NORTHWAY FINANCIAL INC
Form 10-K
March 29, 2006

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, DC 20549
FORM 10-K

x Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the fiscal year ended December 31, 2005

o Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934

Commission File Number 000-23129

NORTHWAY FINANCIAL, INC.
(Exact name of registrant as specified in its charter)

New Hampshire (State or other jurisdiction of incorporation or organization)	04-3368579 (I.R.S. Employer Identification No.)
9 Main Street Berlin, New Hampshire Address of principal executive offices	03570 (Zip Code)

(603) 752-1171
(Registrant's telephone number, including area code)

Securities Registered Pursuant to Section 12(b) of the Act: None

Securities Registered Pursuant to Section 12(g) of the Act:
Common Stock, Par Value $1.00

Indicate by check mark if the registrant is a well-known seasoned issue, as defined in Rule 405 of the Securities Act. YES o NO x

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES o NO x

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated file. See definition of "accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange Act.. Large Accelerated Filer o Accelerated Filer o Non-Accelerated Filer x

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

The number of shares of voting and nonvoting common stock, par value $1.00 per share, held by nonaffiliates of the registrant as of June 30, 2005 was 1,290,784 shares with an aggregate market value, computed by reference to the last reported sales price on the NASDAQ National Market on such date, of $41,305,088. Although directors and executive officers of the registrant were assumed to be "affiliates" of the registrant for purposes of this calculation, this classification is not to be interpreted as an admission of such status.

At March 25, 2006, there were 1,491,174 shares of common stock outstanding, par value $1.00 per share.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's proxy statement for its 2006 Annual Meeting of Stockholders are incorporated by reference in Items 10, 11, 12, 13 and 14 of Part III.

NORTHWAY FINANCIAL, INC.
2005 FORM 10-K ANNUAL REPORT

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FORWARD-LOOKING STATEMENTS

Certain statements in this report are "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements may include, but are not limited to, projections of revenue, income or loss, plans for future operations and acquisitions, projections based on assumptions regarding market and liquidity risk, and plans related to products or services of Northway Financial, Inc. ("Northway") and its subsidiaries (the "Company"). Such forward-looking statements are subject to known and unknown risks, uncertainties and contingencies, many of which are beyond the control of the Company. To the extent any such risks, uncertainties and contingencies are realized, the Company's actual results, performance or achievements could differ materially from anticipated results, performance or achievements. Factors that might affect such forward-looking statements include, among other factors, the factors described under the caption "Risk Factors" in Item 1A of this report, overall economic and business conditions, economic and business conditions in the Company's market areas, interest rate fluctuations, the demand for the Company's products and services, competitive factors in the industries in which the Company competes, changes in government regulations, and the timing, impact and other uncertainties of future acquisitions.

In addition to the factors described above, the following are some additional factors that could cause our financial performance to differ from any forward-looking statement contained herein: i) changes in interest rates over the past year and the relative relationship between the various interest rate indices that the Company uses; ii) a determination in the financial market affecting the valuation of securities held in the Company's investment portfolio; (iii) a change in product mix attributable to changing interest rates, customer preferences or competition; iv) a significant portion of the Company's loan customers are in the hospitality business and therefore could be affected by a slower economy, adverse weather conditions and/or rising gasoline prices; and v) the effectiveness of advertising, marketing and promotional programs.

The words "believe," "expect," "anticipate," "intend," "estimate," "project" or the negative of such terms and other si expressions which are predications of or indicate future events and trends and which do not relate to historical matters identify forward-looking statements. Reliance should not be placed on forward-looking statements because they involve known or unknown risks, uncertainties or other factors, which may cause the actual results, performance or achievements of the Company to differ materially from anticipated future results, performance or achievements expressed or implied by such forward-looking statements. The Company expressly disclaims any obligation to publicly update or revise any forward-looking statement, whether as a result of new information, future events or otherwise.

Though the Company has attempted to list comprehensively the factors which might affect forward-looking statements, the Company wishes to caution you that other factors may in the future prove to be important in affecting the Company's results of operations. New factors emerge from time to time and it is not possible for management to anticipate all of such factors, nor can it assess the impact of each such factor, or combination of factors, which may cause actual results to differ materially from forward-looking statements.

PART 1

ITEM 1. BUSINESS

Description of Business

Northway Financial, Inc. was incorporated on March 7, 1997, under the laws of the State of New Hampshire, for the purpose of becoming the holding company of The Berlin City Bank, a New Hampshire-chartered bank headquartered in Berlin, New Hampshire ("BCB"), pursuant to a reorganization transaction (the "BCB Reorganization") by and among the Company, BCB, and a subsidiary of BCB, and, thereafter, the merger (the "Merger") by and among the Company, BCB, Pemi Bancorp, Inc. (“PEMI”), and PEMI’s wholly owned subsidiary, The Pemigewasset National Bank of Plymouth, New Hampshire, a national bank headquartered in Plymouth, New Hampshire (“PNB”). The BCB Reorganization and the Merger became effective on September 30, 1997. As of such date, BCB and PNB became wholly owned subsidiaries of the Company. On October 1, 2005, BCB was renamed Northway Bank and PNB was merged into Northway Bank (“Bank”). Unless the context otherwise requires, references herein to the “Company" include Northway Financial, Inc. and its consolidated subsidiary.

The Company derives substantially all of its revenue and income from the furnishing of bank and bank-related services, principally to individuals and small and medium-sized companies in New Hampshire. The Bank operates as a typical community banking institution and does not engage in any specialized finance or capital market activities. The Company functions primarily as the holder of stock of its subsidiaries and assists the management of its subsidiaries as appropriate.

The Company is subject to regulation by the New Hampshire Bank Commissioner (the “Commissioner”), the Federal Deposit Insurance Corporation (the “FDIC”), and the Board of Governors of the Federal Reserve System. See "Supervision and Regulation."

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The Bank is engaged in a general commercial banking business and offers commercial and construction loans, real estate mortgages, consumer loans, including personal secured and unsecured loans, and lines of credit.

During 1998 the Bank established an indirect lending business unit in Concord, New Hampshire. On August 25, 2004, the Company announced its exit from the indirect automobile lending line of business. Effective August 31, 2004, the Company ceased accepting applications from its dealer network. As of December 31, 2005 this line of business accounted for approximately 14% of the Company’s loan portfolio. The Bank will continue to service the existing portfolio of approximately 7,000 loans. The decision to exit this line of business was predicated on the low interest rate environment and competitive pressures. Over the next twelve months, cash flows from the existing portfolio are expected to be redeployed into commercial loans, residential mortgage loans, consumer loans, such as home equity loans and automobile loans, and the Company’s investment portfolio.

The Bank accepts savings, time, demand, NOW and money market deposit accounts, and offers a variety of banking services including safe deposit boxes, credit card accounts, official checks and money orders, overdraft lines of credit and wire transfer services.

Northway is a legal entity separate and distinct from its subsidiary. The right of Northway to participate in any distribution of assets or earnings of the subsidiary is subject to the prior claims of creditors of the subsidiary, except to the extent that claims, if any, of Northway itself as a creditor may be recognized. See “Supervision and Regulation.”

The following information concerning the Company’s investment activities, lending activities, asset quality and allowance for loan losses should be read in conjunction with “Management’s Discussion and Analysis of Financial Condition and Results of Operations,” appearing under Item 7 of this report and the Company’s Consolidated Financial Statements and Notes thereto.

Investment Activities

The following table presents the carrying amount of the Company’s securities available-for-sale as of December 31, 2005, 2004 and 2003 (dollars in thousands):

	2005	2004	2003
U.S. Treasury and other U.S. government agency securities	$ 47,751	$ 54,563	$ 37,840
Mortgage-backed securities [1]	23,939	29,301	2,903
Marketable equity securities	2,809	1,931	2,766
Corporate bonds	5,569	12,287	21,983
State and political subdivision bonds and notes	23,176	3,051	2,590
Total securities	$ 103,244	$ 101,133	$ 68,082

[1] Includes collateralized mortgage obligations of $8

The following table sets forth the amortized cost of the Company’s investment in debt securities maturing within stated periods and their related weighted average yields, reported on a tax equivalent basis, as of December 31, 2005 (dollars in thousands):

		Maturities		
Within one year	One to five	Five to ten	Over ten	Total amortized

		years	years	years	cost
Available-for-sale:					
U.S. Treasury and other					
U.S. government agency securities	$ 5,998	$ 37,730	$ 5,000	$ -	$ 48,728
Mortgage-backed securities [(1)]	-	29	-	24,683	24,712
Corporate bonds	2,003	3,538	-	-	5,541
State and political subdivision bonds and notes	1,101	425	562	21,308	23,396
Total amortized cost	$ 9,102	$ 41,722	$ 5,562	$ 45,991	$ 102,377
Market value	$ 9,052	$ 40,916	$ 5,485	$ 44,982	$ 100,435
Weighted average yield	3.69%	3.97%	5.29%	5.32%	4.63%

(1) Includes collateralized mortgage obligations of $8

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Lending Activities

The following table sets forth information with respect to the composition of the Company's loan portfolio, excluding loans held for sale, as of December 31, 2005, 2004, 2003, 2002 and 2001 (dollars in thousands):

	December 31,				
	2005	2004	2003	2002	2001
Real estate:					
Residential	$ 158,729	$ 147,333	$ 129,493	$ 114,526	$ 109,261
Commercial	143,456	130,334	120,366	111,941	111,642
Construction	13,241	5,366	3,851	6,330	1,581
Commercial	27,349	27,013	24,528	23,885	22,727
Installment	35,786	29,345	30,291	40,169	28,210
Indirect installment	62,221	116,520	150,807	139,477	120,761
Other	19,507	18,901	14,530	9,652	6,303
Total loans	460,289	474,812	473,866	445,980	400,485
Less:					
(Unamortized cost)/unearned income	(84)	106	247	207	169
Allowance for loan losses	5,150	5,204	5,036	4,920	4,642
Total unearned income and allowance for loan losses	5,066	5,310	5,283	5,127	4,811
Net loans	$ 455,223	$ 469,502	$ 468,583	$ 440,853	$ 395,674

The following table presents the maturity distribution of the Company's real estate construction and commercial loans at December 31, 2005 (dollars in thousands):

	Amount	Percent of Total
Within one year	$ 13,532	33.34%
One to five years	12,324	30.36
Over five years	14,734	36.30
	$ 40,590	100.00%

The Company's real estate construction and commercial loans due after one year at December 31, 2005 were comprised of the following (dollars in thousands):

	Amount
Fixed interest rate	$ 10,004
Adjustable interest rate	17,054
	$ 27,058

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Analysis of the Allowance for Loan Losses

The following table reflects activity in the Company's allowance for loan losses for the years ended December 31, 2005, 2004, 2003, 2002 and 2001 (dollars in thousands):

	Years ended December 31, 2005	2004	2003	2002	2001
Balance at the beginning of period	$ 5,204	$ 5,036	$ 4,920	$ 4,642	$ 4,354
Charge-offs:					
Real estate	8	56	-	83	110
Commercial	10	28	120	12	95
Installment loans to individuals	397	581	750	729	529
Total	415	665	870	824	734
Recoveries:					
Real estate	44	162	25	64	35
Commercial	85	16	11	4	-
Installment loans to individuals	157	160	145	134	87
Total	286	338	181	202	122
Net charge-offs	129	327	689	622	612
Provision charged to expense	75	495	805	900	900
Balance at the end of period	$ 5,150	$ 5,204	$ 5,036	$ 4,920	$ 4,642
Ratio of net charge-offs to average loans	0.03%	0.07%	0.15%	0.15%	0.15%

Allocation of the Allowance for Loan Losses

The following table sets forth the breakdown of the Company's allowance for loan losses in the Company's portfolio by category of loan and the percentage of loans in each category to total loans in the respective portfolios at the dates indicated (dollars in thousands):

	December 31, 2005		2004		2003		2002		2001	
	Amount	Percent of loans in each category to total loans	Amount	Percent of loans in each category to total loans	Amount	Percent of loans in each category to total loans	Amount	Percent of loans in each category to total loans	Amount	Percent of loans in each category to total loans
Real estate:										

Residential	$ 784	34.5%	$ 644	31.0%	$ 624	27.3%	$ 598	25.9%	$ 585	27.2%
Commercial & construction	3,032	34.0	1,892	28.6	1,724	26.2	2,008	26.7	1,621	28.3
Commercial	278	6.0	174	5.7	155	5.2	216	5.4	208	5.7
Installment	985	21.3	2,398	30.7	2,505	38.2	2,084	40.6	1,719	37.2
Other	71	4.2	96	4.0	28	3.1	14	1.4	17	1.6
Unallocated	-	N/A	-	N/A	-	N/A	-	N/A	492	N/A
	$ 5,150	100.0%	$ 5,204	100.0%	$ 5,036	100.0%	$ 4,920	100.0%	$ 4,642	100.0%

Deposits

See "Financial Statements and Supplementary Data" in Item 8 of this report.

Supervision and Regulation

The business in which the Company is engaged is subject to extensive supervision, regulation and examination by various bank regulatory authorities and other governmental agencies. State and federal banking laws have as their principal objective either the maintenance of the safety and soundness of financial institutions and the federal deposit insurance system or the protection of consumers or classes of consumers, and depositors in particular, rather than the specific protection of stockholders of a bank or its parent company.

Set forth below is a brief description of certain laws and regulations that relate to the regulation of the Company. To the extent the following material describes statutory or regulatory provisions, it is qualified in its entirety by reference to the particular statute or regulation.

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Regulation of the Company

General. As a registered bank holding company, the Company is subject to regulation under the Bank Holding Company Act of 1956, as amended ("BHCA") and to inspection, examination and supervision by the Board of Governors of the Federal Reserve System ("FRB"). The Company is also subject to the laws of the State of New Hampshire.

The FRB has the authority to issue orders to bank holding companies to cease and desist from unsound banking practices and violations of conditions imposed by, or violations of agreements with, the FRB. The FRB is also empowered to assess civil money penalties against companies or individuals who violate the BHCA or orders or regulations thereunder, to order termination of non-banking activities of non-banking subsidiaries of bank holding companies, and to order termination of ownership and control of a non-banking subsidiary by a bank holding company. Under the BHCA, the Company may not generally engage in activities or acquire more than 5% of any class of voting securities of any company engaged in activities other than banking or activities that are closely related to banking. However, a bank holding company that has elected to be treated as a "financial holding company" may engage in activities that are financial in nature or incidental or complementary to such financial activities, as determined by the FRB alone, or together with the Secretary of the Department of the Treasury. The Company has not elected financial holding company status. Under certain circumstances, the Company may be required to give notice to or seek approval of the FRB before engaging in activities other than banking.

Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 ("Riegle-Neal"). Riegle-Neal permits adequately- or well-capitalized and adequately- or well-managed bank holding companies, as determined by the FRB, to acquire banks in any state subject to certain concentration limits and other conditions. Riegle-Neal also generally authorizes the interstate merger of banks. In addition, among other things, Riegle-Neal permits banks to establish new branches on an interstate basis provided that the law of the host state specifically authorizes such action. However, as a bank holding company, the Company is required to obtain prior FRB approval before acquiring more than 5% of a class of voting securities, or substantially all of the assets of a bank holding company, bank or savings association.

Control Acquisitions. The Change in Bank Control Act prohibits a person or group of persons from acquiring "control" of a bank holding company, such as the Company, unless the FRB has been notified and has not objected to the transaction. Under a rebuttable presumption established by the FRB, the acquisition of 10% or more of a class of voting securities of a bank holding company with a class of securities registered under Section 12 of the Securities Exchange Act of 1934, as amended, would, under the circumstances set forth in the presumption, constitute acquisition of control of the bank holding company. In addition, a company is required to obtain the approval of the FRB under the BHCA before acquiring 25% (5% in the case of an acquirer that is a bank holding company) or more of any class of outstanding voting securities of a bank holding company, or otherwise obtaining control or a "controlling influence" over that bank holding company.

Bank Holding Company Dividends. The FRB has authority to prohibit bank holding companies from paying dividends if such payment is deemed to be unsafe or unsound. The FRB has indicated generally that it may be an unsafe or unsound practice for bank holding companies to pay dividends unless the bank holding company's net income over the preceding year is sufficient to fund the dividends and the expected rate of earnings retention is consistent with the organization's capital needs, asset quality and overall financial condition. The Company depends in part upon dividends received from its subsidiary bank to fund its activities, including the payment of dividends. As described below, the Federal Deposit Insurance Corporation ("FDIC") and the Banks' regulatory agencies may regulate the amount of dividends payable by the subsidiary banks. The inability of the Bank to pay a dividend may have an adverse effect on the Company.

Regulation of the Bank

The Bank is organized under New Hampshire law and is subject to the regulations of the Commissioner and the FDIC, including requirements and restrictions related to the maintenance of adequate levels of capital, the payment of dividends, investments, the nature and amount of loans which can be originated and the rate of interest that can be charged thereon, and other activities. Capital requirements applicable to the Bank are substantially similar to those adopted by the FRB regarding bank holding companies as described above.

Insurance of Accounts and FDIC Regulation. The Bank pays deposit insurance premiums to the FDIC based on an assessment rate established by the FDIC for Bank Insurance Fund-member institutions. The FDIC has established a risk-based premium system under which the FDIC classifies institutions based on their capital ratios and on other relevant factors and generally assesses higher rates on those institutions that tend to pose greater risks to the federal deposit insurance funds. The Federal Deposit Insurance Act (“FDIA”) does not require the FDIC to charge all banks deposit insurance premiums when the ratio of deposit insurance reserves to insured deposits is maintained above specified levels. During 2005, the Bank risk classification was A1, the most favorable rating, resulting in premiums totaling $63,000. As a result of general economic conditions, and a decline in the health of the banking industry, it is possible that the ratio of deposit insurance reserves to insured deposits could fall below the minimum ratio that FDIA requires, which would result in the FDIC setting deposit insurance assessment rates sufficient to increase deposit insurance reserves to the required ratio. We cannot predict whether the FDIC will be required to increase deposit insurance assessments on the Banks above their current levels.

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In February 2006, Congress enacted the Federal Deposit Insurance Reform Act of 2005 (the "FDIR Act"). As a result of the passage of the FDIR Act, over the course of the next year, among other things: (i) the BIF will be merged with the FDIC's Savings Association Insurance Fund creating the Deposit Insurance Fund (the "DIF"); (ii) the $100,000 per account insurance level will be indexed to reflect inflation; (iii) deposit insurance coverage for certain retirement accounts will be increased to $250,000; and (iv) a cap will be placed on the level of the DIF and dividends will be paid to banks once the level of the DIF exceeds the specified threshold.

Bank Holding Company Support of Subsidiary Banks. Under FRB policy, a bank holding company is expected to act as a source of financial and managerial strength to each of its subsidiary banks and to commit resources to their support. This support may be required at times when the bank holding company may not have the resources to provide it. Similarly, under the cross-guarantee provisions of FDIA, the FDIC can hold any FDIC-insured depository institution liable for any loss suffered or anticipated by the FDIC in connection with (1) the "default" of a commonly controlled FDIC-insured depository institution; or (2) any assistance provided by the FDIC to a commonly controlled FDIC-insured depository institution "in danger of default." The Bank is an FDIC-insured depository institution.

Regulatory Capital Requirements. The FRB and the FDIC have issued substantially similar risk-based and leverage capital guidelines applicable to United States banking organizations. In addition, these regulatory agencies may from time to time require that a banking organization maintain capital above the minimum levels, whether because of its financial condition or actual or anticipated growth.

The FRB risk-based guidelines define a three-tier capital framework. Tier 1 capital includes common stockholders' equity and qualifying preferred stock, less goodwill and other adjustments. Tier 2 capital consists of preferred stock not qualifying as Tier 1 capital, mandatory convertible debt, limited amounts of subordinated debt, other qualifying term debt and the allowance for loan losses up to 1.25 percent of risk-weighted assets. Tier 3 capital includes subordinated debt that is unsecured, fully paid, has an original maturity of at least two years, is not redeemable before maturity without prior approval by the FRB and includes a lock-in clause precluding payment of either interest or principal if the payment would cause the issuing bank's risk-based capital ratio to fall or remain below the required minimum. The sum of Tier 1 and Tier 2 capital less investments in unconsolidated subsidiaries represents qualifying total capital. Risk-based capital ratios are calculated by dividing Tier 1 and total capital by risk-weighted assets. Assets and off-balance sheet exposures are assigned to one of four categories of risk-weights, based primarily on relative credit risk. The minimum Tier 1 capital ratio is four percent and the minimum total capital ratio is eight percent. The Company's tier 1 calculation as of December 31, 2005 equaled 13.07% and its total capital ratio as of December 31, 2005 was 15.24%.

The leverage ratio is determined by dividing Tier 1 capital by adjusted average total assets for the quarter. Although the stated minimum ratio is 100 to 200 basis points above three percent, banking organizations are required to maintain a ratio of at least five percent to be classified as "well capitalized". The Company's leverage ratio as of December 31, 2005 was 8.96%.

The Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA"), among other things, identifies five capital categories for insured depository institutions (well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized) and requires the federal bank regulatory agencies to implement systems for "prompt corrective action" for insured depository institutions that do not meet minimum capital requirements within such categories. FDICIA imposes progressively more restrictive constraints on operations, management and capital distributions, depending on the category in which an institution is classified. Failure to meet the capital guidelines could also subject a banking institution to capital raising requirements. An "undercapitalized" bank must develop a capital restoration plan and its parent holding company must guarantee that bank's compliance with the plan. The liability of the parent holding company under any such guarantee is limited to the lesser of five percent of the bank's assets at the time it became "undercapitalized" or the amount needed to comply with the plan.

Furthermore, in the event of the bankruptcy of the parent holding company, such guarantee would take priority over the parent's general unsecured creditors. In addition, FDICIA requires the various regulatory agencies to prescribe certain non-capital standards for safety and soundness relating generally to operations and management, asset quality and executive compensation and permits regulatory action against a financial institution that does not meet such standards.

The various regulatory agencies have adopted substantially similar regulations that define the five capital categories identified by FDICIA, using the total risk-based capital, Tier 1 risk-based capital and leverage capital ratios as the relevant capital measures. Such regulations establish various degrees of corrective action to be taken when an institution is considered undercapitalized. Under the regulations, a "well capitalized" institution must have a Tier 1 risk-based capital ratio of at least six percent, a total risk-based capital ratio of at least ten percent and a leverage ratio of at least five percent and not be subject to a capital directive order.

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Regulators also must take into consideration (a) concentrations of credit risk; (b) interest rate risk (when the interest rate sensitivity of an institution's assets does not match the sensitivity of its liabilities or its off-balance-sheet position); and (c) risks from non-traditional activities, as well as an institution's ability to manage those risks, when determining the adequacy of an institution's capital. This evaluation will be made as a part of the institution's regular safety and soundness examination. In addition, the Company, and any bank with significant trading activity, must incorporate a measure for market risk in their regulatory capital calculations. As of December 31, 2005, the most recent notification from the FDIC categorized the Bank as "well capitalized".

In October 2005, the federal banking agencies issued an advance notice of proposed rulemaking ("ANPR") concerning potential changes in the risk-based capital rules ("Basel IA") that are designed to apply to, and potentially reduce the risk capital requirements of bank holding companies, such as the Company, that are not among the 20 or so larges US bank holding companies. It remains uncertain whether the Basel IA rules will be adopted and, even if adopted, how closely the final Basel IA rules will resemble the rules described in the ANPR and what the effective date of such rules will be. Accordingly, the Company is not yet in a position to determine the effect of such rules on its risk capital requirements.

Transactions with Affiliates. Under Sections 23A and 23B of the Federal Reserve Act and Regulation W thereunder, there are various legal restrictions on the extent to which a bank holding company and its non-bank subsidiaries may borrow, obtain credit from or otherwise engage in "covered transactions" with its FDIC insured depository institution subsidiaries. Such borrowings and other covered transactions by an insured depository institution subsidiary (and its subsidiaries) with its non-depository institution affiliates are limited to the following amounts: (a) in the case of one such affiliate, the aggregate amount of covered transactions of the insured depository institution and its subsidiaries cannot exceed ten percent (10%) of the capital stock and surplus of the insured depository institution; and (b) in the case of all affiliates, the aggregate amount of covered transactions of the insured depository institution and its subsidiaries cannot exceed twenty percent (20%) of the capital stock and surplus of the insured depository institution.

"Covered transactions" are defined by statute for these purposes to include a loan or extension of credit to an affiliate, a purchase of or investment in securities issued by an affiliate, a purchase of assets from an affiliate unless exempted by the Federal Reserve Board, the acceptance of securities issued by an affiliate as collateral for a loan or extension of credit to any person or company, or the issuance of a guarantee, acceptance, or letter of credit on behalf of an affiliate. Covered transactions are also subject to certain collateral security requirements. Further, a bank holding company and its subsidiaries are prohibited from engaging in certain tying arrangements in connection with any extension of credit, lease or sale of property of any kind, or furnishing of any service.

Limitations on Bank Dividends. The FDIC has the authority to use its enforcement powers to prohibit a bank from paying dividends if, in its opinion, the payment of dividends would constitute an unsafe or unsound practice. Federal law also prohibits the payment of dividends by a bank that will result in the bank failing to meet its applicable capital requirements on a pro forma basis.

Customer Information Security. The FDIC and other bank regulatory agencies have adopted final guidelines for establishing standards for safeguarding nonpublic personal information about customers that implement provisions of the Gramm-Leach-Bliley Act of 1999 or "GLBA," which establishes a comprehensive framework to permit affiliations among commercial banks, insurance companies, securities firms, and other financial service providers by revising and expanding the BHCA framework. Specifically, the Information Security Guidelines established by the GLBA require each financial institution, under the supervision and ongoing oversight of its Board of Directors or an appropriate committee thereof, to develop, implement and maintain a comprehensive written information security program designed to ensure the security and confidentiality of customer information, to protect against anticipated threats or hazards to the security or integrity of such information; and to protect against unauthorized access to or use of such information that could result in substantial harm or inconvenience to any customer. The federal banking regulators have issued guidance for banks on response programs for unauthorized access to customer information. This guidance, among other things, requires notice to be sent to customers whose “sensitive information” has been compromised if unauthorized use of this information is “reasonably possible.” Various states have enacted legislation concerning breaches of data security and various bills requiring consumer notice of data security breaches are being considered by Congress.

Privacy. The GLBA requires financial institutions to implement policies and procedures regarding the disclosure of nonpublic personal information about consumers to nonaffiliated third parties. In general, the statute requires financial institutions to explain to consumers their policies and procedures regarding the disclosure of such nonpublic personal information, and, unless otherwise required or permitted by law, financial institutions are prohibited from disclosing such information except as provided in their policies and procedures.

USA Patriot Act. The USA Patriot Act of 2001, designed to deny terrorists and others the ability to obtain anonymous access to the U.S. financial system, has significant implications for depository institutions, broker-dealers, mutual funds, insurance companies and businesses of other types involved in the transfer of money. The USA Patriot Act, together with the implementing regulations of various federal regulatory agencies, have caused financial institutions, including banks, to adopt and implement additional, or amend existing, policies and procedures with respect to, among other things, anti-money laundering compliance, suspicious activity and currency transaction reporting, customer identity verification and customer risk analysis. The statute and its underlying regulations also permit information sharing for counter-terrorist purposes between federal law enforcement agencies and financial institutions, as well as among financial institutions, subject to certain conditions, and require the FRB (and other federal banking agencies) to evaluate the effectiveness of an applicant and a target institution in combating money laundering activities when considering applications filed under Section 3 of the BHCA or under the Bank Merger Act. Management believes that the Company is in compliance with all the requirements prescribed by the USA Patriot Act and all applicable final implementing regulations.

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The Community Reinvestment Act. The Community Reinvestment Act ("CRA") requires lenders to identify the communities served by the institution's offices and other deposit taking facilities and to make loans and investments and provide services that meet the credit needs of these communities. Regulatory agencies examine each of the banks and rate such institutions' compliance with CRA as "Outstanding", "Satisfactory", "Needs to Improve," or "Substantial Noncompliance". Failure of an institution to receive at least a "Satisfactory" rating could inhibit such institution or its holding company from undertaking certain activities, including engaging in activities newly permitted as a financial holding company under the GLBA and acquisitions of other financial institutions. The FRB must take into account the record of performance of banks in meeting the credit needs of the entire community served, including low-and moderate-income neighborhoods. The Bank has achieved a rating of Satisfactory on their respective most recent examination. New Hampshire also has enacted substantially similar community reinvestment requirements. In 2005, the federal banking agencies adopted less burdensome CRA requirements for "intermediate - small banks," which are banks with $250 million or more, but less than $1 billion in total assets, under which such banks, including Northway Bank, will be examined using only two tests, a Lending Test and a new Community Development Test, and will be relieved of certain data collection and reporting requirements.

Competition

The banking industry in the United States, which includes commercial banks, savings and loan associations, mutual savings banks, capital stock savings banks, credit unions, and bank and savings and loan holding companies, is part of the broader financial services industry which includes insurance companies, mutual funds, and the brokerage industry, among others. In recent years, intense market demands and economic pressures have eroded once clearly defined industry classifications and have forced financial services institutions to diversify their services, increase returns on deposits, and become more cost-effective as a result of competition with one another and with new types of financial services companies, including non-bank competitors.

The Company's banking subsidiary faces significant competition in its markets from commercial banks, savings banks, credit unions, consumer finance companies, insurance companies, "non-bank banks," mutual funds, government agencies, investment management companies, investment advisors, brokers and investment bankers. In addition, increasing consolidation within the banking and financial services industry, as well as increased competition from larger regional and out-of-state banking organizations and non-bank providers of various financial services, may adversely affect the Company's ability to achieve its financial goals. Federal banking laws permit adequately capitalized bank holding companies to venture across state lines to offer banking services through bank subsidiaries to a wider geographic market. Consequently, it is possible for large organizations to enter many new markets including the markets served by the Company. Certain of these competitors, by virtue of their size and resources, may enjoy certain efficiencies and competitive advantages over the Company in pricing, delivery, and marketing of their products and services. The Company's long-term success depends on the ability of the Company's banking subsidiaries to compete successfully with other financial institutions in their service areas. It is not possible to assess what impact these changes in the regulatory environment will have on the Company. Many of these large competitors have significantly more financial resources, larger market share and greater name recognition in the market areas served by the Company and its banking subsidiaries.

The Bank competes in this environment by providing a broad range of financial services, competitive interest rates and a personal level of service that, combined, tend to retain the loyalty of its customers in its market areas against competitors with far larger resources. To a lesser extent, convenience of branch locations and hours of operations are also considered competitive advantages of the Bank.

Employees

As of December 31, 2005 the Company has 234 full-time equivalent employees. The Company considers its employee relations to be good.

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Website Access to Company Reports

The Company's annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports are available free of charge on the Company's website at www.northwaybank.com as soon as reasonably practicable after such material is electronically filed with or furnished to the Securities and Exchange Commission. Also, copies of the Company's annual report will be made available, free of charge, upon written request.

ITEM 1A. RISK FACTORS

Recent accounting changes could give rise to adverse changes in the regulatory capital treatment of our outstanding junior subordinated debenture, which, in turn, could adversely affect our regulatory capital position. In January 2003, the Financial Accounting Standards Board ("FASB") issued FASB Interpretation No. 46, "Consolidation of Variable Interest Entities" ("FIN 46") that addresses the consolidation rules to be applied to "variable interest entities" as defined in FIN 46. FIN 46, which applies to certain variable interest entities as of February 1, 2003 and to all variable interest entities as of December 14, 2003, provides that certain variable interest entities should not be treated as consolidated subsidiaries. Northway Capital Trust I and Northway Capital Trust II, our Delaware statutory business trusts, may constitute variable interest entities. Historically, issuer trusts, such as Northway Capital Trust I and Northway Capital Trust II that issued junior subordinated debentures have been consolidated by their parent companies. In addition, junior subordinated debentures have been treated as eligible for Tier 1 capital treatment by bank holding companies under the FRB's rules and regulations relating to minority interests in equity accounts of consolidated subsidiaries. Accordingly, we have consolidated our existing issuer trusts in preparing our consolidated financial statements in the past, and our outstanding junior subordinated debentures have been treated as Tier 1 capital.

On December 24, 2003, FASB issued a revision to FIN 46 ("FIN46R"), to clarify some of the provisions of FIN 46. Based on FIN46R, we deconsolidated our existing issuer trusts as of December 31, 2003, and restated our historical financial statements. The adoption of FIN46R results in the reclassification of the redeemable junior subordinated debentures from mezzanine capital to other liabilities as well as the reclassification of interest cost from minority interest to interest expense.

This deconsolidation could result in a change to the regulatory capital treatment of junior subordinated debentures issued by us and other U.S. bank holding companies. Specifically, it is possible that since the issuer trusts would no longer be consolidated by us the junior subordinated debentures issued by each such issuer trust would not be considered a minority interest in equity accounts of a consolidated subsidiary and therefore not be accorded Tier 1 capital treatment by the FRB. Trust preferred securities have historically been eligible for Tier 1 capital treatment by bank holding companies under FRB rules and regulations relating to minority interests in equity accounts of consolidated subsidiaries. Following the issuance of FIN 46, including the consolidation rules with respect to variable interest entities, the FRB requested public comment on a proposed rule that would limit trust preferred securities in the Tier 1 capital of bank holding companies, but with stricter limits and clearer qualitative standards. After considering the public comments, the FRB issued a final rule on March 1, 2005, which provides that after a five-year transition period ending on March 31, 2009, the aggregate amount of the trust preferred securities and certain other capital elements would be limited to 25% of Tier 1 capital elements, net of goodwill and intangibles. As of December 31, 2005, assuming the aggregate amount of the trust preferred securities is limited to 25% of Tier 1 capital, we would still exceed the regulatory required minimums for capital adequacy purposes.

We could be adversely impacted by changes in applicable regulations. We are subject to extensive federal and state laws and regulations and are subject to supervision, regulation and examination by various federal and state bank regulatory agencies. The restrictions imposed by such laws and regulations limit the manner in which we and our bank subsidiary may conduct business and obtain financing. There can be no assurance that any modification of these laws and regulations, or new legislation that may be enacted, in the future will not make compliance more difficult or expensive, restrict our ability to originate, broker or sell loans or otherwise adversely affect our operations. See "Supervision and Regulation" on page 4 of this report.

Our business is largely dependent upon the hospitality industry. A number of our loan customers are in the hospitality industry. The hospitality industry is dependent on personal discretionary spending levels. As a result, the hospitality industry may be adversely impacted by economic trends, including recession and increased unemployment. Additionally, unforeseen events including acts of terrorism, war, increases in fuel prices, travel-related accidents and unusual weather patterns also may adversely affect the hospitality industry. As a result, our business also is likely to be adversely affected by those events.

Interest rate volatility may adversely impact our results of operations. The principal component of our income stream is net interest and dividend income. Net interest and dividend income is the difference between interest and fee income on earning assets, such as loans and investments, and the interest expense paid on interest bearing liabilities, such as deposits and borrowed funds. Our net interest and dividend income may be significantly affected by changes in market interest rates. A decrease in interest rates could reduce our net interest and dividend income as the difference between interest and fee income and interest expense decreases. An increase in interest rates could also negatively impact our results of operations by reducing borrowers' ability to repay their current loan obligations, resulting in increased loan defaults, foreclosures and write-offs and could necessitate increases to our allowance for loan losses.

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Our allowance for loan losses may not be adequate to cover actual losses. We make various assumptions and judgments about the collectibility of our loan portfolio and provide an allowance for potential loan losses based on several factors. If our assumptions are incorrect, our allowance for loan losses may be insufficient to cover our actual losses, which would have an adverse effect on our results of operations, and may cause us to increase the allowance in the future.