FALMOUTH BANCORP INC
Form 10KSB
December 21, 2001

U.S. SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D. C. 20549

FORM 10-KSB

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

For the fiscal year ended September 30, 2001

Commission File No.: 01-13465

FALMOUTH BANCORP, INC.
(Name of small business issuer in its charter)

Delaware	04-3337685
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

20 Davis Straits, Falmouth, Massachusetts 02540
(Address of principal executive offices)
(508) 548-3500
(Issuer's Telephone Number)

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

Title of each class	Name of Each Exchange on Which Registered:
Common Stock, par value $0.01 per share	American Stock Exchange

Check whether the issuer (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act during the past 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

Check if there is no disclosure of delinquent filers in response to Item 405 of Regulation S-B is not contained in this form, and no disclosure will be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-KSB or any amendment to this Form 10-KSB. [X]

The revenues for the issuer's fiscal year ended September 30, 2001 were $10,341,488.

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was sold, as of a specified date within the last 60 days. On December 1, 2001: $24,503,955.

State the number of shares outstanding of each of the issuer's classes of common equity, as of the latest practicable date. The Company had 929,007 shares outstanding as of December 1, 2001.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the definitive proxy statement pursuant to Regulation 14A, which was delivered to the Commission for filing on December 14, 2001, and the 2001 Annual Report to Stockholders for the fiscal year ended September 30, 2001, are incorporated by reference into Part II and III of this report.

Transitional Small Business Disclosure Format (check one):
Yes ___ No X

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PART I

ITEM 1. BUSINESS

General

Falmouth Bancorp, Inc. (the "Company" or "Bancorp"), a Delaware corporation, is the holding company for Falmouth Co-operative Bank (the "Bank"), a Massachusetts-chartered stock co-operative bank. The Bank converted to stock form on March 28, 1996, and issued 1,454,750 shares of common stock at $10.00 per share. On October 14, 1997, the Company acquired all of the capital stock of the Bank and stockholders of the Bank became stockholders of the Company in a share for share exchange pursuant to a plan of reorganization approved by the Bank's stockholders on January 21, 1997 (the "Reorganization") whereby the Bank became the wholly-owned subsidiary of the Company. At September 30, 2001, there were 938,007 shares outstanding. The Company's sole business activity is ownership of the Bank. The Company also makes investments in long and short-term marketable securities and other liquid investments. The Company's common stock trades on the American Stock Exchange under the symbol "FCB." Unless otherwise disclosed, the information presented in this Report on Form 10-KSB represents the activity of the Bank for fiscal 1997 and the period prior to the Reorganization, and the consolidated activity of Falmouth Bancorp, Inc. and subsidiaries thereafter. The Company had total assets of $147.4 million as of September 30, 2001.

The Bank conducts its business through an office located in Falmouth, Massachusetts, where it was originally founded in 1925 as a Massachusetts chartered mutual co-operative Bank, and two branches located in East Falmouth and North Falmouth, Massachusetts. The Bank's deposits are currently insured up to applicable limits by the Bank Insurance Fund of the Federal Deposit Insurance Corporation ("FDIC") and the Share Insurance Fund of the Co-operative Central Bank of Massachusetts. The Bank has one subsidiary, Falmouth Capital Corporation, a real estate investment trust.

The Bank's principal business consists of attracting deposits from the general public and using these funds to originate mortgage loans secured by one- to four-family residences located primarily in Falmouth, Massachusetts and surrounding areas and to invest in United States Government and Agency securities.

Business Strategy

The Bank's business strategy is to operate as a profitable and independent community bank dedicated primarily to financing home ownership and consumer needs in its market area and to provide quality service to its customers. The Bank has implemented this strategy by: (i) closely monitoring the needs of customers and providing quality service; (ii) emphasizing consumer-oriented banking by originating residential mortgage loans and consumer loans, and by offering checking accounts and other financial services and products; (iii) focusing on expanding lending activities to produce moderate increases in loan originations; (iv) maintaining asset quality; (v) maintaining capital in excess of regulatory requirements; and (vi) producing stable earnings.

The Bank serves its primary market area, the Massachusetts communities of Falmouth and Mashpee located in the Cape Cod region of Massachusetts, through its three offices in Falmouth, North Falmouth and East Falmouth, Massachusetts. The Bank continues to offer traditional retail and commercial banking services as well as electronics services such as its toll free Voice Response System "ON CALL," which enables its customers to access current balance information and transfer funds between accounts by telephone, its new Internet Banking and Bill Paying product on its web site at www.falmouthbank.com, and three on-site, as well as three off-site ATMs. The newest ATMs are located at the Woods Hole, Martha's Vineyard and Nantucket Steamship Authority's terminals located at Vineyard Haven on

Martha's Vineyard and Woods Hole. The Bank competes with fifteen branches of financial institutions (including national banks, savings banks, savings and loans and credit unions), which are headquartered outside its market area. The Bank is the only independent financial institution headquartered in Falmouth.

To a lesser extent, the Bank also makes commercial real estate loans, commercial and industrial, and consumer loans, including passbook loans, automobile, home equity and other consumer loans. The Bank originates both fixed-rate and adjustable-rate loans and emphasizes the origination of residential real estate mortgage loans with adjustable interest rates, and makes other investments which allow the Bank to more closely match the interest rate and maturities of its assets and liabilities.

Market Area

The Bank considers its primary market area to be the communities of Falmouth and Mashpee in Barnstable County, which is located in the Cape Cod region of Massachusetts, approximately 72 miles south of Boston. The year-round population of Barnstable County is over 200,000. The majority of the Bank's lending has been in Falmouth and Mashpee. The Cape Cod region is a major recreational resort/retirement community, with seasonal tourism being the most significant economic activity. Falmouth's year-round population of 29,585 (1996 census) increases to a summer population of approximately 70,000. Falmouth is the second most populous and second largest town on the Cape. Visitors find accommodations in the many motels, hotels and inns in the area. Falmouth has approximately 44 miles of ocean and lake shoreline. There are nine harbors and inlets, some with docking and most with mooring facilities. Two major harbors offer access, via ferry, to the island of Martha's Vineyard with service to the island of Nantucket during the summer months from Woods Hole. In addition to swimming, boating, fishing and other forms of water recreation, Falmouth also has four public and two private golf courses.

The major employers in the Falmouth area are the Woods Hole Oceanographic Institute, with approximately 800 employees, Falmouth Hospital, with 750 employees and Woods Hole, Martha's Vineyard and Nantucket Steamship Authority, with 500 employees. Other major employers include Marine Biological Laboratories.

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Employees

At September 30, 2001, the Bank employed 31 full-time and 5 part-time employees. The Bank's employees are not represented by a collective bargaining agreement, and the Bank considers its relationship with its employees to be good.

Lending Activities

General. The principal lending activity of the Bank is the origination of conventional mortgage loans for the purpose of purchasing or refinancing owner-occupied, one- to four-family residential properties in its designated community reinvestment area of the Massachusetts towns of Falmouth and Mashpee. To a lesser extent, the Bank also originates consumer loans including home equity and passbook loans and commercial loans. The Bank also originates and retains in its loan portfolio adjustable-rate loans and fixed-rate loans with maturities of up to 30 years. Traditionally, fixed-rate loans with terms in excess of 30 years are originated and sold in the secondary market. Loan originations for the year ended September 30, 2001, achieved the level of $54.7 million and were primarily single-family residential loans. During this period, the Bank was ranked by Banker and Tradesman as one of the largest producers of residential mortgage loans in the Falmouth market. The mortgage market in the Falmouth area was vigorous in both the purchase money and refinance categories during fiscal 2001. The Bank is a qualified seller/servicer for Federal National Mortgage Corporation ("FNMA") and was servicing $10.8 million in loans for FNMA and $2.2 million for other investors at September 30, 2001.

Loan Portfolio. The following table presents selected data relating to the composition of the Bank's loan portfolio by type of loan on the dates indicated.

	At September 30,						
	2001		2000		1999		
	Amount	Percent	Amount	Percent	Amount	Percent	Amou
	(Dollars in thousands)						
Residential mortgage loans...	$ 94,084	79.63%	$ 88,647	79.50%	$ 67,709	81.02%	$ 69,
Commercial real estate loans.	10,406	8.81	11,865	10.64	8,488	10.16	4,
Consumer loans...............	546	.46	527	.47	577	.69	
Home equity loans............	8,486	7.18	7,143	6.41	4,621	5.53	3,
Commercial loans.............	4,634	3.92	3,331	2.98	2,175	2.60	1,
Gross loans..................	118,156	100.00%	111,513	100.00%	83,570	100.00%	79,
Less:							
Unearned income (cost), net..	(362)		(190)		(19)		
Unadvanced principal........	5,019		5,216		2,533		1,
Allowance for loan losses...	945		755		569		
Loans, net..................	$112,554		$105,732		$ 80,487		$ 77,

One- to Four-Family Residential Real Estate Lending. The primary emphasis of the Bank's lending activity is the origination of conventional mortgage loans secured by one- to four-family residential dwellings located in the Bank's primary market area. As of September 30, 2001, loans on one- to four-family residential properties accounted for 79.6% of the Bank's loan portfolio.

The Bank's mortgage loan originations are for terms of up to 30 years, amortized on a monthly basis with interest and principal due each month. Residential real estate loans often remain outstanding for significantly shorter periods than their contractual terms as borrowers may refinance or prepay loans at their option, without penalty. Conventional residential mortgage loans granted by the Bank customarily contain "due-on-sale" clauses that permit the Bank to accelerate the indebtedness of the loan upon transfer of ownership of the mortgaged property.

The Bank makes conventional mortgage loans and it uses standard FNMA documents to allow for the sale of loans in the secondary mortgage market. The Bank's lending policies generally limit the maximum loan-to-value ratio on mortgage loans secured by owner-occupied properties to 95% of the lesser of the appraised value or purchase price of the property, with the condition that private mortgage insurance is required on loans with a loan-to-value ratio in excess of 80%.

The Bank, since the early 1980s, has offered adjustable-rate mortgage loans with terms of up to 30 years. Adjustable-rate loans offered by the Bank include loans which reprice every one, three, five and seven years and provide for an interest rate which is based on the interest rate paid on United States Treasury securities of a corresponding term, plus a margin of 2.75%. The Bank currently offers adjustable-rate loans with initial rates below those that would prevail under the foregoing computations, based upon the Bank's determination of market factors and competitive rates for adjustable-rate loans in its market area. For adjustable-rate loans, borrowers are qualified at the initial rate plus an anticipated upward adjustment of 200 basis points.

The Bank retains all adjustable-rate mortgages it originates. The Bank's adjustable-rate mortgages include caps on increases or decreases of 2% per year, and 6% over the life of the loan (2% per adjustment, and 5% over the life of the loan for five-year adjustable-rate loans). The retention of adjustable-rate mortgage loans in the Bank's loan portfolio helps reduce the Bank's exposure to increases in interest rates. However, there are unquantifiable credit risks resulting from potential increased costs to the borrower as a result of repricing of adjustable-rate mortgage loans. It is possible that during periods of rising interest rates, the risk of default on adjustable-rate mortgage loans may increase due to the upward adjustment of interest cost to the borrower.

During the year ended September 30, 2001, the Bank originated $6.4 million in adjustable-rate mortgage loans and $27.6 million in fixed-rate mortgage loans for portfolio. Approximately 20.9% of all loan originations during fiscal 2001 were the refinancing of loans already in the Bank's loan portfolio. At September 30, 2001, the Bank's loan portfolio included $27.9 million in adjustable-rate one- to four-family residential mortgage loans, or 23.6% of the Bank's total loan portfolio, and $61.5 million in fixed-rate one- to four-family residential mortgage loans, or 52.0% of the Bank's total loan portfolio.

The Bank engages in a limited amount of construction lending generally for the construction of single-family residences. Most are construction/permanent loans structured to

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become permanent loans upon the completion of construction. All construction loans are secured by first liens on the property. Loan proceeds are disbursed as construction progresses and inspections warrant. Loans involving construction financing present a greater risk than loans for the purchase of existing homes, since collateral values and construction costs can only be estimated at the time the loan is approved. Due to the small amount of construction loans in the Bank's portfolio, the risk in this area is limited.

Commercial Real Estate Loans. At September 30, 2001, the Bank's commercial real estate loan portfolio totaled $10.4 million, or 8.8% of total loans. The Bank's largest loan is a commercial loan with an outstanding balance of $1.4 million at September 30, 2001 secured by a golf course located in Falmouth, Massachusetts.

Commercial real estate lending entails additional risks compared with one- to four-family residential lending. For example, commercial real estate loans typically involve large loan balances to single borrowers or groups of related borrowers and the payment experience on such loans is typically dependent on the successful operation of a real estate project and/or the collateral value of the commercial real estate securing the loan. At September 30, 2001, all of the Bank's commercial real estate loans were performing.

Home Equity Loans. The Bank also originates home equity loans, which are loans, secured by available equity based on the appraised value of one- to four-family residential property. Home equity loans will be made for up to 80% of the tax assessed or appraised value of the property (less the amount of the first mortgage). Home equity loans have an adjustable interest rate which ranges from 0% to 1% above the prime rate as reported in The Wall Street Journal and have terms of twenty years or less. At September 30, 2001, the Bank had $18.7 million in home equity loans with unused credit available to existing borrowers of $10.2 million.

Consumer Loans. The Bank's consumer loans consist of passbook loans, and other consumer loans, including automobile loans. At September 30, 2001, the consumer loan portfolio totaled $546,000 or .46% of total loans. Consumer loans generally are offered for terms of up to five years at fixed interest rates. Consumer loans do not exceed $15,000 individually. Management expects to continue to promote consumer loans as part of its strategy to provide a wide range of personal financial services to its customers and as a means to increase the yield on the Bank's diversified loan portfolio.

The Bank makes loans up to 90% of the amount of the depositor's savings account balance. The interest rate on the loan is 4.0% higher than the rate being paid on regular savings accounts and 3% higher than the rate being paid on certificates of deposit. The Bank also makes other consumer loans, which may or may not be secured. The terms of such loans usually depend on the collateral. At September 30, 2001, the total amount of passbook and other consumer loans, including overdraft lines of credit, was $337,000.

The Bank makes loans for automobiles, both new and used, directly to the borrowers. The loans are generally limited to 80% of the purchase price or the retail value listed by the National Automobile Dealers Book. The terms of the loans are determined by the age and condition of the collateral. Collision insurance policies are required on all these loans. At September 30, 2001, the total amount of automobile loans was $209,000.

Consumer loans generally are originated at higher interest rates than residential mortgage loans but also tend to have a higher credit risk than residential loans due to the loan being unsecured or secured by rapidly depreciable assets. Despite this risk, the Bank's level of consumer loan delinquencies generally has been low. No assurance can be given, however, that the Bank's delinquency rate on consumer loans will continue to remain low in the future, or that the Bank will not incur future losses on these activities.

Commercial Loans. The Bank employs a commercial loan officer with over 20 years of experience in commercial lending in the Falmouth market. The Bank is pursuing on a selective basis the origination of commercial loans to meet the working capital and short-term financing needs of established local businesses. Unless otherwise structured as a mortgage on commercial real estate, such loans are generally being limited to terms of five years or less. Substantially all such commercial loans have variable interest rates tied to the prime rate as reported in The Wall Street Journal. Whenever possible, the Bank collateralizes these loans with a lien on commercial real estate, or alternatively, with a lien on business assets and equipment and the personal guarantees from principals of the borrower. Commercial loans do not presently comprise a significant portion of the Bank's loan portfolio. At September 30, 2001 the Bank's non-real estate commercial loan portfolio totaled $4.6 million.

Commercial business loans generally are considered to involve a higher degree of risk than residential mortgage loans because the collateral may be in the form of intangible assets and/or inventory subject to market obsolescence. Commercial loans also may involve relatively large loan balances to single borrowers or groups of related borrowers, with the repayment of such loans typically dependent on the successful operation and income stream of the borrower. Such risks can be affected significantly by economic conditions. In addition, commercial business lending generally requires substantially greater oversight efforts compared to residential real estate lending.

Loan Commitments. The Bank makes a 60-day loan commitment to borrowers. At September 30, 2001, the Bank had $2.1 million in loan commitments outstanding for the origination of one- to four-family residential real estate loans.

Loan Solicitation Origination and Loan Fees. The Bank originates loans through its main office located in Falmouth, Massachusetts and two branch offices located in East and North Falmouth. Loan originations are derived from a number of sources, including the Bank's existing customers, referrals, realtors, advertising and "walk-in" customers at the Bank's offices.

The Bank has one full-time residential loan originator who is compensated by salary and commission. The originator meets with applicants at their convenience and location and is in regular contact with real estate brokers, attorneys, accountants, building contractors, developers and others in the Bank's local market area. The Bank increased its advertising in locally distributed newspapers and has utilized local radio advertising to increase market share of residential loan originations.

Upon receipt of a loan application from a prospective borrower, a credit report and verifications are ordered to verify specific information relating to the loan applicant's employment, income and credit standing. For all mortgage loans, an appraisal of real estate intended to secure the proposed loan is obtained from an independent fee appraiser who has been

approved by the Bank's Board of Directors. Fire, casualty and sometimes flood insurance are required on all loans secured by improved real estate.

Insurance on other collateral is required unless waived by the loan committee. The Board of Directors of the Bank has the responsibility and authority for the general supervision over the loan policies of the Bank. The Board has established written lending policies for the Bank. All applications for residential and commercial real estate mortgages and commercial business loans must be ratified by the Bank's Board of Directors. In addition, certain designated officers of the Bank have limited authority to approve consumer loans.

Interest rates charged by the Bank on all loans are primarily determined by competitive loan rates offered in its market area and the Bank generally charges an origination fee on new mortgage loans. The origination fees, net of direct origination costs, are deferred and amortized into income over the life of the loan.

Loan Maturities. The following table sets forth certain information at September 30, 2001 regarding the dollar amount of loans maturing in the Bank's portfolio based on their contractual terms to maturity, including scheduled repayments of principal. Demand loans, loans having no stated schedule of repayments and no stated maturity, and overdrafts are reported as due in one year or less.

	At September 30, 2001(1)		
	Real Estate	Consumer and Other	Total Loans
		(In thousands)	
Total loans scheduled to mature:			
In one year or less......................	$ 8,450	$ 1,070	$ 9,520
After one year through five years........	7,509	3,088	10,597
Beyond five years........................	92,342	1,040	93,382
Total................................	$108,301	$ 5,198	$113,499
Loan balance by type scheduled to mature after one year:			
Fixed....................................	$ 62,629	$ 2,623	$ 65,252
Adjustable...............................	$ 37,222	$ 1,505	$ 38,727