

A Proud History of Personal Service



A MOST DISTINGUISHED CUSTOMER

Daniel Webster was a former United States Senator from Massachusetts and Secretary of State in the Cabinet of President John Tyler, when, in May of 1844, he entered the Hingham Institution for Savings to apply for a loan.

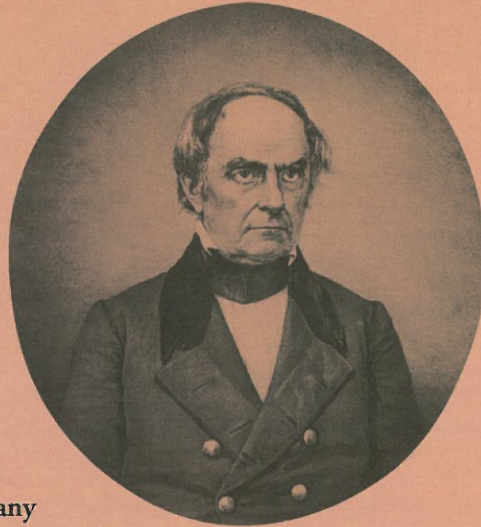
As his piercing dark eyes gazed around him, it is unlikely that he was impressed by our premises, for the bank was little more than a modest office on the second floor of the Isaac Little Hose Company building. However, Mr. Webster, attired in blue tail coat with brass buttons and spit-shined black shoes, knew that he had come to the right place. In our short time in business we already had garnered a reputation for being a fair and professional community bank.

In addition to being a respected statesman, Webster was also a famous lawyer, considered by many to be the greatest orator of his day. He had argued successfully on several occasions before the Supreme Court. This leads us to conclude that his was probably the most eloquent request for a loan ever received by this bank, and of course, as the promissory note will attest, it was granted. The \$1,500 he obtained was to make improvements to his home and farm in Marshfield.

In 1845, a famous guest noted how the funds were put to good use. The great rambling house had been enlarged and beautified, at Webster's direction. The library, "in a splendid new wing," was apparently as impressive as one would expect. At Marshfield, he enjoyed hunting, fishing, and being the perfect summer host.

The courtesy and friendly, prompt service that Daniel Webster was accorded so many years ago, remains prevalent at Hingham Institution for Savings.

We are proud to have helped the great man fulfill his dreams in Marshfield, just as we are proud to serve every customer, large or small, who banks with us today.



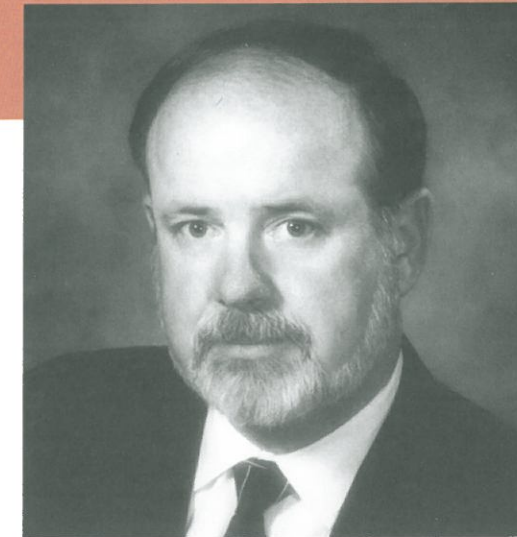
Cover photograph shows the secretary desk of Daniel Webster, on which is a likeness of the Daniel Webster Note. Dated May 17, 1844, by the famed orator and statesman, it is written to the Hingham Institution for Savings, promising to repay with interest a loan for \$1,500. The photograph was taken at The Old Ordinary, in Hingham.

Dear Stockholder:

Nineteen ninety-six was a year of continued consolidation in our industry. Many larger banks were focused on mergers and consolidation. We took advantage of this opportunity to reach out to new customers searching for the strength, stability, and personal service that we offer in banking relationships. The growth achieved through these efforts has placed us well along on the path to becoming the preeminent community bank in our area.

Customer response to our efforts produced significant growth in all major components of our balance sheet. Assets increased by 15% from \$175,409,000 to \$201,586,000. Deposits increased by 13% from \$133,042,000 to \$150,015,000, and total loans increased by 27% from \$119,472,000 to \$151,166,000. During the year, we originated over \$60,000,000 in new loans as compared to \$38,200,000 in 1995. We remain keenly aware of the need to closely monitor asset quality while implementing our aggressive growth strategy. Our lending strategy continues to emphasize a balance of multi-family and commercial real estate loans as well as one to four-family residential mortgages and home equity lines.

This growth produced corresponding increases in core earnings. Net income for the year ended December 31, 1996 was \$2,044,000 or \$1.57 per share as compared to \$1,906,000 or \$1.47 in 1995. This increase was realized notwithstanding the fact that 1995 earnings were positively impacted by tax benefits. Indeed, pretax earnings increased by 17%



over those of 1995.

This strong financial performance enabled us to increase the dividends declared to stockholders from \$0.35 per share in 1995 to \$0.45 per share in 1996. Stockholders' equity increased from \$17.8 million to \$19.2 million

during the year. Our capital ratio of 9.53% at year end exceeded all regulatory requirements and provides us with the financial strength necessary to continue our planned expansion. We have planned major enhancements in our technology for 1997. These improvements will allow us to remain current in an ever-changing technological environment.

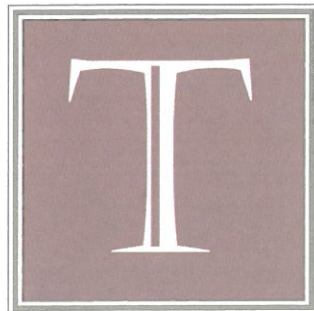
On a more personal note, the Bank suffered the loss of one of its most dedicated and productive Directors with the recent death of our friend and colleague, Thomas H. Youngworth. Tom's unwavering support of the Bank during turbulent times played a major role in its emergence as a source of financial strength and stability in our community. We will honor his memory by renewing our commitment to developing a company that will provide for the needs of our stockholders, employees, and community well into a third century of its operation.

Thanking you for your continued support, I am

Very truly yours,

Robert H. Gaughen, Jr.
President and C.E.O.

TRULY A BANK FOR THE COMMUNITY



The Hingham Institution for Savings has played a vital role in the growth and prosperity of this area since 1834. From our modest beginnings – the bank's deposits were \$30,713 at the end of the first year – we have grown significantly. Along the way we have never wavered from our commitment to winning and holding the confidence of our customers, large and small. As the South Shore's hometown bank, we consider ourselves neighbors to all who bank here, and we act accordingly.

Daniel Webster may well have been the most famous Hingham Institution customer, but in fact he received no more preferential treatment than any other local resident.

We are a community bank. Over the years, we have taken pride in service that includes a wave of the hand, a smile, and acknowledgment by name, from tellers and bank officers alike. We also return phone calls.

Unfortunately, in these days of mergers and big-bank takeovers, our approach is on the wane. All too often it seems, size is more significant than service, and good community relationships are being replaced by faceless technology.

Efficiency and speed are necessary in banking, but to us, a one-on-one rapport with our

customers is a priority.

Therefore, we would rather treat each loan application on its merits, and work creatively to help make you a satisfied customer. With our knowledge of the area, and of the people who work and raise their families here, we understand changing market conditions and can make adjustments quickly and knowledgeably. Just as we knew the appropriateness of Daniel Webster's needs so many years ago, we know how to take care of your needs today.

What's more, as a customer of Hingham Institution for Savings, there's a sense of security in knowing that we won't sell the servicing of your mortgage to a company out of town or out of state. We keep it in Hingham, so that if you ever have any questions, we're right here to answer them.

In short, to be community oriented is to be community spirited, and that is the philosophy we live by.

Over the past few years, we have improved our product lines, strengthened the bank's management group, and reached out to Cohasset and Scituate, so that we are truly a significant bank for the South Shore. Our expanded community presence has also been reflected in substantial appreciation in stock value.

On a daily basis, we continue to reaffirm our total commitment to both customers and stockholders, so that we remain a solid, vibrant, independent community bank.

A HEALTHY APPROACH TO BANKING.

Mignosa Family The Fruit Center

Bank Services:
*Commercial Real Estate
Loan, Deposit Accounts.*

Photo: Julie Foley, Mark Mignosa, Rita Mignosa, Don Mignosa, Steve DiGiusto, Freddy Zagrodny and Robert H. Gaughen Jr., President and C.E.O. of Hingham Institution for Savings



Owned and operated by the Mignosa family for over 20 years, the Fruit Center is a landmark at the Hingham Rotary and favorite of locals for fresh produce.

Hingham Institution for Savings provides depository services and daily operating cash requirements of the Center.

Like many other small businesses, the Mignosas appreciate the personal attention and good service they get from a local community bank.

That's why they knew that when they came to us for financing of the Fruit Centers in Hingham and Milton, our response would be understanding and helpful.

Today, we handle the personal banking needs of the owners as well as many of their employees.

The Fruit Center and Hingham Institution for Savings. It's a relationship that's good for all concerned.

THE AMERICAN DREAM
IS ALIVE IN HINGHAM.

James and Theresa Gordon
Hingham

Bank Services:
Residential Construction Loan.

Photo: Sally A. Paulson, Assistant Vice President, Hingham Institution for Savings, Theresa Gordon, James Gordon, and their children, Jack and James

Owning your own home is the realization of the American dream. For Jim and Theresa Gordon, it was even more so, because their dream home is in Hingham, their hometown.

It all began when they purchased a house lot shortly after they were married. Then, like most of us, they sacrificed and saved. As their family came along, the Gordons realized it was time to apply for a loan at Hingham Institution for Savings. Perhaps they were unaware of our long history of helping young families with their first mortgage, but they were very pleasantly surprised at how painless we made the process.

With guidance and financing from this



community bank, the house on Pioneer Road has become a reality.

As Jim and Theresa will tell you, with perseverance and hard work, your dream can come true. Having an understanding and helpful bank is important as well.

FOR THIS APARTMENT BUILDING
WE WERE VERY ACCOMMODATING.

Edward and Shirley Tatalias
Hingham

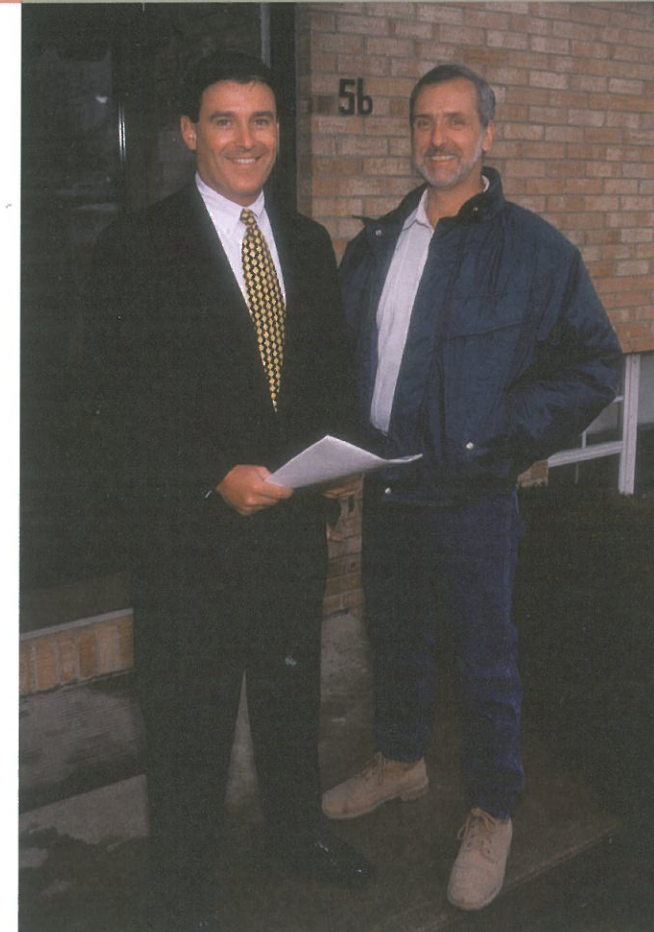
Bank Services:
Commercial Real Estate Loan.

Photo: Shawn T. Sullivan, Assistant Vice President, Hingham Institution for Savings and Edward A. Tatalias

had a personal account, and was a stockholder, Hingham Institution for Savings.

We have a great deal of experience with commercial real estate in our community. We thoroughly understood the market and all the ramifications of the deal and so were able to respond very quickly and complete the loan on time.

The result is, we have strengthened a long-term banking relationship with Edward and Shirley Tatalias and continue to be the source of advice for future financing needs. Which only goes to prove that if you want to open more doors in this market area, speaking first to Hingham Institution for Savings, is the key.



Investing in a twelve-unit apartment building could be nerve-racking for anyone, but for Edward Tatalias it was especially tense. This was his first such venture, and the time frame on completing the deal was very tight.

Fortunately, he came to the bank where he

FRIENDS HELPING FRIENDS.



Thayer House at the
New England Friends
Home
Hingham

Bank Services:
*Proposed Financing of
Building Expansion.*

*Photo: Peter R. Smollett,
Vice President, Hingham
Institution for Savings and
Gretchen Condon, Execu-
tive Director, Thayer House*

Over the years, Hingham Institution for Savings has played a significant role in the financing of not-for-profit enterprises within our community. Examples include the Hingham Visiting Nurses Association, Glastonbury Abbey, Temple Sha'Aray Shalom, Habitat for Humanity, and the Montessori School.

Thayer House, an assisted-living residence, is operated by the Society of Friends. Approximately fifteen residents and six staff live together as a supportive family. It is not a nursing home.

Presently, the Society of Friends is planning an addition, adding beds and renovating the existing property.

Hingham Institution for Savings has assisted in developing a sound financial plan and reviewing the feasibility study for them.

Thayer House is discovering, as many have before, that when we say we work for the community, we mean all of the community, neighbors and friends alike.

SEE JESSICA SAVE. SEE JANET SAVE.



Jessica and Janet Keefe
Hingham

Bank Services:
Deposit Accounts, Long-Term Savings Plans.

Photo: Janet Keefe, Jessica Keefe and Helen Fuda, Customer Service Representative, Hingham Institution for Savings

Being the grandnieces of Marion Fahey, a Director of Hingham Institution for Savings, should certainly have instilled sound saving habits into Jessica and Janet Keefe.

These six-year-old twins could go a long way on good looks alone, but they do have a lot to save for.

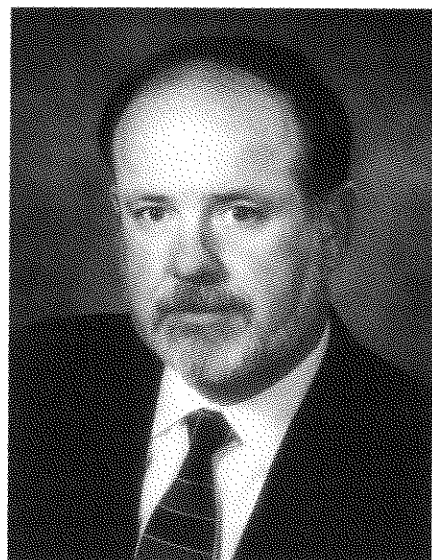
We could begin with Christmas gifts, and the fact that they have no excuse for forgetting each other's birthday, plus special family events like vacations. Then there's the more mundane, such as college tuition.

Hingham Institution for Savings encourages every youngster to open his or her own savings

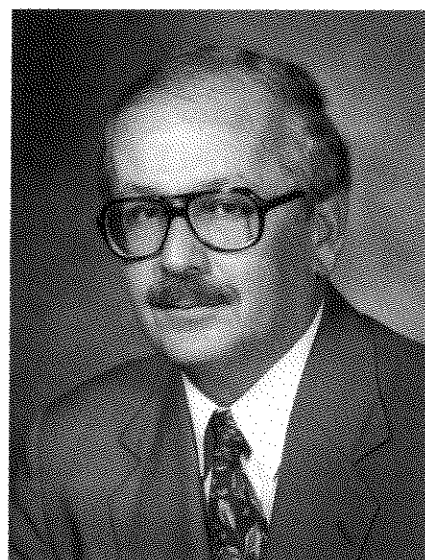
account. With our "Savings Makes Cents" program, we send bank staff out to two area elementary schools to talk to children in their classrooms about banking and why it's meaningful. We even open accounts and take deposits right in the schools. We try to make banking fun for our youngsters so that they'll save regularly.

After all, the most rewarding part of investing in our community is to invest in the community's future. With young ladies like Jessica and Janet, we're doubly blessed.

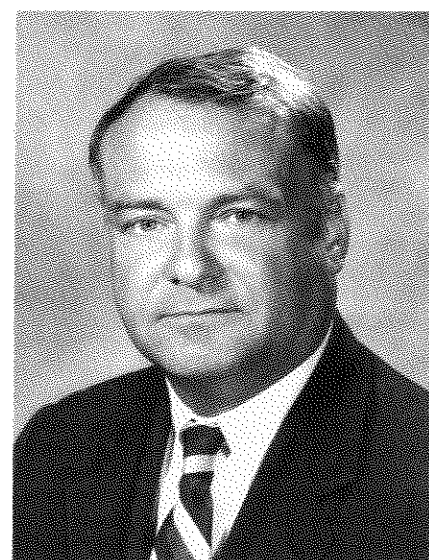
SENIOR OFFICERS



Robert H. Gaughen, Jr.
President and C.E.O.



William M. Donovan, Jr.
Vice President-Administration



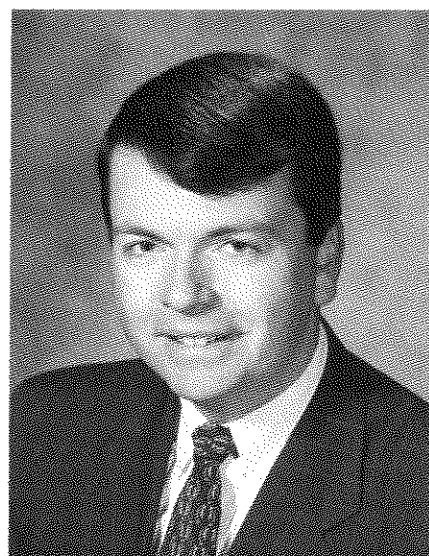
Peter R. Smollett
Vice President-Lending



Edward P. Zec
Vice President-Branch Operations

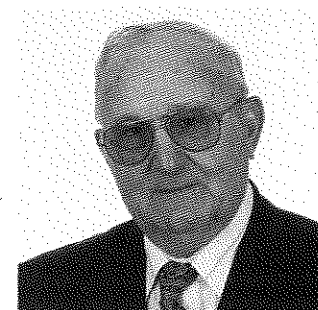


Deborah J. Jackson
Vice President and Treasurer



Michael J. Sinclair
Retail Lending Officer

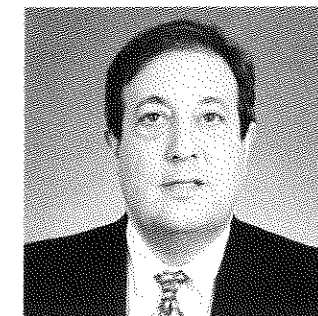
DIRECTORS



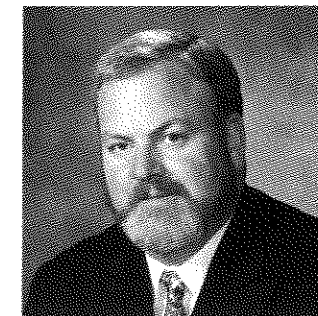
James V. Consentino



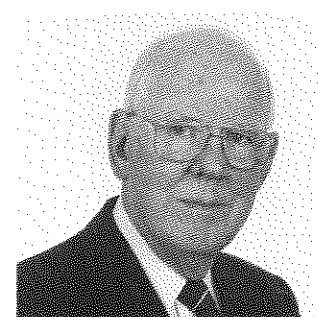
Marion J. Fahey



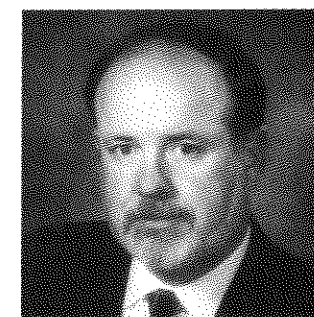
Ronald D. Falcione



Kevin W. Gaughen, Esq.



Robert H. Gaughen, Esq.



Robert H. Gaughen, Jr., Esq.



Julio R. Hernando, Esq.



Robert A. Lane, Esq.



Warren B. Noble



Stacy M. Page



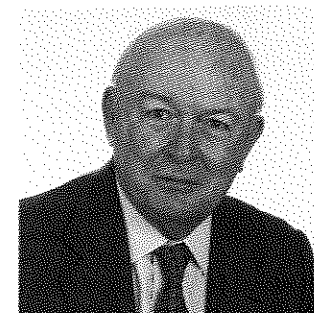
Edward L. Sparda



Donald E. Staszko



Donald M. Tardiff, M.D.



James R. White



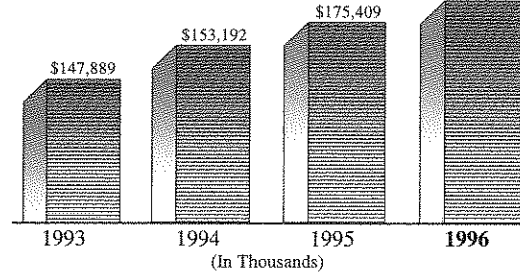
Geoffrey C. Wilkinson, Sr.



Jacqueline M. Youngworth

FINANCIAL HIGHLIGHTS

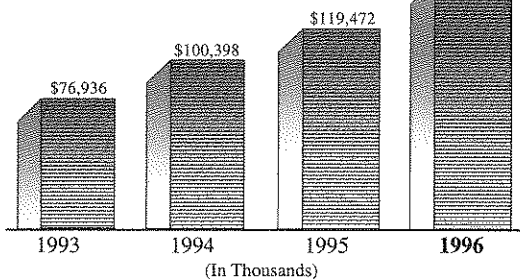
Assets



Assets have increased more than 36% since the end of 1993. The Bank is poised for continued controlled growth with a strong capital to asset ratio of 9.53%.

For the second consecutive year, the Bank had deposit growth in excess of 12%. Our new branch offices in Scituate and Cohasset have contributed to the deposit growth.

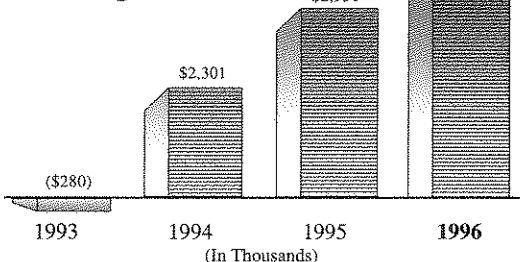
Loans



The loan portfolio has grown dramatically over the past four years. Management has made a concerted effort to attract quality loans while decreasing reliance on its investment portfolio.

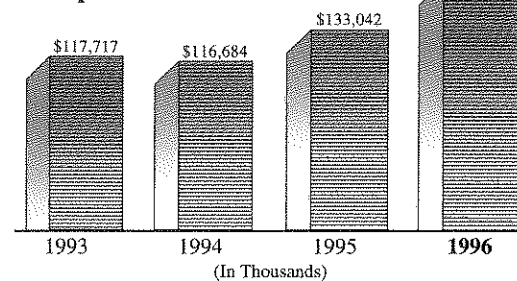
Quarterly dividends have shown steady improvement since 1993, culminating in a \$0.09 per share dividend declared in the fourth quarter of 1996. Included in the chart are special dividends of \$0.08 and \$0.10 per share which were declared in 1995 and 1996, respectively.

Pre-Tax Earnings

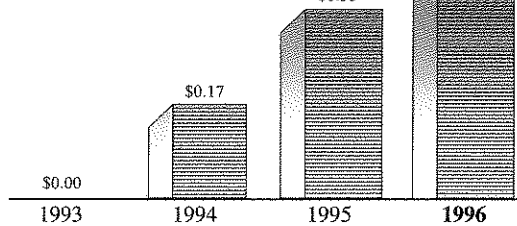


Pre-tax earnings grew nearly \$500,000, or 17% in 1996 over 1995. The results for 1996 represent the third consecutive year of double-digit increases in pre-tax earnings.

Deposits



Dividends Declared Per Share



SELECTED CONSOLIDATED FINANCIAL DATA

The following information does not purport to be complete and is qualified in its entirety by the more detailed information contained elsewhere herein.

	At December 31,				
	1996	1995	1994	1993	1992
	(In Thousands)				
Balance Sheet Data:					
Total assets.....	\$201,586	\$175,409	\$153,192	\$147,889	\$149,460
Investment securities	32,321	39,152	42,930	58,904	66,183
Loans:					
Residential Mortgage	79,418	69,872	61,607	54,222	47,963
Commercial Mortgage	65,839	43,734	33,763	20,004	16,867
Construction, net	5,421	5,437	4,649	1,951	3,122
Other	2,107	1,999	2,004	2,121	3,145
Allowance for loan losses	1,393	1,277	1,338	1,191	1,501
Foreclosed real estate, net	—	34	439	2,384	2,938
Deposits	150,015	133,042	116,684	117,717	119,885
Federal Home Loan Bank advances	29,754	22,000	19,000	15,000	15,000
Other borrowed funds	188	—	—	—	—
Stockholders' equity	19,212	17,819	15,981	14,074	13,712

	Years Ended December 31,				
	1996	1995	1994	1993	1992
	(In Thousands, Except Per Share Amounts)				
Income Statement Data:					
Total interest and dividend income	\$ 13,962	\$ 12,074	\$ 9,963	\$ 9,232	\$ 11,374
Total interest expense	6,956	5,871	4,324	4,593	6,451
Net interest income	7,006	6,203	5,639	4,639	4,923
Provision for loan losses	107	120	120	63	390
Other income	614	509	642	1,484	1,624
Operating expenses	4,066	3,641	3,860	6,340	4,999
Income (loss) before income taxes	3,447	2,951	2,301	(280)	1,158
Income tax provision (benefit)	1,403	1,045	(255)	(469)	(398)
Net income	<u>\$ 2,044</u>	<u>\$ 1,906</u>	<u>\$ 2,556</u>	<u>\$ 189</u>	<u>\$ 1,556</u>
Net income per share	<u>\$ 1.57</u>	<u>\$ 1.47</u>	<u>\$ 1.99</u>	<u>\$ 0.15</u>	<u>\$ 1.24</u>
Weighted average shares outstanding	1,298	1,294	1,284	1,268	1,251

Financial Ratios:					
Return on average assets	1.10%	1.17%	1.70%	0.13%	1.02%
Return on average equity.....	11.06	11.11	17.09	1.34	12.01
Average equity to average assets.....	9.94	10.54	9.94	9.52	8.52
Interest rate spread.....	3.38	3.42	3.55	3.06	3.21
Net yield on average earning assets.....	3.90	3.96	3.92	3.34	3.49
Dividend payout ratio	28.66	23.81	8.54	—	—
Cash dividends declared per share	\$ 0.45	\$ 0.35	\$ 0.17	—	—

MANAGEMENT'S DISCUSSION AND ANALYSIS

Founded in 1834, Hingham Institution for Savings has served the local community for more than 162 years. On December 20, 1988, the Bank converted its ownership from mutual to stock form. Banking services are provided through branch offices in Hingham, South Hingham, Hull, Scituate and Cohasset.

The following information should be read in conjunction with the Consolidated Financial Statements and Notes contained in this report.

COMPARISON OF THE YEARS 1996, 1995, and 1994 RESULTS OF OPERATIONS

For the year ended December 31, 1996, the Bank earned \$2.0 million, or \$1.57 per share, as compared to \$1.9 million, or \$1.47 per share, for the same period in 1995, and \$2.6 million, or \$1.99 per share in 1994. Earnings for 1994 and 1995 were positively impacted by tax benefits.

Pre-tax income shows continued and significant improvement. In 1996, pre-tax income was \$3.4 million as compared to \$3.0 million for 1995 and \$2.3 million for 1994. Net interest income increased nearly 13% when comparing 1996 to 1995, and increased 10% when comparing 1995 to 1994. Operating expenses increased \$425,000 when comparing 1996 to 1995, resulting primarily from the addition of two branch offices in late 1995. When comparing 1995 to 1994, operating expenses decreased \$219,000, resulting primarily from reduced deposit insurance premiums and lower legal fees, a trend which continued through 1996.

Net Interest Income

The Bank reported \$7.0 million in net interest income for 1996 as compared to \$6.2 million in 1995, and \$5.6 million in 1994. This positive trend was primarily the result of growth in loans which averaged \$136.8 million for 1996 as compared to \$109.8 million for 1995 and \$88.6 million for 1994.

The following table presents information regarding changes in interest and dividend income and interest expense of the Bank for the years indicated. For each category, information is provided with respect to changes attributable to changes in rate (change in rate multiplied by old volume) and changes in volume (change in volume multiplied by old rate.) The change attributable to both volume and rate is allocated proportionately to the changes due to volume and rate.

	Years Ended December 31,					
	1996 Compared to 1995			1995 Compared to 1994		
	Increase (Decrease)			Increase (Decrease)		
	Due to			Due to		
	Volume	Rate	Total	Volume	Rate	Total
(In Thousands)						
Interest and dividend income:						
Total loans.....	\$ 2,263	\$ (144)	\$ 2,119	\$ 1,792	\$ 380	\$ 2,172
Investment securities and						
Federal Home Loan Bank stock	(326)	48	(278)	(533)	334	(199)
Interest-bearing deposits.....	72	(25)	47	70	68	138
Total interest and dividend income	2,009	(121)	1,888	1,329	782	2,111
Interest expense:						
Deposits	946	41	987	591	523	1,114
Borrowings	141	(43)	98	232	201	433
Total interest expense	1,087	(2)	1,085	823	724	1,547
Net interest income.....	\$ 922	\$ (119)	\$ 803	\$ 506	\$ 58	\$ 564

MANAGEMENT'S DISCUSSION AND ANALYSIS

The following table details changes in net interest income and net yield on average earning assets.

	1996			Years Ended December 31,			1994		
	Average Balance	Interest	Yield/Rate	Average Balance	Interest	Yield/Rate	Average Balance	Interest	Yield/Rate
(Dollars in Thousands)									
Assets:									
Loans:									
Real estate loans	\$134,775	\$11,283	8.37%	\$107,842	\$9,157	8.49%	\$ 86,748	\$7,011	8.08%
Commercial loans	1,080	105	9.72	1,062	112	10.55	634	60	9.46
Other loans.....	994	86	8.65	944	86	9.11	1,264	112	8.86
Total loans (1) (2)	136,849	11,474	8.38	109,848	9,355	8.52	88,646	7,183	8.10
Investment securities (3) (4)	37,218	2,195	5.90	42,759	2,473	5.78	52,467	2,672	5.09
Interest-bearing deposits	5,564	293	5.27	4,232	246	5.81	2,795	108	3.86
Total earning assets.....	179,631	13,962	7.77	156,839	12,074	7.70	143,908	9,963	6.92
Other assets	6,277			5,884			6,571		
Total assets	\$185,908			\$162,723			\$150,479		
Liabilities and stockholders' equity:									
Interest-bearing deposits: *									
NOW accounts (5).....	\$ 12,980	184	1.42	\$ 10,581	157	1.48	\$ 10,889	171	1.57
Money market deposits	20,269	606	2.99	20,392	603	2.96	28,744	795	2.77
Regular.....	31,292	783	2.50	30,956	775	2.50	35,814	929	2.59
Term certificates.....	71,153	4,053	5.70	55,213	3,104	5.62	36,757	1,630	4.43
Total interest-bearing deposits	135,694	5,626	4.15	117,142	4,639	3.96	112,204	3,525	3.14
Borrowings.....	22,557	1,330	5.90	20,181	1,232	6.10	16,032	799	4.98
Total interest-bearing liabilities	158,251	6,956	4.40	137,323	5,871	4.28	128,236	4,324	3.37
Demand deposits.....	7,854			6,572			6,540		
Other liabilities	1,323			1,672			748		
Stockholders' equity.....	18,480			17,156			14,955		
Total liabilities and stockholders' equity.....	\$185,908			\$162,723			\$150,479		
Net interest income		\$ 7,006			\$6,203			\$5,639	
Weighted average rate spread ..			3.37%			3.42%			3.55%
Net yield on average earning assets (6)			3.90%			3.96%			3.92%

(1) Gross of allowance for loan losses.

(2) Includes average non-accrual loans.

(3) Excludes the impact of the average unrealized gain (loss) on securities available for sale.

(4) Includes Federal Home Loan Bank stock.

(5) Includes mortgagors' escrow accounts.

(6) Net interest income divided by average total earning assets.

Interest income is derived from residential and commercial mortgages, home equity, commercial and installment loans, and the investment portfolio. The Bank earned an average yield of 7.77% on these assets in 1996, as compared to 7.70% in 1995 and 6.92% in 1994. For 1996, 1995 and 1994, interest income totaled \$14.0 million, \$12.1 million and \$10.0 million, respectively. Average total earning assets increased \$22.8 million, or 15%, in 1996 over 1995 and \$12.9 million, or 9%, in 1995 over 1994. The Bank achieved this growth by continuing to focus on real estate lending and decreasing its emphasis on the investment portfolio.

Average deposit and borrowing balances increased in 1996 and 1995 as the Bank employed these sources to fund its loan growth. As a result, interest expense, which is incurred on certificates of deposit, NOW, savings and money market deposit accounts, Federal Home Loan Bank ("FHLB") advances and other borrowings, collectively increased in these periods.

The average rate paid on interest-bearing deposit accounts was 4.15% during 1996, as compared to 3.96% for 1995 and 3.14% for 1994 resulting primarily from a shift in the Bank's deposit mix. Certificates of deposit comprised 52% of average interest-bearing deposits for 1996, at an average rate of 5.70%. Comparably, certificates of deposit comprised 47% of average interest-bearing deposits in 1995 and 33% in 1994 at an average rate of 5.62% and 4.43% in 1995 and 1994, respectively.

Interest expense on FHLB advances continued to rise during 1996 resulting primarily from an increase in advances. However, the downturn in market interest rates in 1996 allowed the Bank to refinance a substantial portion of its advances at lower rates, resulting in a twenty basis point decline in the average rate from 1995. Also, during 1996, the Bank became a note option depositor for treasury, tax and loan deposits which allowed it to borrow short-term funds at a preferred interest rate.

Provision for Loan Losses

The provision for loan losses is based on management's assessment of the adequacy of the allowance for loan losses. Management considers the size of the loan portfolio, the risks associated with certain loan types, and the underlying collateral values of individual loans as well as other factors. During 1996, the Bank originated nearly

\$60.5 million in residential, commercial, and personal loans combined, increasing the loan portfolio to a total of \$151.2 million at December 31, 1996. The provision for loan losses for 1996 was \$107,000 as compared to \$120,000 in each of 1995 and 1994. Recoveries in 1996 of previously charged-off loans enabled the Bank to maintain an adequate level of allowance for loan losses while lowering its annual provision.

Other Income

Other income is comprised of customer service fees, net gains or losses on sales of investments and loans, and other miscellaneous items. For 1994, other income also included a litigation settlement in the amount of \$282,000. The most significant component of other income was fees earned on customer accounts with \$409,000 reported for 1996, \$346,000 for 1995, and \$345,000 for 1994. These increases reflect a higher volume of transactions along with a modest rise in the fee schedule in late 1996. In 1995 and 1994, the Bank reported \$49,000 and \$232,000, respectively, in net losses on sales of securities classified as available for sale. The securities were earning below-market rates of interest and were sold to obtain liquidity to fund growth in the loan portfolio. Further, the Bank sold \$2.4 million in fixed rate mortgages and student loans during the first quarter of 1994 at a combined gain of \$30,000.

Operating Expenses

There were \$4.1 million in operating expenses in 1996 as compared to \$3.6 million in 1995, and \$3.9 million in 1994. The rise in expenses in 1996 is primarily attributable to the addition of two branch offices which opened in the fourth quarter of 1995.

Salaries and employee benefits were the largest component of operating expenses at \$2.3 million for 1996, \$1.8 million for 1995, and \$1.7 million for 1994. In the fourth quarter of 1995, the Bank hired eight employees to staff the two new branches. This increased expense continued throughout 1996.

Foreclosed and other real estate expenses, net, include write-downs in property values, professional fees such as legal and property management, utilities, as well as various sundry items which are necessary to the operation of the real estate. These expenses are offset by any

gains upon sale or recovery of expenses. Expenses related to foreclosed and other real estate, net, declined significantly over each of the past three years with a net recovery of \$5,000 in 1996, and net expenses of \$15,000 in 1995 and \$265,000 in 1994. These declines are attributable to comparable declines in the number and value of foreclosed real estate properties. The Bank held no properties at year end 1996, only one property at year end 1995 at a net value of \$34,000, and a total of \$439,000 at year end 1994.

Deposit insurance expense, comprised of federal and state deposit insurance premiums, also declined when comparing 1996 to 1995 and 1994. Significant decreases occurred in 1995 when the Federal Deposit Insurance Corporation ("FDIC") awarded the Bank its lowest premium rate, due to the Bank's improved financial condition and then, effective June 1995 reduced this premium rate 85% to only \$0.04 per hundred dollars of average deposits. In 1996, the FDIC further reduced the Bank's annual premium to \$2,000, a rate awarded to well-capitalized banks.

Other operating expenses including data processing, occupancy and equipment, legal, and other were \$1.8 million combined for 1996 as compared to \$1.6 million in each of 1995 and 1994. Data processing expenses rose in each of the three periods as a result of an increase in the number of deposit accounts and their associated transaction volumes. Occupancy and equipment expense increased in each of the three periods, primarily as a result of the addition of the two branch offices. Legal expenses, which are incurred primarily in the collection of delinquent and charged-off debt, declined in each of the three periods.

Income Taxes

In 1995 and 1994, the Bank was able to utilize net operating loss carryforwards to offset current taxable income and recognize deferred tax assets. As a result, the Bank recognized a net provision for income taxes in the amount of \$1.0 million for 1995 versus income tax benefits amounting to \$255,000 during 1994. There were no further tax benefits available in 1996, and as a result, the Bank reported a provision for income taxes of \$1.4 million at an effective tax rate of 40.7%. In the fourth quarter of 1996 the Bank employed strategies with respect to its securities portfolio which should reduce its effective tax rate to below 40% in 1997.

COMPARISON OF THE YEARS 1996 AND 1995

BALANCE SHEET ANALYSIS

The Bank had total assets of \$201.6 million at December 31, 1996, an increase of \$26.2 million, or 15%, from the \$175.4 million level at year end 1995.

Loans

At December 31, 1996, the Bank reported net loans of \$151.2 million, or 75% of total assets. Comparably at December 31, 1995, net loans were \$119.5 million, or 68% of total assets. This dramatic growth of \$31.7 million, or 27%, was achieved through the origination of nearly \$60.5 million in mortgage and other loan products. A more stringent underwriting policy continues to complement this lending strategy. At December 31, 1996 and 1995, mortgage loans accounted for more than 98% of gross loans with commercial mortgages representing approximately 43% of the mortgage portfolio in 1996 and 36% in 1995.

The Bank's lending strategy during 1996 and 1995 has been to provide commercial property, residential, and multi-family loans at an initial fixed rate for three to five years with a floating rate thereafter. Residential mortgages are generally underwritten to conform to Federal National Mortgage Association or Federal Home Loan Mortgage Corporation guidelines. The Bank also offers home equity loans tied to the prime lending rate.

The Bank's loan portfolio is reported net of the allowance for loan losses. At December 31, 1996 and 1995, the allowance had a balance of \$1.4 million and \$1.3 million, respectively. The allowance is maintained at a level to absorb possible losses. Loan losses are charged against the allowance when the collectibility of loan principal becomes unlikely. Recoveries are recorded as additional reserves when received. There were \$48,000 in charge-offs and \$57,000 in recoveries in 1996. Comparably in 1995 there were \$188,000 in charge-offs and \$7,000 in recoveries.

Non-performing assets, which consist of non-accrual loans and foreclosed real estate totaled \$1.2 million, or 0.58% of total assets, at December 31, 1996, as compared to \$672,000, or 0.38% of total assets, at year end 1995. The increase in non-accrual loans is primarily the result of one mortgage borrower, with whom the Bank is

MANAGEMENT'S DISCUSSION AND ANALYSIS

working to resolve the delinquency. No significant write-offs related to this mortgage are anticipated.

The following table presents information regarding the Bank's non-performing assets:

At December 31,	1996	1995
	(In Thousands)	
Non-accrual Loans:		
Residential Mortgages ⁽¹⁾	\$1,168	\$630
Commercial Loans	—	6
Installment Loans	—	2
Total Non-accrual Loans	1,168	638
Foreclosed Real Estate, Net	—	34
Total Non-performing Assets	<u>\$1,168</u>	<u>\$672</u>

(1) Includes home equity loans.

Investments

The purpose of the Bank's investment portfolio is to supplement the Bank's lending activities by generating income, providing liquidity through the receipt of principal and interest payments, and use as collateral to obtain borrowed funds. At December 31, 1996, the portfolio was comprised of mortgage-backed and agency issues for a total of \$32.3 million, or 16% of total assets, as compared to \$39.2 million, or 22% of total assets, at year end 1995. All securities in the portfolio are issued or guaranteed by U.S. Government agencies or U.S. Government sponsored agencies and, as such, carry a relatively low risk-weighting under Federal Deposit Insurance Corporation risk-based capital guidelines.

A substantial portion of the Bank's investment portfolio is comprised of mortgage-backed securities which are subject to declines in principal balances due to principal repayments. These repayments tend to increase as market interest rates fall and the individual underlying mortgages are refinanced at lower rates. Conversely, repayments tend to decrease as market interest rates rise. There were \$6.1 million in principal repayments received during 1996 as compared to \$3.7 million during 1995.

At year end 1996 and 1995, the entire investment portfolio was classified as available for sale and was carried at fair value with unrealized gains or losses reported as a separate component of stockholders' equity. The unrealized loss on the investment portfolio amounted to \$244,000, net of tax effects, at December 31, 1996 as

compared to \$155,000 at year end 1995, reflecting a deterioration in market conditions. The fair value of securities fluctuates with the movement of interest rates. Generally, during periods of decreasing interest rates, the fair values increase whereas the opposite may hold true during a rising interest rate environment.

Deposits

At December 31, 1996, the Bank held a total of \$150.0 million in deposits, an increase of \$17.0 million from the \$133.0 million in deposits at year end 1995. The Bank offers a wide range of products, competitively priced, accompanied by quality service. During the fourth quarter of 1995 the Bank opened branch offices in the towns of Scituate and Cohasset which have assisted in the growth of the deposit base.

Primary competition for deposits are other banks and credit unions in the Bank's market area and mutual funds. The Bank's ability to attract and retain deposits depends upon satisfaction of depositors' requirements with respect to rate, liquidity, risk, and service. The Bank offers competitive rates, convenient branch locations, and the added convenience of automated teller machines. Deposits are insured in full through the Federal Deposit Insurance Corporation and Deposit Insurance Fund of Massachusetts. This insurance, combined with the Bank's strong capital position, provides an advantage in allaying customer concerns regarding the safety of deposits.

Core deposits, comprised of savings, NOW, and money market accounts were \$71.3 million, or 48% of total deposits, at December 31, 1996 as compared to \$69.2 million, or 52% of total deposits, at year end 1995, an increase of \$2.1 million. Certificates of deposit were \$78.7 million at December 31, 1996 as compared to \$63.9 million at year end 1995, an increase of \$14.8 million. This continued growth in certificates of deposit, at higher rates, has resulted in increased deposit interest expense.

Borrowings

The Bank had \$29.8 million in FHLB advances at December 31, 1996, as compared to \$22.0 million at year end 1995. The Bank borrowed an additional \$7.8 million in 1996 to fund growth in the loan portfolio and to effectively manage its interest rate sensitivity position. During

1996, the Bank became a note option depository for treasury, tax and loan deposits, which provides the Bank with an additional source of short-term funding at a preferred interest rate. At December 31, 1996, there was \$188,000 in such borrowings.

Liquidity and Capital Resources

The Bank's primary sources of liquidity are its available for sale securities portfolio, principal and interest payments on loans and investment securities, net increases in deposit balances, and FHLB advances.

As a member of the Federal Home Loan Bank of Boston, the Bank is eligible to obtain both short and long-term credit advances. The Bank can borrow up to approximately \$100.9 million to meet its borrowing needs. Borrowing capacity is limited to the Bank's available qualified collateral which consists primarily of 1-4 family residential mortgages and certain investment securities. At December 31, 1996, the Bank had \$29.8 million in advances with original maturities of up to three years.

The Bank can also enter into repurchase agreement transactions should the need for additional liquidity arise. At December 31, 1996, the Bank had no repurchase agreements outstanding.

At December 31, 1996, the Bank had capital of \$19.2 million, or 9.53% of total assets, as compared to \$17.8 million, or 10.16%, at December 31, 1995. Total capital is adjusted by the unrealized gains or losses in the Bank's available for sale securities portfolio, and as such it is subject to fluctuations resulting from changes in the market values of its investment securities. At December 31, 1996 and 1995 the Bank's entire securities portfolio was classified as available for sale, which had the effect of reducing capital by \$244,000 for 1996 and \$155,000 for 1995.

Massachusetts chartered savings banks that are insured by the FDIC are subject to minimum capital maintenance requirements. Regulatory guidelines define the minimum amount of qualifying capital an institution must maintain as a percentage of risk-weighted assets (Risk-Based Capital Ratios) and average total assets (Leverage Ratio). The Bank's ratios exceeded these regulatory capital requirements in both 1996 and 1995.

MANAGEMENT'S DISCUSSION AND ANALYSIS

Tier One Capital, Total Capital and the Leverage ratios were 15.04%, 16.12% and 9.90%, respectively, at December 31, 1996 and 17.05%, 18.26% and 10.33%, respectively at December 31, 1995.

These high capital levels were maintained despite a more aggressive dividend policy. During 1996 the Bank declared dividends of \$0.45 per share, which included a \$0.10 per share special dividend which was declared in the fourth quarter. In comparison, in 1995, the Bank declared \$0.35 per share in dividends. The Bank's dividend payout ratio, which is calculated by dividing dividends per share into earnings per share, increased to 28.7% for 1996 as compared to 23.8% for 1995.

IMPACT OF INFLATION AND CHANGING PRICES

The consolidated financial statements and related consolidated financial data presented herein have been prepared in accordance with generally accepted accounting principles which generally require the measurement of financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. The primary impact of inflation on operations of the Bank is reflected in increased operating costs. Unlike most industrial companies, virtually all the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than 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.

MATERIAL LITIGATION

In a 1993 lawsuit, the Bank contended that a substantial amount of cumulative loan losses it sustained prior to 1993 resulted from former president Wilfred H. Creighton's alleged conduct. In February 1994, the Bank obtained four parcels of developed real estate from the former president as settlement of its lawsuit. This recovery of \$282,000 is reflected in the Statement of Income in 1994.

Currently, the Bank is not a party to any legal proceedings other than routine litigation incidental to the Bank's business, the impact of which is not anticipated to have a material negative impact on the Bank's financial statements.

INDEPENDENT AUDITORS' REPORT

To the Board of Directors and Stockholders of
Hingham Institution for Savings

We have audited the consolidated balance sheets of Hingham Institution for Savings and subsidiaries as of December 31, 1996 and 1995, 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, 1996. These consolidated financial statements are the responsibility of the Bank'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 Hingham Institution for Savings and subsidiaries as of December 31, 1996 and 1995, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 1996 in conformity with generally accepted accounting principles.

Wolf + Company, P.C.

Boston, Massachusetts
January 22, 1997

CONSOLIDATED BALANCE SHEETS

December 31, 1996 and 1995

ASSETS

	1996	1995
	(In Thousands)	
Cash and due from banks (Note 2)	\$ 3,323	\$ 4,515
Interest-bearing deposits	8,317	6,071
Cash and cash equivalents	11,640	10,586
Securities available for sale (Notes 3 and 8)	32,321	39,152
Loans, net of allowance for loan losses of \$1,393,000 in 1996 and \$1,277,000 in 1995 (Notes 4 and 8)	151,166	119,472
Foreclosed real estate, net (Note 5)	—	34
Banking premises and equipment, net (Note 6)	2,418	2,496
Accrued interest receivable	1,060	1,048
Deferred income tax asset, net (Note 9)	1,106	1,045
Federal Home Loan Bank stock, at cost (Note 8)	1,450	1,200
Other assets	425	376
	<u>\$201,586</u>	<u>\$ 175,409</u>

LIABILITIES AND STOCKHOLDERS' EQUITY

Deposits (Note 7)	\$ 150,015	\$ 133,042
Federal Home Loan Bank advances (Note 8)	29,754	22,000
Other borrowed funds	188	—
Accrued interest payable	582	505
Mortgagors' escrow accounts	292	287
Other liabilities (Note 14)	1,543	1,756
Total liabilities	<u>182,374</u>	<u>157,590</u>
Commitments and contingencies (Notes 10 and 11)		
Stockholders' equity (Notes 12 and 13):		
Preferred stock, \$1.00 par value, 2,500,000 shares authorized; none issued	—	—
Common stock, \$1.00 par value, 5,000,000 shares authorized; 1,297,500 and 1,295,000 shares issued and outstanding	1,298	1,295
Additional paid-in capital	8,616	8,597
Undivided profits	9,542	8,082
	<u>19,456</u>	<u>17,974</u>
Net unrealized loss on securities available for sale, after tax effect (Notes 3 and 9)	(244)	(155)
Total stockholders' equity	<u>19,212</u>	<u>17,819</u>
	<u>\$201,586</u>	<u>\$175,409</u>

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF INCOME

Years Ended December 31, 1996, 1995 and 1994

	1996	1995	1994
	(In Thousands, Except Per Share Data)		
Interest and dividend income:			
Loans	\$11,474	\$ 9,355	\$ 7,183
Investment securities	2,195	2,473	2,672
Interest-bearing deposits	293	246	108
Total interest and dividend income	<u>13,962</u>	<u>12,074</u>	<u>9,963</u>
Interest expense:			
Deposits (Note 7)	5,626	4,639	3,525
Borrowed funds	1,330	1,232	799
Total interest expense	<u>6,956</u>	<u>5,871</u>	<u>4,324</u>
Net interest income	7,006	6,203	5,639
Provision for loan losses (Note 4)	107	120	120
Net interest income, after provision for loan losses	<u>6,899</u>	<u>6,083</u>	<u>5,519</u>
Other income:			
Customer service fees on deposits	409	346	345
Loss on sale of securities available for sale, net (Note 3)	—	(49)	(232)
Litigation settlement (Note 11)	—	—	282
Other	205	212	247
Total other income	<u>614</u>	<u>509</u>	<u>642</u>
Operating expenses:			
Salaries and employee benefits (Note 14)	2,268	1,838	1,677
Data processing	331	298	288
Occupancy and equipment (Note 6)	485	372	332
Foreclosed and other real estate, net (Note 5)	(5)	15	265
Legal	10	66	143
Deposit insurance	4	159	309
Other	973	893	846
Total operating expenses	<u>4,066</u>	<u>3,641</u>	<u>3,860</u>
Income before income taxes	3,447	2,951	2,301
Income tax provision (benefit) (Note 9)	1,403	1,045	(255)
Net income	<u>\$ 2,044</u>	<u>\$ 1,906</u>	<u>\$ 2,556</u>
Earnings per common share	<u>\$ 1.57</u>	<u>\$ 1.47</u>	<u>\$ 1.99</u>
Weighted average shares outstanding	<u>1,298</u>	<u>1,294</u>	<u>1,284</u>

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

Years Ended December 31, 1996, 1995 and 1994

	Common Stock	Additional Paid-in Capital	Undivided Profits	Net Unrealized Gain (Loss) on Securities Available for Sale (In Thousands)	Total Stockholders' Equity
Balance at December 31, 1993	\$ 1,277	\$ 8,453	\$ 4,292	\$ 52	\$14,074
Net income	—	—	2,556	—	2,556
Change in net unrealized gain (loss) on securities available for sale, after tax effect	—	—	—	(577)	(577)
Stock options exercised, after tax effect	16	131	—	—	147
Cash dividends declared (\$.17 per share)	—	—	(219)	—	(219)
Balance at December 31, 1994	1,293	8,584	6,629	(525)	15,981
Net income	—	—	1,906	—	1,906
Change in net unrealized gain (loss) on securities available for sale, after tax effect	—	—	—	370	370
Stock options exercised, after tax effect	2	13	—	—	15
Cash dividends declared (\$.35 per share)	—	—	(453)	—	(453)
Balance at December 31, 1995	1,295	8,597	8,082	(155)	17,819
Net income	—	—	2,044	—	2,044
Change in net unrealized gain (loss) on securities available for sale, after tax effect	—	—	—	(89)	(89)
Stock options exercised, after tax effect	3	19	—	—	22
Cash dividends declared (\$.45 per share)	—	—	(584)	—	(584)
Balance at December 31, 1996	<u>\$ 1,298</u>	<u>\$ 8,616</u>	<u>\$ 9,542</u>	<u>\$ (244)</u>	<u>\$19,212</u>

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years Ended December 31, 1996, 1995 and 1994

	1996	1995	1994
		(In Thousands)	
Cash flows from operating activities:			
Net income	\$2,044	\$1,906	\$2,556
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	107	120	120
Provision for losses on foreclosed and other real estate	—	20	142
Amortization of premium on investment securities, net of accretion	242	288	514
Amortization of deferred loan fees, net	(73)	(62)	(54)
Depreciation	195	133	115
Loss on sale of securities available for sale, net	—	49	232
Gain on sale of loans	—	—	(30)
Gain on sale of foreclosed and other real estate	(31)	(4)	(63)
Changes in operating assets and liabilities:			
Accrued interest receivable	(12)	(213)	67
Deferred income tax asset	(16)	249	(300)
Other assets	(49)	(17)	(127)
Accrued interest payable and other liabilities	(164)	843	302
Net cash provided by operating activities	2,243	3,312	3,474
Cash flows from investing activities:			
Proceeds from sale of securities available for sale	—	1,463	10,400
Purchase of securities available for sale	(3,991)	(4,882)	(2,036)
Purchase of securities held to maturity	—	(2,183)	(3,000)
Proceeds from maturities of securities available for sale	4,324	4,000	100
Proceeds from maturities of securities held to maturity	—	2,000	—
Principal payments received on mortgage-backed securities	6,122	3,676	8,802
Loans originated, net of payments received	(31,694)	(18,832)	(25,295)
Proceeds from sale of loans	—	—	2,424
Additions to foreclosed and other real estate, net of payments	—	(110)	4
Proceeds from sale of foreclosed and other real estate	31	279	1,414
Increase in Federal Home Loan Bank stock	(250)	(206)	—
Additions to banking premises and equipment	(117)	(930)	(265)
Net cash used in investing activities	(25,575)	(15,725)	(7,452)

(continued)

See accompanying notes to consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Concluded)

Years Ended December 31, 1996, 1995 and 1994

	1996	1995	1994
		(In Thousands)	
Cash flows from financing activities:			
Increase (decrease) in deposits, net	\$16,973	\$16,358	\$(1,033)
Increase in mortgagors' escrow accounts	5	35	62
Proceeds from stock options exercised	11	8	122
Cash dividends paid on common stock	(545)	(310)	(154)
Proceeds from borrowings with maturities of less than three months	3,442	—	—
Proceeds from Federal Home Loan Bank advances with maturities of three months or more	24,000	50,500	7,000
Repayment of Federal Home Loan Bank advances with maturities of three months or more	(19,500)	(47,500)	(3,000)
Net cash provided by financing activities	24,386	19,091	2,997
Net increase (decrease) in cash and cash equivalents	1,054	6,678	(981)
Cash and cash equivalents at beginning of year	10,586	3,908	4,889
Cash and cash equivalents at end of year	\$11,640	\$10,586	\$ 3,908
Supplementary information:			
Interest paid on deposit accounts	\$ 5,579	\$ 4,499	\$ 3,509
Interest paid on borrowed funds	1,300	1,225	768
Income taxes paid	1,734	72	51
Loans transferred to foreclosed real estate	—	—	913
Financed sales of foreclosed real estate	34	171	1,254
Foreclosed real estate transferred to loans	—	129	286
Securities held to maturity transferred to available for sale	—	26,301	—

See accompanying notes to consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 1996, 1995 and 1994

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of presentation and consolidation

The consolidated financial statements include the accounts of Hingham Institution for Savings ("Bank") and its wholly-owned subsidiaries, Hingham Securities Corporation and Hingham Motel Corporation. Hingham Securities Corporation holds title to securities available for sale and Hingham Motel Corporation is presently inactive. All intercompany accounts and transactions have been eliminated in consolidation. The accounting and reporting policies of the Bank conform to generally accepted accounting principles and prevailing practices within the banking industry.

Use of estimates

In preparing financial statements in conformity with generally accepted accounting principles, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the consolidated balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. 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 reserve against deferred tax assets.

Business

The Bank provides a variety of financial services to individuals and small businesses through its five offices in southeastern Massachusetts. Its primary deposit products are savings, checking and term certificate accounts and its primary lending products are residential and commercial mortgage loans.

Reclassification

Certain amounts have been reclassified in the 1995 and 1994 consolidated financial statements to conform to the 1996 presentation.

Cash and cash equivalents

Cash and cash equivalents include amounts due from banks and interest-bearing deposits.

Interest-bearing deposits

Interest-bearing deposits mature within ninety days and are carried at cost, which approximates fair value.

Securities Available for Sale

Investments are classified as available for sale and reflected at fair value, with unrealized gains and losses, after tax effect, excluded from earnings and reported as a separate component of stockholders' equity.

Federal Home Loan Bank of Boston stock is reflected at cost.

Purchased premiums and discounts are amortized to earnings by a method which approximates the interest method over the terms of the investments. Declines in the value of investments that are deemed to be other than temporary are reflected in earnings when identified. Gains and losses on disposition of investments are computed by the specific identification method.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Loans

The Bank grants mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio is represented by mortgage loans in the southeastern Massachusetts area. The ability of the Bank's debtors to honor their contracts is dependent upon the real estate, construction and general economic sectors.

Loans, as reported, have been reduced by unadvanced loan funds, net deferred interest and loan fees and the allowance for loan losses.

Interest on loans is recognized on a simple interest basis and is not accrued on loans which are ninety days or more past due or for which collection is not assured. Interest income previously accrued on such loans is reversed against current period interest income. Interest income on all non-accrual loans is recognized only to the extent of interest payments received.

Net deferred interest and loan fees are amortized as an adjustment of the related loan yields using the level-interest method.

Allowance for loan losses

The allowance for loan losses is established through a provision for loan losses charged to earnings and is maintained at a level considered adequate to provide for reasonably foreseeable loan losses.

The provision and the level of the allowance are evaluated on a regular basis by management and are based upon management's periodic review of the collectibility of the loans in light of historical experience, known and inherent risks in the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant change. Ultimately losses may vary from current estimates and future additions to the allowance may be necessary.

Loan losses are charged against the allowance when management believes the collectibility of the loan balance is unlikely. Subsequent recoveries, if any, are credited to the allowance.

Effective January 1, 1995, the Bank adopted Statement of Financial Accounting Standards ("SFAS") No. 114, "Accounting by Creditors for Impairment of a Loan," as amended by SFAS No. 118. Under this Statement, a loan is considered impaired when, based on current information and events, it is probable that a creditor will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Substantially all of the Bank's loans which are identified as impaired are measured by the fair value of existing collateral.

The Statement is not applicable to large groups of smaller balance homogeneous loans that are collectively evaluated for impairment, and loans that are measured at fair value. Accordingly, the Bank has not applied SFAS No. 114 to its consumer loans which are collectively evaluated for impairment.

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

SFAS No. 114 also limits the classification of loans as in-substance foreclosures to situations where the creditor actually receives physical possession of the debtor's assets. Accordingly, upon adoption of SFAS No. 114, the Bank transferred loans previously classified as in-substance foreclosures in the amount of \$129,000 to its impaired loan portfolio.

The adoption of SFAS No. 114 had no effect on the Bank's assessment of the overall adequacy of the allowance for loan losses. The restatement of previously issued financial statements to conform with SFAS No. 114 is expressly prohibited.

Foreclosed real estate

Foreclosed real estate includes both formally foreclosed properties and in-substance foreclosed properties, whereby the Bank has taken physical possession of the property without formal foreclosure proceedings.

Foreclosed real estate is initially recorded at the lower of cost or fair value at the date of foreclosure. Costs relating to development and improvement of property are capitalized, whereas costs relating to holding property are expensed.

Valuations are periodically performed by management and an allowance for losses is established through a charge to operations if the carrying value of a property exceeds its fair value less estimated costs to sell.

In prior years, the Bank classified certain loans meeting more extensive in-substance foreclosure criteria as foreclosed real estate. Upon the adoption of SFAS No. 114, the Bank reclassified all in-substance foreclosed assets that were not in its possession to loans.

Banking premises and equipment

Land is carried at cost. Buildings and equipment are carried at cost, less accumulated depreciation computed on the straight-line method over the estimated useful lives of the assets.

It is general practice to charge the cost of maintenance and repairs to earnings when incurred; major expenditures for betterments are capitalized and depreciated.

Income taxes

Deferred tax assets and liabilities are reflected at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted accordingly through the provision for income taxes. The Bank's base amount of its federal income tax reserve for loan losses is a permanent difference for which there is no recognition of a deferred tax liability. However, the loan loss allowance maintained for financial reporting purposes is a temporary difference with allowable recognition of a related deferred tax asset, if it is deemed realizable. The Bank and its subsidiaries file state and consolidated federal income tax returns based on an October 31 year end.

Retirement plan

The compensation cost of an employee's pension benefit is recognized on the net periodic pension cost method over the employee's approximate service period. The aggregate cost method is utilized for funding purposes.

Stock Compensation Plans

In October 1995, the Financial Accounting Standards Board ("FASB") issued SFAS No. 123, "Accounting for Stock-Based Compensation." This Statement encourages all entities to adopt a fair value based method of accounting for employee stock compensation plans, whereby compensation cost is measured at the grant date based on the value of the award and is recognized over the service period, which is usually the vesting period. However, it also allows an entity to continue to measure compensation cost for those plans using the intrinsic value based method of accounting prescribed

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (concluded)

by APB Opinion No. 25, "Accounting for Stock Issued to Employees," whereby compensation cost is the excess, if any, of the quoted market price of the stock at the grant date (or other measurement date) over the amount an employee must pay to acquire the stock. Stock options issued under the Bank's stock option plans have no intrinsic value at the grant date, and under Opinion No. 25 no compensation cost is recognized for them. The Bank has elected to remain with the accounting in Opinion No. 25 and, as a result, must make pro forma disclosures of net income and earnings per share and other disclosures, as if the fair value based method of accounting had been applied. The disclosure requirements of this Statement are effective for the Bank's consolidated financial statements for the year ended December 31, 1996. The pro forma disclosures include the effects of all awards granted on or after January 1, 1995. (See Note 13.)

Earnings per share

Earnings per share is computed based on the weighted average number of common and common equivalent shares outstanding during the year.

Stock options, when dilutive, are included as common stock equivalents using the treasury stock method.

Recent accounting pronouncement

In June 1996, the FASB issued SFAS No. 125, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities". The accounting and reporting standards of this Statement are based on a financial components approach that focuses on control, whereby after a transfer of financial assets, an entity recognizes only financial and servicing assets it controls and liabilities it has incurred. Liabilities incurred will be initially recognized at fair value, if practicable. Financial assets are derecognized when control has been surrendered, and liabilities are derecognized when extinguished. The determination of whether control over a financial asset has been surrendered is based on meeting specific criteria as defined in the Statement.

The Statement provides standards for distinguishing transfers of financial assets that are sales from transfers that are secured borrowings, and impacts the accounting for various transactions including the servicing of financial assets, securitizations, securities lending transactions, repurchase agreements including "dollar rolls," "wash sales," loan syndications and participations, and transfers of receivables with recourse.

The Statement is effective for transfers and servicing of financial assets and extinguishments of liabilities occurring after December 31, 1996, and is to be applied on a prospective basis. In December 1996, the FASB voted to defer for one year the provisions of the Statement that relate to secured borrowings and collateral.

Management is currently evaluating the impact of the Statement and in management's opinion, it will not have a significant impact on the consolidated financial statements.

2. CASH AND DUE FROM BANKS

The Bank is required to maintain cash reserve balances with the Federal Reserve Bank based upon a percentage of certain deposits. At December 31, 1996 and 1995, cash and due from banks included \$228,000 and \$275,000, respectively, to satisfy such reserve requirements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

3. SECURITIES AVAILABLE FOR SALE

The amortized cost and estimated fair value of securities available for sale, with gross unrealized gains and losses, follows:

	December 31, 1996			
	Amortized Cost	Gross	Gross	Fair Value
		Unrealized Gains	Unrealized Losses	
		(In Thousands)		
U.S. Government and federal agency obligations	\$ 9,030	\$ 11	\$ (62)	\$ 8,979
Mortgage-backed - FHLMC	12,134	26	(165)	11,995
Mortgage-backed - FNMA	9,669	18	(154)	9,533
REMIC's - FNMA	1,899	—	(85)	1,814
Total securities available for sale	<u>\$ 32,732</u>	<u>\$ 55</u>	<u>\$ (466)</u>	<u>\$ 32,321</u>

	December 31, 1995			
	Amortized Cost	Gross	Gross	Fair Value
		Unrealized Gains	Unrealized Losses	
		(In Thousands)		
U.S. Government and federal agency obligations	\$ 8,714	\$ 21	\$ (27)	\$ 8,708
Mortgage-backed - FHLMC	17,347	5	(161)	17,191
Mortgage-backed - FNMA	11,471	17	(90)	11,398
REMIC's - FNMA	1,897	—	(42)	1,855
Total securities available for sale	<u>\$ 39,429</u>	<u>\$ 43</u>	<u>\$ (320)</u>	<u>\$ 39,152</u>

At December 31, 1996, the Bank has pledged U.S. Government obligations with an amortized cost of \$1,001,000 and a fair value of \$993,000 as collateral against its treasury, tax and loan account.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

SECURITIES AVAILABLE FOR SALE (concluded)

The amortized cost and estimated fair value of debt securities by contractual maturity at December 31, 1996 are shown below. Expected maturities will differ from contractual maturities because of prepayments and scheduled payments on mortgage-backed securities. Further, certain obligors have the right to call bonds and obligations without prepayment penalties.

	Amortized Cost	Fair Value
	(In Thousands)	
Bonds and obligations:		
Over 1 year to 5 years	\$ 6,018	\$ 5,984
Over 5 years to 10 years	3,012	2,995
	<u>9,030</u>	<u>8,979</u>
Mortgage-backed securities:		
Within 1 year	2,325	2,328
Over 1 year to 5 years	10,923	10,744
Over 5 years to 10 years	776	770
Over 10 years	9,678	9,500
	<u>23,702</u>	<u>23,342</u>
Total debt securities	<u>\$ 32,732</u>	<u>\$ 32,321</u>

For the years ended December 31, 1995 and 1994, proceeds from the sale of securities available for sale amounted to \$1,463,000 and \$10,400,000, respectively. Gross realized gains of zero and \$10,000 and gross realized losses of \$49,000 and \$242,000 were realized during 1995 and 1994, respectively. There were no sales of securities during 1996.

In November 1995, the FASB issued guidance allowing a one-time reassessment of an entity's investment classifications during the period November 15, 1995 to December 31, 1995. As a result, the amortized cost of securities held to maturity that were transferred to securities available for sale on December 31, 1995 amounted to \$26,301,000, and the related net unrealized loss amounted to \$168,000.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. LOANS

A summary of the balances of loans follows:

	December 31,	
	1996	1995
	(In Thousands)	
Mortgage loans:		
Residential.....	\$ 71,409	\$ 63,895
Commercial	65,839	43,734
Construction	9,252	7,030
Equity lines-of-credit	7,842	5,698
Second mortgages	167	279
	<u>154,509</u>	<u>120,636</u>
Less unadvanced loan funds.....	(3,831)	(1,593)
Total mortgage loans, net.....	<u>150,678</u>	<u>119,043</u>
Commercial loans:		
Secured	1,169	933
Unsecured	48	45
Total commercial loans	<u>1,217</u>	<u>978</u>
Consumer loans:		
Personal installment	819	934
Education.....	14	22
Revolving credit	57	65
Total consumer loans	<u>890</u>	<u>1,021</u>
Total loans	<u>152,785</u>	<u>121,042</u>
Less: Allowance for loan losses.....	(1,393)	(1,277)
Net deferred interest and loan fees.....	(226)	(293)
Loans, net	<u>\$151,166</u>	<u>\$119,472</u>

The Bank has sold mortgage loans in the secondary mortgage market and has retained the servicing responsibility and receives fees for the services provided. Loans sold and serviced for others amounted to \$6,667,000, \$8,787,000 and \$10,087,000 at December 31, 1996, 1995 and 1994, respectively. All loans serviced for others were sold without recourse provisions and are not included in the accompanying consolidated balance sheets.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

LOANS (concluded)

An analysis of the allowance for loan losses follows:

	Years Ended December 31,		
	1996	1995	1994
	(In Thousands)		
Balance at beginning of year.....	\$1,277	\$1,338	\$1,191
Provision for loan losses	107	120	120
	<u>1,384</u>	<u>1,458</u>	<u>1,311</u>
Loans charged-off	(48)	(188)	(105)
Recoveries on loans previously charged-off	57	7	132
Balance at end of year	<u>\$1,393</u>	<u>\$1,277</u>	<u>\$1,338</u>

The following is a summary of the recorded investment in impaired loans (See Note 1):

	December 31,	
	1996	1995
	(In Thousands)	
Loans with no valuation allowance	\$1,075	\$ 495
Loans with a corresponding valuation allowance	93	143
Total impaired loans.....	<u>\$1,168</u>	<u>\$ 638</u>
Corresponding valuation allowance	<u>\$ 46</u>	<u>\$ 58</u>

No additional funds are committed to be advanced in connection with impaired loans.

For the years ended December 31, 1996 and 1995, the average recorded investment in impaired loans amounted to \$992,000 and \$556,000, respectively. The Bank recognized \$53,000 and \$41,000, respectively, of interest income on impaired loans, during the period that they were impaired, on the cash basis.

Non-accrual loans totaled \$1,168,000 and \$638,000 at December 31, 1996 and 1995, respectively. Interest not accrued on such loans amounted to \$102,000 and \$14,000 at December 31, 1996 and 1995, respectively.

Prior to the adoption of SFAS No.114, restructured loans totaled \$1,107,000 at December 31, 1994. Interest income that would have been recorded under the original terms of such loans amounted to \$101,000 and the interest income actually recognized amounted to \$83,000 for the year ended December 31, 1994.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

5. FORECLOSED REAL ESTATE

At December 31, 1995, foreclosed real estate consisted of a parcel of land with a carrying value of \$100,000 and an allowance for losses of \$66,000.

An analysis of the allowance for losses is as follows:

	Years Ended December 31,		
	1996	1995	1994
	(In Thousands)		
Balance at beginning of year	\$ 66	\$ 77	\$ 51
Provision for losses.....	—	20	142
Write-downs and losses, net.....	(66)	(31)	(116)
Balance at end of year.....	<u>\$ —</u>	<u>\$ 66</u>	<u>\$ 77</u>

An analysis of foreclosed and other real estate expense (income) is as follows:

	Years Ended December 31,		
	1996	1995	1994
	(In Thousands)		
Provision for losses	\$ —	\$ 20	\$ 142
Recoveries, net.....	(31)	(4)	(63)
Foreclosure and holding costs, net.....	26	(1)	186
	<u>\$ (5)</u>	<u>\$ 15</u>	<u>\$ 265</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

6. BANKING PREMISES AND EQUIPMENT

A summary of the cost and accumulated depreciation of banking premises and equipment and their estimated useful lives follows:

	December 31,		Estimated Useful Lives
	1996	1995	
	(In Thousands)		
Banking premises:			
Land	\$ 548	\$ 548	
Buildings	2,155	2,129	3 - 65 years
Equipment	1,293	1,203	3 - 25 years
	<u>3,996</u>	<u>3,880</u>	
Less accumulated depreciation	<u>(1,578)</u>	<u>(1,384)</u>	
	<u>\$2,418</u>	<u>\$2,496</u>	

Depreciation expense for the years ended December 31, 1996, 1995 and 1994 amounted to \$195,000, \$133,000 and \$115,000, respectively.

7. DEPOSITS

A summary of deposit balances, by type, is as follows:

	December 31,	
	1996	1995
	(In Thousands)	
Non-certificate accounts:		
Regular	\$ 30,989	\$ 31,119
Money market deposits.....	20,991	19,421
NOW	12,589	12,026
Demand	6,732	6,613
Total non-certificate accounts.....	<u>71,301</u>	<u>69,179</u>
Term certificates less than \$100,000	59,126	50,422
Term certificates \$100,000 or more	19,588	13,441
Total certificate accounts.....	<u>78,714</u>	<u>63,863</u>
Total deposits	<u>\$150,015</u>	<u>\$133,042</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DEPOSITS (concluded)

The maturity distribution of term certificates is as follows:

	December 31,			
	1996		1995	
	Amount	Weighted Average Rate (Dollars in Thousands)	Amount	Weighted Average Rate
Within 1 year	\$60,233	5.47%	\$45,271	5.79%
Over 1 year to 2 years.....	7,320	5.92	7,253	5.86
Over 2 years to 3 years.....	4,581	5.70	3,457	6.32
Over 3 years to 5 years.....	6,580	6.51	7,882	6.37
	<u>\$78,714</u>	<u>5.61%</u>	<u>\$63,863</u>	<u>5.90%</u>

A summary of interest expense on deposits is as follows:

	Years Ended December 31,		
	1996	1995	1994
	(In Thousands)		
Regular	\$ 783	\$ 775	\$ 929
Money market deposits.....	606	603	795
NOW	184	157	171
Term certificates	4,053	3,104	1,630
	<u>\$ 5,626</u>	<u>\$4,639</u>	<u>\$3,525</u>

8. FEDERAL HOME LOAN BANK ADVANCES

A summary of advances from the Federal Home Loan Bank of Boston follows:

Maturing During the Year Ending December 31,	December 31,			
	1996		1995	
	Amount	Weighted Average Rate (Dollars in Thousands)	Amount	Weighted Average Rate
1996	\$ —	—%	\$11,000	6.04%
1997	22,754	5.76	6,000	5.70
1998	7,000	5.82	5,000	6.03
	<u>\$29,754</u>	<u>5.78%</u>	<u>\$22,000</u>	<u>5.94%</u>

All borrowings from the Federal Home Loan Bank of Boston are secured by stock in the Federal Home Loan Bank of Boston and a blanket lien on "qualified collateral" defined principally as 90% of the market value of certain U.S. Government and federal agency obligations and 75% of the carrying value of first mortgage loans on owner-occupied residential property.

The Bank also has an available line of credit with the Federal Home Loan Bank of Boston at an interest rate that adjusts daily. Borrowings under this line are limited to \$3,508,00 at December 31, 1996.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

9. INCOME TAXES

Allocation of federal and state income taxes between current and deferred portions is as follows:

	Years Ended December 31,		
	1996	1995	1994
	(In Thousands)		
Current tax provision:			
Federal	\$1,094	\$ 868	\$ 18
State	325	310	27
Utilization of operating loss carryforwards	—	(382)	—
	<u>1,419</u>	<u>796</u>	<u>45</u>
Deferred tax provision (benefit):			
Federal	(5)	397	452
State	(11)	41	139
	<u>(16)</u>	<u>438</u>	<u>591</u>
Change in valuation reserve realization assumptions	—	(189)	(891)
	<u>\$1,403</u>	<u>\$1,045</u>	<u>\$(255)</u>

The reasons for the differences between the statutory federal income tax rate and the effective tax rates are summarized as follows:

	Years Ended December 31,		
	1996	1995	1994
Statutory rate	34.0%	34.0%	34.0%
Increase (decrease) resulting from:			
State taxes, net of federal tax benefit.....	6.0	7.8	.6
Change in valuation allowance	—	(6.4)	(46.5)
Other, net7	—	.8
Effective tax rates	<u>40.7%</u>	<u>35.4%</u>	<u>(11.1)%</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

INCOME TAXES (continued)

The components of the net deferred tax asset are as follows:

	December 31,	
	1996	1995
	(In Thousands)	
Deferred tax asset:		
Federal	\$ 897	\$ 870
State	395	393
	1,292	1,263
Valuation reserve on asset	(57)	(65)
	1,235	1,198
Deferred tax liability:		
Federal	(101)	(118)
State	(28)	(35)
	(129)	(153)
Net deferred tax asset.....	<u>\$1,106</u>	<u>\$1,045</u>

The tax effects of each type of income and expense item that give rise to deferred taxes are as follows:

	December 31,	
	1996	1995
	(In Thousands)	
Allowance for loan losses	\$ 524	\$ 522
Employee benefits	223	222
Other accrued expenses	218	167
Net unrealized loss on securities available for sale	167	122
Other	31	77
	1,163	1,110
Valuation reserve	(57)	(65)
Net deferred tax asset.....	<u>\$1,106</u>	<u>\$1,045</u>

A summary of the change in the net deferred tax asset is as follows:

	Years Ended December 31,		
	1996	1995	1994
	(In Thousands)		
Balance at beginning of year	\$1,045	\$1,557	\$ 872
Deferred tax benefit (provision).....	16	(249)	300
Net unrealized loss on securities available for sale	45	(263)	385
Balance at end of year	<u>\$1,106</u>	<u>\$1,045</u>	<u>\$1,557</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

INCOME TAXES (concluded)

A summary of the change in the valuation reserve applicable to the net deferred tax asset is as follows:

	Years Ended December 31,		
	1996	1995	1994
	(In Thousands)		
Balance at beginning of year	\$ 65	\$ 254	\$1,145
Benefits expired	(8)	—	—
Change in assumptions due to anticipation of future income.....	—	(189)	(891)
Balance at end of year	<u>\$ 57</u>	<u>\$ 65</u>	<u>\$ 254</u>

Tax reserve for loan losses

The federal income tax reserve for loan losses at the Bank's base year was \$3,780,000. If any portion of the reserve is used for purposes other than to absorb loan losses, approximately 150% of the amount actually used, limited to the amount of the reserve, will be subject to taxation in the fiscal year in which used. As the Bank intends to use the reserve only to absorb loan losses, a deferred tax liability of approximately \$1,550,000 has not been provided. (See Note 1)

10. COMMITMENTS AND CONTINGENCIES

In the normal course of business, there are outstanding commitments and contingencies which are not reflected in the consolidated financial statements.

Loan commitments

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include unused lines-of-credit, commitments to originate loans, and standby letters of credit. The instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets.

The Bank's exposure to credit loss in the event of non-performance by the other party to its financial instruments is represented by the contractual amount of these commitments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

COMMITMENTS AND CONTINGENCIES (concluded)

At December 31, 1996 and 1995, the following financial instruments were outstanding whose contract amounts represent credit risk:

	Contract Amount	
	1996	1995
	(In Thousands)	
Unused lines-of-credit.....	\$7,782	\$6,019
Commitments to originate loans:		
Commercial Mortgages.....	5,830	3,330
Residential Mortgages.....	3,149	1,133
Standby letters of credit.....	80	—

Commitments to extend credit are agreements to lend to a customer provided there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the borrower. The commitments to originate loans and the majority of unused lines-of-credit are secured by real estate.

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

Employment agreements

The Bank has entered into employment agreements with certain senior executives. The original terms of the agreements are for three or two years and automatically extend unless either party gives notice to the contrary. The agreements generally provide for certain lump sum severance payments under certain circumstances, within a one-year period following a "change in control", as defined in the agreements.

11. LITIGATION

In a 1993 lawsuit, the Bank contended that a substantial amount of cumulative loan losses it sustained prior to 1993 resulted from former president Wilfred H. Creighton's alleged conduct. In February of 1994, the Bank obtained four parcels of developed real estate from the former president as settlement of its lawsuit. This recovery of \$282,000 is reflected in the Statement of Income in 1994.

Various legal claims also arise from time to time in the normal course of business, which, in the opinion of management, will have no material effect on the Bank's consolidated financial position.

12. STOCKHOLDERS' EQUITY

Minimum regulatory requirements

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of its assets, liabilities and certain off-balance-sheet items as calculated under regulatory

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

STOCKHOLDERS' EQUITY (concluded)

accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of total and Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 1996, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 1996, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, it must maintain minimum total risk-based, Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following table. There are no conditions or events since the notification that management believes have changed the Bank's category. The Bank's actual capital amounts and ratios as of December 31, 1996 are also presented in the table.

	Actual		For Minimum Capital Adequacy Purposes		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in Thousands)						
Total Capital to Risk Weighted Assets . .	\$20,849	16.12%	\$10,347	8.0%	\$12,934	10.0%
Tier 1 Capital to Risk Weighted Assets . .	19,456	15.04	5,173	4.0	7,760	6.0
Tier 1 Capital to Average Assets	19,456	9.90	5,894 to 9,824	3.0 to 5.0	9,824	5.0

Liquidation account

At the time of conversion from mutual to stock form, the Bank established a liquidation account for the benefit of eligible account holders. The liquidation account is reduced annually to the extent that eligible account holders reduce their qualifying deposit. In the event of a complete liquidation, eligible account holders will be entitled to receive a distribution from the liquidation account to the extent that funds are available. According to the Bank's transfer agent, the balance of the liquidation account at December 31, 1996 amounted to \$1,028,000 (unaudited).

13. STOCK OPTION PLANS

At December 31, 1996, the Bank has two fixed stock option plans as described below. The Bank applies APB Opinion 25 and related Interpretations in accounting for the plans. Accordingly, no compensation cost has been recognized for the plans. Had compensation cost for the plans been determined based on the fair value at the grant dates for awards under the plans consistent with the method prescribed by SFAS No. 123, "Accounting for Stock-Based Compensation", the Bank's net income and earnings per share would have been reduced to the pro forma amounts indicated below:

	Years Ended December 31,	
	1996	1995
(In Thousands, except per share amounts)		
Net Income:		
As reported.....	\$2,044	\$1,906
Pro forma.....	1,966	1,827
Earnings per share:		
As reported.....	\$ 1.57	\$ 1.47
Pro forma.....	1.51	1.41

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

STOCK OPTION PLANS (concluded)

Under the Bank's 1988 and 1996 stock option plans, options may be granted to officers, other employees and certain directors as the Stock Option Committee of the Board may determine. A total of 125,000 shares of common stock were reserved for issuance pursuant to options granted under the 1988 plan and a total of 60,000 shares of common stock were reserved for issuance pursuant to options granted under 1996 plan. Both "incentive options" and "non-qualified options" may be granted under the plans. All options under both plans will have an exercise price per share equal to, or in excess of, the fair market value of a share of common stock at the date the option is granted and will have a maximum option term of 10 years. Non-qualified stock options granted during 1996, 1995 and 1993 are immediately exercisable and options granted prior to 1993 vest over a five-year period.

The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option pricing model with the following assumptions used for grants in 1996 and 1995, respectively; dividend yield of 3.27 % and 2.75 %; expected volatility of 25.79 % and 27.06 %; risk-free interest rates of 6.11 % and 6.28 % and expected lives of 10 years.

Stock option activity is as follows:

	Years Ended December 31,					
	1996		1995		1994	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Shares under option:						
Outstanding at beginning of year	70,500	\$10.17	44,500	\$ 8.27	63,080	\$ 7.96
Granted	32,000	13.75	28,000	12.75	—	—
Forfeited	—	—	—	—	(2,920)	4.00
Exercised.....	(2,500)	4.00	(2,000)	4.00	(15,660)	7.79
Outstanding at end of year	<u>100,000</u>	<u>\$11.47</u>	<u>70,500</u>	<u>\$10.17</u>	<u>44,500</u>	<u>\$ 8.27</u>
Options exercisable at end of year.....	100,000	\$11.47	70,500	\$10.17	41,500	\$ 8.58
Weighted average fair value of options granted during the year		\$ 4.11		\$ 4.36		\$ —

Options outstanding consist of the following:

Option price	December 31,			
	1996		1995	
	Shares	Weighted Average Remaining Contractual Life in Years	Shares	Weighted Average Remaining Contractual Life in Years
\$13.750.....	32,000	10	—	—
12.750.....	28,000	9	28,000	10
8.875.....	39,000	7	39,000	8
4.000.....	<u>1,000</u>	<u>4</u>	<u>3,500</u>	<u>5</u>
	<u>100,000</u>		<u>70,500</u>	

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

14. EMPLOYEE BENEFIT PLANS

Pension Plan

The Bank provides pension benefits for all of its eligible officers and employees through membership in a defined benefit plan of the Savings Banks Employees Retirement Association ("SBERA"). Each employee reaching the age of 21 and having completed at least one year of continuous service and 1,000 hours of service during each twelve-month period beginning with such employee's date of employment becomes a Participant of the Plan. All Participants become fully vested after three years of service or age 62 if earlier. Under the Plan, retirement benefits are based on years of credited service, the highest average compensation (as defined), and the primary social security benefit. In addition, employees may make optional, voluntary contributions to the Plan under several methods. The optional contributions provide retirement benefits to the employee in addition to those otherwise available under the Bank's Plan. Annual contributions by the Bank are based on assessments from SBERA.

Net periodic pension cost is as follows:

	Plan Years Ended October 31,		
	1996	1995	1994
		(In Thousands)	
Service cost - benefits earned during year.....	\$123	\$ 82	\$ 81
Interest cost on projected benefits	95	87	85
Actual return on plan assets.....	(210)	(221)	(71)
Net amortization and deferral.....	3	3	3
Amortization of net (gain) loss.....	<u>66</u>	<u>99</u>	<u>(36)</u>
Net periodic pension cost.....	<u>\$ 77</u>	<u>\$ 50</u>	<u>\$ 62</u>

Pension expense for the years ended December 31, 1996, 1995 and 1994 amounted to \$89,000, \$54,000, and \$51,000 respectively.

According to SBERA, a reconciliation of the funded status of the plan is as follows:

	October 31,	
	1996	1995
	(In Thousands)	
Plan assets at fair value	\$1,808	\$1,389
Actuarial present value of projected benefit obligation.....	<u>1,424</u>	<u>1,352</u>
Plan assets greater than projected benefit obligation	384	37
Unamortized net obligation since adoption of SFAS No. 87	29	32
Unrecognized net gain	<u>(944)</u>	<u>(586)</u>
Pension liability.....	<u>\$ (531)</u>	<u>\$ (517)</u>

The accumulated benefit obligation (substantially all vested) at October 31, 1996 amounted to \$1,081,000.

For the plan years ended October 31, 1996, 1995 and 1994, actuarial assumptions include an assumed discount rate on benefit obligations of 7.50%, 7.00% and 8.00%, respectively, and an expected long-term rate of return on plan assets of 8.00%, 8.00% and 7.00%, respectively. An annual salary increase of 6.00% was utilized for all years.

401(k) Plan

Effective August 1, 1996, the Bank has adopted a 401(k) Plan whereby each employee reaching the age of 21 and having completed at least 1,000 hours of service in a twelve-month period, beginning with date of employment, becomes eligible to participate in the Plan. Employees may contribute up to 15% of their compensation subject to certain limits based on federal tax laws. The Bank does not make matching contributions to the Plan.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

15. RELATED PARTY TRANSACTIONS

In the ordinary course of business, the Bank has granted loans to principal officers and directors and their affiliates amounting to \$22,000 at December 31, 1996 and \$23,000 at December 31, 1995. In 1993, the Bank established a policy whereby new loans (excluding passbook loans) cannot be granted to employees, officers or directors.

16. FAIR VALUE OF FINANCIAL INSTRUMENTS

SFAS No. 107, "Disclosures about Fair Value of Financial Instruments" requires disclosure of estimated fair values of all financial instruments where it is practicable to estimate such values. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. Statement No. 107 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Bank.

The following methods and assumptions were used by the Bank in estimating fair value disclosures for financial instruments:

Cash and cash equivalents: The carrying amounts of cash, due from banks and interest-bearing deposits approximate fair values.

Securities available for sale: Fair values for securities available for sale are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

Loans: For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Fair values for non-performing loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

Federal Home Loan Bank stock: The carrying value of Federal Home Loan Bank stock is deemed to approximate fair value based on the redemption provisions of the Federal Home Loan Bank of Boston.

Deposits: The fair values of non-certificate accounts are, by definition, equal to the amount payable on demand at the reporting date which is their carrying amount. Fair values for certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Federal Home Loan Bank advances: The fair values of the Bank's borrowings are estimated using discounted cash flow analyses based on the Bank's current incremental borrowing rates for similar types of borrowing arrangements.

Other borrowed funds: The carrying amounts of other borrowed funds approximate fair value.

Accrued interest: The carrying amounts of accrued interest approximate fair value.

Off-balance-sheet instruments: Fair values for off-balance-sheet lending commitments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. At December 31, 1996 and 1995, the fair value of commitments outstanding are not significant since fees charged are not material.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

FAIR VALUE OF FINANCIAL INSTRUMENTS (concluded)

The carrying amounts and estimated fair values of the Bank's financial instruments are as follows:

	December 31,			
	1996		1995	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(In Thousands)			
Financial assets:				
Cash and cash equivalents	\$ 11,640	\$ 11,640	\$ 10,586	\$ 10,586
Securities available for sale	32,321	32,321	39,152	39,152
Loans, net	151,166	152,381	119,472	121,160
Accrued interest receivable	1,060	1,060	1,048	1,048
Federal Home Loan Bank stock	1,450	1,450	1,200	1,200
Financial liabilities:				
Deposits	150,015	150,328	133,042	133,368
Federal Home Loan Bank advances	29,754	29,767	22,000	22,048
Other borrowed funds	188	188	—	—
Accrued interest payable	582	582	505	505

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

17. QUARTERLY FINANCIAL DATA (UNAUDITED)

Quarterly results of operations for the years ended December 31, 1996 and 1995 are as follows:

	Years Ended December 31,							
	1996				1995			
	Fourth Quarter	Third Quarter	Second Quarter	First Quarter	Fourth Quarter	Third Quarter	Second Quarter	First Quarter
	(In Thousands, Except Per Share Data)							
Interest and dividend income	\$3,734	\$3,587	\$3,387	\$3,254	\$3,247	\$3,048	\$2,968	\$2,811
Interest expense	1,844	1,778	1,679	1,655	1,653	1,527	1,454	1,237
Net interest income	1,890	1,809	1,708	1,599	1,594	1,521	1,514	1,574
Provision for loan losses	38	30	30	9	30	30	30	30
Net interest income, after provision for loan losses	1,852	1,779	1,678	1,590	1,564	1,491	1,484	1,544
Other income	180	141	157	136	162	129	138	80
Operating expenses	1,063	1,010	999	994	946	840	929	926
Income before income taxes	969	910	836	732	780	780	693	698
Income tax provision	369	382	349	303	294	280	230	241
Net income	\$ 600	\$ 528	\$ 487	\$ 429	\$ 486	\$ 500	\$ 463	\$ 457
Earnings per common share	\$.46	\$.40	\$.38	\$.33	\$.37	\$.39	\$.36	\$.35
Cash dividends declared per share	\$.19 ⁽¹⁾	\$.09	\$.09	\$.08	\$.16 ⁽²⁾	\$.07	\$.07	\$.05

(1) Includes a special dividend of \$0.10 per share declared on December 2, 1996.

(2) Includes a special dividend of \$0.08 per share declared on December 21, 1995.

STOCKHOLDER INFORMATION

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Form F-2

A copy of the Bank's Annual Report on Form F-2 for the fiscal year ended December 31, 1996 as filed with the Federal Deposit Insurance Corporation, may be obtained without charge, by any stockholder of the Bank upon written request addressed to the Investor Relations Department.

STOCK DATA

Hingham Institution for Savings common shares are listed and traded on the NASDAQ National Market System under the symbol HIFS.

As of December 31, 1996 there were approximately 533 stockholders of record, holding 674,097 outstanding shares of common stock. These shares do not include the number of persons who hold their shares in nominee or street name through various brokerage firms.

The following table presents the quarterly high and low bid prices for the Bank's common stock reported by NASDAQ.

	High	Low
1996		
First Quarter	\$15	\$13
Second Quarter	14 3/4	13 3/4
Third Quarter	15 1/2	14
Fourth Quarter	18 3/4	15
1995		
First Quarter	\$12	\$ 9 1/2
Second Quarter	12	10 1/2
Third Quarter	12 3/4	10 3/4
Fourth Quarter	14 3/4	12 1/4

The closing sale price of the Bank's common stock at December 31, 1996 was \$18.75 per share.



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