

UNITY BANCORP INC /NJ/
Form 10-Q
August 12, 2015

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2015

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ____ to ____.

Commission File Number 1-12431

Unity Bancorp, Inc.

(Exact name of registrant as specified in its charter)

New Jersey 22-3282551
(State or other jurisdiction of incorporation or organization) (I.R.S. Employer Identification No.)

64 Old Highway 22, Clinton, NJ 08809
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code (908) 730-7630

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, as amended, during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days:

Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company (as defined in Rule 12b-2 of the Exchange Act):

Large accelerated filer Accelerated filer Nonaccelerated filer Smaller reporting company

Indicate by check mark whether the registrant is a shell company as defined in Rule 12b-2 of the Exchange Act:

Yes No

The number of shares outstanding of each of the registrant's classes of common equity stock, as of July 31, 2015
common stock, no par value: 8,426,455 shares outstanding.

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PART I CONSOLIDATED FINANCIAL INFORMATION

ITEM 1 Consolidated Financial Statements (Unaudited)

Unity Bancorp, Inc.

Consolidated Balance Sheets

(Unaudited)

| (In thousands) | June 30, 2015 | December 31, 2014 |
|---|------------------|----------------------|
| ASSETS | | |
| Cash and due from banks | \$ 28,240 | \$ 29,351 |
| Federal funds sold and interest-bearing deposits | 62,202 | 100,470 |
| Cash and cash equivalents | 90,442 | 129,821 |
| Securities: | | |
| Securities available for sale | 55,766 | 60,073 |
| Securities held to maturity (fair value of \$18,729 and \$20,281, respectively) | 18,609 | 20,009 |
| Total securities | 74,375 | 80,082 |
| Loans: | | |
| SBA loans held for sale | 11,368 | 5,179 |
| SBA loans held for investment | 39,663 | 40,401 |
| SBA 504 loans | 29,125 | 34,322 |
| Commercial loans | 428,371 | 401,949 |
| Residential mortgage loans | 243,259 | 220,878 |
| Consumer loans | 69,910 | 59,096 |
| Total loans | 821,696 | 761,825 |
| Allowance for loan losses | (12,404) | (12,551) |
| Net loans | 809,292 | 749,274 |
| Premises and equipment, net | 15,385 | 15,231 |
| Bank owned life insurance ("BOLI") | 13,190 | 13,001 |
| Deferred tax assets | 5,928 | 5,860 |
| Federal Home Loan Bank ("FHLB") stock | 5,635 | 6,032 |
| Accrued interest receivable | 3,690 | 3,518 |
| Other real estate owned ("OREO") | 2,265 | 1,162 |
| Goodwill and other intangibles | 1,516 | 1,516 |
| Other assets | 2,585 | 3,291 |
| Total assets | \$ 1,024,303 | \$ 1,008,788 |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | |

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Liabilities:

Deposits:

| | | |
|---|--------------|--------------|
| Noninterest-bearing demand | \$ 175,287 | \$ 152,785 |
| Interest-bearing demand | 117,988 | 128,875 |
| Savings | 284,369 | 300,348 |
| Time, under \$100,000 | 113,846 | 113,119 |
| Time, \$100,000 and over | 123,937 | 99,214 |
| Total deposits | 815,427 | 794,341 |
| Borrowed funds | 115,000 | 125,000 |
| Subordinated debentures | 15,465 | 15,465 |
| Accrued interest payable | 418 | 474 |
| Accrued expenses and other liabilities | 4,303 | 3,385 |
| Total liabilities | 950,613 | 938,665 |
| Commitments and contingencies | - | - |
| Shareholders' equity: | | |
| Common stock | 59,067 | 58,785 |
| Retained earnings | 15,055 | 11,195 |
| Accumulated other comprehensive (loss) income | (432) | 143 |
| Total shareholders' equity | 73,690 | 70,123 |
| Total liabilities and shareholders' equity | \$ 1,024,303 | \$ 1,008,788 |
| Issued and outstanding common shares | 8,425 | 8,388 |

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Unity Bancorp, Inc.

Consolidated Statements of Income

(Unaudited)

| (In thousands, except per share amounts) | For the three | | For the six months | |
|---|----------------------------------|-------|------------------------|--------|
| | months ended June 30, 2015 | 2014 | ended June 30, 2015 | 2014 |
| INTEREST INCOME | | | | |
| Federal funds sold and interest-bearing deposits | \$ 6 | \$ 10 | \$ 16 | \$ 19 |
| FHLB stock | 38 | 40 | 81 | 87 |
| Securities: | | | | |
| Taxable | 363 | 552 | 750 | 1,278 |
| Tax-exempt | 71 | 90 | 143 | 195 |
| Total securities | 434 | 642 | 893 | 1,473 |
| Loans: | | | | |
| SBA loans | 605 | 643 | 1,284 | 1,226 |
| SBA 504 loans | 369 | 433 | 715 | 832 |
| Commercial loans | 5,276 | 4,738 | 10,342 | 9,340 |
| Residential mortgage loans | 2,716 | 2,052 | 5,298 | 4,110 |
| Consumer loans | 774 | 544 | 1,473 | 1,039 |
| Total loans | 9,740 | 8,410 | 19,112 | 16,547 |
| Total interest income | 10,218 | 9,102 | 20,102 | 18,126 |
| INTEREST EXPENSE | | | | |
| Interest-bearing demand deposits | 103 | 109 | 209 | 220 |
| Savings deposits | 271 | 188 | 535 | 370 |
| Time deposits | 725 | 693 | 1,411 | 1,337 |
| Borrowed funds and subordinated debentures | 750 | 807 | 1,558 | 1,606 |
| Total interest expense | 1,849 | 1,797 | 3,713 | 3,533 |
| Net interest income | 8,369 | 7,305 | 16,389 | 14,593 |
| Provision for loan losses | - | 550 | 200 | 1,150 |
| Net interest income after provision for loan losses | 8,369 | 6,755 | 16,189 | 13,443 |
| NONINTEREST INCOME | | | | |
| Branch fee income | 373 | 342 | 719 | 718 |
| Service and loan fee income | 466 | 285 | 762 | 580 |
| Gain on sale of SBA loans held for sale, net | - | 255 | 363 | 337 |
| Gain on sale of mortgage loans, net | 687 | 188 | 1,031 | 553 |
| BOLI income | 95 | 96 | 189 | 192 |

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| | | | | |
|--|----------|----------|----------|----------|
| Net security gains | 28 | 268 | 28 | 378 |
| Other income | 244 | 206 | 442 | 408 |
| Total noninterest income | 1,893 | 1,640 | 3,534 | 3,166 |
| NONINTEREST EXPENSE | | | | |
| Compensation and benefits | 3,481 | 3,122 | 6,952 | 6,340 |
| Occupancy | 601 | 619 | 1,273 | 1,279 |
| Processing and communications | 614 | 597 | 1,210 | 1,179 |
| Furniture and equipment | 422 | 379 | 795 | 735 |
| Professional services | 242 | 247 | 478 | 458 |
| Loan costs | 160 | 174 | 382 | 344 |
| OREO expenses | 67 | 95 | 103 | 342 |
| Deposit insurance | 150 | 171 | 333 | 349 |
| Advertising | 343 | 287 | 525 | 438 |
| Other expenses | 572 | 453 | 1,103 | 939 |
| Total noninterest expense | 6,652 | 6,144 | 13,154 | 12,403 |
| Income before provision for income taxes | 3,610 | 2,251 | 6,569 | 4,206 |
| Provision for income taxes | 1,182 | 723 | 2,202 | 1,385 |
| Net income | \$ 2,428 | \$ 1,528 | \$ 4,367 | \$ 2,821 |
| | | | | |
| Net income per common share - Basic | \$ 0.29 | \$ 0.20 | \$ 0.52 | \$ 0.37 |
| Net income per common share - Diluted | \$ 0.28 | \$ 0.20 | \$ 0.51 | \$ 0.37 |
| | | | | |
| Weighted average common shares outstanding - Basic | 8,425 | 7,605 | 8,421 | 7,596 |
| Weighted average common shares outstanding - Diluted | 8,524 | 7,690 | 8,519 | 7,672 |

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Unity Bancorp, Inc.

Consolidated Statements of Comprehensive Income

(Unaudited)

| | For the three months ended | | | | | |
|--|----------------------------|---------------------------------------|-------------------------|-------------------------|---------------------------------------|-------------------------|
| | June 30, 2015 | | | June 30, 2014 | | |
| | Before tax amount | Income tax expense (benefit) | Net of tax amount | Before tax amount | Income tax expense (benefit) | Net of tax amount |
| (In thousands) | | | | | | |
| Net income | \$ 3,610 | \$ 1,182 | \$ 2,428 | \$ 2,251 | \$ 723 | \$ 1,528 |
| Other comprehensive (loss) income | | | | | | |
| Investment securities available for sale: | | | | | | |
| Unrealized holding (losses) gains on securities arising during the period | (201) | (80) | (121) | 553 | 202 | 351 |
| Less: reclassification adjustment for gains on securities included in net income | 28 | 10 | 18 | 268 | 90 | 178 |
| Total unrealized (losses) gains on securities available for sale | (229) | (90) | (139) | 285 | 112 | 173 |
| Adjustments related to defined benefit plan: | | | | | | |
| Initial recognition of prior service cost | (830) | (332) | (498) | - | - | - |
| Amortization of prior service cost | 42 | 17 | 25 | - | - | - |
| Total adjustments related to defined benefit plan | (788) | (315) | (473) | - | - | - |
| Total other comprehensive (loss) income | (1,017) | \$ (405) | \$ (612) | 285 | \$ 112 | \$ 173 |
| Total comprehensive income | \$ 2,593 | \$ 777 | \$ 1,816 | \$ 2,536 | \$ 835 | \$ 1,701 |

| | For the six months ended | | | | | |
|--|--------------------------|---------------------------------------|-------------------------|-------------------------|---------------------------------------|-------------------------|
| | June 30, 2015 | | | June 30, 2014 | | |
| | Before tax amount | Income tax expense (benefit) | Net of tax amount | Before tax amount | Income tax expense (benefit) | Net of tax amount |
| (In thousands) | | | | | | |
| Net income | \$ 6,569 | \$ 2,202 | \$ 4,367 | \$ 4,206 | \$ 1,385 | \$ 2,821 |
| Other comprehensive (loss) income | | | | | | |
| Investment securities available for sale: | | | | | | |
| Unrealized holding (losses) gains on securities arising during the period | (139) | (55) | (84) | 1,171 | 437 | 734 |
| Less: reclassification adjustment for gains on securities included in net income | 28 | 10 | 18 | 378 | 127 | 251 |

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| | | | | | | |
|--|----------|----------|----------|----------|----------|----------|
| Total unrealized (losses) gains on securities available for sale | (167) | (65) | (102) | 793 | 310 | 483 |
| Adjustments related to defined benefit plan: | | | | | | |
| Initial recognition of prior service cost | (830) | (332) | (498) | - | - | - |
| Amortization of prior service cost | 42 | 17 | 25 | - | - | - |
| Total adjustments related to defined benefit plan | (788) | (315) | (473) | - | - | - |
| Total other comprehensive (loss) income | (955) | \$ (380) | \$ (575) | 793 | \$ 310 | \$ 483 |
| Total comprehensive income | \$ 5,614 | \$ 1,822 | \$ 3,792 | \$ 4,999 | \$ 1,695 | \$ 3,304 |

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

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Unity Bancorp, Inc.

Consolidated Statements of Changes in Shareholders' Equity

For the six months ended June 30, 2015 and 2014

(Unaudited)

| (In thousands) | Common stock | | Retained earnings | Accumulated other | Total shareholders' equity |
|---|--------------|-----------|-------------------|-------------------|----------------------------|
| | Shares | Amount | | (loss) income | |
| Balance, December 31, 2014 | 8,388 | \$ 58,785 | \$ 11,195 | \$ 143 | \$ 70,123 |
| Net income | | | 4,367 | | 4,367 |
| Other comprehensive loss, net of tax | | | | (575) | (575) |
| Dividends on common stock (\$0.06 per share) | | 33 | (507) | | (474) |
| Common stock issued and related tax effects (1) | 37 | 249 | | | 249 |
| Balance, June 30, 2015 | 8,425 | \$ 59,067 | \$ 15,055 | \$ (432) | \$ 73,690 |

| (In thousands) | Common stock | | Retained earnings | Accumulated other | Total shareholders' equity |
|---|--------------|-----------|-------------------|-------------------|----------------------------|
| | Shares | Amount | | income (loss) | |
| Balance, December 31, 2013 | 7,577 | \$ 52,051 | \$ 5,598 | \$ (476) | \$ 57,173 |
| Net income | | | 2,821 | | 2,821 |
| Other comprehensive income, net of tax | | | | 483 | 483 |
| Dividends on common stock (\$0.04 per share) | | 21 | (305) | | (284) |
| Common stock issued and related tax effects (1) | 30 | 284 | | | 284 |
| Balance, June 30, 2014 | 7,607 | \$ 52,356 | \$ 8,114 | \$ 7 | \$ 60,477 |

(1) Includes the issuance of common stock under employee benefit plans, which includes nonqualified stock options and restricted stock expense related entries, employee option exercises and the tax benefit of options exercised

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Unity Bancorp, Inc.

Consolidated Statements of Cash Flows

(Unaudited)

| (In thousands) | For the six months ended June 30, | |
|---|--------------------------------------|----------|
| | 2015 | 2014 |
| OPERATING ACTIVITIES: | | |
| Net income | \$ 4,367 | \$ 2,821 |
| Adjustments to reconcile net income to net cash provided by (used in) operating activities: | | |
| Provision for loan losses | 200 | 1,150 |
| Net amortization of purchase premiums and discounts on securities | 279 | 270 |
| Depreciation and amortization | 352 | 610 |
| Deferred income tax expense | 345 | 293 |
| Net security gains | (28) | (378) |
| Stock compensation expense | 226 | 206 |
| Loss on sale of OREO | 22 | 99 |
| Gain on sale of mortgage loans held for sale, net | (911) | (406) |
| Gain on sale of SBA loans held for sale, net | (363) | (337) |
| Origination of mortgage loans held for sale | (42,184) | (28,597) |
| Origination of SBA loans held for sale | (9,866) | (4,009) |
| Proceeds from sale of mortgage loans held for sale, net | 43,095 | 29,003 |
| Proceeds from sale of SBA loans held for sale, net | 3,829 | 3,534 |
| BOLI income | (189) | (192) |
| Net change in other assets and liabilities | 733 | (457) |
| Net cash (used in) provided by operating activities | (93) | 3,610 |
| INVESTING ACTIVITIES | | |
| Purchases of securities available for sale | (1,002) | (9,947) |
| Purchases of FHLB stock, at cost | (9,570) | (4,451) |
| Maturities and principal payments on securities held to maturity | 1,350 | 4,611 |
| Maturities and principal payments on securities available for sale | 4,414 | 5,360 |
| Proceeds from sales of securities available for sale | 528 | 17,919 |
| Proceeds from redemption of FHLB stock | 9,967 | 3,465 |
| Proceeds from sale of OREO | 1,044 | 2,351 |
| Net increase in loans | (55,953) | (33,830) |
| Purchases of premises and equipment | (676) | (317) |
| Net cash used in investing activities | (49,898) | (14,839) |
| FINANCING ACTIVITIES | | |
| Net increase (decrease) in deposits | 21,086 | (10,615) |
| Proceeds from new borrowings | 50,000 | 50,000 |
| Repayments of borrowings | (60,000) | (32,000) |
| Proceeds from exercise of stock options | - | 62 |
| Dividends on common stock | (474) | (284) |
| Net cash provided by financing activities | 10,612 | 7,163 |

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| | | |
|--|-----------|-----------|
| Decrease in cash and cash equivalents | (39,379) | (4,066) |
| Cash and cash equivalents, beginning of period | 129,821 | 99,404 |
| Cash and cash equivalents, end of period | \$ 90,442 | \$ 95,338 |

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Unity Bancorp, Inc.

Consolidated Statements of Cash Flows (Continued)

(Unaudited)

| (In thousands) | For the six months ended June 30, | |
|---|--------------------------------------|----------|
| | 2015 | 2014 |
| SUPPLEMENTAL DISCLOSURES | | |
| Cash: | | |
| Interest paid | \$ 3,767 | \$ 3,521 |
| Income taxes paid | 1,868 | 1,069 |
| Noncash investing activities: | | |
| Transfer of SBA loans held for sale to held to maturity | - | 83 |
| Capitalization of servicing rights | 240 | 258 |
| Transfer of loans to OREO | 2,194 | 2,932 |

The accompanying notes to the Consolidated Financial Statements are an integral part of these statements.

Unity Bancorp, Inc.

Notes to the Consolidated Financial Statements (Unaudited)

June 30, 2015

NOTE 1. Significant Accounting Policies

The accompanying Consolidated Financial Statements include the accounts of Unity Bancorp, Inc. (the "Parent Company") and its wholly-owned subsidiary, Unity Bank (the "Bank" or when consolidated with the Parent Company, the "Company"), and reflect all adjustments and disclosures which are generally routine and recurring in nature, and in the opinion of management, necessary for a fair presentation of interim results. The Bank has multiple subsidiaries used to hold part of its investment and loan portfolios and OREO properties. All significant intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications have been made to prior period amounts to conform to the current year presentation, with no impact on current earnings or shareholders' equity. The financial information has been prepared in accordance with U.S. generally accepted accounting principles and has not been audited. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and revenues and expenses during the reporting periods. Actual results could differ from those estimates. Amounts requiring the use of significant estimates include the allowance for loan losses, valuation of deferred tax and servicing assets, the carrying value of loans held for sale and other real estate owned, the valuation of securities and the determination of other-than-temporary impairment for securities and fair value disclosures. Management believes that the allowance for loan losses is adequate. While management uses available information to recognize losses on loans, future additions to the allowance for loan losses may be necessary based on changes in economic conditions. The Company has evaluated subsequent events for potential recognition and/or disclosure through the date the Consolidated Financial Statements included in this Quarterly Report on Form 10-Q were available to be issued.

The interim unaudited Consolidated Financial Statements included herein have been prepared in accordance with instructions for Form 10-Q and the rules and regulations of the Securities and Exchange Commission ("SEC") and consist of normal recurring adjustments necessary for the fair presentation of interim results. The results of operations for the three and six months ended June 30, 2015 are not necessarily indicative of the results which may be expected for the entire year. As used in this Form 10-Q, "we" and "us" and "our" refer to Unity Bancorp, Inc., and its consolidated subsidiary, Unity Bank, depending on the context. Certain information and financial disclosures required by U.S. generally accepted accounting principles have been condensed or omitted from interim reporting pursuant to SEC rules. Interim financial statements should be read in conjunction with the Company's Consolidated Financial Statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2014.

Stock Transactions

Stock Option Plans

The Company has incentive and nonqualified option plans, which allow for the grant of options to officers, employees and members of the Board of Directors. Transactions under the Company's stock option plans for the six months ended June 30, 2015 are summarized in the following table:

| | Shares | Weighted average exercise price | Weighted average remaining contractual life in years | Aggregate intrinsic value |
|----------------------------------|---------|--|--|---------------------------------|
| Outstanding at December 31, 2014 | 418,921 | \$ 6.76 | 5.5 | \$ 1,257,968 |
| Options granted | 40,000 | 9.12 | | |
| Options exercised | - | - | | |
| Options cancelled | - | - | | |
| Outstanding at June 30, 2015 | 458,921 | \$ 6.96 | 5.4 | \$ 1,418,599 |
| Exercisable at June 30, 2015 | 362,426 | \$ 6.64 | 4.5 | \$ 1,262,684 |

Grants under the Company's incentive and nonqualified option plans generally vest over 3 years and must be exercised within 10 years of the date of grant. The exercise price of each option is the market price on the date of grant. As of June 30, 2015, 1,920,529 shares have been reserved for issuance upon the exercise of options, 458,921 option grants are outstanding, and 1,252,416 option grants have been exercised, forfeited or expired, leaving 209,192 shares available for grant.

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The fair values of the options granted during the three and six months ended June 30, 2015 and 2014 were estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

| | For the three months ended June 30, | | For the six months ended June 30, | |
|--|-------------------------------------|---------|-----------------------------------|---------|
| | 2015 | 2014 | 2015 | 2014 |
| Number of options granted | - | 1,000 | 40,000 | 41,000 |
| Weighted average exercise price | \$ - | \$ 7.94 | \$ 9.12 | \$ 7.90 |
| Weighted average fair value of options | \$ - | \$ 2.69 | \$ 3.82 | \$ 3.02 |
| Expected life in years (1) | - | 5.40 | 6.69 | 5.40 |
| Expected volatility (2) | - % | 38.76 % | 46.76 % | 45.05 % |
| Risk-free interest rate (3) | - % | 1.61 % | 1.80 % | 1.52 % |
| Dividend yield (4) | - % | 1.01 % | 1.33 % | 1.02 % |

- (1) The expected life of the options was estimated based on historical employee behavior and represents the period of time that options granted are expected to be outstanding.
- (2) The expected volatility of the Company's stock price was based on the historical volatility over the period commensurate with the expected life of the options.
- (3) The risk-free interest rate is the U.S. Treasury rate commensurate with the expected life of the options on the date of grant.
- (4) The expected dividend yield is the projected annual yield based on the grant date stock price.

Upon exercise, the Company issues shares from its authorized but unissued common stock to satisfy the options. The following table presents information about options exercised during the three and six months ended June 30, 2015 and 2014:

| | For the three months ended June 30, | | For the six months ended June 30, | |
|---|-------------------------------------|------|-----------------------------------|-----------|
| | 2015 | 2014 | 2015 | 2014 |
| Number of options exercised | - | - | - | 19,950 |
| Total intrinsic value of options exercised | \$ - | \$ - | \$ - | \$ 67,417 |
| Cash received from options exercised | - | - | - | 62,445 |
| Tax deduction realized from options exercised | - | - | - | 26,926 |

The following table summarizes information about stock options outstanding and exercisable at June 30, 2015:

Options outstanding

Options exercisable

| Range of exercise prices | Options outstanding | Weighted average remaining contractual life (in years) | Weighted average exercise price | Options exercisable | Weighted average exercise price |
|--------------------------|---------------------|--|---------------------------------|---------------------|---------------------------------|
| \$ 0.00 - 4.00 | 89,000 | 3.7 | \$ 3.85 | 89,000 | \$ 3.85 |
| 4.01 - 7.00 | 166,500 | 6.2 | 6.15 | 150,667 | 6.16 |
| 7.01 - 10.00 | 155,975 | 6.5 | 7.97 | 80,313 | 7.46 |
| 10.01 - 13.00 | 47,446 | 2.4 | 12.36 | 42,446 | 12.60 |
| Total | 458,921 | 5.4 | \$ 6.96 | 362,426 | \$ 6.64 |

Financial Accounting Standards Board Accounting Standards Codification ("FASB ASC") Topic 718, "Compensation - Stock Compensation," requires an entity to recognize the fair value of equity awards as compensation expense over the period during which an employee is required to provide service in exchange for such an award (vesting period). Compensation expense related to stock options and the related income tax benefit for the three and six months ended June 30, 2015 and 2014 are detailed in the following table:

| | For the three months ended June 30, | | For the six months ended June 30, | |
|----------------------|-------------------------------------|-----------|-----------------------------------|-----------|
| | 2015 | 2014 | 2015 | 2014 |
| Compensation expense | \$ 39,072 | \$ 43,834 | \$ 68,990 | \$ 84,397 |
| Income tax benefit | 15,605 | 17,507 | 27,555 | 33,708 |

As of June 30, 2015, unrecognized compensation costs related to nonvested share-based compensation arrangements granted under the Company's stock option plans totaled approximately \$273 thousand. That cost is expected to be recognized over a weighted average period of 2.1 years.

Restricted Stock Awards

Restricted stock is issued under the stock bonus program to reward employees and directors and to retain them by distributing stock over a period of time. The following table summarizes nonvested restricted stock activity for the six months ended June 30, 2015:

| | Shares | Average grant date fair value |
|---|----------|-------------------------------|
| Nonvested restricted stock at December 31, 2014 | 77,750 | \$ 7.24 |
| Granted | 34,800 | 9.27 |
| Vested | (10,875) | 6.77 |
| Forfeited | - | - |
| Nonvested restricted stock at June 30, 2015 | 101,675 | \$ 7.96 |

Restricted stock awards granted to date vest over a period of 4 years and are recognized as compensation to the recipient over the vesting period. The awards are recorded at fair market value at the time of grant and amortized into salary expense on a straight line basis over the vesting period. As of June 30, 2015, 471,551 shares of restricted stock were reserved for issuance, of which 179,700 shares are available for grant.

Restricted stock awards granted during the three and six months ended June 30, 2015 and 2014 were as follows:

| | For the three months ended June 30, | | For the six months ended June 30, | |
|-------------------------------|-------------------------------------|---------|-----------------------------------|---------|
| | 2015 | 2014 | 2015 | 2014 |
| Number of shares granted | - | 1,000 | 34,800 | 11,000 |
| Average grant date fair value | \$ - | \$ 8.78 | \$ 9.27 | \$ 7.92 |

Compensation expense related to restricted stock for the three and six months ended June 30, 2015 and 2014 is detailed in the following table:

| | For the three months ended June 30, | | For the six months ended June 30, | |
|----------------------|-------------------------------------|-----------|-----------------------------------|------------|
| | 2015 | 2014 | 2015 | 2014 |
| Compensation expense | \$ 79,961 | \$ 62,380 | \$ 157,510 | \$ 121,650 |
| Income tax benefit | 31,937 | 24,915 | 62,909 | 48,587 |

As of June 30, 2015, there was approximately \$654 thousand of unrecognized compensation cost related to nonvested restricted stock awards granted under the Company's stock incentive plans. That cost is expected to be recognized over a weighted average period of 2.8 years.

Benefit Plans

In addition to the 401(k) savings plan which covers substantially all employees, the Company has established in 2015 an unfunded supplemental defined benefit plan to provide additional retirement benefits for the President and Chief Executive Officer ("CEO").

On June 4, 2015, the Company approved the Supplemental Executive Retirement Plan (the "SERP") pursuant to which the President and CEO is entitled to receive certain supplemental nonqualified retirement benefits.

Upon separation from service after age 66, the President and CEO will be entitled to an annual benefit in the amount of \$156,000 subject to annual 2% increases. The President and CEO commenced vesting to this retirement benefit on January 1, 2014, and shall vest an additional 3% each year until fully vested on January 1, 2024. In the event that the President and CEO's separation from service from the Registrant were to occur prior to full vesting, the President and CEO would be entitled to and shall be paid the vested portion of the retirement benefit calculated as of the date of separation from service.

Notwithstanding the foregoing, upon a Change in Control, and provided that within 6 months following the Change in Control the President and CEO is involuntary terminated for reasons other than "cause" or the President and CEO resigns for "good reason", as such is defined in the SERP, or the President and CEO voluntarily terminates his employment after being offered continued employment in a positions that is not a "Comparable Position", as such is also defined in the SERP, the President and CEO shall become 100% vested in the full retirement benefit.

No contributions or payments have been made or are anticipated for the year 2015. The following table summarizes the components of the net periodic pension cost of the defined benefit plan recognized during the three- and six-month periods ended:

| (In thousands) | For the three and six months ended June 30, 2015 |
|---|---|
| Components of net periodic benefits cost: | |
| Service cost | \$ 30 |
| Interest cost | 17 |
| Amortization of prior service cost | 42 |
| Net periodic benefit cost | \$ 89 |

Other-Than-Temporary Impairment

The Company has a process in place to identify debt securities that could potentially incur credit impairment that is other-than-temporary. This process involves monitoring late payments, pricing levels, downgrades by rating agencies, key financial ratios, financial statements, revenue forecasts and cash flow projections as indicators of credit issues. Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concern warrants such evaluation. This evaluation considers relevant facts and circumstances in evaluating whether a credit or interest rate-related impairment of a security is other-than-temporary. Relevant facts and circumstances considered include: (1) the extent and length of time the fair value has been below cost; (2) the reasons for the decline in value; (3) the financial position and access to capital of the issuer, including the current and future impact of any specific events and (4) for fixed maturity securities, our intent to sell a security or whether it is more likely than not we will be required to sell the security before the recovery of its amortized cost which, in some cases, may extend to maturity and for equity securities, our ability and intent to hold the security for a forecasted period of time that allows for the recovery in value.

Management assesses its intent to sell or whether it is more likely than not that it will be required to sell a security before recovery of its amortized cost basis less any current-period credit losses. For debt securities that are considered other-than-temporarily impaired with no intent to sell and no requirement to sell prior to recovery of its amortized cost basis, the amount of the impairment is separated into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings and is the difference between the security's amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security's fair value and the present value of future expected cash flows is due to factors that are not credit related and is recognized in other comprehensive income. For debt securities where management has the intent to sell, the amount of the impairment is reflected in earnings as realized losses.

The present value of expected future cash flows is determined using the best estimate cash flows discounted at the effective interest rate implicit to the security at the date of purchase or the current yield to accrete an asset-backed or floating rate security. The methodology and assumptions for establishing the best estimate cash flows vary depending on the type of security. The asset-backed securities cash flow estimates are based on bond specific facts and circumstances that may include collateral characteristics, expectations of delinquency and default rates, loss severity and prepayment speeds and structural support, including subordination and guarantees. The corporate bond cash flow estimates are derived from scenario-based outcomes of expected corporate restructurings or the disposition of assets using bond specific facts and circumstances including timing, security interests and loss severity.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Loans

Loans Held for Sale

Loans held for sale represent the guaranteed portion of Small Business Administration (“SBA”) loans and are reflected at the lower of aggregate cost or market value. The Company originates loans to customers under an SBA program that historically has provided for SBA guarantees of up to 90 percent of each loan. The Company generally sells the guaranteed portion of its SBA loans to a third party and retains the servicing, holding the nonguaranteed portion in its portfolio. The net amount of loan origination fees on loans sold is included in the carrying value and in the gain or loss on the sale. When sales of SBA loans do occur, the premium received on the sale and the present value of future cash flows of the servicing assets are recognized in income. All criteria for sale accounting must be met in order for the loan sales to occur; see details under the “Transfers of Financial Assets” heading above.

Servicing assets represent the estimated fair value of retained servicing rights, net of servicing costs, at the time loans are sold. Servicing assets are amortized in proportion to, and over the period of, estimated net servicing revenues. Impairment is evaluated based on stratifying

the underlying financial assets by date of origination and term. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. Any impairment, if temporary, would be reported as a valuation allowance.

Serviced loans sold to others are not included in the accompanying Consolidated Balance Sheets. Income and fees collected for loan servicing are credited to noninterest income when earned, net of amortization on the related servicing assets.

Loans Held to Maturity

Loans held to maturity are stated at the unpaid principal balance, net of unearned discounts and deferred loan origination fees and costs. In accordance with the level yield method, loan origination fees, net of direct loan origination costs, are deferred and recognized over the estimated life of the related loans as an adjustment to the loan yield. Interest is credited to operations primarily based upon the principal balance outstanding.

Loans are reported as past due when either interest or principal is unpaid in the following circumstances: fixed payment loans when the borrower is in arrears for two or more monthly payments; open end credit for two or more billing cycles; and single payment notes if interest or principal remains unpaid for 30 days or more.

Nonperforming loans consist of loans that are not accruing interest as a result of principal or interest being in default for a period of 90 days or more or when the ability to collect principal and interest according to the contractual terms is in doubt (nonaccrual loans). When a loan is classified as nonaccrual, interest accruals are discontinued and all past due interest previously recognized as income is reversed and charged against current period earnings. Generally, until the loan becomes current, any payments received from the borrower are applied to outstanding principal until such time as management determines that the financial condition of the borrower and other factors merit recognition of a portion of such payments as interest income. Loans may be returned to an accrual status when the ability to collect is reasonably assured and when the loan is brought current as to principal and interest.

Loans are charged off when collection is sufficiently questionable and when the Company can no longer justify maintaining the loan as an asset on the balance sheet. Loans qualify for charge-off when, after thorough analysis, all possible sources of repayment are insufficient. These include: 1) potential future cash flows, 2) value of collateral, and/or 3) strength of co-makers and guarantors. All unsecured loans are charged off upon the establishment of the loan's nonaccrual status. Additionally, all loans classified as a loss or that portion of the loan classified as a loss is charged off. All loan charge-offs are approved by the Board of Directors.

Troubled debt restructurings ("TDRs") occur when a creditor, for economic or legal reasons related to a debtor's financial condition, grants a concession to the debtor that it would not otherwise consider. These concessions typically include reductions in interest rate, extending the maturity of a loan, or a combination of both. Interest income on accruing TDRs is credited to operations primarily based upon the principal amount outstanding, as stated in the

paragraphs above.

The Company evaluates its loans for impairment. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. The Company has defined impaired loans to be all TDRs and nonperforming loans individually evaluated for impairment. Impairment is evaluated in total for smaller-balance loans of a similar nature (consumer and residential mortgage loans), and on an individual basis for all other loans. Impairment of a loan is measured based on the present value of expected future cash flows, discounted at the loan's effective interest rate, or as a practical expedient, based on a loan's observable market price or the fair value of collateral, net of estimated costs to sell, if the loan is collateral-dependent. If the value of the impaired loan is less than the recorded investment in the loan, the Company establishes a valuation allowance, or adjusts existing valuation allowances, with a corresponding charge to the provision for loan losses.

For additional information on loans, see Note 8 to the Consolidated Financial Statements and the section titled "Loan Portfolio" under Item 2. Management's Discussion and Analysis.

Allowance for Loan Losses and Reserve for Unfunded Loan Commitments

The allowance for loan losses is maintained at a level management considers adequate to provide for probable loan losses as of the balance sheet date. The allowance is increased by provisions charged to expense and is reduced by net charge-offs.

The level of the allowance is based on management's evaluation of probable losses in the loan portfolio, after consideration of prevailing economic conditions in the Company's market area, the volume and composition of the loan portfolio, and historical loan loss experience. The allowance for loan losses consists of specific reserves for individually impaired credits and TDRs, reserves for nonimpaired loans based on historical loss factors and reserves based on general economic factors and other qualitative risk factors such as changes in delinquency trends, industry concentrations or local/national economic trends. This risk assessment process is performed at least quarterly, and, as adjustments become necessary, they are realized in the periods in which they become known.

Although management attempts to maintain the allowance at a level deemed adequate to provide for probable losses, future additions to the allowance may be necessary based upon certain factors including changes in market conditions and underlying collateral values. In addition, various regulatory agencies periodically review the adequacy of the Company's allowance for loan losses. These agencies may

require the Company to make additional provisions based on their judgments about information available to them at the time of their examination.

The Company maintains an allowance for unfunded loan commitments that is maintained at a level that management believes is adequate to absorb estimated probable losses. Adjustments to the allowance are made through other expenses and applied to the allowance which is maintained in other liabilities.

For additional information on the allowance for loan losses and unfunded loan commitments, see Note 9 to the Consolidated Financial Statements and the sections titled "Asset Quality" and "Allowance for Loan Losses and Reserve for Unfunded Loan Commitments" under Item 2. Management's Discussion and Analysis.

Income Taxes

The Company accounts for income taxes according to the asset and liability method. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using the enacted tax rates applicable to taxable income for the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

Valuation reserves are established against certain deferred tax assets when it is more likely than not that the deferred tax assets will not be realized. Increases or decreases in the valuation reserve are charged or credited to the income tax provision.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that ultimately would be sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. The evaluation of a tax position taken is considered by itself and not offset or aggregated with other positions. Tax positions that meet the more likely than not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

Interest and penalties associated with unrecognized tax benefits would be recognized in income tax expense on the income statement.

NOTE 2. Litigation

The Company may, in the ordinary course of business, become a party to litigation involving collection matters, contract claims and other legal proceedings relating to the conduct of its business. In the best judgment of management, based upon consultation with counsel, the consolidated financial position and results of operations of the Company will not be affected materially by the final outcome of any pending legal proceedings or other contingent liabilities and commitments.

NOTE 3. Net Income per Share

Basic net income per common share is calculated as net income divided by the weighted average common shares outstanding during the reporting period.

Diluted net income per common share is computed similarly to that of basic net income per common share, except that the denominator is increased to include the number of additional common shares that would have been outstanding if all potentially dilutive common shares, principally stock options, were issued during the reporting period utilizing the Treasury stock method.

The following is a reconciliation of the calculation of basic and diluted income per share:

| (In thousands, except per share amounts) | For the three months ended June 30, | | For the six months ended June 30, | |
|---|---|----------|--------------------------------------|----------|
| | 2015 | 2014 | 2015 | 2014 |
| Net income | \$ 2,428 | \$ 1,528 | \$ 4,367 | \$ 2,821 |
| Weighted average common shares outstanding - Basic | 8,425 | 7,605 | 8,421 | 7,596 |
| Plus: Potential dilutive common stock equivalents | 99 | 85 | 98 | 76 |
| Weighted average common shares outstanding - Diluted | 8,524 | 7,690 | 8,519 | 7,672 |
| Net income per common share - Basic | \$ 0.29 | \$ 0.20 | \$ 0.52 | \$ 0.37 |
| Net income per common share - Diluted | 0.28 | 0.20 | 0.51 | 0.37 |
| Stock options and common stock excluded from the income per share calculation as their effect would have been anti-dilutive | 141 | 126 | 127 | 114 |

NOTE 4. Income Taxes

The Company follows FASB ASC Topic 740, "Income Taxes," which prescribes a threshold for the financial statement recognition of income taxes and provides criteria for the measurement of tax positions taken or expected to be taken in a tax return. ASC 740 also includes guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition of income taxes.

For the quarter ended June 30, 2015, the Company reported income tax expense of \$1.2 million for an effective tax rate of 32.7 percent, compared to an income tax expense of \$723 thousand and an effective tax rate of 32.1 percent for the prior year's quarter. For the six months ended June 30, 2015, the Company reported income tax expense of \$2.2 million for an effective tax rate of 33.5 percent, compared to an income tax expense of \$1.4 million and effective tax rate of 32.9 percent for the six months ended June 30, 2014. The Company did not recognize or accrue any interest or penalties related to income taxes during the three or six months ended June 30, 2015 or 2014. The Company did not have an accrual for uncertain tax positions as of June 30, 2015 or December 31, 2014, as deductions taken and benefits accrued are based on widely understood administrative practices and procedures and are based on clear and unambiguous tax law. Tax returns for all years 2010 and thereafter are subject to future examination by tax authorities.

NOTE 5. Other Comprehensive (Loss) Income

The following tables show the changes in other comprehensive (loss) income for the three and six months ended June 30 2015 and 2014, net of tax:

| (In thousands) | For the three months ended June 30, 2015 | | | 2014 | |
|--|--|---|--|--|--|
| | Net unrealized gains (losses) on securities | Adjustments related to defined benefit plan | Accumulated other comprehensive (loss) income | Net unrealized (losses) gains on securities | Accumulated other comprehensive (loss) income |
| Balance at March 31 | \$ 180 | \$ - | \$ 180 | \$ (166) | \$ (166) |
| Other comprehensive (loss) income before reclassifications | (121) | (498) | (619) | 351 | 351 |
| Less amounts reclassified from accumulated other comprehensive loss | 18 | (25) | (7) | 178 | 178 |
| Period change | (139) | (473) | (612) | 173 | 173 |
| Balance at June 30 | \$ 41 | \$ (473) | \$ (432) | \$ 7 | \$ 7 |

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| (In thousands) | For the six months ended June 30, | | | 2014 | |
|---|--|---|--|--|--|
| | Net unrealized gains (losses) on securities | Adjustments related to defined benefit plan | Accumulated other comprehensive (loss) income | Net unrealized (losses) gains on securities | Accumulated other comprehensive (loss) income |
| Balance at January 1 | \$ 143 | \$ - | \$ 143 | \$ (476) | \$ (476) |
| Other comprehensive (loss) income before reclassifications | (84) | (498) | (582) | 734 | 734 |
| Less amounts reclassified from accumulated other comprehensive loss | 18 | (25) | (7) | (251) | (251) |
| Period change | (102) | (473) | (575) | 483 | 483 |
| Balance at June 30 | \$ 41 | \$ (473) | \$ (432) | \$ 7 | \$ 7 |

Amounts reclassified out of accumulated other comprehensive income were as follows:

| Details about accumulated other comprehensive (loss) income components | Amounts reclassified from accumulated other comprehensive (loss) income | | Affected line item in the statement where net income is presented |
|--|---|--------|---|
| | For the three months ended June 30, | | |
| (In thousands) | 2015 | 2014 | |
| Investment securities available for sale: | | | |
| Reclassification adjustment for gains on securities included in net income | \$ 28 | \$ 268 | Net security sales |
| Adjustments related to defined benefit plan: | | | |
| Amortization of prior service cost included in net periodic pension cost | (42) | - | Compensation and benefits |
| Effect on accumulated other loss (income) for the period | (14) | 268 | Total before tax |
| Income tax benefit (expense) | 7 | (90) | Provision for income taxes |
| Total reclassification for the period | \$ (7) | \$ 178 | Net income |

| Details about accumulated other comprehensive (loss) income components | Amounts reclassified from accumulated other comprehensive (loss) income | | Affected line item in the statement where net income is presented |
|--|---|--------|---|
| (In thousands) | For the six months ended June 30, | | |
| | 2015 | 2014 | |
| Investment securities available for sale: | | | |
| Reclassification adjustment for gains on securities included in net income | \$ 28 | \$ 378 | Net security sales |
| Adjustments related to defined benefit plan: | | | |
| Amortization of prior service cost included in net periodic pension cost | (42) | - | Compensation and benefits |
| Effect on accumulated other loss (income) for the period | (14) | 378 | Total before tax |
| Income tax benefit (expense) | 7 | (127) | Provision for income taxes |
| Total reclassification for the period | \$ (7) | \$ 251 | Net income |

NOTE 6. Fair Value

Fair Value Measurement

The Company follows FASB ASC Topic 820, “Fair Value Measurement and Disclosures,” which requires additional disclosures about the Company’s assets and liabilities that are measured at fair value. Fair value is the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. In determining fair value, the Company uses various methods including market, income and cost approaches. Based on these approaches, the Company often utilizes certain assumptions that market participants would use in pricing the asset or liability, including assumptions about risk and/or the risks inherent in the inputs to the valuation technique. These inputs can be readily observable, market corroborated, or generally unobservable inputs. The Company utilizes techniques that maximize the use of observable inputs and minimize the use of unobservable inputs. The fair value hierarchy ranks the quality and reliability of the information used to determine fair values. Financial assets and liabilities carried at fair value will be classified and disclosed as follows:

Level 1 Inputs

- Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.
- Generally, this includes debt and equity securities and derivative contracts that are traded in an active exchange market (i.e. New York Stock Exchange), as well as certain U.S. Treasury, U.S. Government and sponsored entity agency mortgage-backed securities that are highly liquid and are actively traded in over-the-counter markets.

Level 2 Inputs

- Quoted prices for similar assets or liabilities in active markets.
- Quoted prices for identical or similar assets or liabilities in inactive markets.
- Inputs other than quoted prices that are observable, either directly or indirectly, for the term of the asset or liability (i.e., interest rates, yield curves, credit risks, prepayment speeds or volatilities) or “market corroborated inputs.”
- Generally, this includes U.S. Government and sponsored entity mortgage-backed securities, corporate debt securities and derivative contracts.

Level 3 Inputs

- Prices or valuation techniques that require inputs that are both unobservable (i.e. supported by little or no market activity) and that are significant to the fair value of the assets or liabilities.
- These assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

Fair Value on a Recurring Basis

The following is a description of the valuation methodologies used for instruments measured at fair value on a recurring basis:

Securities Available for Sale

The fair value of available for sale ("AFS") securities is the market value based on quoted market prices, when available, or market prices provided by recognized broker dealers (Level 1). If listed prices or quotes are not available, fair value is based upon quoted market prices for similar or identical assets or other observable inputs (Level 2) or externally developed models that use unobservable inputs due to limited or no market activity of the instrument (Level 3).

As of June 30, 2015, the fair value of the Company's AFS securities portfolio was \$55.8 million. Approximately 54 percent of the portfolio was made up of residential mortgage-backed securities, which had a fair value of \$30.3 million at June 30, 2015. Approximately \$29.3 million of the residential mortgage-backed securities are guaranteed by the Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA") or the Federal Home Loan Mortgage Corporation ("FHLMC"). The underlying loans for these securities are residential mortgages that are geographically dispersed throughout the United States.

All of the Company's AFS securities were classified as Level 2 assets at June 30, 2015. The valuation of AFS securities using Level 2 inputs was primarily determined using the market approach, which uses quoted prices for similar assets or liabilities in active markets and all other relevant information. It includes model pricing, defined as valuing securities based upon their relationship with other benchmark securities.

There were no changes in the inputs or methodologies used to determine fair value during the period ended June 30, 2015, as compared to the periods ended December 31, 2014 and June 30, 2014.

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The tables below present the balances of assets and liabilities measured at fair value on a recurring basis as of June 30, 2015 and December 31, 2014:

| (In thousands) | June 30, 2015 | | | |
|--|---------------|-----------|-------|-----------|
| | Level | | Level | |
| | 1 | Level 2 | 3 | Total |
| Securities available for sale: | | | | |
| U.S. Government sponsored entities | \$ - | \$ 5,479 | \$ - | \$ 5,479 |
| State and political subdivisions | - | 10,650 | - | 10,650 |
| Residential mortgage-backed securities | - | 30,283 | - | 30,283 |
| Corporate and other securities | - | 9,354 | - | 9,354 |
| Total securities available for sale | \$ - | \$ 55,766 | \$ - | \$ 55,766 |

| (In thousands) | December 31, 2014 | | | |
|--|-------------------|-----------|-------|-----------|
| | Level | | Level | |
| | 1 | Level 2 | 3 | Total |
| Securities available for sale: | | | | |
| U.S. Government sponsored entities | \$ - | \$ 4,618 | \$ - | \$ 4,618 |
| State and political subdivisions | - | 11,132 | - | 11,132 |
| Residential mortgage-backed securities | - | 34,383 | - | 34,383 |
| Corporate and other securities | - | 9,940 | - | 9,940 |
| Total securities available for sale | \$ - | \$ 60,073 | \$ - | \$ 60,073 |

The following table summarizes changes in Level 3 assets during the three and six months ended June 30, 2015 and 2014, consisting of commercial mortgage-backed available for sale securities, measured at fair value on a recurring basis:

| (In thousands) | For the three months ended | | | | For the six months ended June 30, | | | |
|--|----------------------------|--------|----------|--------|-----------------------------------|--------|----------|--------|
| | June 30, | | June 30, | | June 30, | | June 30, | |
| | 2015 | 2014 | 2015 | 2014 | 2015 | 2014 | 2015 | 2014 |
| Commercial mortgage-backed securities: | | | | | | | | |
| Balance, beginning of period | \$ - | \$ 499 | \$ - | \$ 888 | \$ - | \$ 888 | \$ - | \$ 888 |
| Payoffs | - | (342) | - | (714) | - | (714) | - | (714) |
| Principal paydowns | - | (153) | - | (173) | - | (173) | - | (173) |
| Total net losses included in: | | | | | | | | |
| Other comprehensive income | - | (4) | - | (1) | - | (1) | - | (1) |
| Balance, end of period | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - | \$ - |

There were no gains or losses (realized or unrealized) on Level 3 securities included in earnings for assets and liabilities held at June 30, 2015 or 2014.

Fair Value on a Nonrecurring Basis

Certain assets and liabilities are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The following is a description of the valuation methodologies used for instruments measured at fair value on a nonrecurring basis:

Appraisal Policy

All appraisals must be performed in accordance with the Uniform Standards of Professional Appraisal Practice ("USPAP"). Appraisals are certified to the Company and performed by appraisers on the Company's approved list of appraisers. Evaluations are completed by a person independent of Company management. The content of the appraisal depends on the complexity of the property. Appraisals are completed on a "retail value" and an "as is value".

The Company requires current real estate appraisals on all loans that become OREO or in-substance foreclosure, loans that are classified substandard, doubtful or loss, or loans that are over \$100,000 and nonperforming. Prior to each balance sheet date, the Company values impaired collateral-dependent loans and OREO based upon a third party appraisal, broker's price opinion, drive by appraisal, automated valuation model, updated market evaluation, or a combination of these methods. The amount is discounted for the decline in market real estate values (for original appraisals), for any known damage or repair costs, and for selling and closing costs. The amount of the discount ranges from 10 to 25 percent and is dependent upon the method used to determine the original value. The original appraisal is generally used when a loan is first determined to be impaired. When applying the discount, the Company takes into consideration when the appraisal was performed, the collateral's location, the type of collateral, any known damage to the property and the type of business. Subsequent to entering impaired status and the Company determining that there is a collateral shortfall, the Company will generally, depending on the type of collateral, order a third party appraisal, broker's price opinion, automated valuation model or updated market evaluation. After receiving the third party results, the Company will discount the value 8 to 10 percent for selling and closing costs.

OREO

The fair value of OREO is determined using appraisals, which may be discounted based on management's review and changes in market conditions (Level 3 Inputs).

Impaired Collateral-Dependent Loans

The fair value of impaired collateral-dependent loans is derived in accordance with FASB ASC Topic 310, "Receivables." Fair value is determined based on the loan's observable market price or the fair value of the collateral. Partially charged-off loans are measured for impairment based upon an appraisal for collateral-dependent loans. When an updated appraisal is received for a nonperforming loan, the value on the appraisal is discounted in the manner discussed above. If there is a deficiency in the value after the Company applies these discounts, management applies a specific reserve and the loan remains in nonaccrual status. The receipt of an updated appraisal would not qualify as a reason to put a loan back into accruing status. The Company removes loans from nonaccrual status generally when the borrower makes nine months of contractual payments and demonstrates the ability to service the debt going forward. Charge-offs are determined based upon the loss that management believes the Company will incur after evaluating collateral for impairment based upon the valuation methods described above and the ability of the borrower to pay any deficiency.

The valuation allowance for impaired loans is included in the allowance for loan losses in the consolidated balance sheets. At June 30, 2015 and December 31, 2014, the valuation allowance for impaired loans was \$1.2 million.

The following tables present the assets and liabilities subject to fair value adjustments (impairment) on a non-recurring basis carried on the balance sheet by caption and by level within the hierarchy (as described above):

| (In thousands) | Fair value at June 30, 2015 | | | |
|-------------------------------------|-----------------------------|---------|----------|----------|
| | Level 1 | Level 2 | Level 3 | Total |
| | Financial assets: | | | |
| OREO | \$ - | \$ - | \$ 2,265 | \$ 2,265 |
| Impaired collateral-dependent loans | - | - | 8,109 | 8,109 |

| (In thousands) | Fair value at December 31, 2014 | | | |
|-------------------------------------|---------------------------------|---------|----------|----------|
| | Level 1 | Level 2 | Level 3 | Total |
| | Financial assets: | | | |
| OREO | \$ - | \$ - | \$ 1,162 | \$ 1,162 |
| Impaired collateral-dependent loans | - | - | 4,897 | 4,897 |

Fair Value of Financial Instruments

FASB ASC Topic 825, "Financial Instruments," requires the disclosure of the estimated fair value of certain financial instruments, including those financial instruments for which the Company did not elect the fair value option. These estimated fair values as of June 30, 2015 and December 31, 2014 have been determined using available market information and appropriate valuation methodologies. Considerable judgment is required to interpret market data to develop estimates of fair value. The estimates presented are not necessarily indicative of amounts the Company could realize in a current market exchange. The use of alternative market assumptions and estimation methodologies could have had a material effect on these estimates of fair value. The methodology for estimating the fair value of financial assets and liabilities that are measured on a recurring or nonrecurring basis are discussed above. The following methods and assumptions were used to estimate the fair value of other financial instruments for which it is practicable to estimate that value:

Cash and Cash Equivalents

For these short-term instruments, the carrying value is a reasonable estimate of fair value.

Securities

The fair value of securities is based upon quoted market prices for similar or identical assets or other observable inputs (Level 2) or externally developed models that use unobservable inputs due to limited or no market activity of the instrument (Level 3).

SBA Loans Held for Sale

The fair value of SBA loans held for sale is estimated by using a market approach that includes significant other observable inputs.

Loans

The fair value of loans is estimated by discounting the future cash flows using current market rates that reflect the interest rate risk inherent in the loan, except for previously discussed impaired loans.

FHLB Stock

Federal Home Loan Bank stock is carried at cost. Carrying value approximates fair value based on the redemption provisions of the issues.

Servicing Assets

SBA servicing assets do not trade in an active, open market with readily observable prices. The Company estimates the fair value of servicing assets using discounted cash flow models incorporating numerous assumptions from the perspective of a market participant including market discount rates and prepayment speeds.

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

OREO

The fair value of OREO is determined using appraisals, which may be discounted based on management's review and changes in market conditions (Level 3 Inputs).

Deposit Liabilities

The fair value of demand deposits and savings accounts is the amount payable on demand at the reporting date (i.e. carrying value). The fair value of fixed-maturity certificates of deposit is estimated by discounting the future cash flows using current market rates.

Borrowed Funds and Subordinated Debentures

The fair value of borrowings is estimated by discounting the projected future cash flows using current market rates.

Standby Letters of Credit

At June 30, 2015, the Bank had standby letters of credit outstanding of \$1.5 million, consistent with December 31, 2014. The fair value of these commitments is nominal.

The table below presents the carrying amount and estimated fair values of the Company's financial instruments presented as of June 30, 2015 and December 31, 2014:

| (In thousands) | Fair value level | June 30, 2015 | | December 31, 2014 | |
|---|------------------|-----------------|----------------------|-------------------|----------------------|
| | | Carrying amount | Estimated fair value | Carrying amount | Estimated fair value |
| Financial assets: | | | | | |
| Cash and cash equivalents | Level 1 | \$ 90,442 | \$ 90,442 | \$ 129,821 | \$ 129,821 |
| Securities (1) | Level 2 | 74,375 | 74,495 | 80,082 | 80,354 |
| SBA loans held for sale | Level 2 | 11,368 | 12,611 | 5,179 | 5,655 |
| Loans, net of allowance for loan losses (2) | Level 2 | 797,924 | 800,478 | 744,095 | 748,093 |
| FHLB stock | Level 2 | 5,635 | 5,635 | 6,032 | 6,032 |
| Servicing assets | Level 3 | 872 | 872 | 753 | 753 |
| Accrued interest receivable | Level 2 | 3,690 | 3,690 | 3,518 | 3,518 |
| OREO | Level 3 | 2,265 | 2,265 | 1,162 | 1,162 |
| Financial liabilities: | | | | | |
| Deposits | Level 2 | 815,427 | 815,799 | 794,341 | 794,436 |
| Borrowed funds and subordinated debentures | Level 2 | 130,465 | 134,416 | 140,465 | 145,333 |
| Accrued interest payable | Level 2 | 418 | 418 | 474 | 474 |

(1) Includes held to maturity ("HTM") commercial mortgage-backed securities that are considered Level 3. These securities had book values of \$4.0 million at June 30, 2015 and December 31, 2014, and market values of \$3.9 million and \$4.0 million at June 30, 2015 and December 31, 2014, respectively.

(2) Includes collateral-dependent impaired loans that are considered Level 3 and reported separately in the tables under the "Fair Value on a Nonrecurring Basis" heading. Collateral-dependent impaired loans, net of specific reserves totaled \$8.1 million and \$4.9 million at June 30, 2015 and December 31, 2014, respectively.

NOTE 7. Securities

This table provides the major components of AFS and HTM securities at amortized cost and estimated fair value at June 30, 2015 and December 31, 2014:

| (In thousands) | June 30, 2015 | | | | December 31, 2014 | | | |
|--|----------------|------------------------|-------------------------|----------------------|-------------------|------------------------|-------------------------|----------------------|
| | Amortized cost | Gross unrealized gains | Gross unrealized losses | Estimated fair value | Amortized cost | Gross unrealized gains | Gross unrealized losses | Estimated fair value |
| Available for sale: | | | | | | | | |
| U.S. Government sponsored entities | \$ 5,564 | \$ - | \$ (85) | \$ 5,479 | \$ 4,711 | \$ - | \$ (93) | \$ 4,618 |
| State and political subdivisions | 10,708 | 73 | (131) | 10,650 | 11,055 | 112 | (35) | 11,132 |
| Residential mortgage-backed securities | 29,886 | 602 | (205) | 30,283 | 33,884 | 646 | (147) | 34,383 |
| Corporate and other securities | 9,540 | 71 | (257) | 9,354 | 10,188 | 63 | (311) | 9,940 |
| Total securities available for sale | \$ 55,698 | \$ 746 | \$ (678) | \$ 55,766 | \$ 59,838 | \$ 821 | \$ (586) | \$ 60,073 |
| Held to maturity: | | | | | | | | |
| U.S. Government sponsored entities | \$ 4,220 | \$ - | \$ (118) | \$ 4,102 | \$ 4,440 | \$ - | \$ (124) | \$ 4,316 |
| State and political subdivisions | 2,413 | 207 | - | 2,620 | 2,417 | 277 | - | 2,694 |
| Residential mortgage-backed securities | 7,038 | 178 | (50) | 7,166 | 8,164 | 211 | (29) | 8,346 |
| Commercial mortgage-backed securities | 3,954 | - | (71) | 3,883 | 4,005 | 13 | (53) | 3,965 |
| Corporate and other securities | 984 | - | (26) | 958 | 983 | - | (23) | 960 |
| Total securities held to maturity | \$ 18,609 | \$ 385 | \$ (265) | \$ 18,729 | \$ 20,009 | \$ 501 | \$ (229) | \$ 20,281 |

This table provides the remaining contractual maturities and yields of securities within the investment portfolios. The carrying value of securities at June 30, 2015 is distributed by contractual maturity. Mortgage-backed securities and other securities, which may have principal prepayment provisions, are distributed based on contractual maturity. Expected maturities will differ materially from contractual maturities as a result of early prepayments and calls.

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| (In thousands, except percentages) | Within one year | | After one through five years | | After five through ten years | | After ten years | | Total carrying value | | | |
|--|--------------------|-------|------------------------------------|-------|---------------------------------|-------|-----------------|-------|-------------------------|-------|--------|-------|
| | Amount | Yield | Amount | Yield | Amount | Yield | Amount | Yield | Amount | Yield | Amount | Yield |
| Available for sale at fair value: | | | | | | | | | | | | |
| U.S. Government sponsored entities | \$ - | - | % \$ 2,015 | 1.35 | % \$ 940 | 2.06 | % \$ 2,524 | 2.04 | % \$ 5,479 | 1.79 | % | |
| State and political subdivisions | 39 | 6.48 | 856 | 2.56 | 6,258 | 2.41 | 3,497 | 2.56 | 10,650 | 2.49 | | |
| Residential mortgage-backed securities | - | - | 1,350 | 1.79 | 2,056 | 1.90 | 26,877 | 2.72 | 30,283 | 2.62 | | |
| Corporate and other securities | - | - | 2,417 | 1.04 | 1,384 | 1.16 | 5,553 | 1.27 | 9,354 | 1.19 | | |
| Total securities available for sale | \$ 39 | 6.48 | % \$ 6,638 | 1.48 | % \$ 10,638 | 2.12 | % \$ 38,451 | 2.45 | % \$ 55,766 | 2.28 | % | |
| Held to maturity at cost: | | | | | | | | | | | | |
| U.S. Government sponsored entities | \$ - | - | % \$ - | - | % \$ - | - | % \$ 4,220 | 1.97 | % \$ 4,220 | 1.97 | % | |
| State and political subdivisions | 309 | 0.75 | - | - | - | - | 2,104 | 4.72 | 2,413 | 4.22 | | |
| Residential mortgage-backed securities | - | - | 329 | 4.86 | 236 | 5.20 | 6,473 | 2.56 | 7,038 | 2.76 | | |
| Commercial mortgage-backed securities | - | - | - | - | - | - | 3,954 | 2.76 | 3,954 | 2.76 | | |
| Corporate and other securities | - | - | - | - | 984 | 2.95 | - | - | 984 | 2.95 | | |
| Total securities held to maturity | \$ 309 | 0.75 | % \$ 329 | 4.86 | % \$ 1,220 | 3.39 | % \$ 16,751 | 2.73 | % \$ 18,609 | 2.78 | % | |

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The fair value of securities with unrealized losses by length of time that the individual securities have been in a continuous unrealized loss position at June 30, 2015 and December 31, 2014 are as follows:

| | June 30, 2015 | | | | | | |
|--|---|-------------------------|--------------------|--------------------------|--------------------|-------------------------|--------------------|
| | Total number in a loss position | Less than 12 months | | 12 months and greater | | Total | |
| | | Estimated fair value | Unrealized loss | Estimated fair value | Unrealized loss | Estimated fair value | Unrealized loss |
| (In thousands, except number in a loss position) | | | | | | | |
| Available for sale: | | | | | | | |
| U.S. Government sponsored entities | 6 | \$ 2,933 | \$ (11) | \$ 2,541 | \$ (74) | \$ 5,474 | \$ (85) |
| State and political subdivisions | 8 | 4,363 | (131) | - | - | 4,363 | (131) |
| Residential mortgage-backed securities | 10 | 7,273 | (45) | 5,172 | (160) | 12,445 | (205) |
| Corporate and other securities | 6 | 1,367 | (48) | 3,789 | (209) | 5,156 | (257) |
| Total temporarily impaired securities | 30 | \$ 15,936 | \$ (235) | \$ 11,502 | \$ (443) | \$ 27,438 | \$ (678) |
| Held to maturity: | | | | | | | |
| U.S. Government sponsored entities | 2 | \$ - | \$ - | \$ 4,102 | \$ (118) | \$ 4,102 | \$ (118) |
| Residential mortgage-backed securities | 3 | - | - | 2,117 | (50) | 2,117 | (50) |
| Commercial mortgage-backed securities | 2 | 3,883 | (71) | - | - | 3,883 | (71) |
| Corporate and other securities | 1 | 958 | (26) | - | - | 958 | (26) |
| Total temporarily impaired securities | 8 | \$ 4,841 | \$ (97) | \$ 6,219 | \$ (168) | \$ 11,060 | \$ (265) |

| | December 31, 2014 | | | | | | |
|--|---|-------------------------|--------------------|--------------------------|--------------------|-------------------------|--------------------|
| | Total number in a loss position | Less than 12 months | | 12 months and greater | | Total | |
| | | Estimated fair value | Unrealized loss | Estimated fair value | Unrealized loss | Estimated fair value | Unrealized loss |
| (In thousands, except number in a loss position) | | | | | | | |
| Available for sale: | | | | | | | |
| U.S. Government sponsored entities | 4 | \$ - | \$ - | \$ 4,590 | \$ (93) | \$ 4,590 | \$ (93) |
| State and political subdivisions | 7 | - | - | 4,103 | (35) | 4,103 | (35) |
| Residential mortgage-backed securities | 9 | 6,579 | (16) | 5,889 | (131) | 12,468 | (147) |
| Corporate and other securities | 7 | 1,053 | (46) | 3,736 | (265) | 4,789 | (311) |
| Total temporarily impaired securities | 27 | \$ 7,632 | \$ (62) | \$ 18,318 | \$ (524) | \$ 25,950 | \$ (586) |
| Held to maturity: | | | | | | | |
| U.S. Government sponsored entities | 2 | \$ - | \$ - | \$ 4,316 | \$ (124) | \$ 4,316 | \$ (124) |
| Residential mortgage-backed securities | 3 | - | - | 2,586 | (29) | 2,586 | (29) |

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| | | | | | | | |
|---------------------------------------|---|------|------|----------|----------|----------|----------|
| Commercial mortgage-backed securities | 1 | - | - | 1,822 | (53) | 1,822 | (53) |
| Corporate and other securities | 1 | - | - | 960 | (23) | 960 | (23) |
| Total temporarily impaired securities | 7 | \$ - | \$ - | \$ 9,684 | \$ (229) | \$ 9,684 | \$ (229) |

Unrealized Losses

The unrealized losses in each of the categories presented in the tables above are discussed in the paragraphs that follow:

U.S. government sponsored entities and state and political subdivision securities: The unrealized losses on investments in these types of securities were caused by the increase in interest rate spreads or the increase in interest rates at the long end of the Treasury curve. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the par value of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be at maturity, the Company did not consider these investments to be other-than temporarily impaired as of June 30, 2015. There was no impairment on these securities at December 31, 2014.

Residential and commercial mortgage-backed securities: The unrealized losses on investments in mortgage-backed securities were caused by increases in interest rate spreads or the increase in interest rates at the long end of the Treasury curve. The majority of contractual cash flows of these securities are guaranteed by the FNMA, GNMA, and the FHLMC. It is expected that the securities would not be settled at a price significantly less than the par value of the investment. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be at maturity, the Company did not consider these investments to be other-than-temporarily impaired as of June 30, 2015 or December 31, 2014.

Corporate and other securities: Included in this category are corporate debt securities, Community Reinvestment Act (“CRA”) investments, asset-backed securities, and one trust preferred security. The unrealized losses on corporate debt securities were due to widening credit spreads or the increase in interest rates at the long end of the Treasury curve and the unrealized losses on CRA investments were caused by decreases in the market value of underlying bonds and rate changes. The Company evaluated the prospects of the issuers and forecasted a recovery period; and as a result determined it did not consider these investments to be other-than-temporarily impaired as of June 30, 2015 or December 31, 2014. The unrealized loss on the trust preferred security was caused by an inactive trading market and changes in market credit spreads. At June 30, 2015 and December 31, 2014, this category consisted of one single-issuer trust preferred security. The contractual terms do not allow the security to be settled at a price less than the par value. Because the Company does not intend to sell the security and it is not more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis, which may be at maturity, the Company did not consider this security to be other-than-temporarily impaired as of June 30, 2015 or December 31, 2014.

Realized Gains and Losses

Gross realized gains (losses) on securities for the three and six months ended June 30, 2015 and 2014 are detailed in the table below:

| (In thousands) | For the three months ended | | For the six months ended | |
|-------------------------------------|-------------------------------|--------|-----------------------------|--------|
| | June 30, 2015 | 2014 | June 30, 2015 | 2014 |
| Available for sale: | | | | |
| Realized gains | \$ 28 | \$ 271 | \$ 28 | \$ 385 |
| Realized losses | - | (3) | - | (7) |
| Total securities available for sale | 28 | 268 | 28 | 378 |
| Held to maturity: | | | | |
| Realized gains | - | - | - | - |
| Realized losses | - | - | - | - |

| | | | | |
|-----------------------------------|-------|--------|-------|--------|
| Total securities held to maturity | - | - | - | - |
| Net gains on sales of securities | \$ 28 | \$ 268 | \$ 28 | \$ 378 |

The net realized gains are included in noninterest income in the Consolidated Statements of Income as net security gains. For the three and six months ended June 30, 2015 there was a gross realized gain of \$28 thousand. The net realized gain during 2015 was a result of the following:

- For the three months ended June 30, 2015, the Company sold one corporate bond totaling \$500 thousand in book value, resulting in pre-tax gains of approximately \$28 thousand.

For the three and six months ended June 30, 2014, there were gross realized gains of \$271 thousand and \$385 thousand, respectively. For the three and six months ended June 30, 2014, there were gross realized losses of \$3 thousand and \$7 thousand, respectively. The net realized gains during 2014 were a result of the following:

- For the six months ended June 30, 2014, the Company sold approximately \$15.5 million in book value of available for sale municipal securities, mortgage-backed securities, asset-backed securities, and corporate bonds, resulting in pre-tax gains of approximately \$385 thousand.

Pledged Securities

Securities with a carrying value of \$19.5 million and \$50.4 million at June 30, 2015 and December 31, 2014, respectively, were pledged to secure Government deposits, secure other borrowings and for other purposes required or permitted by law. Securities pledged for Government deposits totaled \$0 and \$32.1 million at June 30, 2015 and December 31, 2014, respectively. In June 2015, the FHLB issued a letter of credit in the name of Unity Bank naming the NJ Dept. of Banking and Insurance as beneficiary. The letter of credit will take the place of securities previously pledged to the state for the Bank's municipal deposits. For additional information on amounts pledged to secure Government deposits at June 30, 2015, see section titled "Borrowed Funds and Subordinated Debentures" under Item 2. Management Discussion and Analysis.

Note 8. Loans

The following table sets forth the classification of loans by class, including unearned fees, deferred costs and excluding the allowance for loan losses as of June 30, 2015 and December 31, 2014:

| (In thousands) | June 30, 2015 | December 31, 2014 |
|-------------------------------------|------------------|----------------------|
| SBA loans held for investment | \$ 39,663 | \$ 40,401 |
| SBA 504 loans | 29,125 | 34,322 |
| Commercial loans | | |
| Commercial other | 40,578 | 40,607 |
| Commercial real estate | 361,866 | 339,693 |
| Commercial real estate construction | 25,927 | 21,649 |
| Residential mortgage loans | 243,259 | 220,878 |
| Consumer loans | | |
| Home equity | 44,935 | 41,451 |
| Consumer other | 24,975 | 17,645 |
| Total loans held for investment | \$ 810,328 | \$ 756,646 |
| SBA loans held for sale | 11,368 | 5,179 |
| Total loans | \$ 821,696 | \$ 761,825 |

Loans are made to individuals as well as commercial entities. Specific loan terms vary as to interest rate, repayment, and collateral requirements based on the type of loan requested and the credit worthiness of the prospective borrower. Credit risk tends to be geographically concentrated in that a majority of the loan customers are located in the markets serviced by the Bank. As a preferred SBA lender, a portion of the SBA portfolio is to borrowers outside the Company's market area. However, during late 2008, the Company withdrew from SBA lending outside of its primary trade area, but continues to offer SBA loan products as an additional credit product within its primary trade area. Loan performance may be adversely affected by factors impacting the general economy or conditions specific to the real estate market such as geographic location and/or property type. A description of the Company's different loan segments follows:

SBA Loans: SBA 7(a) loans, on which the SBA has historically provided guarantees of up to 90 percent of the principal balance, are considered a higher risk loan product for the Company than its other loan products. The guaranteed portion of the Company's SBA loans is generally sold in the secondary market with the nonguaranteed portion held in the portfolio as a loan held for investment. SBA loans are for the purpose of providing working capital, financing the purchase of equipment, inventory or commercial real estate and for other business purposes. Loans are guaranteed by the businesses' major owners. SBA loans are made based primarily on the

historical and projected cash flow of the business and secondarily on the underlying collateral provided.

SBA 504 Loans: The SBA 504 program consists of real estate backed commercial mortgages where the Company has the first mortgage and the SBA has the second mortgage on the property. SBA 504 loans are made based primarily on the historical and projected cash flow of the business and secondarily on the underlying collateral provided. Generally, the Company has a 50 percent loan to value ratio on SBA 504 program loans at origination.

Commercial Loans: Commercial credit is extended primarily to middle market and small business customers. Commercial loans are generally made in the Company's market place for the purpose of providing working capital, financing the purchase of equipment, inventory or commercial real estate and for other business purposes. Loans will generally be guaranteed in full or for a meaningful amount by the businesses' major owners. Commercial loans are made based primarily on the historical and projected cash flow of the business and secondarily on the underlying collateral provided.

Residential Mortgage and Consumer Loans: The Company originates mortgage and consumer loans including principally residential real estate and home equity lines and loans. Each loan type is evaluated on debt to income, type of collateral and loan to collateral value, credit history and Company's relationship with the borrower.

Inherent in the lending function is credit risk, which is the possibility a borrower may not perform in accordance with the contractual terms of their loan. A borrower's inability to pay their obligations according to the contractual terms can create the risk of past due loans and, ultimately, credit losses, especially on collateral deficient loans. The Company minimizes its credit risk by loan diversification and adhering to credit administration policies and procedures. Due diligence on loans begins when we initiate contact regarding a loan with a borrower. Documentation, including a borrower's credit history, materials establishing the value and liquidity of potential collateral, the purpose of the loan, the source of funds for repayment of the loan, and other factors, are analyzed before a loan is submitted for approval. The loan portfolio is then subject to on-going internal reviews for credit quality which in part is derived from ongoing collection and review of borrowers' financial information, as well as independent credit reviews by an outside firm.

The Company's extension of credit is governed by the Credit Risk Policy which was established to control the quality of the Company's loans. These policies and procedures are reviewed and approved by the Board of Directors on a regular basis.

Credit Ratings

For SBA 7(a), SBA 504 and commercial loans, management uses internally assigned risk ratings as the best indicator of credit quality. A loan's internal risk rating is updated at least annually and more frequently if circumstances warrant a change in risk rating. The Company uses a 1 through 10 loan grading system that follows regulatorily accepted definitions.

Pass: Risk ratings of 1 through 6 are used for loans that are performing, as they meet, and are expected to continue to meet, all of the terms and conditions set forth in the original loan documentation, and are generally current on principal and interest payments. These performing loans are termed "Pass".

Special Mention: Criticized loans are assigned a risk rating of 7 and termed "Special Mention", as the borrowers exhibit potential credit weaknesses or downward trends deserving management's close attention. If not checked or corrected, these trends will weaken the Bank's collateral and position. While potentially weak, these borrowers are currently marginally acceptable and no loss of interest or principal is anticipated. As a result, special mention assets do not expose an institution to sufficient risk to warrant adverse classification. Included in "Special Mention" could be turnaround situations, such as borrowers with deteriorating trends beyond one year, borrowers in startup or deteriorating industries, or borrowers with a poor market share in an average industry. "Special Mention" loans may include an element of asset quality, financial flexibility, or below average management. Management and ownership may have limited depth or experience. Regulatory agencies have agreed on a consistent definition of "Special Mention" as an asset with potential weaknesses which, if left uncorrected, may result in deterioration of the repayment prospects for the asset or in the Bank's credit position at some future date. This definition is intended to ensure that the "Special Mention" category is not used to identify assets that have as their sole weakness credit data exceptions or collateral documentation exceptions that are not material to the repayment of the asset.

Substandard: Classified loans are assigned a risk rating of an 8 or 9, depending upon the prospect for collection, and deemed "Substandard". A risk rating of 8 is used for borrowers with well-defined weaknesses that jeopardize the orderly liquidation of debt. The loan is inadequately protected by the current paying capacity of the obligor or by the collateral pledged, if any. Normal repayment from the borrower is in jeopardy, although no loss of principal is envisioned. There is a distinct possibility that a partial loss of interest and/or principal will occur if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of substandard assets, does not have to exist in individual assets classified "Substandard".

A risk rating of 9 is used for borrowers that have all the weaknesses inherent in a loan with a risk rating of 8, with the added characteristic that the weaknesses make collection of debt in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. Serious problems exist to the point where partial loss of principal is likely. The possibility of loss is extremely high, but because of certain important, reasonably specific pending factors that may work to strengthen the assets, the loans' classification as estimated losses is deferred until a more exact status may be determined. Pending factors include proposed merger, acquisition, or liquidation

procedures; capital injection; perfecting liens on additional collateral; and refinancing plans. Partial charge-offs are likely.

Loss: Once a borrower is deemed incapable of repayment of unsecured debt, the risk rating becomes a 10, the loan is termed a "Loss", and charged-off immediately. Loans to such borrowers are considered uncollectible and of such little value that continuance as active assets of the Bank is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off these basically worthless assets even though partial recovery may be affected in the future.

For residential mortgage and consumer loans, management uses performing versus nonperforming as the best indicator of credit quality. Nonperforming loans consist of loans that are not accruing interest (nonaccrual loans) as a result of principal or interest being in default for a period of 90 days or more or when the ability to collect principal and interest according to the contractual terms is in doubt. These credit quality indicators are updated on an ongoing basis, as a loan is placed on nonaccrual status as soon as management believes there is sufficient doubt as to the ultimate ability to collect interest on a loan.

At June 30, 2015, the Company owned \$100 thousand of residential consumer properties that were included in OREO in the Consolidated Balance Sheets. Additionally, there were \$1.8 million of residential consumer loans in the process of foreclosure.

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The tables below detail the Company's loan portfolio by class according to their credit quality indicators discussed in the paragraphs above as of June 30, 2015:

| | June 30, 2015 | | | |
|---|---|-----------------|-------------|------------|
| | SBA, SBA 504 & Commercial loans - Internal risk ratings | | | |
| (In thousands) | Pass | Special mention | Substandard | Total |
| SBA loans held for investment | \$ 35,437 | \$ 2,064 | \$ 2,162 | \$ 39,663 |
| SBA 504 loans | 23,664 | 5,010 | 451 | 29,125 |
| Commercial loans | | | | |
| Commercial other | 36,693 | 2,747 | 1,138 | 40,578 |
| Commercial real estate | 337,172 | 20,868 | 3,826 | 361,866 |
| Commercial real estate construction | 25,229 | 698 | - | 25,927 |
| Total commercial loans | 399,094 | 24,313 | 4,964 | 428,371 |
| Total SBA, SBA 504 and commercial loans | \$ 458,195 | \$ 31,387 | \$ 7,577 | \$ 497,159 |

| | Residential mortgage & Consumer loans - Performing/Nonperforming | | |
|----------------------------|--|---------------|------------|
| (In thousands) | Performing | Nonperforming | Total |
| Residential mortgage loans | \$ 241,500 | \$ 1,759 | \$ 243,259 |
| Consumer loans | | | |
| Home equity | 44,039 | 896 | 44,935 |
| Consumer other | 24,975 | - | 24,975 |
| Total consumer loans | 69,014 | 896 | |