.68 |
| Weighted average fair value of an option share granted during the year | $ 8.16 |

The fair value of stock options granted by the Company was estimated through the use of the Black-Scholes option pricing model applying the following assumptions:

| | |
|---|---|
| Risk-free interest rate | 6.25% |
| Expected option life | 6 years |
| Expected volatility | 25% |
| Expected dividend yield | 2.50% |

A summary of option activity for the year ended December 31, 1997 follows:

| | Number of Shares | Weighted Average Exercise Price |
|---|---|---|
| Outstanding at beginning of year | - | $ - |
| Granted | 810,879 | 28.90 |

| | | |
|---|---|---|
| Exercised | - | - |
| Forfeited | (27,178) | 28.82 |
| Outstanding at end of year | 783,701 | $ 28.91 |
| At December 31, 1997 | | |
| Options exercisible | None | |

Range of exercise prices $28.82 - $37.12 ................................................................................ Weighted average remaining contractual life 9.1 years

(15)Commitments, Contingencies and Concentrations of Credit Risk

The Company, in the normal course of business, is party to financial instruments and commitments which involve, to varying degrees, elements of risk in excess of the amounts recognized in the consolidated financial statements. These financial instruments and commitments include unused consumer lines of credit and commitments to extend credit.

At December 31, 1997, the following commitments and contingent liabilities existed which are not reflected in the accompanying consolidated financial statements (in thousands):

| December 31, | 1997 |
|---|---|
| Unused consumer and construction loan lines of credit (primarily floating-rate) | $20,485 |
| Unused commercial loan lines of credit (primarily floating rate) | 2,682 |
| Other commitments to extend credit: | |
| Fixed Rate | 24,536 |
| Adjustable Rate | 17,371 |
| Floating Rate | 1,007 |

The Company's fixed-rate loan commitments expire within 90 days of issuance and carried interest rates ranging from 6.625% to 7.75% at December 31, 1997.

The Company's maximum exposure to credit losses in the event of nonperformance by the other party to these financial instruments and commitments is represented by the contractual amounts. The Company uses the same credit policies in granting commitments and conditional obligations as it does for financial instruments recorded in the consolidated statements of financial condition.

These commitments and obligations do not necessarily represent future cash flow requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary, is based on management's assessment of risk. The unused consumer and construction loan lines of credit are collateralized by mortgages on real estate.

The Bank has an available overnight line of credit with the Federal Home Loan Bank of New York for $50,000,000 which expires November 25, 1998. When utilized, the line bears a floating interest rate of 1/8% over the current Federal funds rate and is secured by the Bank's mortgage loans, mortgage-backed securities and U.S. Government agency obligations.

At December 31, 1997, the Company is obligated under noncancellable operating leases for premises and equipment. Rental expense under these leases aggregated approximately $515,000, $822,000 and $791,000 for the years ended December 31, 1997, 1996 and 1995, respectively.

The projected minimum rental commitments as of December 31, 1997 are as follows (in thousands):

| December 31 | 1997 |
|---|---|
| 1998 | $ 472 |
| 1999 | 537 |
| 2000 | 403 |
| 2001 | 326 |
| 2002 | 235 |
| Thereafter | 1290 |
| | $3,263 |

The Company grants one to four-family first mortgage real estate loans and multifamily first mortgage real estate loans to borrowers primarily located in Ocean, Middlesex and Monmouth Counties, New Jersey. Its borrowers' abilities to repay their obligations are dependent upon various factors including the borrowers' income and net worth, cash flows generated by the underlying collateral, value of the underlying collateral and priority of the Company's lien on the property. Such factors are dependent upon various economic conditions and individual circumstances beyond the Company's control; the Company is, therefore, subject to risk of loss.

The Company believes its lending policies and procedures adequately minimize the potential exposure to such risks and that adequate provisions for loan losses are provided for all known and inherent risks. Collateral and/or guarantees are required for all loans.

**Contingencies**

The Company is a defendant in certain claims and legal actions arising in the ordinary course of business. Management and its legal counsel are of the opinion that the ultimate disposition of these matters will not have a material adverse effect on the Company's consolidated financial condition, results of operations or liquidity.

(16)Fair Value of Financial Instruments

Statement of Financial Accounting Standards No. 107, "Disclosures about Fair Value of Financial Instruments" (SFAS 107), requires that the Company disclose estimated fair values for its financial instruments. Fair value estimates, methods and assumptions are set forth below for the Company's financial instruments.

Cash and due from banks

For cash and due from banks, the carrying amount approximates fair value.

Investments and Mortgage-backed securities

The fair value of investment and mortgage-backed securities is estimated based on bid quotations received from securities dealers, if available. If a quoted market price was not available, fair value was estimated using quoted market prices of similar instruments, adjusted for differences between the quoted instruments and the instruments being valued.

**Federal Home Loan Bank of New York stock**

The fair value for Federal Home Loan Bank of New York Stock is its carrying value since this is the amount for which it could be redeemed. There is no active market for this stock and the Company is required to maintain a minimum balance based upon the unpaid principal of home mortgage loans and mortgage-backed securities.

**Loans**

Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as residential mortgage, construction, land, consumer and commercial. Each loan category is further segmented into fixed and adjustable rate interest terms and by performing and nonperforming categories.

Fair value of performing loans was estimated using the quoted market prices for securities backed by similar loans, adjusted for differences in loan characteristics, if applicable.

Fair value for significant nonperforming loans is based on recent external appraisals of collateral securing such loans, adjusted for the timing of anticipated cash flows.

**Deposits**

The fair value of deposits with no stated maturity, such as non-interest bearing demand deposits, savings, and NOW and money market accounts, is equal to the amount payable on demand. The fair value of certificates of deposit is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities.

Federal Home Loan Bank borrowings

Federal Home Loan Bank borrowings are short-term in nature and the carrying amount approximates fair value.

Securities sold under agreements to repurchase

Fair value estimates are based on discounting contractual cash flows using rates which approximate the rates offered for borrowings of similar remaining maturities.

Commitments to extend credit, and to purchase or sell securities

The fair value of commitments to extend credit is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates.

The estimated fair values of the Bank's financial instruments as of December 31, 1997 and 1996 are presented in the following tables (in thousands). Since the fair value of off-balance sheet commitments approximate book value, these disclosures are not included.

| December 31, 1997 | Book Value | Fair Value |
|---|---|---|
| Financial Assets: | | |
| Cash and due from banks | $ 2,225 | $ 2,225 |
| Investment securities available for sale | 207,357 | 207,357 |
| Mortgage-backed securities available for sale | 457,148 | 457,148 |
| Federal Home Loan Bank of New York stock | 14,980 | 14,980 |
| Loans receivable and mortgage loans held for sale | 783,695 | 807,651 |
| Financial Liabilities: | | |
| Deposits | 976,764 | 978,631 |
| Federal Home Loan Bank borrowings | 20,400 | 20,400 |
| Securities sold under agreements to repurchase | $288,200 | $288,547 |

| December 31, 1996 | Book Value | Fair Value |
|---|---|---|
| Financial Assets: | | |
| Cash and due from banks | $ 5,372 | $ 5,372 |
| Investment securities available for sale | 174,028 | 174,028 |
| Mortgage-backed securities available for sale | 395,542 | 395,542 |
| Federal Home Loan Bank of New York stock | 8,457 | 8,457 |
| Loans receivable and mortgage loans held for sale | 679,455 | 688,015 |
| Financial Liabilities: | | |
| Deposits | 934,730 | 936,541 |
| Federal Home Loan Bank borrowings | 8,800 | 8,800 |
| Securities sold under agreements to repurchase | $ 99,322 | $ 99,628 |

**Limitations**

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial assets or liabilities include the mortgage banking operation, deferred tax assets, and premises and equipment. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

(17)Parent-Only Financial Information

The following condensed statements of financial condition at December 31, 1997 and 1996 and condensed statements of operations and cash flows for the year ended December 31, 1997 and for the period from July 2, 1996 (date of conversion) to December 31, 1996 for Ocean Financial Corp. (parent company only) reflects the Company's investment in its wholly-owned subsidiary, the Bank, using the equity method of accounting. The Company had no results of operations prior to July 2, 1996.

**CONDENSED STATEMENTS OF FINANCIAL CONDITION**

| December 31, | 1997 | 1996 |
|---|---|---|
| (in thousands) | | |
| ASSETS | | |
| Cash and due from banks | $ 7 | $ 7 |
| Advances to subsidiary Bank | 9,931 | 71,553 |
| Investment securities | 10,780 | - |
| ESOP loan receivable | 11,184 | 12,302 |
| Investment in subsidiary Bank | 181,470 | 166,147 |
| Other assets | 3,320 | 3,470 |
| Total Assets | $ 216,692 | $ 253,479 |
| LIABILITIES AND STOCKHOLDERS' EQUITY | | |
| Taxes payable | $ 1,148 | $ 690 |
| Stockholders' Equity | 215,544 | 252,789 |
| Total Liabilities and Stockholders' Equity | $ 216,692 | $ 253,479 |

**CONDENSED STATEMENTS OF OPERATIONS**

| | Year Ended December 31, 1997 | For the period from July 2, 1996 to December 31, 1996 |
|---|---|---|
| (in thousands) | | |
| Interest income - Investment securities | $ 2,889 | $ - |
| Interest income - Advances to subsidiary Bank | 132 | 1,840 |
| Interest income - ESOP loan receivable | 1,015 | 547 |
| Total interest income | 4,036 | 2,387 |
| Other income | 2 | - |
| Charitable donation | - | 13,419 |
| Other operating expenses | 383 | 152 |
| Income (loss) before income taxes and equity in undistributed earnings of subsidiary Bank | 3,655 | (11,184) |
| Provision (benefit) for income taxes | 1,233 | (2,755) |
| Income (loss) before equity in undistributed earnings of subsidiary Bank | 2,422 | (8,429) |
| Equity in undistributed earnings of subsidiary Bank | 11,403 | 1,817 |

| | | |
|---|---|---|
| Net income (loss) | $ 13,825 | $ (6,612) |

**CONDENSED STATEMENTS OF CASH FLOWS**

| (in thousands) | Year ended December 31, 1997 | For the period from July 2, 1996 to December 31, 1996 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income (loss) | $ 13,825 | $ (6,612) |
| Donation of 671,046 shares of common stock to the Ocean Federal Foundation | - | 13,419 |
| Decrease (increase) in advances to subsidiary Bank | 61,622 | (71,553) |
| Equity in undistributed earnings of subsidiary Bank | (11,403) | (1,817) |
| Decrease (increase) in other assets | 289 | (3,470) |
| Increase in taxes payable | 458 | 690 |
| Reduction in Incentive Awards | 1,773 | - |
| Net cash provided by (used in) operating activities | 66,564 | (69,343) |
| Cash flows from investing activities: | | |
| Purchase of investment securities available for sale | (71,170) | - |
| Sale of investment securities available for sale | 60,000 | - |
| Funding of ESOP loan receivable, net of repayments | 1,118 | (12,302) |
| Payments for investments in subsidiary Bank | - | (81,650) |
| Net cash used in investing activities | (10,052) | (93,952) |
| Cash flows from financing activities: | | |
| Net proceeds of common stock issuance | - | 163,302 |
| Dividends paid | (4,800) | - |
| Purchase of Incentive Award shares | (10,176) | - |
| Purchase of treasury stock | (41,536) | - |
| Net cash (used in) provided by financing activities | (56,512) | 163,302 |
| Net increase in cash and due from banks | - | 7 |
| Cash and due from banks at beginning of period | 7 | - |
| Cash and due from banks at end of period | $ 7 | $ 7 |

(18)Recapitalization of Savings Association Insurance Fund (SAIF)

On September 30, 1996, legislation was enacted which, among other things, imposed a special one-time assessment on Saving Association Insurance Fund (SAIF) member institutions, including the Bank, to recapitalize the SAIF and spread the obligations for payment of Financing Corporation (FICO) bonds across all SAIF and Bank Insurance Fund (BIF) members. The Federal Deposit Insurance Corporation (FDIC) special assessment amounted to 65.7 basis points on SAIF assessable deposits held as of March 31, 1995. The Company incurred a charge of $5,720,000 before taxes as a result of the FDIC special assessment. This legislation eliminated the substantial disparity between the amount that BIF and SAIF member institutions had been paying for deposit insurance premiums.

Effective January 1, 1997, BIF members paid a portion of the FICO payment equal to 1.3 basis points on BIF-insured deposits compared to 6.5 basis points on SAIF-insured deposits, and will pay a pro rata share of the FICO payment on the earlier of January 1, 2000, or the date upon which the last savings association ceases to exist. The legislation also requires BIF and SAIF to be merged by January 1, 1999, provided that subsequent legislation is adopted to eliminate the savings association charter and no savings associations remain as of that time.

Beginning January 1, 1997 SAIF assessment rates ranged from 0 to 27 basis points based upon an institutions risk classification and capital group. Based upon its current classification the rate applicable to the Bank is 0.

**INDEPENDENT AUDITORS' REPORT**

**The Board of Directors and Stockholders**

**Ocean Financial Corp.:**

We have audited the consolidated statements of financial condition of Ocean Financial Corp. and subsidiary as of December 31, 1997 and 1996, and the related consolidated statements of income, changes in stockholders' equity and cash flows for each of the years in the three-year period ended December 31, 1997. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Ocean Financial Corp. and subsidiary as of December 31, 1997 and 1996, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 1997 in conformity with generally accepted accounting principles.

*/s/ KPMG Peat Marwick LLP*

*Short Hills, NJ*
*January 23, 1998*

## SELECTED CONSOLIDATED QUARTERLY FINANCIAL DATA

(Unaudited)

| Quarter ended | Dec. 31 | Sept. 30 | June 30 | March 31 |
|---|---|---|---|---|
| (dollars in thousands, except per share data) | | | | |
| 1997 | | | | |
| Interest income | $ 26,233 | $ 25,568 | $ 24,310 | $ 22,545 |
| Interest expense | 15,407 | 14,658 | 13,510 | 12,033 |
| Net interest income | 10,826 | 10,910 | 10,800 | 10,512 |
| Provision for loan losses | 225 | 225 | 225 | 225 |
| Net interest income after provision for loan losses | 10,601 | 10,685 | 10,575 | 10,287 |
| Other income | 776 | 572 | 575 | 586 |
| Operating expenses | 6,116 | 5,724 | 5,845 | 5,460 |
| Income before provision for income taxes | 5,261 | 5,533 | 5,305 | 5,413 |
| Provision for income taxes | 1,781 | 1,993 | 1,889 | 2,024 |
| Net income | $ 3,480 | $ 3,540 | $ 3,416 | $ 3,389 |
| Basic earnings per share | $ .49 | $ .48 | $ .43 | $ .41 |
| Diluted earnings per share | $ .47 | $ .47 | $ .43 | $ .41 |

| | Dec. 31 | Sept. 30 | June 30 | March 31 |
|---|---|---|---|---|
| 1996 | | | | |
| Interest income | $ 21,136 | $ 20,342 | $ 19,770 | $ 18,988 |
| Interest expense | 10,898 | 10,178 | 11,573 | 11,208 |
| Net interest income | 10,238 | 10,164 | 8,197 | 7,780 |
| Provision for loan losses | 225 | 225 | 125 | 125 |
| Net interest income after provision for loan losses | 10,013 | 9,939 | 8,072 | 7,655 |
| Other income | 887 | 552 | 746 | 696 |
| Operating expenses | 5,715 | 23,999 | 5,032 | 4,460 |
| Income (loss) before provision benefit for income taxes | 5,185 | (13,508) | 3,786 | 3,891 |
| Provision (benefit) for income taxes | 1,980 | (3,690) | 1,313 | 1,480 |
| Net income (loss) | $ 3,205 | $ (9,818) | $ 2,473 | $ 2,411 |
| Basic earnings (loss) per share | $ .38 | $ (1.16) | N/A | N/A |
| Diluted earnings (loss) per share | $ .38 | $ (1.16) | N/A | N/A |

**Exhibit 23**

## INDEPENDENT ACCOUNTANTS' CONSENT

The Board of Directors
Ocean Financial Corp.:

We consent to incorporation by reference in the registration statement (No. 33- 34143) on Form S-8, pertaining to the Ocean Financial Corp. 1997 Incentive Plan, and to the registration statement (No. 33-34145), on Form S-8, pertaining to the Retirement Plan for Ocean Federal Savings Bank, of Ocean Financial Corp., of our report dated January 23, 1998, relating to the consolidated statements of financial condition of Ocean Financial Corp. and subsidiary as of December 31, 1997 and 1996 and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 1997, which report is incorporated by reference in the December 31, 1997 Annual Report on Form 10-K of Ocean Financial Corp.

**KPMG PEAT MARWICK LLP**

Short Hills, New Jersey

March 25, 1998

**ARTICLE 9**

MULTIPLIER: 1,000

| | |
|---|---|
| PERIOD TYPE | YEAR |
| FISCAL YEAR END | DEC 31 1997 |
| PERIOD START | JAN 01 1997 |
| PERIOD END | DEC 31 1997 |
| CASH | 2,225 |
| INT BEARING DEPOSITS | 0 |
| FED FUNDS SOLD | 0 |
| TRADING ASSETS | 0 |
| INVESTMENTS HELD FOR SALE | 664,505 |
| INVESTMENTS CARRYING | 0 |
| INVESTMENTS MARKET | 0 |
| LOANS | 783,695 |
| ALLOWANCE | 6,612 |
| TOTAL ASSETS | 1,510,947 |
| DEPOSITS | 976,764 |
| SHORT TERM | 308,600 |
| LIABILITIES OTHER | 10,039 |
| LONG TERM | 0 |
| PREFERRED MANDATORY | 0 |
| PREFERRED | 0 |
| COMMON | 91 |
| OTHER SE | 215,453 |
| TOTAL LIABILITIES AND EQUITY | 1,510,947 |
| INTEREST LOAN | 57,540 |
| INTEREST INVEST | 41,116 |
| INTEREST OTHER | 0 |
| INTEREST TOTAL | 98,656 |
| INTEREST DEPOSIT | 42,960 |
| INTEREST EXPENSE | 55,608 |
| INTEREST INCOME NET | 43,048 |
| LOAN LOSSES | 900 |
| SECURITIES GAINS | (142) |
| EXPENSE OTHER | 23,145 |
| INCOME PRETAX | 21,512 |
| INCOME PRE EXTRAORDINARY | 21,512 |
| EXTRAORDINARY | 0 |
| CHANGES | 0 |
| NET INCOME | 13,825 |
| EPS PRIMARY | 1.80 |
| EPS DILUTED | 1.77 |
| YIELD ACTUAL | 7.15 |
| LOANS NON | 5,554 |
| LOANS PAST | 0 |
| LOANS TROUBLED | 0 |
| LOANS PROBLEM | 0 |
| ALLOWANCE OPEN | 6,021 |
| CHARGE OFFS | 337 |
| RECOVERIES | 28 |
| ALLOWANCE CLOSE | 6,612 |
| ALLOWANCE DOMESTIC | 3,649 |
| ALLOWANCE FOREIGN | 0 |
| ALLOWANCE UNALLOCATED | 2,963 |

**End of Filing**