

UNION BANKSHARES INC  
Form 10-Q  
August 14, 2014

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

OR

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

For the quarterly period ended: June 30, 2014

Commission file number: 001-15985

UNION BANKSHARES, INC.

VERMONT

03-0283552

P.O. BOX 667  
20 LOWER MAIN STREET  
MORRISVILLE, VT 05661

Registrant's telephone number: 802-888-6600

Former name, former address and former fiscal year, if changed since last report: Not applicable

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

|  |  |
|--|--|
| Common Stock, \$2.00 par value<br>(Title of class) | Nasdaq Stock Market<br>(Exchanges registered on) |
|--|--|

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

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. See definitions of "large accelerated filer," "accelerated filer" and "smaller reporting

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company” in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer [ ]

Accelerated filer [ ]

Non-accelerated filer [ ] (Do not check if a smaller reporting company)

Smaller reporting company [ X ]

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

Yes [ ] No [X]

Indicate the number of shares outstanding of each of the issuer’s classes of common stock as of August 1, 2014:

Common Stock, \$2 par value

4,458,517 shares

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## PART I FINANCIAL INFORMATION

## Item 1. Financial Statements

UNION BANKSHARES, INC. AND SUBSIDIARY  
CONSOLIDATED BALANCE SHEETS

|  | June 30,<br>2014       | December 31,<br>2013 |
|--|------------------------|----------------------|
|  | (Unaudited)            |                      |
| Assets   | (Dollars in thousands) |                      |
| Cash and due from banks  | \$4,154                | \$5,223              |
| Federal funds sold and overnight deposits  | 15,490                 | 25,496               |
| Cash and cash equivalents  | 19,644                 | 30,719               |
| Interest bearing deposits in banks   | 13,713                 | 17,613               |
| Investment securities available-for-sale   | 40,359                 | 34,281               |
| Investment securities held-to-maturity (fair value \$9.3 million and \$10.4 million at June 30, 2014 and December 31, 2013, respectively)              | 9,642                  | 11,211               |
| Loans held for sale  | 6,662                  | 3,840                |
| Loans  | 455,345                | 461,113              |
| Allowance for loan losses  | (4,610)                | (4,647)              |
| Net deferred loan costs  | 238                    | 170                  |
| Net loans  | 450,973                | 456,636              |
| Accrued interest receivable  | 1,741                  | 1,663                |
| Premises and equipment, net  | 10,979                 | 10,678               |
| Core deposit intangible  | 1,181                  | 1,267                |
| Goodwill   | 2,223                  | 2,223                |
| Investment in real estate limited partnerships   | 2,791                  | 3,119                |
| Company-owned life insurance   | 3,477                  | 3,393                |
| Other assets   | 8,103                  | 8,800                |
| Total assets   | \$571,488              | \$585,443            |
| Liabilities and Stockholders' Equity   |                        |                      |
| Liabilities  |                        |                      |
| Deposits   |                        |                      |
| Noninterest bearing  | \$81,140               | \$87,247             |
| Interest bearing   | 290,980                | 269,614              |
| Time   | 118,736                | 161,493              |
| Total deposits   | 490,856                | 518,354              |
| Borrowed funds   | 24,759                 | 13,216               |
| Accrued interest and other liabilities   | 3,986                  | 4,053                |
| Total liabilities  | 519,601                | 535,623              |
| Commitments and Contingencies  |                        |                      |
| Stockholders' Equity   |                        |                      |
| Common stock, \$2.00 par value; 7,500,000 shares authorized; 4,928,996 shares issued at June 30, 2014 and 4,927,286 shares issued at December 31, 2013 | 9,858                  | 9,855                |
| Additional paid-in capital   | 404                    | 363                  |
| Retained earnings  | 44,769                 | 43,405               |
| Treasury stock at cost; 470,742 shares at June 30, 2014 and 468,927 shares at December 31, 2013  | (3,922)                | (3,880)              |
| Accumulated other comprehensive income   | 778                    | 77                   |
| Total stockholders' equity   | 51,887                 | 49,820               |
| Total liabilities and stockholders' equity   | \$571,488              | \$585,443            |

See accompanying notes to unaudited interim consolidated financial statements.

Union Bankshares, Inc. Page 1

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UNION BANKSHARES, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

|   | Three Months Ended                            |           | Six Months Ended |           |
|---|---|-----------|------------------|-----------|
|   | June 30,                                      | June 30,  | June 30,         | June 30,  |
|   | 2014  | 2013      | 2014             | 2013      |
|   | (Dollars in thousands, except per share data) |           |                  |           |
| Interest and dividend income  |   |           |                  |           |
| Interest and fees on loans  | \$5,828                                       | \$5,787   | \$11,590         | \$11,455  |
| Interest on debt securities:  |   |           |                  |           |
| Taxable   | 206   | 140       | 411              | 250       |
| Tax exempt  | 91  | 70        | 172              | 140       |
| Dividends   | 16  | 13        | 31               | 29        |
| Interest on federal funds sold and overnight deposits                   | 4   | 10        | 8                | 23        |
| Interest on interest bearing deposits in banks                          | 39  | 59        | 84               | 119       |
| Total interest and dividend income                                      | 6,184   | 6,079     | 12,296           | 12,016    |
| Interest expense  |   |           |                  |           |
| Interest on deposits  | 421   | 486       | 893              | 1,004     |
| Interest on borrowed funds  | 108   | 127       | 213              | 257       |
| Total interest expense  | 529   | 613       | 1,106            | 1,261     |
| Net interest income   | 5,655   | 5,466     | 11,190           | 10,755    |
| Provision for loan losses   | 75  | 75        | 150              | 135       |
| Net interest income after provision for loan losses                     | 5,580   | 5,391     | 11,040           | 10,620    |
| Noninterest income  |   |           |                  |           |
| Trust income  | 191   | 154       | 366              | 317       |
| Service fees  | 1,285   | 1,257     | 2,557            | 2,446     |
| Net gains (losses) on sales of investment securities available-for-sale | 19  | (4        | )62              | (1        |
| Net gains on sales of loans held for sale                               | 508   | 583       | 941              | 1,250     |
| Other income  | 107   | 130       | 147              | 264       |
| Total noninterest income  | 2,110   | 2,120     | 4,073            | 4,276     |
| Noninterest expenses  |   |           |                  |           |
| Salaries and wages  | 2,194   | 2,235     | 4,441            | 4,392     |
| Pension and employee benefits   | 703   | 638       | 1,370            | 1,321     |
| Occupancy expense, net  | 295   | 291       | 634              | 622       |
| Equipment expense   | 410   | 388       | 797              | 814       |
| Other expenses  | 1,668   | 1,670     | 3,217            | 3,252     |
| Total noninterest expenses  | 5,270   | 5,222     | 10,459           | 10,401    |
| Income before provision for income taxes                                | 2,420   | 2,289     | 4,654            | 4,495     |
| Provision for income taxes  | 501   | 492       | 971              | 961       |
| Net income  | \$1,919                                       | \$1,797   | \$3,683          | \$3,534   |
| Earnings per common share   | \$0.43  | \$0.40    | \$0.83           | \$0.79    |
| Weighted average number of common shares outstanding                    | 4,458,439                                     | 4,456,802 | 4,458,359        | 4,456,315 |
| Dividends per common share  | \$0.26  | \$0.25    | \$0.52           | \$0.50    |

See accompanying notes to unaudited interim consolidated financial statements.



UNION BANKSHARES, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

|   | Three Months Ended<br>June 30, |         | Six Months Ended<br>June 30, |         |
|---|--------------------------------|---------|------------------------------|---------|
|   | 2014                           | 2013    | 2014                         | 2013    |
|   | (Dollars in thousands)         |         |                              |         |
| Net income  | \$1,919                        | \$1,797 | \$3,683                      | \$3,534 |
| Other comprehensive income (loss), net of tax:  |                                |         |                              |         |
| Investment securities available-for-sale:   |                                |         |                              |         |
| Net unrealized holding gains (losses) arising during the period on investment securities available-for-sale           | 357                            | (618)   | )742                         | (609)   |
| Reclassification adjustment for net (gains) losses on investment securities available-for-sale realized in net income | (13)                           | )3      | (41)                         | )1      |
| Total   | 344                            | (615)   | )701                         | (608)   |
| Defined benefit pension plan:   |                                |         |                              |         |
| Net actuarial loss arising during the period  | —                              | —       | —                            | (33)    |
| Reclassification adjustment for amortization of net actuarial loss realized in net income                             | —                              | 63      | —                            | 63      |
| Total   | —                              | 63      | —                            | 30      |
| Total other comprehensive income (loss)   | 344                            | (552)   | )701                         | (578)   |
| Total comprehensive income  | \$2,263                        | \$1,245 | \$4,384                      | \$2,956 |

See accompanying notes to unaudited interim consolidated financial statements.



CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
Six Months Ended June 30, 2014 and 2013 (Unaudited)

|   | Common Stock                                  |         |                                  |                      |                   | Accumulated                             | Total                   |
|---|---|---------|----------------------------------|----------------------|-------------------|---|-------------------------|
|   | Shares,<br>net of<br>treasury                 | Amount  | Additional<br>paid-in<br>capital | Retained<br>earnings | Treasury<br>stock | other<br>comprehensive<br>income (loss) | stockholders'<br>equity |
|   | (Dollars in thousands, except per share data) |         |                                  |                      |                   |   |                         |
| Balances, December 31, 2013                   | 4,458,359                                     | \$9,855 | \$363                            | \$43,405             | \$(3,880)         | \$77                                    | \$49,820                |
| Net income                                    | —   | —       | —                                | 3,683                | —                 | —                                       | 3,683                   |
| Other comprehensive income                    | —   | —       | —                                | —                    | —                 | 701                                     | 701                     |
| Cash dividends declared<br>(\$0.52 per share) | —   | —       | —                                | (2,319)              | —                 | —                                       | (2,319)                 |
| Stock based compensation<br>expense           | —   | —       | 11                               | —                    | —                 | —                                       | 11                      |
| Exercise of stock options                     | 1,710   | 3       | 30                               | —                    | —                 | —                                       | 33                      |
| Purchase of treasury stock                    | (1,815)                                       | —       | —                                | —                    | (42)              | —                                       | (42)                    |
| Balances, June 30, 2014                       | 4,458,254                                     | \$9,858 | \$404                            | \$44,769             | \$(3,922)         | \$778                                   | \$51,887                |
| Balances, December 31, 2012                   | 4,456,081                                     | \$9,848 | \$295                            | \$40,772             | \$(3,859)         | \$(2,010)                               | \$45,046                |
| Net income                                    | —   | —       | —                                | 3,534                | —                 | —                                       | 3,534                   |
| Other comprehensive loss                      | —   | —       | —                                | —                    | —                 | (578)                                   | (578)                   |
| Cash dividends declared<br>(\$0.50 per share) | —   | —       | —                                | (2,228)              | —                 | —                                       | (2,228)                 |
| Stock based compensation<br>expense           | —   | —       | 6                                | —                    | —                 | —                                       | 6                       |
| Exercise of stock options                     | 1,800   | 4       | 29                               | —                    | —                 | —                                       | 33                      |
| Purchase of treasury stock                    | (925)   | —       | —                                | —                    | (19)              | —                                       | (19)                    |
| Balances, June 30, 2013                       | 4,456,956                                     | \$9,852 | \$330                            | \$42,078             | \$(3,878)         | \$(2,588)                               | \$45,794                |

See accompanying notes to unaudited interim consolidated financial statements.

UNION BANKSHARES, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

|   | Six Months Ended<br>June 30, |           |
|---|------------------------------|-----------|
|   | 2014                         | 2013      |
|   | (Dollars in thousands)       |           |
| Cash Flows From Operating Activities  |                              |           |
| Net income  | \$3,683                      | \$3,534   |
| Adjustments to reconcile net income to net cash provided by operating activities: |                              |           |
| Depreciation  | 463                          | 464       |
| Provision for loan losses   | 150                          | 135       |
| Deferred income tax provision   | 73                           | 138       |
| Net amortization of investment securities   | 37                           | 24        |
| Equity in losses of limited partnerships  | 328                          | 345       |
| Stock based compensation expense  | 11                           | 6         |
| Net (increase) decrease in unamortized loan costs                                 | (68)                         | )9        |
| Proceeds from sales of loans held for sale  | 43,439                       | 67,450    |
| Origination of loans held for sale  | (45,320)                     | )(59,646) |
| Net gains on sales of loans held for sale   | (941)                        | )(1,250)  |
| Net (gains) losses on sales of investment securities available-for-sale           | (62)                         | )1        |
| Write-downs of impaired assets  | —                            | 36        |
| Net (gains) losses on sales of other real estate owned                            | (6)                          | )5        |
| Increase in accrued interest receivable   | (78)                         | )(34)     |
| Amortization of core deposit intangible   | 86                           | 86        |
| (Increase) decrease in other assets   | (180)                        | )879      |
| (Decrease) increase in other liabilities  | (67)                         | )261      |
| Net cash provided by operating activities   | 1,548                        | 12,443    |
| Cash Flows From Investing Activities  |                              |           |
| Interest bearing deposits in banks  |                              |           |
| Proceeds from maturities and redemptions  | 5,779                        | 4,379     |
| Purchases   | (1,879)                      | )(4,719)  |
| Investment securities held-to-maturity  |                              |           |
| Proceeds from maturities, calls and paydowns                                      | 3,571                        | 500       |
| Purchases   | (2,000)                      | )(4,216)  |
| Investment securities available-for-sale  |                              |           |
| Proceeds from sales   | 4,426                        | 1,015     |
| Proceeds from maturities, calls and paydowns                                      | 2,725                        | 2,798     |
| Purchases   | (12,144)                     | )(11,949) |
| Redemption of nonmarketable stock   | —                            | (77)      |
| Net decrease (increase) in loans  | 5,561                        | (705)     |
| Recoveries of loans charged off   | 20                           | 26        |
| Purchases of premises and equipment   | (764)                        | )(359)    |
| Proceeds from sales of other real estate owned                                    | 365                          | 367       |
| Net cash provided by (used in) investing activities                               | 5,660                        | (12,940)  |

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|  |           |           |
|--|-----------|-----------|
| Cash Flows From Financing Activities                 |           |           |
| Repayment of long-term debt                          | (176      | ) (935    |
| Net increase in short-term borrowings outstanding    | 11,719    | 5,366     |
| Net decrease in noninterest bearing deposits         | (6,107    | ) (3,827  |
| Net increase (decrease) in interest bearing deposits | 21,366    | (7,329    |
| Net decrease in time deposits                        | (42,757   | ) (24,820 |
| Issuance of common stock                             | 33        | 33        |
| Purchase of treasury stock                           | (42       | ) (19     |
| Dividends paid                                       | (2,319    | ) (2,228  |
| Net cash used in financing activities                | (18,283   | ) (33,759 |
| Net decrease in cash and cash equivalents            | (11,075   | ) (34,256 |
| Cash and cash equivalents                            |           |           |
| Beginning of period                                  | 30,719    | 46,510    |
| End of period  | \$ 19,644 | \$ 12,254 |
| Supplemental Disclosures of Cash Flow Information    |           |           |
| Interest paid  | \$ 1,307  | \$ 1,456  |
| Income taxes paid                                    | \$ 670    | \$ 650    |

See accompanying notes to unaudited interim consolidated financial statements.

UNION BANKSHARES, INC. AND SUBSIDIARY  
 NOTES TO UNAUDITED INTERIM CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Basis of Presentation

The accompanying unaudited interim consolidated financial statements of Union Bankshares, Inc. and Subsidiary (the Company) as of June 30, 2014, and for the three and six months ended June 30, 2014 and 2013, have been prepared in conformity with GAAP for interim financial information, general practices within the banking industry, and the accounting policies described in the Company's Annual Report on Form 10-K for the year ended December 31, 2013. The Company's sole subsidiary is Union Bank. In the opinion of the Company's management, all adjustments, consisting only of normal recurring adjustments and disclosures necessary for a fair presentation of the information contained herein, have been made. This information should be read in conjunction with the Company's 2013 Annual Report on Form 10-K. The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the full fiscal year ended December 31, 2014, or any other interim period. Certain amounts in the 2013 consolidated financial statements have been reclassified to conform to the 2014 presentation.

The acronyms, abbreviations and capitalized terms identified below are used throughout this Form 10-Q, including Part I. "Financial Information" and Part II. "Other Information". The following is provided to aid the reader and provide a reference page when reviewing this Form 10-Q.

|                     |   |                   |  |
|---------------------|---|-------------------|--|
| AFS:                | Available-for-sale  | IRS:              | Internal Revenue Service                                 |
| ALL:                | Allowance for loan losses   | MBS:              | Mortgage-backed security                                 |
| ASC:                | Accounting Standards Codification   | MSRs:             | Mortgage servicing rights                                |
| ASU:                | Accounting Standards Update   | OAO:              | Other assets owned                                       |
| Board:              | Board of Directors  | OCI:              | Other comprehensive income (loss)                        |
| bp or bps:          | Basis point(s)  | OFAC:             | U.S. Office of Foreign Assets Control                    |
| Branch Acquisition: | The acquisition of three New Hampshire branches in May 2011                               | OREO:             | Other real estate owned                                  |
| CDARS:              | Certificate of Deposit Accounts Registry Service of the Promontory Interfinancial Network | OTTI:             | Other-than-temporary impairment                          |
| Company:            | Union Bankshares, Inc. and Subsidiary   | OTT:              | Other-than-temporary                                     |
| FASB:               | Financial Accounting Standards Board  | Plan:             | The Union Bank Pension Plan                              |
| FDIC:               | Federal Deposit Insurance Corporation   | RD:               | USDA Rural Development                                   |
| FHA:                | U.S. Federal Housing Administration   | SBA:              | U.S. Small Business Administration                       |
| FHLB:               | Federal Home Loan Bank of Boston  | SEC:              | U.S. Securities and Exchange Commission                  |
| FRB:                | Federal Reserve Board   | TDR:              | Troubled-debt restructuring                              |
| FHLMC/Freddie Mac:  | Federal Home Loan Mortgage Corporation  | Union:            | Union Bank, the sole subsidiary of Union Bankshares, Inc |
| GAAP:               | Generally accepted accounting principles in the United States                             | USDA:             | U.S. Department of Agriculture                           |
| HTM:                | Held-to-maturity  | VA:               | U.S. Veterans Administration                             |
| HUD:                | U.S. Department of Housing and Urban Development  | 2008 ISO Plan:    | 2008 Incentive Stock Option Plan of the Company          |
| ICS:                | Insured Cash Sweeps of the Promontory Interfinancial Network                              | 2014 Equity Plan: | 2014 Equity Incentive Plan                               |

Note 2. Legal Contingencies

In the normal course of business, the Company is involved in various legal and other proceedings. In the opinion of management, any liability resulting from such proceedings is not expected to have a material adverse effect on the

Company's consolidated financial condition or results of operations.

Union Bankshares, Inc. Page 7

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Note 3. Per Share Information

Earnings per common share are computed based on the weighted average number of shares of common stock outstanding during the period and reduced for shares held in treasury. The assumed conversion of outstanding exercisable stock options does not result in material dilution and is not included in the calculation.

Note 4. Recent Accounting Pronouncements

In January 2014, the FASB issued ASU No. 2014-01, Accounting for Investments in Qualified Affordable Housing Projects. The amendments in this ASU permit institutions to make accounting policy elections to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). For those investments in qualified affordable housing projects not accounted for using the proportional amortization method, the ASU requires the investment to be accounted for as an equity method investment or a cost method investment. The amendments in this ASU should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those preexisting investments. The amendments in this ASU are effective for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. Management has reviewed the ASU and does not believe that it will have a material effect on the Company's consolidated financial position or results of operations.

In January 2014, the FASB issued ASU No. 2014-04, Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. The amendments in this ASU clarify that an in-substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure. The amendments in this ASU are effective for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. Management has reviewed the ASU and does not believe that it will have a material effect on the Company's consolidated financial position or results of operations.

Note 5. Goodwill and Other Intangible Assets

As a result of the 2011 Branch Acquisition, the Company recorded goodwill amounting to \$2.2 million. The goodwill is not amortizable. Goodwill is evaluated for impairment annually, in accordance with current authoritative accounting guidance. Management assesses qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of the Company, in total, is less than its carrying amount. Management is not aware of any such events or circumstances that would cause it to conclude that the fair value of the Company is less than its carrying amount.

The Company also recorded \$1.7 million of acquired identifiable intangible assets in connection with the branch acquisition, representing the core deposit intangible which is subject to straight-line amortization over the estimated 10 year average life of the core deposit base, absent any future impairment. Management will evaluate the core deposit intangible for impairment if conditions warrant.



Amortization expense for the core deposit intangible was \$43 thousand for the three months ended June 30, 2014 and 2013 and was \$86 thousand for the six months ended June 30, 2014 and 2013. The amortization expense is included in other noninterest expense on the consolidated statement of income and is deductible for tax purposes. As of June 30, 2014, the remaining amortization expense related to the core deposit intangible, absent any future impairment, is expected to be as follows:

|            | (Dollars in thousands) |
|------------|------------------------|
| 2014       | \$85                   |
| 2015       | 171                    |
| 2016       | 171                    |
| 2017       | 171                    |
| 2018       | 171                    |
| Thereafter | 412                    |
| Total      | \$1,181                |

Note 6. Investment Securities

Investment securities as of the balance sheet dates consisted of the following:

| June 30, 2014                         | Amortized<br>Cost      | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---------------------------------------|------------------------|------------------------------|-------------------------------|---------------|
|                                       | (Dollars in thousands) |                              |                               |               |
| Available-for-sale                    |                        |                              |                               |               |
| Debt securities:                      |                        |                              |                               |               |
| U.S. Government-sponsored enterprises | \$11,895               | \$3                          | \$(358)                       | )\$11,540     |
| Agency mortgage-backed                | 5,897                  | 45                           | (27)                          | )5,915        |
| State and political subdivisions      | 14,764                 | 343                          | (59)                          | )15,048       |
| Corporate                             | 6,498                  | 68                           | (63)                          | )6,503        |
| Total debt securities                 | 39,054                 | 459                          | (507)                         | )39,006       |
| Marketable equity securities          | 746                    | 332                          | —                             | 1,078         |
| Mutual funds                          | 275                    | —                            | —                             | 275           |
| Total                                 | \$40,075               | \$791                        | \$(507)                       | )\$40,359     |
| Held-to-maturity                      |                        |                              |                               |               |
| U.S. Government-sponsored enterprises | \$9,642                | \$4                          | \$(351)                       | )\$9,295      |



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| December 31, 2013                     | Amortized<br>Cost      | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|---------------------------------------|------------------------|------------------------------|-------------------------------|---------------|
|                                       | (Dollars in thousands) |                              |                               |               |
| Available-for-sale                    |                        |                              |                               |               |
| Debt securities:                      |                        |                              |                               |               |
| U.S. Government-sponsored enterprises | \$14,327               | \$11                         | \$(1,101)                     | )\$13,237     |
| Agency mortgage-backed                | 3,804                  | 18                           | (75)                          | )3,747        |
| State and political subdivisions      | 11,930                 | 328                          | (94)                          | )12,164       |
| Corporate                             | 3,994                  | —                            | (160)                         | )3,834        |
| Total debt securities                 | 34,055                 | 357                          | (1,430)                       | )32,982       |
| Marketable equity securities          | 746                    | 296                          | (1)                           | )1,041        |
| Mutual funds                          | 258                    | —                            | —                             | 258           |
| Total                                 | \$35,059               | \$653                        | \$(1,431)                     | )\$34,281     |
| Held-to-maturity                      |                        |                              |                               |               |
| U.S. Government-sponsored enterprises | \$11,211               | \$2                          | \$(849)                       | )\$10,364     |

Proceeds from the sale of AFS securities were \$2.0 million and \$4.4 million for the three and six months ended June 30, 2014, respectively. Gross realized gains from the sale of AFS securities were \$19 thousand and \$62 thousand for the three and six months ended June 30, 2014, respectively, while there were no gross realized losses for either period. Proceeds from the sale of AFS securities were \$504 thousand and \$1.0 million for the three and six months ended June 30, 2013, respectively. Gross realized gains from the sale of AFS securities were \$0 and \$3 thousand for the three and six months ended June 30, 2013, respectively, while gross realized losses were \$4 thousand for both periods. The specific identification method is used to determine realized gains and losses on sales of securities AFS.

The amortized cost and estimated fair value of debt securities by contractual scheduled maturity as of June 30, 2014 were as follows:

|  | Amortized<br>Cost      | Fair<br>Value |
|--|------------------------|---------------|
|  | (Dollars in thousands) |               |
| Available-for-sale                       |                        |               |
| Due in one year or less                  | \$827                  | \$827         |
| Due from one to five years               | 3,813                  | 3,855         |
| Due from five to ten years               | 17,780                 | 17,778        |
| Due after ten years                      | 10,737                 | 10,631        |
|  | 33,157                 | 33,091        |
| Agency mortgage-backed                   | 5,897                  | 5,915         |
| Total debt securities available-for-sale | \$39,054               | \$39,006      |
| Held-to-maturity                         |                        |               |
| Due from one to five years               | \$1,996                | \$1,988       |
| Due from five to ten years               | 2,000                  | 1,930         |
| Due after ten years                      | 5,646                  | 5,377         |
| Total debt securities held-to-maturity   | \$9,642                | \$9,295       |

Actual maturities may differ for certain debt securities that may be called by the issuer prior to the contractual maturity. Actual maturities usually differ from contractual maturities on agency MBS because the mortgages underlying the securities may be prepaid, usually without any penalties. Therefore, these agency MBS are shown separately and are not included in the contractual maturity categories in the above maturity summary.



Information pertaining to all investment securities with gross unrealized losses as of the balance sheet dates, aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

| June 30, 2014                    | Less Than 12 Months    |            |                         | 12 Months and over   |            |                         | Total                |            |                         |
|----------------------------------|------------------------|------------|-------------------------|----------------------|------------|-------------------------|----------------------|------------|-------------------------|
|                                  | Number of Securities   | Fair Value | Gross Unrealized Losses | Number of Securities | Fair Value | Gross Unrealized Losses | Number of Securities | Fair Value | Gross Unrealized Losses |
|                                  | (Dollars in thousands) |            |                         |                      |            |                         |                      |            |                         |
| Debt securities:                 |                        |            |                         |                      |            |                         |                      |            |                         |
| U.S.                             |                        |            |                         |                      |            |                         |                      |            |                         |
| Government-sponsored enterprises | —                      | \$—        | \$—                     | 20                   | \$16,314   | \$(709)                 | 20                   | \$16,314   | \$(709)                 |
| Agency mortgage-backed           | 1                      | 464        | (5)                     | 2                    | 846        | (22)                    | 3                    | 1,310      | (27)                    |
| State and political subdivisions | 7                      | 2,267      | (28)                    | 2                    | 573        | (31)                    | 9                    | 2,840      | (59)                    |
| Corporate                        | 3                      | 1,204      | (1)                     | 3                    | 1,457      | (62)                    | 6                    | 2,661      | (63)                    |
| Total                            | 11                     | \$3,935    | \$(34)                  | 27                   | \$19,190   | \$(824)                 | 38                   | \$23,125   | \$(858)                 |
| December 31, 2013                | Less Than 12 Months    |            |                         | 12 Months and over   |            |                         | Total                |            |                         |
|                                  | Number of Securities   | Fair Value | Gross Unrealized Losses | Number of Securities | Fair Value | Gross Unrealized Losses | Number of Securities | Fair Value | Gross Unrealized Losses |
|                                  | (Dollars in thousands) |            |                         |                      |            |                         |                      |            |                         |
| Debt securities:                 |                        |            |                         |                      |            |                         |                      |            |                         |
| U.S.                             |                        |            |                         |                      |            |                         |                      |            |                         |
| Government-sponsored enterprises | 21                     | \$16,213   | \$(1,292)               | 6                    | \$4,839    | \$(658)                 | 27                   | \$21,052   | \$(1,950)               |
| Agency mortgage-backed           | 6                      | 2,844      | (75)                    | —                    | —          | —                       | 6                    | 2,844      | (75)                    |
| State and political subdivisions | 9                      | 3,175      | (72)                    | 1                    | 329        | (22)                    | 10                   | 3,504      | (94)                    |
| Corporate                        | 6                      | 2,420      | (53)                    | 3                    | 1,414      | (107)                   | 9                    | 3,834      | (160)                   |
| Total debt securities            | 42                     | 24,652     | (1,492)                 | 10                   | 6,582      | (787)                   | 52                   | 31,234     | (2,279)                 |
| Marketable equity securities     | —                      | —          | —                       | 1                    | 13         | (1)                     | 1                    | 13         | (1)                     |
| Total                            | 42                     | \$24,652   | \$(1,492)               | 11                   | \$6,595    | \$(788)                 | 53                   | \$31,247   | \$(2,280)               |

The Company evaluates all investment securities on a quarterly basis, and more frequently when economic conditions warrant, to determine if OTTI exists. A security is considered impaired if the fair value is lower than its amortized cost basis at the report date. If impaired, management then assesses whether the unrealized loss is OTT.

Declines in the fair values of individual equity securities that are deemed to be OTT are reflected in noninterest income when identified. An unrealized loss on a debt security is generally deemed to be OTT and a credit loss is deemed to exist if the present value of the expected future cash flows is less than the amortized cost basis of the debt security. The credit loss component of OTTI write-down is recorded, net of tax effect, through net income as a component of net OTTI losses in the consolidated statement of income, while the remaining portion of the impairment loss is recognized in OCI, provided the Company does not intend to sell the underlying debt security and it is "more likely than not" that the Company will not have to sell the debt security prior to recovery.

Management considers the following factors in determining whether OTTI exists and the period over which the debt security is expected to recover:

¶ The length of time, and extent to which, the fair value has been less than the amortized cost;

• Adverse conditions specifically related to the security, industry, or geographic area;

- The historical and implied volatility of the fair value of the security;

• The payment structure of the debt security and the likelihood of the issuer being able to make payments that may increase in the future;

• Failure of the issuer of the security to make scheduled interest or principal payments;

• Any changes to the rating of the security by a rating agency;

• Recoveries or additional declines in fair value subsequent to the balance sheet date; and

The nature of the issuer, including whether it is a private company, public entity or government-sponsored enterprise, and the existence or likelihood of any government or third party guaranty.

The Company has the ability to hold the investment securities that had unrealized losses at June 30, 2014 for the foreseeable future and no declines were deemed by management to be OTT.

Investment securities with a carrying amount of \$3.1 million and \$3.3 million at June 30, 2014 and December 31, 2013, respectively, were pledged as collateral for public deposits and for other purposes as required or permitted by law.

#### Note 7. Loans

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their unpaid principal balances, adjusted for any charge-offs, the ALL, and any deferred fees or costs on originated loans and unamortized premiums or discounts on purchased loans.

Loan interest income is accrued daily on outstanding balances. The following accounting policies, related to accrual and nonaccrual loans, apply to all portfolio segments and to all loan classes, which the Company considers to be the same as the portfolio segments. The accrual of interest is normally discontinued when a loan is specifically determined to be impaired and/or management believes, after considering collection efforts and other factors, that the borrower's financial condition is such that collection of interest is doubtful. Generally, any unpaid interest previously accrued on those loans is reversed against current period interest income. A loan may be restored to accrual status when its financial status has significantly improved and there is no principal or interest past due. A loan may also be restored to accrual status if the borrower makes six consecutive monthly payments or the lump sum equivalent. Income on nonaccrual loans is generally not recognized unless a loan is returned to accrual status or after all principal has been collected. Interest income generally is not recognized on impaired loans unless the likelihood of further loss is remote. Interest payments received on such loans are generally recorded as a reduction of the loan principal balance. Delinquency status is determined based on contractual terms for all portfolio segments and loan classes. Loans past due 30 days or more are considered delinquent.

Loan origination fees and direct loan origination costs are deferred and amortized as an adjustment of the related loan's yield using methods that approximate the interest method. The Company generally amortizes these amounts over the estimated average life of the related loans.

The loans purchased in the 2011 Branch Acquisition were recorded at \$32.9 million, the estimated fair value at the time of purchase. The estimated fair value contains both accretable and nonaccretable components. The accretable component is amortized as an adjustment to the related loan yield over the average life of the loan. The nonaccretable component represents probable loss due to credit risk and is reviewed by management periodically and adjusted as deemed necessary. At the acquisition date, the fair value of the loans acquired resulted in an accretable loan premium component of \$545 thousand, less a nonaccretable credit risk component of \$318 thousand.

The following table summarizes activity in the accretable loan premium component for the acquired loan portfolio:

|                                | For The Three Months Ended |       | For The Six Months Ended |       |
|--------------------------------|----------------------------|-------|--------------------------|-------|
|                                | June 30,                   |       | June 30,                 |       |
|                                | 2014                       | 2013  | 2014                     | 2013  |
|                                | (Dollars in thousands)     |       |                          |       |
| Balance at beginning of period | \$354                      | \$434 | \$374                    | \$454 |
| Loan premium amortization      | (20)                       | )(20) | )(40)                    | )(40) |
| Balance at end of period       | \$334                      | \$414 | \$334                    | \$414 |

Loan premium amortization has been charged to Interest and fees on loans on the Company's consolidated statements of income for the periods reported. The remaining accretable loan premium component balance was \$334 thousand at June 30, 2014 and \$374 thousand at December 31, 2013. The balance of the nonaccretable credit risk component was \$296 thousand at June 30, 2014 and December 31, 2013. The net carrying amounts of the acquired loans were \$16.5 million and \$17.0 million at June 30, 2014 and December 31, 2013, respectively, and are included in the loan balances

below.

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The composition of Net loans as of the balance sheet dates were as follows:

|                           | June 30,<br>2014       | December 31,<br>2013 |
|---------------------------|------------------------|----------------------|
|                           | (Dollars in thousands) |                      |
| Residential real estate   | \$160,662              | \$159,441            |
| Construction real estate  | 31,755                 | 30,898               |
| Commercial real estate    | 218,517                | 210,718              |
| Commercial                | 23,264                 | 20,569               |
| Consumer                  | 4,493                  | 5,396                |
| Municipal                 | 16,654                 | 34,091               |
| Gross loans               | 455,345                | 461,113              |
| Allowance for loan losses | (4,610)                | (4,647)              |
| Net deferred loan costs   | 238                    | 170                  |
| Net loans                 | \$450,973              | \$456,636            |

Residential real estate loans aggregating \$3.7 million and \$22.7 million at June 30, 2014 and December 31, 2013, respectively, were pledged as collateral on deposits of municipalities. Qualifying residential first mortgage loans held by Union may be pledged as collateral for borrowings from the FHLB under a blanket lien.

A summary of current, past due and nonaccrual loans as of the balance sheet dates follows:

| June 30, 2014            | Current                | 30-59 Days | 60-89 Days | 90 Days and<br>Over and<br>Accruing | Nonaccrual | Total     |
|--------------------------|------------------------|------------|------------|-------------------------------------|------------|-----------|
|                          | (Dollars in thousands) |            |            |                                     |            |           |
| Residential real estate  | \$157,842              | \$128      | \$1,235    | \$508                               | \$949      | \$160,662 |
| Construction real estate | 31,675                 | —          | 41         | 12                                  | 27         | 31,755    |
| Commercial real estate   | 215,436                | 1,698      | 122        | 434                                 | 827        | 218,517   |
| Commercial               | 23,182                 | —          | 37         | —                                   | 45         | 23,264    |
| Consumer                 | 4,443                  | 6          | 12         | 2                                   | 30         | 4,493     |
| Municipal                | 16,654                 | —          | —          | —                                   | —          | 16,654    |
| Total                    | \$449,232              | \$1,832    | \$1,447    | \$956                               | \$1,878    | \$455,345 |

| December 31, 2013        | Current                | 30-59 Days | 60-89 Days | 90 Days and<br>Over and<br>Accruing | Nonaccrual | Total     |
|--------------------------|------------------------|------------|------------|-------------------------------------|------------|-----------|
|                          | (Dollars in thousands) |            |            |                                     |            |           |
| Residential real estate  | \$153,469              | \$3,371    | \$1,247    | \$262                               | \$1,092    | \$159,441 |
| Construction real estate | 30,513                 | 300        | 59         | —                                   | 26         | 30,898    |
| Commercial real estate   | 207,429                | 1,117      | 1,938      | —                                   | 234        | 210,718   |
| Commercial               | 20,326                 | 195        | —          | —                                   | 48         | 20,569    |
| Consumer                 | 5,295                  | 66         | —          | 1                                   | 34         | 5,396     |
| Municipal                | 34,091                 | —          | —          | —                                   | —          | 34,091    |
| Total                    | \$451,123              | \$5,049    | \$3,244    | \$263                               | \$1,434    | \$461,113 |

Aggregate interest on nonaccrual loans not recognized was \$1.0 million and \$1.1 million as of June 30, 2014 and 2013, respectively, and \$1.1 million as of December 31, 2013.

Note 8. Allowance for Loan Losses and Credit Quality

The ALL is established for estimated losses in the loan portfolio through a provision for loan losses charged to earnings. For all loan classes, loan losses are charged against the ALL when management believes the loan balance is uncollectible or in accordance with federal guidelines. Subsequent recoveries, if any, are credited to the ALL.

The ALL is maintained at a level believed by management to be appropriate to absorb probable credit losses inherent in the loan portfolio as of the balance sheet date. The amount of the ALL is based on management's periodic evaluation of the collectability of the loan portfolio, including the nature, volume and risk characteristics of the portfolio, credit concentrations, trends in historical loss experience, estimated value of any underlying collateral, specific impaired loans and economic conditions. There has been no change to the methodology used to estimate the ALL during the second quarter of 2014. While management uses available information to recognize losses on loans, future additions to the ALL may be necessary based on changes in economic conditions or other relevant factors.

In addition, various regulatory agencies, as an integral part of their examination process, regularly review the Company's ALL. Such agencies may require the Company to recognize additions to the ALL, with a corresponding charge to earnings, based on their judgments about information available to them at the time of their examination, which may not be currently available to management.

The ALL consists of specific, general and unallocated components. The specific component relates to the loans that are classified as impaired. Loans are evaluated for impairment and may be classified as impaired when management believes it is probable that the Company will not collect all the contractual interest and principal payments as scheduled in the loan agreement. Impaired loans may also include troubled loans that are restructured. A TDR occurs when the Company, for economic or legal reasons related to the borrower's financial difficulties, grants a concession to the borrower that would otherwise not be granted. A TDR classification may result from the transfer of assets to the Company in partial satisfaction of a troubled loan, a modification of a loan's terms (such as reduction of stated interest rates below market rates, extension of maturity that does not conform to the Company's policies, reduction of the face amount of the loan, reduction of accrued interest, or reduction or deferment of loan payments), or a combination of factors. A specific reserve amount is allocated to the allowance for individual loans that have been classified as impaired based on management's estimate of the fair value of the collateral for collateral dependent loans, an observable market price, or the present value of anticipated future cash flows. The Company accounts for the change in present value attributable to the passage of time in the loan loss reserve. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer, real estate or small balance commercial loans for impairment evaluation, unless such loans are subject to a restructuring agreement or have been identified as impaired as part of a larger customer relationship. Management has established the threshold for individual impairment evaluation for commercial loans with balances greater than \$500 thousand, based on an evaluation of the Company's historical loss experience on substandard commercial loans.

The general component represents the level of ALL allocable to each loan portfolio segment with similar risk characteristics and is determined based on historical loss experience, adjusted for qualitative factors, for each class of loan. Management deems a five year average to be an appropriate time frame on which to base historical losses for each portfolio segment. Qualitative factors considered include underwriting, economic and market conditions, portfolio composition, collateral values, delinquencies, lender experience and legal issues. The qualitative factors are determined based on the various risk characteristics of each portfolio segment. Risk characteristics relevant to each portfolio segment are as follows:

Residential real estate - Loans in this segment are collateralized by owner-occupied 1-4 family residential real estate, second and vacation homes, 1-4 family investment properties, home equity and second mortgage loans. Repayment is dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment rates and housing prices, could have an effect on the credit quality of this segment.



Construction real estate - Loans in this segment include residential and commercial construction properties, land and land development loans. Repayment is dependent on the credit quality of the individual borrower and/or the underlying cash flows generated by the properties being constructed. The overall health of the economy, including unemployment rates, housing prices, vacancy rates and material costs, could have an effect on the credit quality of this segment.

Commercial real estate - Loans in this segment are primarily properties occupied by businesses or income-producing properties. The underlying cash flows generated by the properties may be adversely impacted by a downturn in the economy as evidenced by a general slowdown in business or increased vacancy rates which, in turn, could have an effect on the credit quality of this segment. Management requests business financial statements at least annually and monitors the cash flows of these loans.

Commercial - Loans in this segment are made to businesses and are generally secured by nonreal estate assets of the business. Repayment is expected from the cash flows of the business. A weakened economy, and resultant decreased consumer or business spending, could have an effect on the credit quality of this segment.

Consumer - Loans in this segment are made to individuals for personal expenditures, such as an automobile purchase, and include unsecured loans. Repayment is primarily dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment, could have an effect on the credit quality of this segment.

Municipal - Loans in this segment are made to municipalities located within the Company's service area. Repayment is primarily dependent on taxes or other funds collected by the municipalities. Management considers there to be minimal risk surrounding the credit quality of this segment.

An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the ALL reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

All evaluations are inherently subjective as they require estimates that are susceptible to significant revision as more information becomes available or as changes occur in economic conditions or other relevant factors. Despite the allocation shown in the tables below, the ALL is general in nature and is available to absorb losses from any loan segment.

Changes in the ALL, by class of loans, for the three and six months ended June 30, 2014 and 2013 were as follows:

| For The Three Months Ended June 30, 2014 | Residential Real Estate | Construction Real Estate | Commercial Real Estate | Commercial | Consumer | Municipal | Unallocated | Total   |
|--|-------------------------|--------------------------|------------------------|------------|----------|-----------|-------------|---------|
| Balance, March 31, 2014                  | \$1,237                 | \$374                    | \$2,575                | \$169      | \$22     | \$43      | \$274       | \$4,694 |
| Provision (credit) for loan losses       | 39                      | 12                       | 164                    | 36         | 3        | (25)      | (154)       | 75      |
| Recoveries of amounts charged off        | —                       | 3                        | —                      | 1          | 2        | —         | —           | 6       |
| Amounts charged off                      | 1,276                   | 389                      | 2,739                  | 206        | 27       | 18        | 120         | 4,775   |
| Balance, June 30, 2014                   | (18)                    | —                        | (142)                  | —          | (5)      | —         | —           | (165)   |
| For The Three Months Ended June 30, 2013 | \$1,258                 | \$389                    | \$2,597                | \$206      | \$22     | \$18      | \$120       | \$4,610 |
| Balance, March 31, 2013                  | \$1,281                 | \$373                    | \$2,722                | \$175      | \$34     | \$32      | \$97        | \$4,714 |
| Provision (credit) for loan losses       | 24                      | 71                       | 47                     | 36         | (1)      | (18)      | (84)        | 75      |
| Recoveries of amounts charged off        | 9                       | 3                        | —                      | 2          | 1        | —         | —           | 15      |
| Amounts charged off                      | 1,314                   | 447                      | 2,769                  | 213        | 34       | 14        | 13          | 4,804   |
| Balance, June 30, 2013                   | (16)                    | (16)                     | —                      | (18)       | (2)      | —         | —           | (52)    |
| For The Six Months Ended June 30, 2014   | \$1,298                 | \$431                    | \$2,769                | \$195      | \$32     | \$14      | \$13        | \$4,752 |
| Balance, December 31, 2013               | \$1,251                 | \$390                    | \$2,644                | \$163      | \$23     | \$35      | \$141       | \$4,647 |
| Provision (credit) for loan losses       | 60                      | (7)                      | 95                     | 41         | (1)      | (17)      | (21)        | 150     |

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|                                   |         |       |         |       |      |      |       |         |
|-----------------------------------|---------|-------|---------|-------|------|------|-------|---------|
| Recoveries of amounts charged off | 2       | 6     | —       | 2     | 10   | —    | —     | 20      |
|                                   | 1,313   | 389   | 2,739   | 206   | 32   | 18   | 120   | 4,817   |
| Amounts charged off               | (55     | )—    | (142    | )—    | (10  | )—   | —     | (207 )  |
| Balance, June 30, 2014            | \$1,258 | \$389 | \$2,597 | \$206 | \$22 | \$18 | \$120 | \$4,610 |

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| For The Six Months Ended<br>June 30, 2013 | Residential<br>Real Estate | Construction<br>Real Estate | Commercial<br>Real Estate | Commercial | Consumer | Municipal | Unallocated | Total   |
|---|----------------------------|-----------------------------|---------------------------|------------|----------|-----------|-------------|---------|
|   | (Dollars in thousands)     |                             |                           |            |          |           |             |         |
| Balance, December 31, 2012                | \$1,291                    | \$456                       | \$2,532                   | \$159      | \$39     | \$30      | \$150       | \$4,657 |
| Provision (credit) for loan losses        | 23                         | (15)                        | (237)                     | 51         | (8)      | (16)      | (137)       | 135     |
| Recoveries of amounts charged off         | 10                         | 6                           | —                         | 3          | 7        | —         | —           | 26      |
|   | 1,324                      | 447                         | 2,769                     | 213        | 38       | 14        | 13          | 4,818   |
| Amounts charged off                       | (26)                       | (16)                        | (—)                       | (18)       | (6)      | (—)       | (—)         | (66)    |
| Balance, June 30, 2013                    | \$1,298                    | \$431                       | \$2,769                   | \$195      | \$32     | \$14      | \$13        | \$4,752 |

The allocation of the ALL, summarized on the basis of the Company's impairment methodology by class of loan, as of the balance sheet dates were as follows:

| June 30, 2014                         | Residential<br>Real Estate | Construction<br>Real Estate | Commercial<br>Real Estate | Commercial | Consumer | Municipal | Unallocated | Total   |
|---------------------------------------|----------------------------|-----------------------------|---------------------------|------------|----------|-----------|-------------|---------|
|                                       | (Dollars in thousands)     |                             |                           |            |          |           |             |         |
| Individually evaluated for impairment | \$40                       | \$2                         | \$134                     | \$—        | \$—      | \$—       | \$—         | \$176   |
| Collectively evaluated for impairment | 1,218                      | 387                         | 2,463                     | 206        | 22       | 18        | 120         | 4,434   |
| Total allocated                       | \$1,258                    | \$389                       | \$2,597                   | \$206      | \$22     | \$18      | \$120       | \$4,610 |

  

| December 31, 2013                     | Residential<br>Real Estate | Construction<br>Real Estate | Commercial<br>Real Estate | Commercial | Consumer | Municipal | Unallocated | Total   |
|---------------------------------------|----------------------------|-----------------------------|---------------------------|------------|----------|-----------|-------------|---------|
|                                       | (Dollars in thousands)     |                             |                           |            |          |           |             |         |
| Individually evaluated for impairment | \$46                       | \$13                        | \$278                     | \$—        | \$—      | \$—       | \$—         | \$337   |
| Collectively evaluated for impairment | 1,205                      | 377                         | 2,366                     | 163        | 23       | 35        | 141         | 4,310   |
| Total allocated                       | \$1,251                    | \$390                       | \$2,644                   | \$163      | \$23     | \$35      | \$141       | \$4,647 |

The recorded investment in loans, summarized on the basis of the Company's impairment methodology by class of loan, as of the balance sheet dates were as follows:

| June 30, 2014                         | Residential<br>Real Estate | Construction<br>Real Estate | Commercial<br>Real Estate | Commercial | Consumer | Municipal | Total     |
|---------------------------------------|----------------------------|-----------------------------|---------------------------|------------|----------|-----------|-----------|
|                                       | (Dollars in thousands)     |                             |                           |            |          |           |           |
| Individually evaluated for impairment | \$645                      | \$301                       | \$4,227                   | \$99       | \$—      | \$—       | \$5,272   |
| Collectively evaluated for impairment | 152,948                    | 31,454                      | 205,620                   | 22,945     | 4,388    | 16,212    | 433,567   |
|                                       | 153,593                    | 31,755                      | 209,847                   | 23,044     | 4,388    | 16,212    | 438,839   |
| Acquired loans                        | 7,069                      | —                           | 8,670                     | 220        | 105      | 442       | 16,506    |
| Total                                 | \$160,662                  | \$31,755                    | \$218,517                 | \$23,264   | \$4,493  | \$16,654  | \$455,345 |

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| December 31, 2013                        | Residential<br>Real Estate<br>(Dollars in thousands) | Construction<br>Real Estate | Commercial<br>Real Estate | Commercial | Consumer | Municipal | Total     |
|--|--|-----------------------------|---------------------------|------------|----------|-----------|-----------|
| Individually evaluated<br>for impairment | \$821  | \$348                       | \$4,219                   | \$109      | \$—      | \$—       | \$5,497   |
| Collectively evaluated<br>for impairment | 151,297  | 30,550                      | 197,696                   | 20,145     | 5,264    | 33,627    | 438,579   |
| Acquired loans                           | 152,118  | 30,898                      | 201,915                   | 20,254     | 5,264    | 33,627    | 444,076   |
| Total                                    | 7,323  | —                           | 8,803                     | 315        | 132      | 464       | 17,037    |
|  | \$159,441  | \$30,898                    | \$210,718                 | \$20,569   | \$5,396  | \$34,091  | \$461,113 |

Risk and collateral ratings are assigned to loans and are subject to ongoing monitoring by lending and credit personnel with such ratings updated annually or more frequently if warranted. The following is an overview of the Company's loan rating system:

1-3 Rating - Pass

Risk-rating grades "1" through "3" comprise those loans ranging from those with lower than average credit risk, defined as borrowers with high liquidity, excellent financial condition, strong management, favorable industry trends or loans secured by highly liquid assets, through those with marginal credit risk, defined as borrowers that, while creditworthy, exhibit some characteristics requiring special attention by the account officer.

4/M Rating - Satisfactory/Monitor

Borrowers exhibit potential credit weaknesses or downward trends warranting management's attention. While potentially weak, these borrowers are currently marginally acceptable; no loss of principal or interest is envisioned. When warranted, these credits may be monitored on the watch list.

5-7 Rating - Substandard

Borrowers exhibit well defined weaknesses that jeopardize the orderly liquidation of debt. The loan may be inadequately protected by the net worth and paying capacity of the obligor and/or the underlying collateral is inadequate.

The following tables summarize the loan ratings applied to the Company's loans by class as of the balance sheet dates:

| June 30, 2014        | Residential<br>Real Estate<br>(Dollars in thousands) | Construction<br>Real Estate | Commercial<br>Real Estate | Commercial | Consumer | Municipal | Total     |
|----------------------|--|-----------------------------|---------------------------|------------|----------|-----------|-----------|
| Pass                 | \$143,965  | \$29,254                    | \$161,740                 | \$20,603   | \$4,307  | \$16,212  | \$376,081 |
| Satisfactory/Monitor | 7,494  | 2,200                       | 40,618                    | 2,147      | 73       | —         | 52,532    |
| Substandard          | 2,134  | 301                         | 7,489                     | 294        | 8        | —         | 10,226    |
| Total                | 153,593  | 31,755                      | 209,847                   | 23,044     | 4,388    | 16,212    | 438,839   |
| Acquired loans       | 7,069  | —                           | 8,670                     | 220        | 105      | 442       | 16,506    |
| Total                | \$160,662  | \$31,755                    | \$218,517                 | \$23,264   | \$4,493  | \$16,654  | \$455,345 |

  

| December 31, 2013    | Residential<br>Real Estate<br>(Dollars in thousands) | Construction<br>Real Estate | Commercial<br>Real Estate | Commercial | Consumer | Municipal | Total     |
|----------------------|--|-----------------------------|---------------------------|------------|----------|-----------|-----------|
| Pass                 | \$141,909  | \$29,648                    | \$145,225                 | \$17,309   | \$5,180  | \$33,627  | \$372,898 |
| Satisfactory/Monitor | 7,953  | 891                         | 50,198                    | 2,694      | 82       | —         | 61,818    |
| Substandard          | 2,256  | 359                         | 6,492                     | 251        | 2        | —         | 9,360     |
| Total                | 152,118  | 30,898                      | 201,915                   | 20,254     | 5,264    | 33,627    | 444,076   |

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|                |           |          |           |          |         |          |           |
|----------------|-----------|----------|-----------|----------|---------|----------|-----------|
| Acquired loans | 7,323     | —        | 8,803     | 315      | 132     | 464      | 17,037    |
| Total          | \$159,441 | \$30,898 | \$210,718 | \$20,569 | \$5,396 | \$34,091 | \$461,113 |

Acquired loans are risk rated, as appropriate, according to the Company's loan rating system, but such ratings are not taken into account in establishing the ALL. Rather, in accordance with applicable accounting principles, acquired loans are initially recorded

at fair value, determined based upon an estimate of the amount and timing of both principal and interest cash flows expected to be collected and discounted using a market interest rate, which includes an estimate of future credit losses expected to be incurred over the life of the portfolio. The primary credit quality indicator for acquired loans is whether there has been a decrease in expected cash flows. Monitoring of this portfolio is ongoing to determine if there is evidence of deterioration in credit quality since acquisition. As of June 30, 2014, there was no ALL for acquired loans.

The following table provides information with respect to impaired loans by class of loan as of and for the three and six months ended June 30, 2014:

|                             | As of June 30, 2014    |                   |                   | For The Three Months Ended June 30, 2014 |                            | For The Six Months Ended June 30, 2014 |                            |
|-----------------------------|------------------------|-------------------|-------------------|--|----------------------------|--|----------------------------|
|                             | Recorded Investment    | Principal Balance | Related Allowance | Average Recorded Investment              | Interest Income Recognized | Average Recorded Investment            | Interest Income Recognized |
|                             | (Dollars in thousands) |                   |                   |  |                            |  |                            |
| With an allowance recorded: |                        |                   |                   |  |                            |  |                            |
| Residential real estate     | \$336                  | \$345             | \$40              |  |                            |  |                            |
| Construction real estate    | 99                     | 99                | 2                 |  |                            |  |                            |
| Commercial real estate      | 2,185                  | 2,189             | 134               |  |                            |  |                            |
|                             | 2,620                  | 2,633             | 176               |  |                            |  |                            |
| With no allowance recorded: |                        |                   |                   |  |                            |  |                            |
| Residential real estate     | 309                    | 485               | —                 |  |                            |  |                            |
| Construction real estate    | 202                    | 224               | —                 |  |                            |  |                            |
| Commercial real estate      | 2,042                  | 2,088             | —                 |  |                            |  |                            |
| Commercial                  | 99                     | 99                | —                 |  |                            |  |                            |
|                             | 2,652                  | 2,896             | —                 |  |                            |  |                            |
| Total:                      |                        |                   |                   |  |                            |  |                            |
| Residential real estate     | 645                    | 830               | 40                | \$648                                    | \$5                        | \$706                                  | \$10                       |
| Construction real estate    | 301                    | 323               | 2                 | 325                                      | 4                          | 333                                    | 8                          |
| Commercial real estate      | 4,227                  | 4,277             | 134               | 4,230                                    | 45                         | 4,226                                  | 87                         |
| Commercial                  | 99                     | 99                | —                 | 102                                      | 2                          | 104                                    | 4                          |
| Total                       | \$5,272                | \$5,529           | \$176             | \$5,305                                  | \$56                       | \$5,369                                | \$109                      |

The following table provides information with respect to impaired loans by class of loan as of and for the three and six months ended June 30, 2013:

|                          | As of June 30, 2013     |                       |                   | For The Three Months Ended June 30, 2013 |                            | For The Six Months Ended June 30, 2013 |                            |
|--------------------------|-------------------------|-----------------------|-------------------|--|----------------------------|--|----------------------------|
|                          | Recorded Investment (1) | Principal Balance (1) | Related Allowance | Average Recorded Investment              | Interest Income Recognized | Average Recorded Investment            | Interest Income Recognized |
|                          | (Dollars in thousands)  |                       |                   |  |                            |  |                            |
| Total:                   |                         |                       |                   |  |                            |  |                            |
| Residential real estate  | \$888                   | \$1,058               | \$51              | \$820                                    | \$4                        | \$781                                  | \$8                        |
| Construction real estate | 351                     | 373                   | 16                | 246                                      | 1                          | 213                                    | 2                          |
| Commercial real estate   | 3,262                   | 3,358                 | 20                | 3,329                                    | 41                         | 3,362                                  | 70                         |
| Commercial               | 117                     | 117                   | 3                 | 120                                      | 2                          | 122                                    | 4                          |
| Total                    | \$4,618                 | \$4,906               | \$90              | \$4,515                                  | \$48                       | \$4,478                                | \$84                       |

(1) Does not reflect government guaranties on impaired loans as of June 30, 2013 totaling \$750 thousand.



The following table provides information with respect to impaired loans as of December 31, 2013:

|                             | December 31, 2013             |                             |                      |
|-----------------------------|-------------------------------|-----------------------------|----------------------|
|                             | Recorded<br>Investment<br>(1) | Principal<br>Balance<br>(1) | Related<br>Allowance |
| (Dollars in thousands)      |                               |                             |                      |
| With an allowance recorded: |                               |                             |                      |
| Residential real estate     | \$437                         | \$451                       | \$46                 |
| Construction real estate    | 322                           | 322                         | 13                   |
| Commercial real estate      | 2,534                         | 2,534                       | 278                  |
|                             | 3,293                         | 3,307                       | 337                  |
| With no allowance recorded: |                               |                             |                      |
| Residential real estate     | 384                           | 612                         | —                    |
| Construction real estate    | 26                            | 48                          | —                    |
| Commercial real estate      | 1,685                         | 1,742                       | —                    |
| Commercial                  | 109                           | 109                         | —                    |
|                             | 2,204                         | 2,511                       | —                    |
| Total:                      |                               |                             |                      |
| Residential real estate     | 821                           | 1,063                       | 46                   |
| Construction real estate    | 348                           | 370                         | 13                   |
| Commercial real estate      | 4,219                         | 4,276                       | 278                  |
| Commercial                  | 109                           | 109                         | —                    |
| Total                       | \$5,497                       | \$5,818                     | \$337                |

(1) Does not reflect government guaranties on impaired loans as of December 31, 2013 totaling \$669 thousand.

The following is a summary of TDR loans by class of loan as of the balance sheet dates:

|                          | June 30, 2014      |                      | December 31, 2013  |                      |
|--------------------------|--------------------|----------------------|--------------------|----------------------|
|                          | Number of<br>Loans | Principal<br>Balance | Number of<br>Loans | Principal<br>Balance |
| Residential real estate  | 4                  | \$390                | 4                  | \$402                |
| Construction real estate | 3                  | 301                  | 3                  | 349                  |
| Commercial real estate   | 4                  | 1,552                | 2                  | 489                  |
| Total                    | 11                 | \$2,243              | 9                  | \$1,240              |

The TDR loans above represent loan modifications in which a concession was provided to the borrower, including due date extensions, maturity date extensions, interest rate reductions or the forgiveness of accrued interest. Troubled loans, that are restructured and meet established thresholds, are classified as impaired and a specific reserve amount is allocated to the ALL on the basis of the fair value of the collateral for collateral dependent loans, an observable market price, or the present value of anticipated future cash flows.

There was no new TDR activity during the for the the three and six months ended June 30, 2013 or the three months ended June 30, 2014. The following table provides new TDR activity for the six months ended June 30, 2014:

|                        | New TDRs During the<br>Six Months Ended June 30, 2014 |                        |                                       |
|------------------------|---|------------------------|---------------------------------------|
|                        |   | Pre-Modification       | Post-Modification                     |
|                        | Number of Outstanding<br>Loans                        | Recorded<br>Investment | Outstanding<br>Recorded<br>Investment |
|                        | (Dollars in thousands)                                |                        |                                       |
| Commercial real estate | 2   | \$ 1,018               | \$ 1,068                              |

There were no TDR loans modified within the previous twelve months that had subsequently defaulted during the three and six month periods ended June 30, 2014 or June 30, 2013. TDR loans are considered defaulted at 90 days past due.

At June 30, 2014 and December 31, 2013, the Company was not committed to lend any additional funds to borrowers whose loans were nonperforming, impaired or restructured.

#### Note 9. Defined Benefit Pension Plan

Union Bank, the Company's sole subsidiary, sponsors a noncontributory defined benefit pension plan covering all eligible employees employed prior to October 5, 2012. On October 5, 2012, the Company closed the Plan to new participants and froze the accrual of retirement benefits for current participants. It is Union's current intent to continue to maintain the frozen Plan and related Trust account and to distribute benefits to participants at such time and in such manner as provided under the terms of the Plan. The Company will continue to recognize pension (benefit) expense and cash funding obligations for the remaining life of the associated liability for the frozen benefits under the Plan. The Plan provides defined benefits based on years of service and final average salary prior to October 5, 2012.

Net periodic pension (benefit) expense for the three and six months ended June 30 consisted of the following components:

|   | Three Months Ended<br>June 30, |       | Six Months Ended<br>June 30, |         |
|---|--------------------------------|-------|------------------------------|---------|
|   | 2014                           | 2013  | 2014                         | 2013    |
|   | (Dollars in thousands)         |       |                              |         |
| Service cost                                  | \$—                            | \$—   | \$—                          | \$—     |
| Interest cost on projected benefit obligation | 193                            | 175   | 386                          | 350     |
| Expected return on plan assets                | (306                           | )(252 | )(604                        | )(504   |
| Amortization of prior service cost            | —                              | —     | —                            | —       |
| Amortization of net loss                      | —                              | 95    | —                            | 95      |
| Net periodic (benefit) expense                | \$(113                         | )\$18 | \$(218                       | )\$(-59 |

#### Note 10. Other Comprehensive Income (Loss)

Accounting principles generally require recognized revenue, expenses, gains and losses be included in net income or loss. Certain changes in assets and liabilities, such as the after tax effect of unrealized gains and losses on investment securities AFS that are not OTTI and the unfunded liability for the defined benefit pension plan, are not reflected in the consolidated statement of income. The cumulative effect of such items, net of tax effect, is reported as a separate component of the equity section of the consolidated balance sheet (Accumulated OCI). OCI, along with net income, comprises the Company's total comprehensive income or loss.

As of the balance sheet dates, the components of Accumulated OCI, net of tax, were:

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|  | June 30,<br>2014       | December 31,<br>2013 |
|--|------------------------|----------------------|
|  | (Dollars in thousands) |                      |
| Net unrealized gain (loss) on investment securities available-for-sale | \$188                  | \$(513 )             |
| Defined benefit pension plan net unrealized actuarial gain             | 590                    | 590                  |
| Total  | \$778                  | \$77                 |

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The following table discloses the tax effects allocated to each component of OCI for the three months ended June 30:

|   | Three Months Ended |                       | June 30, 2014     |                   | June 30, 2013         |                   | Net-of-Tax Amount |
|---|--------------------|-----------------------|-------------------|-------------------|-----------------------|-------------------|-------------------|
|   | Before-Tax Amount  | Tax (Expense) Benefit | Net-of-Tax Amount | Before-Tax Amount | Tax (Expense) Benefit | Net-of-Tax Amount |                   |
| (Dollars in thousands)  |                    |                       |                   |                   |                       |                   |                   |
| Investment securities available-for-sale:   |                    |                       |                   |                   |                       |                   |                   |
| Net unrealized holding gains (losses) arising during the period on investment securities available-for-sale           | \$541              | \$(184)               | )\$ 357           | \$(936)           | )\$318                |                   | \$( 618 )         |
| Reclassification adjustment for net (gains) losses on investment securities available-for-sale realized in net income | (19)               | )6                    | (13)              | ) 4               | (1)                   | )3                |                   |
| Total   | 522                | (178)                 | )344              | (932)             | )317                  |                   | (615 )            |
| Defined benefit pension plan:   |                    |                       |                   |                   |                       |                   |                   |
| Reclassification adjustment for amortization of net actuarial loss realized in net income                             | —                  | —                     | —                 | 95                | (32)                  | )63               |                   |
| Total other comprehensive income (loss)   | \$522              | \$(178)               | )\$ 344           | \$(837)           | )\$285                |                   | \$( 552 )         |

The following table discloses the tax effects allocated to each component of OCI for the six months ended June 30:

|   | Six Months Ended  |                       | June 30, 2014     |                   | June 30, 2013         |                   | Net-of-Tax Amount |
|---|-------------------|-----------------------|-------------------|-------------------|-----------------------|-------------------|-------------------|
|   | Before-Tax Amount | Tax (Expense) Benefit | Net-of-Tax Amount | Before-Tax Amount | Tax (Expense) Benefit | Net-of-Tax Amount |                   |
| (Dollars in thousands)  |                   |                       |                   |                   |                       |                   |                   |
| Investment securities available-for-sale:   |                   |                       |                   |                   |                       |                   |                   |
| Net unrealized holding gains (losses) arising during the period on investment securities available-for-sale           | \$1,124           | \$(382)               | )\$ 742           | \$(922)           | )\$313                |                   | \$( 609 )         |
| Reclassification adjustment for net (gains) losses on investment securities available-for-sale realized in net income | (62)              | )21                   | (41)              | ) 1               | —                     | ) 1               |                   |
| Total   | 1,062             | (361)                 | )701              | (921)             | )313                  |                   | (608 )            |
| Defined benefit pension plan:   |                   |                       |                   |                   |                       |                   |                   |
| Net actuarial loss arising during the period  | —                 | —                     | —                 | (49)              | )16                   |                   | (33 )             |
| Reclassification adjustment for amortization of net actuarial loss realized in net income                             | —                 | —                     | —                 | 95                | (32)                  | )63               |                   |
| Total   | —                 | —                     | —                 | 46                | (16)                  | )30               |                   |
| Total other comprehensive income (loss)   | \$1,062           | \$(361)               | )\$ 701           | \$(875)           | )\$297                |                   | \$( 578 )         |

The following table discloses information concerning the reclassification adjustments from OCI for the three and six months ended June 30:

| Reclassification Adjustment Description                        | Three Months Ended |               | Six Months Ended |               | Affected Line Item in Consolidated Statement of Income                  |
|--|--------------------|---------------|------------------|---------------|---|
|  | June 30, 2014      | June 30, 2013 | June 30, 2014    | June 30, 2013 |   |
| (Dollars in thousands)   |                    |               |                  |               |   |
| Investment securities available-for-sale:                      |                    |               |                  |               |   |
| Net (gains) losses on investment securities available-for-sale | \$(19              | )\$4          | \$(62            | )\$1          | Net gains (losses) on sales of investment securities available-for-sale |
| Tax benefit (expense)  | 6                  | (1            | )21              | —             | Provision for income taxes  |
|  | (13                | )3            | (41              | )1            | Net income  |
| Defined benefit pension plan:                                  |                    |               |                  |               |   |
| Net actuarial loss   | —                  | 95            | —                | 95            | Pension and employee benefits   |
| Tax expense  | —                  | (32           | )—               | (32           | )Provision for income taxes   |
|  | —                  | 63            | —                | 63            | Net income  |
| Total reclassifications  | \$(13              | )\$66         | \$(41            | )\$64         | Net income  |

#### Note 11. Fair Value Measurements and Disclosures

The Company utilizes FASB ASC Topic 820, Fair Value Measurements and Disclosures, as guidance for accounting for assets and liabilities carried at fair value. This standard defines fair value as the price that would be received, without adjustment for transaction costs, to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is a market based measurement that should be determined based on assumptions that market participants would use in pricing an asset or liability. The guidance in FASB ASC Topic 820 establishes a three-level fair value hierarchy, which prioritizes the inputs used in measuring fair value. A financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

The three levels of the fair value hierarchy are:

- Level 1 - Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;
- Level 2 - Quoted prices for similar assets or liabilities in active markets, quoted prices in markets that are not active, or inputs that are observable, either directly or indirectly, for substantially the full term of the asset or liability;
- Level 3 - Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported by little or no market activity).

The following is a description of the valuation methodologies used for the Company's assets that are measured on a recurring basis at estimated fair value:

AFS securities: Marketable equity securities and mutual funds have been valued using unadjusted quoted prices from active markets and therefore have been classified as Level 1. However, the majority of the Company's AFS securities have been valued utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include market maker bids, quotes and pricing models. Inputs to the pricing models include recent trades, benchmark interest rates, spreads and actual and projected cash flows.

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Assets measured at fair value on a recurring basis at June 30, 2014 and December 31, 2013, segregated by fair value hierarchy level, are summarized below:

|  | Fair Value Measurements |  |   |   |
|--|-------------------------|--|---|---|
|  | Fair Value              | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| (Dollars in thousands)                                     |                         |  |   |   |
| June 30, 2014:   |                         |  |   |   |
| Investment securities available-for-sale (market approach) |                         |  |   |   |
| Debt securities:   |                         |  |   |   |
| U.S. Government-sponsored enterprises                      | \$ 11,540               | \$—  | \$ 11,540                                     | \$—                                       |
| Agency mortgage-backed                                     | 5,915                   | —  | 5,915   | —   |
| State and political subdivisions                           | 15,048                  | —  | 15,048  | —   |
| Corporate  | 6,503                   | —  | 6,503   | —   |
| Total debt securities                                      | 39,006                  | —  | 39,006  | —   |
| Marketable equity securities                               | 1,078                   | 1,078  | —   | —   |
| Mutual funds   | 275                     | 275  | —   | —   |
| Total  | \$ 40,359               | \$ 1,353   | \$ 39,006                                     | \$—                                       |
| December 31, 2013:   |                         |  |   |   |
| Investment securities available-for-sale (market approach) |                         |  |   |   |
| Debt securities:   |                         |  |   |   |
| U.S. Government-sponsored enterprises                      | \$ 13,237               | \$—  | \$ 13,237                                     | \$—                                       |
| Agency mortgage-backed                                     | 3,747                   | —  | 3,747   | —   |
| State and political subdivisions                           | 12,164                  | —  | 12,164  | —   |
| Corporate  | 3,834                   | 1,436  | 2,398   | —   |
| Total debt securities                                      | 32,982                  | 1,436  | 31,546  | —   |
| Marketable equity securities                               | 1,041                   | 1,041  | —   | —   |
| Mutual funds   | 258                     | 258  | —   | —   |
| Total  | \$ 34,281               | \$ 2,735   | \$ 31,546                                     | \$—                                       |

There were no significant transfers in or out of Levels 1 and 2 for the three and six months. Certain other assets and liabilities are measured at fair value on a nonrecurring basis, that is, the instruments 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). Assets and liabilities measured at fair value on a nonrecurring basis in periods after initial recognition, such as impaired loans, HTM securities, MSRs and OREO, were not considered material at June 30, 2014 or December 31, 2013. The Company has not elected to apply the fair value method to any financial assets or liabilities other than those situations where other accounting pronouncements require fair value measurements.

FASB ASC Topic 825, Financial Instruments, requires disclosure of the estimated fair value of financial instruments. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Management's estimates and assumptions are inherently subjective and involve uncertainties and matters of significant judgment. Changes in assumptions could dramatically affect the estimated fair values.

Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. Certain financial instruments and all nonfinancial instruments may be excluded from disclosure requirements. Thus, the aggregate fair value amounts presented may not necessarily represent the actual underlying fair value of such instruments of the Company.

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The following methods and assumptions were used by the Company in estimating the fair value of its significant financial instruments:

**Cash and cash equivalents:** The carrying amounts reported in the balance sheet for cash and cash equivalents approximate those assets' fair values and are classified as Level 1.

**Interest bearing deposits in banks:** Fair values for interest bearing deposits in banks are based on discounted present values of cash flows and are classified as Level 2.

**Investment securities:** Fair values for investment securities are based on quoted market prices, where available. If quoted market prices are not available, fair value measurements consider observable data which may include market maker bids, quotes and pricing models. Inputs to the pricing models include recent trades, benchmark interest rates, spreads and actual and projected cash flows. Investment securities are classified as Level 1 or Level 2 depending on availability of recent trade information.

**Loans held for sale:** The fair value of loans held for sale is estimated based on quotes from third party vendors, resulting in a Level 2 classification.

**Loans:** The fair values of loans are estimated for portfolios of loans with similar financial characteristics and segregated by loan class or segment. For variable-rate loan categories that reprice frequently and with no significant change in credit risk, fair values are based on carrying amounts adjusted for credit risk. The fair values for other loans (for example, fixed-rate residential, commercial real estate, and rental property mortgage loans as well as commercial and industrial loans) are estimated using discounted cash flow analysis, based on interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. Loan fair value estimates include judgments regarding future cash flows, future expected loss experience and risk characteristics. Fair values for impaired loans are estimated using discounted cash flow analysis or underlying collateral values, where applicable. The fair value methods and assumptions that utilize unobservable inputs as defined by current accounting standards are classified as Level 3.

**Accrued interest receivable and payable:** The carrying amounts of accrued interest approximate their fair values and are classified as Level 1, 2, or 3 in accordance with the classification of the related principal's valuation.

**Nonmarketable equity securities:** It is not practical to determine the fair value of the nonmarketable securities, such as FHLB stock, due to restrictions placed on their transferability.

**Deposits:** The fair values disclosed for noninterest bearing deposits are, by definition, equal to the amount payable on demand at the reporting date, resulting in a Level 1 classification. The fair values for time deposits and other interest bearing nontime deposits are estimated using a discounted cash flow calculation that applies interest rates currently being offered on similar deposits to a schedule of aggregated expected maturities on such deposits, resulting in a Level 2 classification.

**Borrowed funds:** The fair values of the Company's long-term debt are estimated using discounted cash flow analysis based on interest rates currently being offered on similar debt instruments, resulting in a Level 2 classification. The fair values of the Company's short-term debt approximate the carrying amounts reported in the balance sheet, resulting in a Level 1 classification.

**Off-balance-sheet financial instruments:** Fair values for off-balance-sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the



agreements and the counterparties' credit standing. The only commitments to extend credit that are normally longer than one year in duration are the home equity lines whose interest rates are variable quarterly. The only fees collected for commitments are an annual fee on credit card arrangements and often a flat fee on commercial lines of credit and standby letters of credit. The fair value of off-balance-sheet financial instruments as of the balance sheet dates was not significant.

As of the balance sheet dates, the estimated fair values and related carrying amounts of the Company's significant financial instruments were as follows:

|                                    | June 30, 2014           |                      |  |   |   |
|------------------------------------|-------------------------|----------------------|--|---|---|
|                                    | Fair Value Measurements |                      |  |   |   |
|                                    | Carrying Amount         | Estimated Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|                                    | (Dollars in thousands)  |                      |  |   |   |
| <b>Financial assets</b>            |                         |                      |  |   |   |
| Cash and cash equivalents          | \$19,644                | \$19,644             | \$19,644   | \$—   | \$—                                       |
| Interest bearing deposits in banks | 13,713                  | 13,767               | —  | 13,767  | —   |
| Investment securities              | 50,001                  | 49,654               | 1,353  | 48,301  | —   |
| Loans held for sale                | 6,662                   | 6,813                | —  | 6,813   | —   |
| <b>Loans, net</b>                  |                         |                      |  |   |   |
| Residential real estate            | 159,488                 | 166,253              | —  | —   | 166,253                                   |
| Construction real estate           | 31,383                  | 31,514               | —  | —   | 31,514                                    |
| Commercial real estate             | 215,914                 | 220,911              | —  | —   | 220,911                                   |
| Commercial                         | 23,070                  | 22,397               | —  | —   | 22,397                                    |
| Consumer                           | 4,473                   | 4,449                | —  | —   | 4,449                                     |
| Municipal                          | 16,645                  | 17,813               | —  | —   | 17,813                                    |
| Accrued interest receivable        | 1,741                   | 1,741                | —  | 291   | 1,450                                     |
| Nonmarketable equity securities    | 2,053                   | N/A                  | N/A  | N/A   | N/A                                       |
| <b>Financial liabilities</b>       |                         |                      |  |   |   |
| <b>Deposits</b>                    |                         |                      |  |   |   |
| Noninterest bearing                | \$81,140                | \$81,140             | \$81,140   | \$—   | \$—                                       |
| Interest bearing                   | 290,980                 | 290,990              | —  | 290,990                                       | —   |
| Time                               | 118,736                 | 118,607              | —  | 118,607                                       | —   |
| <b>Borrowed funds</b>              |                         |                      |  |   |   |
| Short-term                         | 13,109                  | 13,109               | 13,109   | —   | —   |
| Long-term                          | 11,650                  | 12,448               | —  | 12,448  | —   |
| Accrued interest payable           | 93                      | 93                   | —  | 93  | —   |

December 31, 2013  
Fair Value Measurements

|                                    | Carrying Amount | Estimated Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|------------------------------------|-----------------|----------------------|--|---|---|
| (Dollars in thousands)             |                 |                      |  |   |   |
| Financial assets                   |                 |                      |  |   |   |
| Cash and cash equivalents          | \$30,719        | \$30,719             | \$30,719   | \$—   | \$—                                       |
| Interest bearing deposits in banks | 17,613          | 17,721               | —  | 17,721  | —   |
| Investment securities              | 45,492          | 44,645               | 2,735  | 41,910  | —   |
| Loans held for sale                | 3,840           | 3,905                | —  | 3,905   | —   |
| Loans, net                         |                 |                      |  |   |   |
| Residential real estate            | 158,249         | 165,475              | —  | —   | 165,475                                   |
| Construction real estate           | 30,519          | 30,675               | —  | —   | 30,675                                    |
| Commercial real estate             | 208,011         | 212,834              | —  | —   | 212,834                                   |
| Commercial                         | 20,413          | 19,751               | —  | —   | 19,751                                    |
| Consumer                           | 5,375           | 5,387                | —  | —   | 5,387                                     |
| Municipal                          | 34,069          | 34,648               | —  | —   | 34,648                                    |
| Accrued interest receivable        | 1,663           | 1,663                | 4  | 262   | 1,397                                     |
| Nonmarketable equity securities    | 2,053           | N/A                  | N/A  | N/A   | N/A                                       |
| Financial liabilities              |                 |                      |  |   |   |
| Deposits                           |                 |                      |  |   |   |
| Noninterest bearing                | \$87,247        | \$87,247             | \$87,247   | \$—   | \$—                                       |
| Interest bearing                   | 269,614         | 269,614              | —  | 269,614                                       | —   |
| Time                               | 161,493         | 161,640              | —  | 161,640                                       | —   |
| Borrowed funds                     |                 |                      |  |   |   |
| Short-term                         | 1,390           | 1,390                | 1,390  | —   | —   |
| Long-term                          | 11,826          | 12,649               | —  | 12,649  | —   |
| Accrued interest payable           | 295             | 295                  | —  | 295   | —   |

The carrying amounts in the preceding tables are included in the balance sheet under the applicable captions.

## Note 12. Subsequent Events

Subsequent events represent events or transactions occurring after the balance sheet date but before the financial statements are issued. Financial statements are considered “issued” when they are widely distributed to shareholders and others for general use and reliance in a form and format that complies with GAAP. Events occurring subsequent to June 30, 2014 have been evaluated as to their potential impact to the consolidated financial statements.

On July 16, 2014, the Company declared a regular quarterly cash dividend of \$0.26 per share, payable August 7, 2014, to stockholders of record on July 26, 2014.

## Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

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

The following discussion and analysis focuses on those factors that, in management's view, had a material effect on the financial position of the Company as of June 30, 2014 and December 31, 2013, and its results of operations for the three and six months

ended June 30, 2014 and 2013. This discussion is being presented to provide a narrative explanation of the consolidated financial statements and should be read in conjunction with the consolidated financial statements and related notes and with other financial data appearing elsewhere in this filing and with the Company's Annual Report on Form 10-K for the year ended December 31, 2013. In the opinion of the Company's management, the interim unaudited data reflects all adjustments, consisting only of normal recurring adjustments, and disclosures necessary to fairly present the Company's consolidated financial position and results of operations for the interim periods presented. Management is not aware of the occurrence of any events after June 30, 2014 which would materially affect the information presented.

Please refer to Note 1 in the Company's unaudited interim consolidated financial statements at Part I, Item 1 of this Report for definitions of acronyms, abbreviations and capitalized terms used throughout the following discussion and analysis.

#### CAUTIONARY ADVICE ABOUT FORWARD LOOKING STATEMENTS

The Company may from time to time make written or oral statements that are considered "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements may include financial projections, statements of plans and objectives for future operations, estimates of future economic performance or conditions and assumptions relating thereto. The Company may include forward-looking statements in its filings with the SEC, in its reports to stockholders, including this quarterly report, in press releases, other written materials, and in statements made by senior management to analysts, rating agencies, institutional investors, representatives of the media and others.

Forward-looking statements reflect management's current expectations and are subject to uncertainties, both general and specific, and risk exists that actual results will differ from those predictions, forecasts, projections and other estimates contained in forward-looking statements. These risks cannot be readily quantified. When management uses any of the words "believes," "expects," "anticipates," "intends," "projects," "plans," "seeks," "estimates," "targets," "goals," "might," "could," "would," "should," or similar expressions, they are making forward-looking statements. Many possible events or factors, including those beyond the control of management, could affect the future financial results and performance of the Company.

Factors that may cause results or performance to differ materially from those expressed in forward-looking statements include, but are not limited to: (1) continuing general economic conditions and financial instability, either nationally, internationally, regionally or locally resulting from elevated unemployment rates, changes in monetary and fiscal policies, and adverse changes in the credit rating of U.S. government debt; (2) increased competitive pressures from tax-advantaged credit unions and other financial service providers in the Company's northern Vermont and northwestern New Hampshire market area or in the financial services industry generally, from increasing consolidation and integration of financial service providers, and from changes in technology and delivery systems; (3) interest rates change in such a way that continues to put pressure on the Company's margins, or result in lower fee income and lower gain on sale of real estate loans; (4) changes in laws or government rules, or the way in which courts or government agencies interpret or implement those laws or rules, that increase our costs of doing business or otherwise adversely affect the Company's business; (5) changes in federal or state tax policy; (6) the effect of federal and state health care reform efforts; (7) changes in the level of nonperforming assets and charge-offs; (8) changes in estimates of future reserve requirements based upon relevant regulatory and accounting requirements; (9) changes in information technology that require increased capital spending; (10) changes in consumer and business spending, borrowing and savings habits; (11) further changes to the calculation of the Company's regulatory capital ratios which, among other things, would require additional regulatory capital, change the framework for risk-weighting of assets and require accumulated other comprehensive income to be reflected in regulatory capital; and (12) the effect of and changes in the United States monetary and fiscal policies, including interest rate policies and regulation of the money supply by the FRB.

When evaluating forward-looking statements to make decisions with respect to the Company, investors and others are cautioned to consider these and other risks and uncertainties, and are reminded not to place undue reliance on such statements. Investors should not consider the foregoing list of factors to be a complete list of risks or uncertainties. Forward-looking statements speak only as of the date they are made and the Company undertakes no obligation to update them to reflect new or changed information or events, except as may be required by federal securities laws.

#### CRITICAL ACCOUNTING POLICIES

The Company has established various accounting policies which govern the application of GAAP in the preparation of the Company's consolidated financial statements. Certain accounting policies involve significant judgments and assumptions by management which have a material impact on the reported amount of assets, liabilities, capital, revenues and expenses and related disclosures of contingent assets and liabilities in the consolidated financial statements and accompanying notes. The SEC has defined a company's critical accounting policies as the ones that are most important to the portrayal of the company's financial condition and results of operations, and which require management to make its most difficult and subjective judgments, often as a result of the need to make estimates on matters that are inherently uncertain. Based on this definition, management has identified

the accounting policies and judgments most critical to the Company. The judgments and assumptions used by management are based on historical experience and other factors, which are believed to be reasonable under the circumstances. Because of the nature of the judgments and assumptions made by management, actual results could differ from estimates and have a material impact on the carrying value of assets, liabilities, or capital, and/or the results of operations of the Company.

Please refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2013 for a more in-depth discussion of the Company's critical accounting policies. There have been no changes to the Company's critical accounting policies since the filing of that report.

## OVERVIEW

The Company's net income was \$1.9 million for the quarter ended June 30, 2014 compared to \$1.8 million for the quarter ended June 30, 2013, an increase of \$122 thousand, or 6.8%. These results reflected the net effect of an increase in net interest income of \$189 thousand, or 3.5%, partially offset by a decrease in noninterest income of \$10 thousand, or 0.5%, an increase in noninterest expenses of \$48 thousand, or 0.9%, and an increase in the provision for income taxes of \$9 thousand.

Total interest income increased \$105 thousand, or 1.7%, to \$6.2 million for the second quarter of 2014, versus \$6.1 million for the second quarter of 2013, while interest expense decreased \$84 thousand, or 13.7%, from \$613 thousand for the second quarter of 2013 to \$529 thousand for the second quarter of 2014. These changes in interest income and interest expense resulted in net interest income of \$5.7 million for the second quarter of 2014, up \$189 thousand, or 3.5%, from the second quarter of 2013 of \$5.5 million.

Noninterest income decreased \$10 thousand, or 0.5%, for the quarter due to lower net gains on sales of loans held for sale, which decreased \$75 thousand, or 12.9%, from \$583 thousand for the quarter ended June 30, 2013 to \$508 thousand for the quarter ended June 30, 2014. The decrease in net gains was a result of a decrease in the volume of residential loans sold to the secondary market from \$32.5 million in the second quarter of 2013 to \$22.2 million in the second quarter of 2014, a decrease of \$10.4 million, or 31.8%. The decrease in net gains on sales of loans for the quarter was partially offset by an increase in service fees of \$28 thousand, or 2.2%, between periods, an increase in gains on sales of investment securities available-for-sale of \$23 thousand and an increase of \$37 thousand in trust income.

Noninterest expenses increased \$48 thousand, or 0.9%, for the three month period ended June 30, 2014 compared to the same period for 2013, resulting from an increase in pension and employee benefits of \$65 thousand, or 10.2%, an increase in equipment expense of \$22 thousand, or 5.7%, partially offset by a decrease in salaries and wages of \$41 thousand, or 1.8%.

Year to date earnings for 2014 were \$3.7 million, or \$0.83 per share, compared to \$3.5 million, or \$0.79 per share, for 2013, an increase of 4.2% year over year. Net interest income improved \$435 thousand, or 4.0%. This positive change was partially offset by an increase in the provision for loan losses of \$15 thousand, or 11.1%, a decrease in noninterest income of \$203 thousand, or 4.7%, an increase in noninterest expense of \$58 thousand and an increase in the provision for income taxes of \$10 thousand.

At June 30, 2014, the Company had total consolidated assets of \$571.5 million, including gross loans and loans held for sale (total loans) of \$462.0 million, deposits of \$490.9 million, borrowed funds of \$24.8 million and stockholders' equity of \$51.9 million. The Company's total assets decreased \$14.0 million, or 2.4%, from \$585.4 million at December 31, 2013. The decrease in total assets is the result of a decrease in net loans and loans held for sale of \$2.8 million, a decrease in cash and cash equivalents of \$11.1 million and a decrease in interest bearing deposits in banks of \$3.9 million, while investment securities increased \$4.5 million compared to levels at December 31, 2013.

Net loans and loans held for sale decreased \$2.8 million, or 0.6%, to \$457.6 million, or 80.1% of total assets, at June 30, 2014, compared to \$460.5 million, or 78.7% of total assets, at December 31, 2013. Although there was growth of \$15.4 million in the residential, construction, commercial real estate and commercial loan portfolios during the first half of 2014, this was offset by a decrease of \$17.4 million in the municipal loan portfolio, reflecting a one day seasonal fluctuation due to the municipal funding requirements in Vermont where municipalities and school districts utilize their deposits to pay down their annual line of credit prior to their June 30 fiscal year end.

Deposits decreased \$27.5 million, or 5.3%, from \$518.4 million at December 31, 2013 to \$490.9 million at June 30, 2014 primarily as a result of the seasonal fluctuation related to the municipal funding cycle as municipalities utilize deposit monies to paydown outstanding loan balances as discussed above.

The Company's total capital increased from \$49.8 million at December 31, 2013 to \$51.9 million at June 30, 2014. While continuing to meet the regulatory guidelines for the well capitalized capital category, the total risk based capital ratio increased slightly to



13.37% at June 30, 2014 from 13.28% at December 31, 2013. The regulatory guideline for well capitalized is 10.0% and the minimum requirement is 8.0%.

The following unaudited per share information and key ratios depict several measurements of performance or financial condition for the three and six months ended June 30, 2014 and 2013, respectively:

|   | Three Months Ended or |         | Six Months Ended or |         |   |
|---|-----------------------|---------|---------------------|---------|---|
|   | At June 30,           |         | At June 30,         |         |   |
|   | 2014                  | 2013    | 2014                | 2013    |   |
| Return on average assets (ROA) (1)                          | 1.31                  | % 1.27  | % 1.26              | % 1.25  | % |
| Return on average equity (1)                                | 15.01                 | % 15.65 | % 14.55             | % 15.51 | % |
| Net interest margin (1)(2)                                  | 4.22                  | % 4.25  | % 4.21              | % 4.20  | % |
| Efficiency ratio (3)  | 66.33                 | % 68.57 | % 67.17             | % 67.72 | % |
| Net interest spread (4)                                     | 4.13                  | % 4.15  | % 4.12              | % 4.10  | % |
| Loan to deposit ratio                                       | 94.12                 | % 94.77 | % 94.12             | % 94.77 | % |
| Net loan charge-offs to average loans not held for sale (1) | 0.14                  | % 0.03  | % 0.08              | % 0.02  | % |
| Allowance for loan losses to loans not held for sale (5)    | 1.01                  | % 1.07  | % 1.01              | % 1.07  | % |
| Nonperforming assets to total assets (6)                    | 0.53                  | % 0.67  | % 0.53              | % 0.67  | % |
| Equity to assets  | 9.08                  | % 8.38  | % 9.08              | % 8.38  | % |
| Total capital to risk weighted assets                       | 13.37                 | % 13.19 | % 13.37             | % 13.19 | % |
| Book value per share  | \$11.64               | \$10.27 | \$11.64             | \$10.27 |   |
| Earnings per share  | \$0.43                | \$0.40  | \$0.83              | \$0.79  |   |
| Dividends paid per share                                    | \$0.26                | \$0.25  | \$0.52              | \$0.50  |   |
| Dividend payout ratio (7)                                   | 60.47                 | % 62.50 | % 62.65             | % 63.29 | % |

(1) Annualized.

(2) The ratio of tax equivalent net interest income to average earning assets. See pages 30 and 31 for more information.

(3) The ratio of noninterest expense (\$5.3 million in 2014 and \$5.2 million in 2013) to tax equivalent net interest income (\$5.9 million in 2014 and \$5.6 million in 2013) and noninterest income (\$2.1 million in 2014 and 2013) excluding securities gains (losses) (\$19 thousand in 2014 and \$(4) thousand in 2013) for the three months ended June 30, 2014 and 2013, respectively.

The ratio of noninterest expense (\$10.5 million in 2014 and \$10.4 million in 2013) to tax equivalent net interest income (\$11.6 million in 2014 and \$11.1 million in 2013) and noninterest income (\$4.0 million in 2014 and \$4.3 million in 2013) excluding securities gains (losses) (\$62 thousand in 2014 and \$(1) thousand in 2013) for the six months ended June 30, 2014 and 2013, respectively.

(4) The difference between the average rate earned on earning assets and the average rate paid on interest bearing liabilities. See pages 30 and 31 for more information.

(5) Calculation includes the net carrying amount of loans recorded at fair value from the 2011 Branch Acquisition as of June 30, 2014 (\$16.5 million) and June 30, 2013 (\$19.3 million). Excluding such loans, the allowance for loan losses to loans not purchased and not held for sale was 1.05% at June 30, 2014 and 1.12% at June 30, 2013.

(6) Nonperforming assets are loans or investment securities that are in nonaccrual or 90 or more days past due as well as OREO or OAO.

(7) Cash dividends declared and paid per share divided by consolidated net income per share.

## RESULTS OF OPERATIONS

**Net Interest Income.** The largest component of the Company's operating income is net interest income, which is the difference between interest and dividend income received from interest earning assets and the interest expense paid on interest bearing liabilities. The Company's net interest income increased \$189 thousand, or 3.5%, to \$5.7 million for

the three months ended June 30, 2014 from \$5.5 million for the three months ended June 30, 2013. The net interest spread decreased 2 bps to 4.13% for the second quarter of 2014, from 4.15% for the same period last year, despite a 9 bps drop in the average interest rate paid on interest bearing liabilities, from 0.56% for the second quarter of 2013 to 0.47% for the second quarter of 2014, as the average yield earned on interest earning assets dropped 11 bps, from 4.71% for the three months ended June 30, 2013 to 4.60% for the three month period ended June 30, 2014. The net interest margin for the second quarter of 2014 decreased 3 bps to 4.22% from 4.25% for the

second quarter of 2013. The prolonged low rate environment continues to put pressure on the Company's net interest spread and margin.

Yields Earned and Rates Paid. The following tables show for the periods indicated the total amount of income recorded from average interest earning assets, the related average tax equivalent yields, the interest expense associated with average interest bearing liabilities, the related average rates paid, and the resulting tax equivalent net interest spread and margin. Yield and rate information is average information for the period, and is calculated by dividing the annualized tax equivalent income or expense item for the period by the average balance of the appropriate balance sheet item during the period. Net interest margin is annualized tax equivalent net interest income divided by average earning assets. Nonaccrual loans or investments are included in asset balances for the appropriate periods, but recognition of interest on such loans or investments is discontinued and any remaining accrued interest receivable is reversed in conformity with federal regulations.

|   | Three months Ended June 30, |                          |                        | 2013            |                          |                        |   |
|---|-----------------------------|--------------------------|------------------------|-----------------|--------------------------|------------------------|---|
|   | 2014                        | Interest Earned/<br>Paid | Average Yield/<br>Rate | Average Balance | Interest Earned/<br>Paid | Average Yield/<br>Rate |   |
|   | (Dollars in thousands)      |                          |                        |                 |                          |                        |   |
| Average Assets:                               |                             |                          |                        |                 |                          |                        |   |
| Federal funds sold and overnight deposits     | \$11,585                    | \$4                      | 0.13                   | % \$16,670      | \$10                     | 0.25                   | % |
| Interest bearing deposits in banks            | 14,540                      | 39                       | 1.06                   | % 22,624        | 59                       | 1.05                   | % |
| Investment securities (1), (2)                | 52,596                      | 306                      | 2.65                   | % 36,704        | 221                      | 2.76                   | % |
| Loans, net (1), (3)                           | 475,582                     | 5,828                    | 5.05                   | % 453,798       | 5,787                    | 5.23                   | % |
| Nonmarketable equity securities               | 2,053                       | 7                        | 1.45                   | % 1,811         | 2                        | 0.44                   | % |
| Total interest earning assets (1)             | 556,356                     | 6,184                    | 4.60                   | % 531,607       | 6,079                    | 4.71                   | % |
| Cash and due from banks                       | 4,300                       |                          |                        | 4,390           |                          |                        |   |
| Premises and equipment                        | 10,957                      |                          |                        | 10,283          |                          |                        |   |
| Other assets                                  | 14,832                      |                          |                        | 19,385          |                          |                        |   |
| Total assets                                  | \$586,445                   |                          |                        | \$565,665       |                          |                        |   |
| Average Liabilities and Stockholders' Equity: |                             |                          |                        |                 |                          |                        |   |
| Interest bearing checking accounts            | \$103,438                   | \$20                     | 0.08                   | % \$90,975      | \$20                     | 0.09                   | % |
| Savings/money market accounts                 | 184,458                     | 79                       | 0.17                   | % 179,839       | 90                       | 0.20                   | % |
| Time deposits                                 | 143,840                     | 322                      | 0.90                   | % 146,358       | 376                      | 1.03                   | % |
| Borrowed funds                                | 18,324                      | 108                      | 2.34                   | % 16,913        | 127                      | 2.97                   | % |
| Total interest bearing liabilities            | 450,060                     | 529                      | 0.47                   | % 434,085       | 613                      | 0.56                   | % |
| Noninterest bearing deposits                  | 84,372                      |                          |                        | 80,038          |                          |                        |   |
| Other liabilities                             | 851                         |                          |                        | 5,619           |                          |                        |   |
| Total liabilities                             | 535,283                     |                          |                        | 519,742         |                          |                        |   |
| Stockholders' equity                          | 51,162                      |                          |                        | 45,923          |                          |                        |   |
| Total liabilities and stockholders' equity    | \$586,445                   |                          |                        | \$565,665       |                          |                        |   |
| Net interest income                           |                             | \$5,655                  |                        |                 | \$5,466                  |                        |   |
| Net interest spread (1)                       |                             |                          | 4.13                   | %               |                          | 4.15                   | % |
| Net interest margin (1)                       |                             |                          | 4.22                   | %               |                          | 4.25                   | % |

(1) Average yields reported on a tax equivalent basis using a marginal tax rate of 34%.

(2) Average balances of investment securities are calculated on the amortized cost basis and include nonaccrual securities, if applicable.

(3) Includes loans held for sale as well as nonaccrual loans, unamortized costs and unamortized premiums and is net of the allowance for loan losses.



|   | Six Months Ended June 30,<br>2014 |                             |                           | 2013               |                             |                           |   |
|---|-----------------------------------|-----------------------------|---------------------------|--------------------|-----------------------------|---------------------------|---|
|   | Average<br>Balance                | Interest<br>Earned/<br>Paid | Average<br>Yield/<br>Rate | Average<br>Balance | Interest<br>Earned/<br>Paid | Average<br>Yield/<br>Rate |   |
| (Dollars in thousands)                        |                                   |                             |                           |                    |                             |                           |   |
| Average Assets:                               |                                   |                             |                           |                    |                             |                           |   |
| Federal funds sold and overnight deposits     | \$12,335                          | \$8                         | 0.13                      | %\$22,244          | \$23                        | 0.21                      | % |
| Interest bearing deposits in banks            | 15,811                            | 84                          | 1.07                      | %22,635            | 119                         | 1.06                      | % |
| Investment securities (1), (2)                | 51,227                            | 599                         | 2.65                      | %33,004            | 415                         | 2.92                      | % |
| Loans, net (1), (3)                           | 471,563                           | 11,590                      | 5.08                      | %451,693           | 11,455                      | 5.23                      | % |
| Nonmarketable equity securities               | 2,053                             | 15                          | 1.46                      | %1,873             | 4                           | 0.41                      | % |
| Total interest earning assets (1)             | 552,989                           | 12,296                      | 4.62                      | %531,449           | 12,016                      | 4.68                      | % |
| Cash and due from banks                       | 4,503                             |                             |                           | 4,581              |                             |                           |   |
| Premises and equipment                        | 10,864                            |                             |                           | 10,294             |                             |                           |   |
| Other assets                                  | 15,427                            |                             |                           | 19,539             |                             |                           |   |
| Total assets                                  | \$583,783                         |                             |                           | \$565,863          |                             |                           |   |
| Average Liabilities and Stockholders' Equity: |                                   |                             |                           |                    |                             |                           |   |
| Interest bearing checking accounts            | \$100,505                         | \$38                        | 0.08                      | %\$90,856          | \$41                        | 0.09                      | % |
| Savings/money market accounts                 | 180,974                           | 162                         | 0.18                      | %178,934           | 180                         | 0.20                      | % |
| Time deposits                                 | 149,348                           | 693                         | 0.94                      | %147,716           | 783                         | 1.07                      | % |
| Borrowed funds                                | 16,244                            | 213                         | 2.61                      | %16,812            | 257                         | 3.04                      | % |
| Total interest bearing liabilities            | 447,071                           | 1,106                       | 0.50                      | %434,318           | 1,261                       | 0.58                      | % |
| Noninterest bearing deposits                  | 85,123                            |                             |                           | 80,380             |                             |                           |   |
| Other liabilities                             | 973                               |                             |                           | 5,583              |                             |                           |   |
| Total liabilities                             | 533,167                           |                             |                           | 520,281            |                             |                           |   |
| Stockholders' equity                          | 50,616                            |                             |                           | 45,582             |                             |                           |   |
| Total liabilities and stockholders' equity    | \$583,783                         |                             |                           | \$565,863          |                             |                           |   |
| Net interest income                           |                                   | \$11,190                    |                           |                    | \$10,755                    |                           |   |
| Net interest spread (1)                       |                                   |                             | 4.12                      | %                  |                             | 4.10                      | % |
| Net interest margin (1)                       |                                   |                             | 4.21                      | %                  |                             | 4.20                      | % |

(1) Average yields reported on a tax equivalent basis using a marginal tax rate of 34%.

(2) Average balances of investment securities are calculated on the amortized cost basis and include nonaccrual securities, if applicable.

(3) Includes loans held for sale as well as nonaccrual loans, unamortized costs and unamortized premiums and is net of the allowance for loan losses.

Tax exempt interest income amounted to \$433 thousand and \$364 thousand for the three months ended June 30, 2014 and 2013, respectively and \$813 thousand and \$713 thousand for the six months ended June 30, 2014 and 2013, respectively. The following table presents the effect of tax exempt income on the calculation of net interest income, using a marginal tax rate of 34% for 2014 and 2013:

|                                     | For The Three Months<br>Ended June 30, |         | For The Six Months<br>Ended June 30, |          |
|-------------------------------------|--|---------|--------------------------------------|----------|
|                                     | 2014                                   | 2013    | 2014                                 | 2013     |
|                                     | (Dollars in thousands)                 |         |                                      |          |
| Net interest income as presented    | \$5,655                                | \$5,466 | \$11,190                             | \$10,755 |
| Effect of tax-exempt interest       |  |         |                                      |          |
| Investment securities               | 43                                     | 33      | 81                                   | 67       |
| Loans                               | 154                                    | 132     | 289                                  | 258      |
| Net interest income, tax equivalent | \$5,852                                | \$5,631 | \$11,560                             | \$11,080 |

Rate/Volume Analysis. The following table describes the extent to which changes in average interest rates (on a fully tax-equivalent basis) and changes in volume of average interest earning assets and interest bearing liabilities have affected the Company's interest income and interest expense during the periods indicated. For each category of interest earning assets and interest bearing liabilities, information is provided on changes attributable to:

- changes in volume (change in volume multiplied by prior rate);
- changes in rate (change in rate multiplied by prior volume); and
- total change in rate and volume.

Changes attributable to both rate and volume have been allocated proportionately to the change due to volume and the change due to rate.

|   | Three Months Ended June 30, 2014<br>Compared to<br>Three Months Ended June 30, 2013 |                    |                         | Six Months Ended June 30, 2014<br>Compared to<br>Six Months Ended June 30, 2013 |                    |                         |
|---|---|--------------------|-------------------------|---|--------------------|-------------------------|
|   | Increase/<br>Volume   | (Decrease)<br>Rate | Due to Change In<br>Net | Increase/<br>Volume   | (Decrease)<br>Rate | Due to Change In<br>Net |
|   | (Dollars in thousands)  |                    |                         |   |                    |                         |
| Interest earning assets:                  |   |                    |                         |   |                    |                         |
| Federal funds sold and overnight deposits | \$(2)   | \$(4)              | \$(6)                   | \$(8)   | \$(7)              | \$(15)                  |
| Interest bearing deposits in banks        | (21)  | 1                  | (20)                    | (36)  | 1                  | (35)                    |
| Investment securities                     | 101   | (16)               | 85                      | 239   | (55)               | 184                     |
| Loans, net                                | 267   | (226)              | 41                      | 491   | (356)              | 135                     |
| Nonmarketable equity securities           | —   | 5                  | 5                       | —   | 11                 | 11                      |
| Total interest earning assets             | \$345   | \$(240)            | \$105                   | \$686   | \$(406)            | \$280                   |
| Interest bearing liabilities:             |   |                    |                         |   |                    |                         |
| Interest bearing checking accounts        | \$3   | \$(3)              | \$—                     | \$4   | \$(7)              | \$(3)                   |
| Savings/money market accounts             | 2   | (13)               | (11)                    | 2   | (20)               | (18)                    |
| Time deposits                             | (6)   | (48)               | (54)                    | 9   | (99)               | (90)                    |
| Borrowed funds                            | 9   | (28)               | (19)                    | (9)   | (35)               | (44)                    |
| Total interest bearing liabilities        | \$8   | \$(92)             | \$(84)                  | \$6   | \$(161)            | \$(155)                 |
| Net change in net interest income         | \$337   | \$(148)            | \$189                   | \$680   | \$(245)            | \$435                   |

Three Months Ended June 30, 2014, Compared to Three Months Ended June 30, 2013

Interest and Dividend Income. The Company's interest and dividend income increased to \$6.2 million for the three months ended June 30, 2014 compared to \$6.1 million for the same period last year, driven by an overall increase in average earning assets of \$24.7 million, or 4.7%, to \$556.4 million, from \$531.6 million for the three months ended June 30, 2013. However, the positive effect on interest income resulting from the rise in the average volume of earning assets was partially offset by the lower rates earned on all interest earning assets except nonmarketable equity securities and interest bearing deposits in banks. The persistent

low interest rate environment resulted in lower yields earned on new earning assets or refinanced loans in the second quarter of 2014 versus 2013. Despite the lower yields, the second quarter of 2014 saw a slight increase in interest income on loans of \$41 thousand, or 0.7%, compared to the second quarter of 2013, in conjunction with an increase in average loan volume between periods. Average loan volume approximated \$475.6 million at an average yield of 5.05% for the three months ended June 30, 2014, up \$21.8 million, or 4.8%, from an average volume of \$453.8 million at an average yield of 5.23% for the three months ended June 30, 2013. The positive impact of the increase in average total loan volume was partially offset by an 18 bps decrease in average yield.

The average balance of nonloan instruments increased \$3.0 million, or 3.8%, with the average balance of investments increasing \$15.9 million, or 43.3%, to \$52.6 million for the quarter ended June 30, 2014, from \$36.7 million for the quarter ended June 30, 2013, partially offset by a decrease in federal funds sold and overnight deposits of \$5.1 million, or 30.5%, to \$11.6 million for the three months ended June 30, 2014, from \$16.7 million for the three months ended June 30, 2013. The average balance in interest bearing deposits in banks for the quarter ended June 30, 2014 also decreased \$8.1 million, or 35.7%, to \$14.5 million versus \$22.6 million for the 2013 comparison period. These changes in average volume combined with a drop in yields resulted in an increase in interest income from average nonloan instruments of \$64 thousand between periods.

**Interest Expense.** The Company's interest expense decreased \$84 thousand, or 13.7%, to \$529 thousand for the three months ended June 30, 2014, from \$613 thousand for the three months ended June 30, 2013, despite an increase of \$16.0 million, or 3.7%, in the average volume of interest bearing liabilities between periods. The decrease was attributable to lower rates paid on all interest bearing liabilities, reflecting the persistent low interest rate environment and the subsequent payoff of higher rate of FHLB advances that were outstanding during the second quarter of 2013.

Interest expense on deposits decreased \$65 thousand, or 13.4%, to \$421 thousand for the quarter ended June 30, 2014, from \$486 thousand for the quarter ended June 30, 2013, despite an increase of \$14.6 million, or 3.5%, in the average balance of interest bearing deposits to \$431.7 million for the quarter ended June 30, 2014, compared to \$417.2 million for the same period last year, reflecting the overall growth in the franchise. Average time deposits decreased \$2.5 million, or 1.7%, to \$143.8 million for the three months ended June 30, 2014, from \$146.4 million for the three months ended June 30, 2013 with the average rate paid on time deposits during the second quarter of 2014 decreasing 13 bps, to 0.90% from 1.03% for the second quarter of 2013. The average balances for savings and money market accounts increased \$4.6 million, or 2.6%, to \$184.5 million for the quarter ended June 30, 2014, from \$179.8 million for the quarter ended June 30, 2013, while the average rate paid on these accounts dropped from 0.20% to 0.17% between periods. Average interest bearing checking accounts increased \$12.5 million, or 13.7%, to \$103.4 million for the three months ended June 30, 2014 from \$91.0 million for the three months ended June 30, 2013, while the average rate paid on these accounts dropped to 0.08% from 0.09% between the two comparison periods.

Interest expense on borrowed funds decreased \$19 thousand, or 15.0%, to \$108 thousand for the three months ended June 30, 2014, from \$127 thousand for the three months ended June 30, 2013, despite an increase in average borrowed funds of \$1.4 million, or 8.3%, to \$18.3 million for the three months ended June 30, 2014, compared to \$16.9 million for the same period last year. Average borrowings from the FHLB increased \$2.9 million for the quarter, partially offset by a decrease in customer overnight collateralized repurchase sweeps, included in borrowed funds, of \$983 thousand and a decrease in other interest bearing liabilities of \$524 thousand. Despite the increase in average borrowings from the FHLB, higher rate advances had been paid off during 2013 while lower rate advances were taken subsequently in 2013 and 2014, contributing to the decrease in the average rate paid on borrowings from 2.97% for the three months ended June 30, 2013 to 2.34% for the three months ended June 30, 2014.

Six Months Ended June 30, 2014, Compared to Six Months Ended June 30, 2013



Interest and Dividend Income. The Company's interest and dividend income increased to \$12.3 million for the six months ended June 30, 2014 compared to \$12.0 million for the same period last year, driven by an overall increase in average earning assets of \$21.5 million, or 4.1%, to \$553.0 million, from \$531.4 million for the six months ended June 30, 2013. However, the positive effect on interest income resulting from the rise in the average volume of earning assets was partially offset by the lower rates earned on all interest earning assets except nonmarketable equity securities and interest bearing deposits in banks. Interest income on loans increased \$135 thousand, or 1.2%, to \$11.6 million for the first half of 2014 versus \$11.5 million for the 2013 comparison period, in conjunction with an increase in average loan volume between periods. Average loan volume approximated \$471.6 million at an average yield of 5.08% for the six months ended June 30, 2014, up \$19.9 million, or 4.4%, from an average volume of \$451.7 million at an average yield of 5.23% for the six months ended June 30, 2013. The positive impact of the increase in average total loan volume was partially offset by a 15 bps decrease in average yield.

The average balance of nonloan instruments increased \$1.7 million, or 2.1%, with the average balance of investments increasing \$18.2 million, or 55.2%, to \$51.2 million for the six months ended June 30, 2014, from \$33.0 million for the six months ended June 30, 2013, partially offset by a decrease in federal funds sold and overnight deposits of \$9.9 million, or 44.5%, to \$12.3 million

for the six months ended June 30, 2014, from \$22.2 million for the six months ended June 30, 2013. The average balance in interest bearing deposits in banks for the six months ended June 30, 2014 also decreased \$6.8 million, or 30.1%, to \$15.8 million versus \$22.6 million for the 2013 comparison period. These changes in average volume combined with a drop in yields resulted in an increase in interest income from average nonloan instruments of \$145 thousand between periods.

**Interest Expense.** The Company's interest expense decreased \$155 thousand, or 12.3%, to \$1.1 million for the six months ended June 30, 2014, from \$1.3 million for the six months ended June 30, 2013, despite an increase of \$12.8 million, or 2.9%, in the average volume of interest bearing liabilities between periods. The decrease was attributable to lower rates paid on all interest bearing liabilities, reflecting the persistent low interest rate environment and the subsequent payoff of higher rate FHLB advances that were outstanding during the first half of 2013.

Interest expense on deposits decreased \$111 thousand, or 11.1%, to \$893 thousand for the six months ended June 30, 2014, from \$1.0 million for the six months ended June 30, 2013, despite an increase of \$13.3 million, or 3.2%, in the average balance of interest bearing deposits to \$430.8 million for the six months ended June 30, 2014, compared to \$417.5 million for the same period last year, reflecting the overall growth in the franchise. Average time deposits increased \$1.6 million, or 1.1%, to \$149.3 million for the six months ended June 30, 2014, from \$147.7 million for the six months ended June 30, 2013, while the average rate paid on time deposits during the first half of 2014 decreased 13 bps, to 0.94% from 1.07% for the first half of 2013. The average balances for savings and money market accounts increased \$2.0 million, or 1.1%, to \$181.0 million for the six months ended June 30, 2014, from \$178.9 million for the six months ended June 30, 2013, with the average rate paid on these accounts dropping from 0.20% to 0.18% between periods. Average interest bearing checking accounts increased \$9.6 million, or 10.6%, to \$100.5 million for the six months ended June 30, 2014 from \$90.9 million for the six months ended June 30, 2013, while the average rate paid on these accounts dropped to 0.08% from 0.09% between the two comparison periods.

Interest expense on borrowed funds decreased \$44 thousand, or 17.1%, to \$213 thousand for the six months ended June 30, 2014, from \$257 thousand for the six months ended June 30, 2013 in conjunction with a decrease in average borrowed funds of \$568 thousand, or 3.4%, to \$16.2 million for the six months ended June 30, 2014, compared to \$16.8 million for the same period last year. Average customer overnight collateralized repurchase sweeps, included in borrowed funds, decreased \$1.8 million for the comparable period, partially offset by an increase in average borrowings from the FHLB of \$1.5 million. Despite the increase in average borrowings from the FHLB, higher rate advances had been paid off during 2013 while lower rate advances were taken subsequently in 2013 and 2014, contributing to the decrease in the average rate paid on borrowings from 3.04% for the six months ended June 30, 2013 to 2.61% for the six months ended June 30, 2014.

**Provision for Loan Losses.** There was a \$75 thousand loan loss provision for the quarters ended June 30, 2014 and 2013, and a \$150 thousand and \$135 thousand loan loss provision for the six months ended June 30, 2014 and 2013, respectively. The provision for the second quarter and first half of 2014 was deemed appropriate by management based on the size and mix of the loan portfolio (excluding the municipal portfolio), the level of nonperforming loans, the results of the qualitative factor review and the outlook for future economic conditions. For further details, see FINANCIAL CONDITION Allowance for Loan Losses and Asset Quality below.

**Noninterest Income.** Noninterest income before gains on AFS securities was \$2.1 million for the three months ended June 30, 2014 and 2013, representing 25.3% and 25.9% of total income for the three months ended June 30, 2014 and 2013, respectively, and \$4.0 million, or 24.6% of total income, for the first half of 2014 compared to \$4.3 million, or 26.3% for the first half of 2013. The following table sets forth the components of noninterest income and changes between the three and six month comparison periods of 2014 and 2013:

|  |  | For The Three Months Ended June 30, |      | For The Six Months Ended June 30, |      |
|--|--|-------------------------------------|------|-----------------------------------|------|
|  |  | 2014                                | 2013 | 2014                              | 2013 |

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|  |                        |         | \$       | %        |         | \$       | %        |         |
|--|------------------------|---------|----------|----------|---------|----------|----------|---------|
|  |                        |         | Variance | Variance |         | Variance | Variance |         |
|  | (Dollars in thousands) |         |          |          |         |          |          |         |
| Trust income   | \$191                  | \$154   | \$37     | 24.0     | \$366   | \$317    | \$49     | 15.5    |
| Service fees   | 1,285                  | 1,257   | 28       | 2.2      | 2,557   | 2,446    | 111      | 4.5     |
| Net gains on sales of loans held for sale                | 508                    | 583     | (75)     | (12.9)   | 941     | 1,250    | (309)    | (24.7)  |
| Other income   | 107                    | 130     | (23)     | (17.7)   | 147     | 264      | (117)    | (44.3)  |
| Subtotal   | 2,091                  | 2,124   | (33)     | (1.6)    | 4,011   | 4,277    | (266)    | (6.2)   |
| Net gains (losses) on sales of investment securities AFS | 19                     | (4)     | 23       | 575.0    | 62      | (1)      | 63       | 6,300.0 |
| Total noninterest income                                 | \$2,110                | \$2,120 | \$(10)   | (0.5)    | \$4,073 | \$4,276  | \$(203)  | (4.7)   |

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The significant changes in noninterest income for the three months ended June 30, 2014 compared to the same period of 2013 are described below:

**Trust Income.** Trust income increased as dollars in managed fiduciary accounts grew between June 30, 2014 and 2013, aided by the improvement in the stock market.

**Service fees.** The \$28 thousand increase reflected a \$44 thousand increase in debit card and ATM fees resulting from the growth in the volume of electronic transactions, partially offset by a decrease of \$6 thousand of service charge income, including overdraft fees, on deposit accounts.

**Net gains on sales of loans held for sale.** As part of the Company's strategy to mitigate long-term interest rate risk, residential loans totaling \$22.2 million were sold during the second quarter of 2014, versus residential loan sales of \$32.5 million during the second quarter of 2013. The volume of loans sold dropped \$10.4 million, or 31.8%, between periods, with net gains on sold loans decreasing \$75 thousand, or 12.9%, reflecting the decline in the volume of loan sales, offset by premiums at or exceeding levels for the same period of 2013.

**Other income.** The \$23 thousand decrease in other income resulted from a \$50 thousand decrease in income from MSR, net of amortization, due to a reduction in loan sales with servicing retained and a reduction of \$4 thousand in income related to the utilization of state tax credits. These decreases were partially offset by an increase of \$37 thousand in income from Company owned life insurance.

The significant changes in noninterest income for the six months ended June 30, 2014 compared to the same period of 2013 are described below:

**Trust Income.** Trust income increased as dollars in managed fiduciary accounts grew between June 30, 2014 and 2013, aided by the improvement in the stock market.

**Service fees.** The \$111 thousand increase reflected a \$101 thousand increase in debit card and ATM fees resulting from the growth in the volume of electronic transactions and an increase in loan servicing fees of \$46 thousand due to the increased level of residential mortgage loans serviced. These increases were partially offset by a decrease of \$30 thousand of service charge income, including overdraft fees, on deposit accounts.

**Net gains on sales of loans held for sale.** As part of the Company's strategy to mitigate long-term interest rate risk, residential loans totaling \$42.5 million were sold during the first half of 2014, versus residential loan sales of \$66.2 million during the first half of 2013. The volume of loans sold dropped \$23.7 million, or 35.8%, between periods, with net gains on sold loans decreasing \$309 thousand, reflecting the decline in volume of loan sales during the first half of 2014.

**Other income.** The \$117 thousand decrease in other income resulted from an \$136 thousand decrease in income from MSR, net of amortization, due to a reduction in loan sales with servicing retained, a decrease of \$12 thousand in income for 2014 compared to 2013 related to oil and gas royalties and a reduction of \$4 thousand in income related to the utilization of state tax credits. These decreases were partially offset by an increase of \$36 thousand in income from Company owned life insurance.

Noninterest Expense. Noninterest expense increased \$48 thousand, or 0.9%, for the three months ended June 30, 2014 and increased \$58 thousand, or 0.6%, for the six months ended June 30, 2014 compared to the same periods in 2013. The following table sets forth the components of noninterest expense and changes between the three and six month comparison periods of 2014 and 2013:

|  | For The Three Months Ended June 30, |         |                |               | For The Six Months Ended June 30, |          |                |               |
|--|-------------------------------------|---------|----------------|---------------|-----------------------------------|----------|----------------|---------------|
|  | 2014                                | 2013    | \$<br>Variance | %<br>Variance | 2014                              | 2013     | \$<br>Variance | %<br>Variance |
|  | (Dollars in thousands)              |         |                |               |                                   |          |                |               |
| Salaries and wages                                 | \$2,194                             | \$2,235 | \$(41)         | (1.8)         | \$4,441                           | \$4,392  | \$49           | 1.1           |
| Pension and employee benefits                      | 703                                 | 638     | 65             | 10.2          | 1,370                             | 1,321    | 49             | 3.7           |
| Occupancy expense, net                             | 295                                 | 291     | 4              | 1.4           | 634                               | 622      | 12             | 1.9           |
| Equipment expense                                  | 410                                 | 388     | 22             | 5.7           | 797                               | 814      | (17)           | (2.1)         |
| Expenses of OREO and other assets owned, net       | (8)                                 | 44      | (52)           | (118.2)       | 15                                | 90       | (75)           | (83.3)        |
| Vermont franchise tax                              | 126                                 | 123     | 3              | 2.4           | 251                               | 243      | 8              | 3.3           |
| FDIC insurance assessment                          | 89                                  | 73      | 16             | 21.9          | 180                               | 152      | 28             | 18.4          |
| Equity in losses of affordable housing investments | 164                                 | 173     | (9)            | (5.2)         | 328                               | 345      | (17)           | (4.9)         |
| Other expenses                                     | 1,297                               | 1,257   | 40             | 3.2           | 2,443                             | 2,422    | 21             | 0.9           |
| Total noninterest expense                          | \$5,270                             | \$5,222 | \$48           | 0.9           | \$10,459                          | \$10,401 | \$58           | 0.6           |

The significant changes in noninterest expense for the three months ended June 30, 2014 compared to the same period in 2013 are described below:

Salaries and wages. The \$41 thousand net decrease was attributable to the deferral of salary expense due to accounting methods utilized to account for loan origination costs.

Pension and employee benefits. The \$65 thousand increase relates to an increase of \$76 thousand, or 23.9%, in the cost of the Company's medical plan as both premium rates and the number of participants increased between years, and an increase of \$74 thousand in the 401K employer contribution expense. These increases were partially offset by a reduction in expense for the defined benefit pension plan of \$83 thousand, or 280.7%, due to the October 5, 2012 freeze on the plan, which stopped the accrual of benefits and closed the plan to new participants.

Equipment expense. The \$22 thousand increase between years is due to an \$8 thousand, or 3.5%, increase in software licenses and maintenance contracts and a \$13 thousand, or 8.1%, increase in equipment depreciation from the acceleration of depreciation on ATM machines scheduled to be replaced in the third quarter of 2014.

Expenses of OREO and other assets owned, net. There were four residential properties held during the three months ended June 30, 2014 compared to two commercial real estate and five residential properties during the three months ended June 30, 2013, resulting in decreased costs to maintain the properties held in 2014. In addition, there were no write downs of OREO properties charged against earnings in the second quarter of 2014 compared to \$25 thousand of write downs on two OREO properties in 2013.

Other expenses. The \$40 thousand increase is due to a \$48 thousand increase in professional fees, an increase in contributions of \$27 thousand and an increase in trust expense of \$32 thousand from additional costs for professional assistance resulting from the increase in assets in managed accounts. These increases were partially offset by a decrease in other costs of employment of \$22 thousand related to senior position searches incurred in 2013. The 2013 results also included \$51 thousand in penalties on the early payoff of a \$609 thousand long-term FHLB advance, while there was no such penalty in 2014.

The significant changes in noninterest expense for the six months ended June 30, 2014 compared to the same period in 2013 are described below:

Salaries and wages. The \$49 thousand net increase was due to normal annual salary increases and the hiring of employees for open positions in mid 2013 that had been vacant during the first half of 2013, partially offset by an increase in the deferral of salary expense due to accounting methods utilized to account for loan origination costs.

Pension and employee benefits. The \$49 thousand increase relates to an increase of \$161 thousand, or 25.9%, in the cost of the Company's medical plan as both premium rates and the number of participants increased between years, and an increase

of \$63 thousand in the 401K employer contribution expense. These increases were partially offset by a reduction in expense for the defined benefit pension plan of \$159 thousand, or 267.2% due to the October 5, 2012 freeze on the plan, which stopped the accrual of benefits and closed the plan to new participants. In addition, unemployment taxes decreased \$26 thousand, or 30.2%, from a decrease in federal and state unemployment tax rates.

Expenses of OREO and other assets owned, net. There were five residential properties held during the six months ended June 30, 2014 compared to five commercial real estate and seven residential properties during the six months ended June 30, 2013, resulting in decreased costs to maintain the properties held in 2014. In addition, there were no write downs of OREO properties charged against earnings in the first half of 2014 compared to \$36 thousand of write downs on four OREO properties in 2013.

FDIC insurance assessment. The \$28 thousand increase in expense was due to fluctuation in the assessment rate and net asset base for the first half of 2014 compared to the assessment rate and asset base for the same period in the prior year.

Other expenses. The \$21 thousand increase is due to an increase in professional fees of \$111 thousand, an increase in contributions of \$43 thousand and an increase in trust expense of \$38 thousand from additional costs for professional assistance resulting from the increase in assets in managed accounts. These increases were partially offset by a \$61 thousand decrease in ATM and debit card expenses from accrual adjustments related to reward programs and a decrease in other costs of employment of \$46 thousand related to senior position searches. The 2013 results also included \$51 thousand in penalties on the early payoff of a \$609 thousand long-term FHLB advance while there was no such penalty in 2014.

Provision for Income Taxes. The Company has provided for current and deferred federal income taxes for the quarter and six months ended June 30, 2014 and 2013. The Company's net provision for income taxes was \$501 thousand and \$971 thousand for the quarter and six months ended June 30, 2014, respectively, compared to \$492 thousand and \$961 thousand for the same periods in 2013. The Company's effective tax rate was 21.0% and 20.9% for the quarter and six months ended June 30, 2014, compared to an effective tax rate of 21.5% and 21.4% for the same periods in 2013. There was minimal change in federal income taxes and the effective tax rate as tax credits recorded from investments in affordable housing projects were \$158 thousand for the second quarters of 2014 and 2013 and \$315 thousand for the first half of 2014 and 2013. In addition, the increase in taxable income was offset by an increase in tax exempt interest income to \$433 thousand and \$813 thousand for the second quarter and first half of 2014, respectively, from \$364 thousand and \$713 thousand for the second quarter and first half of 2013, respectively.

## FINANCIAL CONDITION

At June 30, 2014, the Company had total consolidated assets of \$571.5 million, including gross loans and loans held for sale (total loans) of \$462.0 million, deposits of \$490.9 million and stockholders' equity of \$51.9 million. The Company's total assets decreased \$14.0 million, or 2.4%, to \$571.5 million at June 30, 2014, from \$585.4 million at December 31, 2013, but grew \$24.8 million, or 4.5%, compared to June 30, 2013.

Net loans and loans held for sale decreased a total of \$2.8 million, or 0.6%, to \$457.6 million, or 80.1% of total assets at June 30, 2014, compared to \$460.5 million, or 78.7% of total assets at December 31, 2013.

Deposits decreased \$27.5 million, or 5.3%, to \$490.9 million at June 30, 2014, from \$518.4 million at December 31, 2013. The majority of this decrease reflects a normal seasonal decline due to the municipal funding requirements in Vermont as municipalities and school districts utilize their deposits to pay down their annual line of credit prior to their June 30 fiscal year end. Noninterest bearing deposits decreased \$6.1 million, or 7.0%, from \$87.2 million at December 31, 2013 to \$81.1 million at June 30, 2014 and time deposits decreased \$42.8 million, or 26.5%, from \$161.5 million at December 31, 2013 to \$118.7 million at June 30, 2014, while interest bearing deposits increased \$21.3 million, or 7.9%, from \$269.6 million at December 31, 2013 to \$291.0 million at June 30, 2014. (See average balances and rates in the Yields Earned and Rates Paid table on pages 30 and 31.)

Total borrowings increased \$11.6 million, or 87.4%, at June 30, 2014, from \$13.2 million at December 31, 2013 to \$24.8 million at June 30, 2014. There was an increase in customer overnight collateralized repurchase sweeps of \$219 thousand and a increase in FHLB amortizing advances of \$11.3 million between December 31, 2013 and June 30, 2014. (See Borrowings on page 43.)

Total stockholders' equity increased \$2.1 million to \$51.9 million at June 30, 2014 from \$49.8 million at December 31, 2013. This increase primarily reflects net income of \$3.7 million for the first six months of 2014, less regular cash dividends paid of \$2.3 million. (See Capital Resources on page 47.)

Loans Held for Sale and Loan Portfolio. Total loans (including loans held for sale) decreased \$2.9 million, or 0.6%, to \$462.0 million, representing 80.8% of assets at June 30, 2014 from \$465.0 million, representing 79.4% of assets at December 31, 2013. The total loan portfolio at June 30, 2014 increased compared to the June 30, 2013 level of \$449.2 million, representing 82.2% of



assets. The Company's loans consist primarily of adjustable-rate and fixed-rate mortgage loans secured by one-to-four family, multi-family residential or commercial real estate. Real estate secured loans represented \$417.6 million, or 90.4% of total loans at June 30, 2014 and \$404.9 million, or 87.1% of total loans at December 31, 2013. Although competition for good loans is strong, especially in the commercial sector, the Company has been able to originate loans to both current and new customers while maintaining credit quality.

The composition of the Company's loan portfolio as of June 30, 2014 and December 31, 2013 was as follows:

| Loan Class                        | June 30, 2014          |         | December 31, 2013 |         |
|-----------------------------------|------------------------|---------|-------------------|---------|
|                                   | Amount                 | Percent | Amount            | Percent |
|                                   | (Dollars in thousands) |         |                   |         |
| Residential real estate           | \$160,662              | 34.8    | \$159,441         | 34.3    |
| Construction real estate          | 31,755                 | 6.9     | 30,898            | 6.7     |
| Commercial real estate            | 218,517                | 47.3    | 210,718           | 45.3    |
| Commercial                        | 23,264                 | 5.0     | 20,569            | 4.4     |
| Consumer                          | 4,493                  | 1.0     | 5,396             | 1.2     |
| Municipal                         | 16,654                 | 3.6     | 34,091            | 7.3     |
| Loans held for sale               | 6,662                  | 1.4     | 3,840             | 0.8     |
| Total loans                       | 462,007                | 100.0   | 464,953           | 100.0   |
| Allowance for loan losses         | (4,610 )               |         | (4,647 )          |         |
| Unamortized net loan costs        | 238                    |         | 170               |         |
| Net loans and loans held for sale | \$457,635              |         | \$460,476         |         |

The Company originates and sells qualified residential mortgage loans in various secondary market avenues, with a majority of sales made to the FHLMC/Freddie Mac. At June 30, 2014, the Company serviced a \$479.5 million residential real estate mortgage portfolio, of which \$6.7 million was held for sale and approximately \$312.2 million was serviced for unaffiliated third parties.

The Company sold \$42.5 million of qualified residential real estate loans originated during the first half of 2014 to the secondary market in order to mitigate long-term interest rate risk and to generate fee income. The Company generally retains the servicing rights on sold residential mortgage loans. The Company originates and sells FHA, VA, and RD residential mortgage loans, and also has an Unconditional Direct Endorsement Approval from HUD which allows the Company to approve FHA loans originated in any of its Vermont or New Hampshire locations without needing prior HUD approval. Some of the government backed loans qualify for zero down payments without geographic or income restrictions. The Company sells VA and FHA loans as originated with servicing released. These loan products increase the Company's ability to serve the borrowing needs of residents in the communities we serve, including low and moderate income borrowers, while the government guaranty mitigates our exposure to credit risk.

The Company also originates commercial real estate and commercial loans under various SBA, USDA and State sponsored programs which provide a government agency guaranty for a portion of the loan amount. There was \$5.6 million guaranteed under these various programs at June 30, 2014 on an aggregate balance of \$7.1 million in subject loans. The Company occasionally sells the guaranteed portion of the loan to other financial concerns and retains servicing rights, which generates fee income. There were no commercial real estate loans sold in the first six months of 2014. The Company recognizes gains and losses on the sale of the principal portion of these loans as they occur.

The Company serviced \$32.8 million of commercial and commercial real estate loans for unaffiliated third parties as of June 30, 2014. This includes \$28.6 million of commercial or commercial real estate loans the Company has participated out to other financial institutions, in the ordinary course of business on a nonrecourse basis, for liquidity or credit concentration management purposes.

The Company capitalizes servicing rights for all loans sold with servicing retained. The unamortized balance of servicing rights on loans sold with servicing retained was \$1.3 million at June 30, 2014, with an estimated market

value in excess of the carrying value as of such date.

There were \$3.7 million of residential real estate loans pledged to secure municipal deposits above the FDIC insurance coverage level as of June 30, 2014. Qualified residential first mortgage loans held by Union are eligible to be pledged as collateral for borrowings from the FHLB under a blanket lien.

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Asset Quality. The Company, like all financial institutions, is exposed to certain credit risks, including those related to the value of the collateral that secures its loans and the ability of borrowers to repay their loans. Consistent application of the Company's conservative loan policies has helped to mitigate this risk and has been prudent for both the Company and its customers. Renewed market volatility, high unemployment rates or weakness in the general economic condition of the country or our market area, may have a negative effect on our customers' ability to make their loan payments on a timely basis and/or on underlying collateral values. Management closely monitors the Company's loan and investment portfolios, OREO and OAO for potential problems and reports to the Company's and Union's Board at regularly scheduled meetings. Repossessed assets and loans or investments that are 90 days or more past due are considered to be nonperforming assets. Board approved policies set forth portfolio diversification levels to mitigate concentration risk and the Company participates large credits out to other financial institutions to further mitigate that risk.

The following table shows the composition of nonperforming assets at the dates indicated and trends of certain ratios monitored by Company's management in reviewing asset quality:

|   | As of or for the<br>six months<br>ended<br>June 30,<br>2014 | As of or for the<br>year ended<br>December 31,<br>2013 | As of or for the<br>six months<br>ended<br>June 30,<br>2013 |   |
|---|---|--|---|---|
|   | (Dollars in thousands)                                      |  |   |   |
| Nonaccrual loans  | \$1,878   | \$1,434  | \$2,102   |   |
| Accruing loans 90+ days delinquent                              | 956   | 263  | 905   |   |
| Total nonperforming loans (1)                                   | 2,834   | 1,697  | 3,007   |   |
| OREO  | 200   | 559  | 644   |   |
| Total nonperforming assets                                      | \$3,034   | \$2,256  | \$3,651   |   |
| Allowance for loan losses to loans not held for sale (2)        | 1.01  | % 1.01   | % 1.07  | % |
| Allowance for loan losses to nonperforming loans                | 162.67  | % 273.84   | % 158.03  | % |
| Nonperforming loans to total loans                              | 0.61  | % 0.36   | % 0.67  | % |
| Nonperforming assets to total assets                            | 0.53  | % 0.39   | % 0.67  | % |
| Delinquent loans (30 days to nonaccruing) to total loans        | 1.32  | % 2.15   | % 1.38  | % |
| Net charge-offs (annualized) to average loans not held for sale | 0.08  | % 0.07   | % 0.02  | % |
| Loan loss provision to net charge-offs, year-to-date            | 80.21   | % 96.90  | % 337.54  | % |

(1) The Company had guarantees of U.S. or state government agencies on the above nonperforming loans totaling \$18 thousand at June 30, 2014, \$19 thousand at December 31, 2013, and \$20 thousand at June 30, 2013.

(2) Calculation includes the net carrying amount of loans recorded at fair value from the 2011 Branch Acquisition as of June 30, 2014 (\$16.5 million), December 31, 2013 (\$17.0 million) and June 30, 2013 (\$19.3 million). Excluding such loans, the ALL to loans not purchased and not held for sale was 1.05% at June 30, 2014, 1.05% at December 31, 2013 and 1.12% at June 30, 2013.

The level of nonaccrual loans increased \$444 thousand, or 31.0%, since December 31, 2013, accruing loans delinquent 90 days or more increased \$693 thousand, or 263.5%, during the same time period and the percentage of nonperforming loans to total loans increased slightly from 0.36% to 0.61%. There was one commercial real estate loan in process of foreclosure at June 30, 2014 included in nonperforming loans. The aggregate interest income not recognized on nonaccrual loans amounted to approximately \$1.0 million as of June 30, 2014 and \$1.1 million as of December 31, 2013 and June 30, 2013.

The Company had loans rated substandard that were on a performing status totaling \$4.0 million at both June 30, 2014 and December 31, 2013. In management's view, substandard loans represent a higher degree of risk of becoming nonperforming loans in the future. The Company's management is focused on the impact that the prolonged weak

economy may have on its borrowers and closely monitors industry and geographic concentrations for evidence of financial problems. Improvement in local economic indicators has been identified in recent months. The unemployment rate has started to stabilize in Vermont and was at a 3.5% level for June 2014 compared to 4.4% for June 2013. New Hampshire was 4.4% for June 2014 compared to 5.2% for June 2013. These rates compare favorably with the nationwide unemployment rate at 6.1% and 7.6% for the comparable periods. Management will continue to monitor the national, regional and local economic environment and its impact on unemployment, business failures and real estate values in the Company's market area.

Vermont and New Hampshire continue to have lower residential mortgage foreclosure rates than the average in the U.S. On occasion, the Company acquires residential or commercial real estate properties through or in lieu of loan foreclosure. These properties are held for sale and are initially recorded as OREO at fair value less estimated selling costs at the date of the Company's acquisition of the property, with fair value based on an appraisal for more significant properties and on a broker's price opinion for less significant properties. Holding costs and declines in the fair value of properties acquired are expensed as incurred. Declines in the fair value after acquisition of the property result in charges against income before tax. There were no such declines for the quarter or six months ended June 30, 2014, compared to a \$25 thousand charge against income before tax for the quarter ended June 30, 2013 and \$36 thousand for the six months ended June 30, 2013. The Company evaluates each OREO property at least quarterly for changes in the fair value. The Company had two residential properties totaling \$200 thousand classified as OREO at June 30, 2014 and five residential properties totaling \$559 thousand at December 31, 2013. There was a \$54 thousand allowance for losses on OREO at June 30, 2014 and a \$104 thousand allowance at December 31, 2013 which was netted out of the above values.

Further softening in the local real estate market would make it more difficult for the Company to recover all principal and related costs for OREO properties.

**Allowance for Loan Losses.** Some of the Company's loan customers ultimately do not make all of their contractually scheduled payments, requiring the Company to charge off a portion or all of the remaining principal balance due. The Company maintains an ALL to absorb such losses. The ALL is maintained at a level believed by management to be appropriate to absorb probable credit losses inherent in the loan portfolio; however, actual loan losses may vary from current estimates. The Company's policy and methodologies for establishing the ALL, described in the Company's Annual Report on Form 10-K for the year ended December 31, 2013, did not change during the first half of 2014.

Impaired loans, including \$2.2 million of TDR loans, were \$5.3 million at June 30, 2014, with no government guaranties and a specific reserve amount allocated of \$176 thousand, which is estimated by management to represent the Company's loss exposure with respect to such loans as of such date. Impaired loans, including \$1.2 million of TDR loans, at December 31, 2013 were \$5.5 million, with government guaranties of \$669 thousand and a specific reserve amount allocated of \$337 thousand as of such date. The decrease of \$225 thousand, or 4.1%, in impaired loans was primarily related to one commercial real estate loan that was upgraded to satisfactory/monitor status that had been classified impaired at December 31, 2013, partially offset by the addition of two TDR commercial real estate loans as of June 30, 2014. Based on management's evaluation of the Company's historical loss experience on substandard commercial loans, commercial loans with balances greater than \$500 thousand was established as the threshold for individual impairment evaluation with a specific reserve allocated when warranted. Commercial loans with balances under this threshold are collectively evaluated for impairment as a homogeneous pool of loans, unless such loans are subject to a restructuring agreement or have been identified as impaired as part of a larger customer relationship. The specific reserve amount allocated to individually identified impaired loans decreased \$161 thousand as a result of the June 30, 2014 impairment evaluation.

The Company's loan portfolio balance not held for sale decreased by \$5.8 million, from \$461.1 million at December 31, 2013 to \$455.3 million at June 30, 2014. There was growth in the residential, construction, commercial real estate and commercial loan portfolios (see chart on page 38 for further details) during the first half of 2014. This loan growth was offset by a large decrease in the municipal loan portfolio, reflecting a one day seasonal fluctuation due to the annual fiscal cycle of Vermont municipalities and school districts. The composition of the Company's loan portfolio remained relatively unchanged from December 31, 2013, and there was no material change in the Company's lending programs or terms during the six months ended June 30, 2014.

The following table reflects activity in the ALL for the three and six months ended June 30, 2014 and 2013:

|                                | For The Three Months Ended |         | For The Six Months Ended |         |
|--------------------------------|----------------------------|---------|--------------------------|---------|
|                                | June 30,                   |         | June 30,                 |         |
|                                | 2014                       | 2013    | 2014                     | 2013    |
|                                | (Dollars in thousands)     |         |                          |         |
| Balance at beginning of period | \$4,694                    | \$4,714 | \$4,647                  | \$4,657 |
| Charge-offs                    | (165                       | )(52    | )(207                    | )(66    |

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|                           |         |         |         |         |   |
|---------------------------|---------|---------|---------|---------|---|
| Recoveries                | 6       | 15      | 20      | 26      |   |
| Net charge-offs           | (159    | ) (37   | ) (187  | ) (40   | ) |
| Provision for loan losses | 75      | 75      | 150     | 135     |   |
| Balance at end of period  | \$4,610 | \$4,752 | \$4,610 | \$4,752 |   |

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The following table (net of loans held for sale) shows the internal breakdown by risk component of the Company's ALL and the percentage of loans in each category to total loans in the respective portfolios at the dates indicated:

|                          | June 30, 2014          |         | December 31, 2013 |         |
|--------------------------|------------------------|---------|-------------------|---------|
|                          | Amount                 | Percent | Amount            | Percent |
|                          | (Dollars in thousands) |         |                   |         |
| Residential real estate  | \$1,258                | 35.3    | \$1,251           | 34.6    |
| Construction real estate | 389                    | 7.0     | 390               | 6.7     |
| Commercial real estate   | 2,597                  | 48.0    | 2,644             | 45.7    |
| Commercial               | 206                    | 5.1     | 163               | 4.4     |
| Consumer                 | 22                     | 1.0     | 23                | 1.2     |
| Municipal                | 18                     | 3.6     | 35                | 7.4     |
| Unallocated              | 120                    | —       | 141               | —       |
| Total                    | \$4,610                | 100.0   | \$4,647           | 100.0   |

Notwithstanding the categories shown in the table above, all funds in the ALL are available to absorb loan losses in the portfolio, regardless of loan category or specific allocation.

There were no changes to the reserve factors assigned to any of the loan portfolios based on the qualitative factor reviews performed during the first half of 2014. Management of the Company believes, in its best estimate, that the ALL at June 30, 2014 is appropriate to cover probable credit losses inherent in the Company's loan portfolio as of such date. However, there can be no assurance that the Company will not sustain losses in future periods which could be greater than the size of the ALL at June 30, 2014. In addition, our banking regulators, as an integral part of their examination process, periodically review our ALL. Such agencies may require us to recognize adjustments to the ALL based on their judgments about information available to them at the time of their examination. A large adjustment to the ALL for losses in future periods may require increased provisions to replenish the ALL, which could negatively affect earnings. While the Company recognizes that economic slowdowns or financial and credit market turmoil may adversely impact its borrowers' financial performance and ultimately their ability to repay their loans, management continues to be cautiously optimistic about the collectability of the Company's loan portfolio.

Investment Activities. At June 30, 2014, investment securities classified as AFS totaled \$40.4 million and securities classified as HTM totaled \$9.6 million, combined comprising 8.7% of assets. Total investment securities increased \$4.5 million, or 9.9%, from \$45.5 million, or 7.8% of total assets at December 31, 2013. There was \$3.1 million of investment securities pledged to secure various public deposits or customer repurchase agreements as of June 30, 2014, compared to \$3.3 million at December 31, 2013. Net unrealized gains for the Company's AFS investment securities portfolio were \$284 thousand as of June 30, 2014, compared to net unrealized losses of \$778 thousand as of December 31, 2013. Net unrealized gains of \$188 thousand, net of income tax effect, were reflected in the Company's accumulated OCI component of stockholders' equity at June 30, 2014. Net unrealized losses in the Company's HTM investment securities portfolio were \$351 thousand at June 30, 2014 compared to net unrealized losses of \$849 thousand at December 31, 2013. No declines in value were deemed by management to be OTT at June 30, 2014. Deterioration in credit quality and/or imbalances in liquidity that may exist in the financial marketplace might adversely affect the fair values of the Company's investment portfolio and the amount of gains or losses ultimately realized on the sale of such securities, and may also increase the potential that certain resulting unrealized losses will be designated as OTT in future periods, resulting in write-downs and charges to earnings.

Deposits. The following table shows information concerning the Company's average deposits by account type and weighted average nominal rates at which interest was paid on such deposits for the six months ended June 30, 2014 and year ended December 31, 2013:

|                                    | Six Months Ended<br>June 30, 2014 |                                 | Average<br>Rate | Year ended<br>December 31, 2013 |                                 |                 |
|------------------------------------|-----------------------------------|---------------------------------|-----------------|---------------------------------|---------------------------------|-----------------|
|                                    | Average<br>Amount                 | Percent<br>of Total<br>Deposits |                 | Average<br>Amount               | Percent<br>of Total<br>Deposits | Average<br>Rate |
| (Dollars in thousands)             |                                   |                                 |                 |                                 |                                 |                 |
| Nontime deposits:                  |                                   |                                 |                 |                                 |                                 |                 |
| Noninterest bearing deposits       | \$85,123                          | 16.5                            | —               | \$83,744                        | 16.7                            | —               |
| Interest bearing checking accounts | 100,505                           | 19.5                            | 0.08            | %94,213                         | 18.7                            | 0.09 %          |
| Money market accounts              | 103,311                           | 20.0                            | 0.21            | %101,581                        | 20.2                            | 0.24 %          |
| Savings accounts                   | 77,663                            | 15.1                            | 0.14            | %73,099                         | 14.5                            | 0.14 %          |
| Total nontime deposits             | 366,602                           | 71.1                            | 0.11            | %352,637                        | 70.1                            | 0.12 %          |
| Time deposits:                     |                                   |                                 |                 |                                 |                                 |                 |
| Less than \$100,000                | 72,060                            | 13.9                            | 0.77            | %76,195                         | 15.1                            | 0.89 %          |
| \$100,000 and over                 | 77,288                            | 15.0                            | 1.09            | %74,302                         | 14.8                            | 1.12 %          |
| Total time deposits                | 149,348                           | 28.9                            | 0.94            | %150,497                        | 29.9                            | 1.00 %          |
| Total deposits                     | \$515,950                         | 100.0                           | 0.35            | %\$503,134                      | 100.0                           | 0.39 %          |

The Company participates in CDARS, which permits the Company to offer full deposit insurance coverage to its customers by exchanging deposit balances with other CDARS participants. Participants may also purchase deposits through CDARS. There were \$10.0 million of time deposits of \$250,000 or less on the balance sheet at June 30, 2014 and \$7.1 million at December 31, 2013, which were exchanged with other CDARS participants and are therefore considered for certain regulatory purposes to be “brokered” deposits. The Company also participates in the ICS program, a service through which Union can offer its customers a savings product with access to unlimited FDIC insurance, while receiving reciprocal deposits from other banks. Like the exchange of certificate of deposit accounts through CDARS, exchange of savings deposits through ICS provides full deposit insurance coverage for the customer, thereby helping Union retain the full amount of the deposit on its balance sheet. There were \$2.3 million in ICS money market deposits on the balance sheet at June 30, 2014 and \$2.3 million at December 31, 2013. None of the Company's CDARS or ICS deposits, as of the respective balance sheet dates, represented purchased deposits, as all such deposits were matched dollar for dollar with Union's customer deposits which were placed in other participating financial institutions, in order to provide our customers with full FDIC insurance coverage for their deposit balances.

The following table provides a maturity distribution of the Company's time deposits in amounts of \$100,000 and over at June 30, 2014 and December 31, 2013:

|                        | June 30, 2014 | December 31, 2013 |
|------------------------|---------------|-------------------|
| (Dollars in thousands) |               |                   |
| Within 3 months        | \$9,180       | \$7,942           |
| 3 to 6 months          | 7,788         | 47,903            |
| 6 to 12 months         | 12,890        | 16,405            |
| Over 12 months         | 18,198        | 16,614            |
|                        | \$48,056      | \$88,864          |

In total, the Company's time deposits in amounts of \$100 thousand and over decreased \$40.8 million, or 45.9%, between December 31, 2013 and June 30, 2014, and the average total balance increased from \$74.3 million to \$77.3 million. There was a change in each of the maturity time frames, especially the 3 to 6 months category. In Vermont, the fiscal year ends on June 30 for the majority of municipalities and school districts, with most of their time deposits maturing on that date, causing the majority of the reduction between time periods.



During the first half of 2014, average total deposits grew \$12.8 million, or 2.5%, compared to the year ended December 31, 2013, with growth in all categories except time deposits less than \$100 thousand. Time deposits have trended towards short duration or migrated to nontime deposits because of the low interest rate environment and the perceived customer desire to be in a position to redeploy funds should there be a rise in interest rates. Time deposits at June 30, 2014 decreased \$42.8 million, or 26.5%, from December 31, 2013, with the majority of the decrease due to Vermont municipalities using their deposits to pay down their annual

credit lines prior to their June 30 fiscal year end in order to comply with applicable legal requirements for short-term municipal borrowing.

A provision of the Dodd-Frank Act permanently raised FDIC deposit insurance coverage to \$250 thousand per depositor per insured depository institution for each account ownership category. At June 30, 2014, the Company had deposit accounts with less than \$250 thousand totaling \$380.3 million, or 77.5% of its deposits, with FDIC insurance protection. An additional \$5.0 million of municipal deposits were over the FDIC insurance coverage limit at June 30, 2014 and were collateralized by Union under applicable state regulations by investment securities or loans.

**Borrowings.** Total borrowed funds at June 30, 2014 were \$24.8 million compared to \$13.2 million at December 31, 2013, a net increase of \$11.6 million, or 87.4%. The FHLB option advance borrowings were \$23.2 million at June 30, 2014, at a weighted average rate of 1.80%, and \$11.8 million at December 31, 2013, at a weighted average rate of 3.33%. The increase in option advance borrowings reflects two one month bullet advances at 0.20% totaling \$6.5 million and a \$5 million one year bullet advance at 0.33% taken during the second quarter for liquidity purposes, partially offset by scheduled monthly payments of \$176 thousand on long-term FHLB amortizing advances. In addition, the Company had overnight secured customer repurchase agreement sweeps at June 30, 2014 of \$1.6 million, at a weighted average rate of 0.24%, compared to \$1.4 million, at a weighted average rate of 0.24% at December 31, 2013, an increase of \$219 thousand, or 15.8%. The volume of the overnight secured customer repurchase agreement sweeps is volatile and is a function of the customer's cash flow needs. The Company had no federal funds purchased or advances on its repurchase agreement line or at the Federal Reserve discount window at either June 30, 2014 or December 31, 2013.

#### OTHER FINANCIAL CONSIDERATIONS

**Market Risk and Asset and Liability Management.** Market risk is the potential of loss in a financial instrument arising from adverse changes in market prices, interest rates, foreign currency exchange rates, commodity prices and equity prices. As of June 30, 2014, the Company did not have any market risk sensitive instruments acquired for trading purposes. The Company's market risk arises primarily from interest rate risk inherent in its lending, investing, deposit taking and borrowing activities, as yields on assets change in a different time period or to a different extent from that of interest costs on liabilities. Many other factors also affect the Company's exposure to changes in interest rates, such as national, regional and local economic and financial conditions, financial market conditions, legislative and regulatory actions, competitive pressures, customer preferences as to loan and deposit products, including loan prepayments and/or early withdrawal of time deposits, and historical pricing relationships. These factors and the Company's methodology to measure and manage these risks are discussed in greater detail in the Company's Annual Report on Form 10-K for the year ended December 31, 2013 and have not changed during the six months ended June 30, 2014.

As of June 30, 2014, \$40.4 million, or 80.7%, of the investment portfolio was classified as AFS. The modified duration of the total portfolio was approximately five years. The modified duration takes into account the likelihood of investments being called as well as estimates for prepayment speeds on MBSs. The Company does not utilize any exotic derivative products or invest in any "high risk" instruments.

The Company's interest rate sensitivity analysis (simulation) as of December 2013 for a flat rate environment (the prime rate at both December 31, 2013 and June 30, 2014 was 3.25%) projected the following for the six months ended June 30, 2014, compared to the actual results:

| June 30, 2014          |        | Percentage<br>Difference |
|------------------------|--------|--------------------------|
| Projected              | Actual |                          |
| (Dollars in thousands) |        |                          |

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|                     |          |          |        |
|---------------------|----------|----------|--------|
| Net Interest Income | \$11,114 | \$11,190 | 0.7    |
| Net Income          | \$3,015  | \$3,683  | 22.2   |
| Return on Assets    | 1.06     | % 1.26   | % 18.9 |
| Return on Equity    | 12.77    | % 14.55  | % 13.9 |

Actual net interest income for the first half of 2014 was \$11.2 million, \$76 thousand or 0.7%, higher than projected due to a positive variance in loan interest income of \$292 thousand, partially offset by negative variances of \$93 thousand in investment income and \$125 thousand in interest expense on deposit accounts.

Net income for the six months ended June 30, 2014 was ahead of the projected amount due to the combined effect of positive variances of \$25 thousand in service charge income, \$62 thousand on gain on sale of investment securities AFS, \$310 thousand in the gain on sale of real estate loans, \$278 thousand in salaries and wages, \$69 thousand in employee benefits, \$72 thousand in ATM & debit card expenses, \$110 thousand in OREO expenses, and \$75 thousand in the provision for loan losses. However, these positive variances were partially offset by the combined effect of negative variances of \$86 thousand in professional fee expense and \$324 thousand in the provision for income taxes.

Commitments, Contingent Liabilities, and Off-Balance-Sheet Arrangements. The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers, to reduce its own exposure to fluctuations in interest rates and to implement its strategic objectives. These financial instruments include commitments to extend credit, standby letters of credit, interest rate caps and floors written on adjustable-rate loans, commitments to participate in or sell loans, commitments to buy or sell securities, certificates of deposit or other investment instruments and risk-sharing commitments or guarantees on certain sold loans. Such instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized on the balance sheet. The contractual or notional amounts of these instruments reflect the extent of involvement the Company has in a particular class of financial instruments.

The Company's maximum exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual or notional amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. For interest rate caps and floors written on adjustable-rate loans, the contractual or notional amounts do not represent the Company's exposure to credit loss. The Company controls the risk of interest rate cap agreements through credit approvals, limits, and monitoring procedures. The Company generally requires collateral or other security to support financial instruments with credit risk.

The following table details the contractual or notional amount of financial instruments that represented credit risk at the dates indicated:

|  | June 30, 2014          | December 31, 2013 |
|--|------------------------|-------------------|
|  | (Dollars in thousands) |                   |
| Commitments to originate loans   | \$46,275               | \$25,292          |
| Unused lines of credit   | 51,527                 | 58,283            |
| Standby and commercial letters of credit                               | 1,924                  | 1,633             |
| Credit card arrangements   | 1,063                  | 1,151             |
| FHLB Mortgage Partnership Finance credit enhancement obligation, net   | 472                    | 461               |
| Commitment to purchase investment in a real estate limited partnership | 505                    | 505               |
| Total  | \$101,766              | \$87,325          |

Commitments to originate loans are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have a fixed expiration date or other termination clause and may require payment of a fee. Since many of the loan commitments are expected to expire without being drawn upon and not all credit lines will be utilized, the total commitment amounts do not necessarily represent future cash requirements. Lines of credit incur seasonal volume fluctuations due to the nature of some customers' businesses, such as tourism and maple syrup products production. The large increase in commitments to originate loans at June 30, 2014 from December 31, 2013 is a result of the municipalities' and school districts' fiscal cycle, with \$25.8 million committed to them on June 30, 2014 for their fiscal year beginning July 1, 2014.

The Company did not hold or issue derivative or hedging instruments during the six month period ended June 30, 2014.

The Company's subsidiary bank is required (as are all banks) to maintain vault cash or a noninterest bearing reserve balance as established by Federal Reserve regulations. The Bank's average total required reserve for the 14 day maintenance period including June 30, 2014 was \$672 thousand and for December 31, 2013 was \$652 thousand, both of which were satisfied by vault cash.

Interest Rate Sensitivity "Gap" Analysis. An interest rate sensitivity "gap" is defined as the difference between interest earning assets and interest bearing liabilities maturing or repricing within a given time period. A gap is considered positive when the amount of interest rate sensitive assets exceeds the amount of interest rate sensitive liabilities. A gap is considered negative when the amount of interest rate sensitive liabilities exceeds the amount of interest rate sensitive assets. During a period of rising interest rates, a negative gap would tend to adversely affect net interest income, while a positive gap would tend to result in an increase in net interest income. During a period of falling interest rates, a negative gap would tend to result in an increase in net interest income, while a positive gap would tend to affect net interest income adversely. Because different types of assets and liabilities with the same or similar maturities may react differently to changes in overall market interest rates or conditions, changes in

interest rates may affect net interest income positively or negatively even if an institution were perfectly matched in each maturity category.

The Company prepares its interest rate sensitivity “gap” analysis by scheduling interest earning assets and interest bearing liabilities into periods based upon the next date on which such assets and liabilities could mature or reprice. The amount of assets and liabilities shown in the table below within a particular period was determined in accordance with the contractual terms of the assets and liabilities, except that:

adjustable-rate loans, investment securities, variable rate interest bearing deposits in banks, variable rate time deposits, FHLB advances and other secured borrowings are included in the period when they are first scheduled to adjust and not in the period in which they mature;

fixed-rate mortgage-related securities and residential loans reflect estimated prepayments, which were estimated based on analyses of broker estimates, the results of a prepayment model utilized by the Company, and empirical data;

other nonmortgage related fixed-rate loans reflect scheduled contractual amortization, with no estimated prepayments; and

interest bearing checking, money markets and savings deposits, which do not have contractual maturities, reflect estimated levels of attrition, which are based on detailed studies by the Company of the sensitivity of each such category of deposit to changes in interest rates.

Management believes that these assumptions approximate actual experience and considers them reasonable. However, the interest rate sensitivity of the Company’s assets and liabilities in the tables could vary substantially if different assumptions were used, callable investment options were modeled, prepayment speeds changed or actual experience differs from the historical experience on which the assumptions are based.

The following table shows the Company's rate sensitivity analysis as of June 30, 2014:

|  | Repriced within                           |                   |                 |                 |                 | Total      |
|--|---|-------------------|-----------------|-----------------|-----------------|------------|
|  | 3 Months<br>or Less                       | 4 to 12<br>Months | 1 to 3<br>Years | 3 to 5<br>Years | Over 5<br>Years |            |
|  | (Dollars in thousands, by repricing date) |                   |                 |                 |                 |            |
| Interest sensitive assets:   |   |                   |                 |                 |                 |            |
| Overnight deposits   | \$ 15,490                                 | \$—               | \$—             | \$—             | \$—             | \$ 15,490  |
| Interest bearing deposits in banks   | 3,093                                     | 3,940             | 4,088           | 1,754           | 838             | 13,713     |
| Investment securities (1)(3)   | 11,104                                    | 4,645             | 7,284           | 7,534           | 18,081          | 48,648     |
| Nonmarketable securities   | —   | —                 | —               | —               | 2,053           | 2,053      |
| Loans and loans held for sale (2)(3)   | 173,393                                   | 90,350            | 79,343          | 71,631          | 47,528          | 462,245    |
| Total interest sensitive assets  | \$ 203,080                                | \$ 98,935         | \$ 90,715       | \$ 80,919       | \$ 68,500       | \$ 542,149 |
| Interest sensitive liabilities:  |   |                   |                 |                 |                 |            |
| Time deposits  | \$ 28,987                                 | \$ 44,352         | \$ 37,275       | \$ 8,122        | \$—             | \$ 118,736 |
| Money markets  | 24,934                                    | —                 | —               | —               | 74,588          | 99,522     |
| Regular savings  | 15,076                                    | —                 | —               | —               | 65,287          | 80,363     |
| Interest bearing checking  | 54,759                                    | —                 | —               | —               | 56,336          | 111,095    |
| Borrowed funds   | 8,199                                     | 5,276             | 3,350           | 7,089           | 845             | 24,759     |
| Total interest sensitive liabilities   | \$ 131,955                                | \$ 49,628         | \$ 40,625       | \$ 15,211       | \$ 197,056      | \$ 434,475 |
| Net interest rate sensitivity gap  | \$ 71,125                                 | \$ 49,307         | \$ 50,090       | \$ 65,708       | \$ (128,556)    | \$ 107,674 |
| Cumulative net interest rate sensitivity gap                                 | \$ 71,125                                 | \$ 120,432        | \$ 170,522      | \$ 236,230      | \$ 107,674      |            |
| Cumulative net interest rate sensitivity gap as a percentage of total assets | 12.4                                      | % 21.1            | % 29.8          | % 41.3          | % 18.8          | %          |
|  | 13.1                                      | % 22.2            | % 31.5          | % 43.6          | % 19.9          | %          |

Cumulative net interest rate sensitivity  
 gap as  
 a percentage of total interest sensitive  
 assets

Cumulative net interest rate sensitivity  
 gap as  
 a percentage of total interest sensitive  
 liabilities

|      |        |        |        |        |   |
|------|--------|--------|--------|--------|---|
| 16.4 | % 27.7 | % 39.2 | % 54.4 | % 24.8 | % |
|------|--------|--------|--------|--------|---|

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(1) Investment securities exclude marketable equity securities and mutual funds shares with a fair value of \$1.1 million and \$275 thousand, respectively, that may be sold by the Company at any time.

(2) Balances shown include deferred unamortized loan costs of \$238 thousand.

(3) Estimated repayment assumptions considered in Asset/Liability model.

Liquidity. Managing liquidity risk is essential to maintaining both depositor confidence and earnings stability. Liquidity is a measurement of the Company's ability to meet potential cash requirements, including ongoing commitments to fund deposit withdrawals, repay borrowings, fund investment and lending activities, and for other general business purposes. The Company's principal sources of funds are deposits; amortization, prepayment and maturity of loans, investment securities, interest bearing deposits and other short-term investments; sales of securities and loans AFS; earnings; and funds provided from operations. Maintaining a relatively stable funding base, which is achieved by diversifying funding sources, competitively pricing deposit products, and extending the contractual maturity of liabilities, reduces the Company's exposure to rollover risk on deposits and limits reliance on volatile short-term purchased funds. Short-term funding needs arise from declines in deposits or other funding sources, funding of loan commitments, draws on unused lines of credit and requests for new loans. The Company's strategy is to fund assets, to the maximum extent possible, with core deposits which provide a source of relatively stable and low-cost funds.

For the quarter ended June 30, 2014, the Company's ratio of average loans to average deposits decreased slightly to 94.1%, compared to 94.8% for the quarter ended June 30, 2013. Municipal, construction and commercial lending were strong during the first six months of 2014. Residential lending demand has decreased for the first six months of 2014 compared to first six months of 2013 as origination of residential loans held for sale was \$45.3 million during the six months ended June 30, 2014, compared to \$59.6 million during the six months ended June 30, 2013. Residential loans totaling \$42.5 million were sold during the six months ended June 30, 2014 versus \$66.2 million for the six months ended June 30, 2013.

As a member of the FHLB, Union had access to unused lines of credit up to \$4.0 million at June 30, 2014 over and above the \$23.2 million term advances already drawn on the lines, based on a FHLB estimate as of that date. With the purchase of required FHLB Class B common stock and evaluation by the FHLB of the underlying collateral available, line availability could rise to approximately \$19.4 million. This line of credit can be used for either short-or-long-term liquidity or other needs. In addition to its borrowing arrangements with the FHLB, Union maintains two pre-approved Federal Funds lines of credit totaling \$12.0 million with two upstream correspondent banks, a \$15.0 million repurchase agreement line of credit and access to the Federal Reserve discount window, which would require pledging of qualified assets. There were no outstanding advances on the federal funds or repurchase agreement lines or at the discount window at June 30, 2014.

There were no purchased deposits through CDARS or ICS (or otherwise) at either June 30, 2014 or December 31, 2013, although Union had exchanged \$12.3 million and \$9.4 million of deposits, respectively, with other CDARS/ICS members at those dates.

The Company's management monitors current and projected cash flows and adjusts positions as necessary to maintain adequate levels of liquidity. Approximately 61.5% of the Company's time deposits will mature within twelve months, which is the lowest percentage over the preceding five years, with the exception of one quarter, which ranged from 62.0% to 85.0%. The deposit gathering activities of financial institutions generally have been affected by the low interest rates which earlier in the recession made customers reluctant to lock in funds for a longer term but short-term rates have dropped so low during the last five years that some customers have extended out in order to receive a better rate or have shifted funds into money markets where the interest rates are higher than on the short-term time deposits. Since the federal funds target rate has remained unchanged at a historic low of 0.00% to 0.25% for more than four years, as customers' time deposits matured, the rollover interest rate available to those customers is lower than their previous deposit rate and therefore the Company's cost of funding has continued to drop. The Company is optimistic that it can maintain and grow its customer deposit base, despite the persistent low rate environment, through good customer service, a variety of deposit product offerings, competitive but prudent pricing strategy and the continued expansion of the branch, electronic and remote network. The relationships developed with local municipalities,



businesses and retail customers are a significant feature of the Company's community banking approach and, in management's view, will help to ensure that Union will retain a substantial portion of these deposits. Management will continue to offer a competitive but prudent pricing strategy to facilitate retention of such deposits. The Federal Open Market Committee has committed to keeping interest rates low until certain unemployment and inflation targets are met. But in the future, as interest rates rise, the increase in rates may lead to early redemptions of certificates of deposit by customers which will present its own liquidity issue which will have to be managed. The movement of funds from FDIC insured deposits back into the financial market is also something that we monitor as it could cause a liquidity concern.

A reduction in total deposits could be offset by purchases of federal funds, utilization of the repurchase agreement line of credit, utilization of the Federal Reserve discount window, purchases of brokered deposits such as one-way CDARS deposits, short-or-long-term FHLB borrowings, or liquidation of interest bearing deposits in banks, investment securities AFS or loans held for sale. Such steps could result in an increase in the Company's cost of funds or a decrease in the yield earned on assets and therefore adversely impact the net interest spread and margin. Management believes the Company has sufficient liquidity to meet all reasonable borrower, depositor, and creditor needs in the present economic environment. However, any projections of future cash needs and flows are subject to substantial uncertainty, including factors outside the Company's control. Management continually

evaluates opportunities to buy/sell securities AFS and loans held for sale, to participate out loans and lines of credit, obtain credit facilities from lenders and restructure debt for strategic reasons or to further strengthen the Company's financial position.

**Capital Resources.** Capital management is designed to maintain an optimum level of capital in a cost-effective structure that meets target regulatory ratios, supports management's internal assessment of economic capital, funds the Company's business strategies and builds long-term stockholder value. Dividends are generally in line with long-term trends in earnings per share and conservative earnings projections, while sufficient profits are retained to support anticipated business growth, fund strategic investments, maintain required regulatory capital levels and provide continued support for deposits. The Company continues to evaluate growth opportunities both through internal growth or potential acquisitions.

As of June 30, 2014, the Company and its subsidiary continue to be considered well capitalized under the capital adequacy requirements to which they are currently subject. The Company has evaluated its capital adequacy at June 30, 2014 on a pro forma basis under the recently adopted (but not yet effective) BASEL III requirements and would be considered well capitalized under such requirements.

The total dollar value of the Company's stockholders' equity at June 30, 2014 of \$51.9 million has increased \$2.1 million from \$49.8 million at December 31, 2013, reflecting net income of \$3.7 million for the first six months of 2014, an increase of \$11 thousand from stock based compensation, an increase of \$33 thousand due to the issuance of 1,710 shares of common stock resulting from the exercise of incentive stock options, and an increase of \$701 thousand in accumulated OCI. These increases were partially offset by cash dividends paid of \$2.3 million and a \$42 thousand purchase of Treasury stock during the six months ended June 30, 2014.

Union Bankshares, Inc. has 7,500,000 shares of \$2.00 par value common stock authorized. As of June 30, 2014, the Company had 4,928,996 shares issued, of which 4,458,254 were outstanding and 470,742 were held in treasury.

In January 2014, the Company's Board reauthorized a limited stock repurchase program initially adopted in May 2010, which permits the repurchase of up to 2,500 shares of the Company's common stock each calendar quarter in open market purchases or privately negotiated transactions, as management deems advisable and as market conditions warrant. The repurchase authorization for a calendar quarter expires at the end of that quarter to the extent it has not been exercised, and is not carried forward into future quarters. The quarterly repurchase authorization expires on December 31, 2014, unless reauthorized. The Company repurchased 1,815 shares during the first half of 2014 pursuant to that authorization, at a total cost of \$42 thousand.

The Company reserved 50,000 shares of common stock for issuance under the 2008 ISO Plan. During the six months ended June 30, 2014, there were no options granted under the 2008 ISO Plan and there were 1,710 shares issued from the exercise of stock options previously granted under such plan. The stock issued upon exercise of options granted under the 2008 ISO Plan consists of authorized but unissued shares of the Company's common stock and/or shares held in treasury. As of June 30, 2014, there were employee incentive stock options outstanding and exercisable under this plan with respect to 3,300 shares of common stock and unvested stock options with respect to an additional 4,500 shares that were granted in the fourth quarter of 2013 that will become exercisable in the fourth quarter of 2014. All exercisable options were "in the money" at June 30, 2014. Unrecognized compensation cost related to the unvested stock options as of June 30, 2014 was \$9 thousand.

The Company has adopted the 2014 Equity Plan, which replaces the 2008 ISO Plan. Under the 2014 Equity Plan, 50,000 shares of the Company's common stock (including approximately 25,000 unused shares from the 2008 ISO Plan) are available for equity awards of incentive stock options, nonqualified stock options, restricted stock and restricted stock units to eligible officers and (except for awards of incentive stock options) nonemployee directors.

Shares available for issuance of awards under the 2014 Equity Plan consist of unissued shares of the Company's common stock and/or shares held in treasury. No awards have yet been made under the plan since it became effective on May 21, 2014 upon approval by the stockholders.

Union Bankshares, Inc. and Union are subject to various regulatory capital requirements administered by the federal banking agencies. Management believes that as of June 30, 2014, both companies met all capital adequacy requirements to which they are subject. As of June 30, 2014, the most recent calculation date, Union was categorized as well capitalized under the regulatory framework for prompt corrective action. The prompt corrective action capital category framework applies to FDIC insured depository institutions such as Union but does not apply directly to bank holding companies such as the Company. To be categorized as well capitalized, Union must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table below. As a bank holding company, the Company is subject to substantially similar capital adequacy requirements of the FRB. There were no conditions or events between June 30, 2014 and the date of this report that management believes have changed either company's regulatory capital category.

|  | Actual                 |       | Minimum For Capital Requirements |       | Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions |       |   |
|--|------------------------|-------|----------------------------------|-------|--|-------|---|
|  | Amount                 | Ratio | Amount                           | Ratio | Amount   | Ratio |   |
| As of June 30, 2014                    | (Dollars in thousands) |       |                                  |       |  |       |   |
| Total capital to risk weighted assets  |                        |       |                                  |       |  |       |   |
| Union                                  | \$52,062               | 13.29 | % \$31,339                       | 8.00  | % \$39,174   | 10.00 | % |
| Company                                | 52,464                 | 13.37 | % 31,392                         | 8.00  | % N/A  | N/A   |   |
| Tier I capital to risk weighted assets |                        |       |                                  |       |  |       |   |
| Union                                  | \$47,312               | 12.08 | % \$15,666                       | 4.00  | % \$23,499   | 6.00  | % |
| Company                                | 47,705                 | 12.15 | % 15,705                         | 4.00  | % N/A  | N/A   |   |
| Tier I capital to average assets       |                        |       |                                  |       |  |       |   |
| Union                                  | \$47,312               | 8.13  | % \$23,278                       | 4.00  | % \$29,097   | 5.00  | % |
| Company                                | 47,705                 | 8.18  | % 23,328                         | 4.00  | % N/A  | N/A   |   |

The total risk based capital ratio for the Company was 13.37% at June 30, 2014 and 13.28% at December 31, 2013.

The Company remains focused on achieving its goals of long-term growth and an above-average shareholder return, while maintaining a strong capital position. Management is aware of the particular importance in today's uncertain economic environment of maintaining strong capital reserves and planning for future capital needs, including those required by the final Basel III capital standards.

A quarterly cash dividend of \$0.26 per share was declared to shareholders of record on July 26, 2014, payable August 7, 2014. Dividends for each of the three previous quarters were \$.26 per share.

**Regulatory Matters.** The Company and Union are subject to periodic examinations by the various regulatory agencies. These examinations include, but are not limited to, procedures designed to review lending practices, risk management, credit quality, liquidity, compliance and capital adequacy. The Company's 2011 corporate tax return was audited by the IRS during 2013. There was no material adjustment to the Company's tax liability as a result of the audit. During 2013, the Vermont Department of Financial Regulation, FDIC (compliance) and FRB, and during 2012, the FDIC and FRB, performed their regular, periodic regulatory examinations of Union. No comments were received that would have a material adverse effect on the Company's or Union's liquidity, financial position, capital resources, or results of operations.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Information called for by this item is incorporated by reference in Management's Discussion and Analysis of Financial Condition and Results of Operations under the caption OTHER FINANCIAL CONSIDERATIONS on pages 43-48.

### Item 4. Controls and Procedures.

**Evaluation of Disclosure Controls and Procedures.** The Company's Chief Executive Officer and Chief Financial Officer, with the assistance of the Disclosure Control Committee, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) as of June 30, 2014. Based on this evaluation they concluded that those disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without

limitation, controls and procedures designed to ensure that information required to be disclosed by the Company in the reports that it files with the Commission is accumulated and communicated to the Company's management, including its principal executive and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required information.

**Changes in Internal Controls over Financial Reporting.** There was no change in the Company's internal control over financial reporting, as defined in Rule 13a-15(f) of the Exchange Act, during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II OTHER INFORMATION

## Item 1. Legal Proceedings.

There are no known pending legal proceedings to which the Company or its subsidiary is a party, or to which any of their properties is subject, other than ordinary litigation arising in the normal course of business activities. Although the amount of any ultimate liability with respect to such proceedings cannot be determined, in the opinion of management, any such liability is not expected to have a material adverse effect on the consolidated financial condition or results of operations of the Company and its subsidiary.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

During the quarter ended June 30, 2014, the Company did not issue any unregistered equity securities.

The following table summarizes repurchases of the Company's equity securities made during the quarter ended June 30, 2014:

## Issuer Purchases of Equity Securities

| Period     | Total Number of Shares Purchased | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (1) | Maximum Number of Shares that May Yet be Purchased Under the Plans or Program |
|------------|----------------------------------|------------------------------|--|---|
| April 2014 | 48                               | \$23.24                      | 48   | 2,452   |
| May 2014   | 967                              | \$23.16                      | 967  | 1,485   |
| June 2014  | 703                              | \$22.90                      | 703  | —   |

(1) All repurchases shown in the table were made pursuant to an informal stock repurchase program initially adopted May 19, 2010 under which the Company may repurchase up to 2,500 shares of its common stock each calendar quarter, in open market or privately negotiated transactions. The repurchase authorization for a calendar quarter expires at the end of that quarter to the extent it has not been exercised, and is not carried forward into future quarters. The program was reauthorized most recently in January 2014 and will expire on December 31, 2014, unless reauthorized.

## Item 6. Exhibits.

- 31.1 Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  
 31.2 Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.  
 32.1 Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.\*  
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 101 The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2014 formatted in eXtensible Business Reporting Language (XBRL): (i) the unaudited consolidated balance sheets, (ii) the unaudited consolidated statements of income for the second quarters and six months ended June 30, 2014 and 2013, (iii) the unaudited consolidated statements of comprehensive income for the second quarters and six months ended June 30, 2014 and 2013, (iv) the unaudited consolidated statements of changes in stockholders' equity, (v) the unaudited consolidated statements of cash flows and (v) related notes.

This exhibit shall not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, or \*otherwise subject to the liability of that section, and shall not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Exchange Act of 1934.



SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned thereunto duly authorized.

Union Bankshares, Inc.

August 14, 2014

/s/ David S. Silverman

David S. Silverman

Director, President and Chief Executive Officer

August 14, 2014

/s/ Karyn J. Hale

Karyn J. Hale

Chief Financial Officer

(Principal Financial Officer)

EXHIBIT INDEX

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