UNITY BANCORP INC /NJ/
Form 10-Q
August 08, 2014

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2014

OR

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

For the transition period from ____ to ____.

Commission File Number 1-12431

Unity Bancorp, Inc.

(Exact name of registrant as specified in its charter)

New Jersey	22-3282551
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
64 Old Highway 22, Clinton, NJ	08809
(Address of principal executive offices)	(Zip Code)

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

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

Yes No

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

Large accelerated filer Accelerated filer Nonaccelerated filer Smaller reporting company

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

Yes No

The number of shares outstanding of each of the registrant's classes of common equity stock, as of July 31, 2014
common stock, no par value: 7,607,133 shares outstanding

Table of Contents

PART ICONSOLIDATED FINANCIAL INFORMATION

ITEM 1Consolidated Financial Statements (Unaudited)

Unity Bancorp, Inc.

Consolidated Balance Sheets

(Unaudited)

(In thousands)	June 30, 2014	December 31, 2013
ASSETS		
Cash and due from banks	$ 35,197	$ 24,272
Federal funds sold and interest-bearing deposits	60,141	75,132
Cash and cash equivalents	95,338	99,404
Securities:		
Securities available for sale	68,734	81,133
Securities held to maturity (fair value of $21,591 and $25,549, respectively)	21,736	26,381
Total securities	90,470	107,514
Loans:		
SBA loans held for sale	6,444	6,673
SBA loans held for investment	46,890	48,918
SBA 504 loans	34,452	31,564
Commercial loans	375,976	363,340
Residential mortgage loans	196,184	182,067
Consumer loans	48,943	46,139
Total loans	708,889	678,701
Allowance for loan losses	(12,858)	(13,141)
Net loans	696,031	665,560
Premises and equipment, net	15,469	15,672
Bank owned life insurance ("BOLI")	12,941	12,749

Deferred tax assets	6,149	6,752
Federal Home Loan Bank stock	6,378	5,392
Accrued interest receivable	3,283	3,272
Other real estate owned ("OREO")	1,115	633
Goodwill and other intangibles	1,516	1,516
Other assets	3,724	2,654
Total assets	$ 932,414	$ 921,118
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Deposits:		
Noninterest-bearing demand deposits	$ 144,848	$ 136,035
Interest-bearing demand deposits	110,590	130,806
Savings deposits	256,991	266,503
Time deposits, under $100,000	114,605	108,258
Time deposits, $100,000 and over	101,049	97,096
Total deposits	728,083	738,698
Borrowed funds	125,000	107,000
Subordinated debentures	15,465	15,465
Accrued interest payable	466	454
Accrued expenses and other liabilities	2,923	2,328
Total liabilities	871,937	863,945
Commitments and contingencies	-	-
Shareholders' equity:		
Common stock	52,356	52,051
Retained earnings	8,114	5,598
Accumulated other comprehensive income (loss)	7	(476)
Total shareholders' equity	60,477	57,173
Total liabilities and shareholders' equity	$ 932,414	$ 921,118
Issued and outstanding common shares	7,607	7,577

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

Unity Bancorp, Inc.

Consolidated Statements of Income

(Unaudited)

(In thousands, except per share amounts)	For the three months ended June 30, 2014	2013	For the six months ended June 30, 2014	2013
INTEREST INCOME				
Federal funds sold and interest-bearing deposits	$ 10	$ 7	$ 19	$ 22
Federal Home Loan Bank stock	40	35	87	78
Securities:				
Taxable	552	620	1,278	1,267
Tax-exempt	90	125	195	245
Total securities	642	745	1,473	1,512
Loans:				
SBA loans	643	778	1,226	1,555
SBA 504 loans	433	441	832	1,092
Commercial loans	4,738	4,250	9,340	8,251
Residential mortgage loans	2,052	1,649	4,110	3,199
Consumer loans	544	496	1,039	1,005
Total loans	8,410	7,614	16,547	15,102
Total interest income	9,102	8,401	18,126	16,714
INTEREST EXPENSE				
Interest-bearing demand deposits	109	90	220	191
Savings deposits	188	164	370	340
Time deposits	693	537	1,337	1,083
Borrowed funds and subordinated debentures	807	808	1,606	1,609
Total interest expense	1,797	1,599	3,533	3,223
Net interest income	7,305	6,802	14,593	13,491
Provision for loan losses	550	300	1,150	950
Net interest income after provision for loan losses	6,755	6,502	13,443	12,541
NONINTEREST INCOME				
Branch fee income	342	348	718	695
Service and loan fee income	285	319	580	623
Gain on sale of SBA loans held for sale, net	255	86	337	327
Gain on sale of mortgage loans, net	188	547	553	1,025
BOLI income	96	75	192	146
Net security gains	268	108	378	334
Other income	206	175	408	332
Total noninterest income	1,640	1,658	3,166	3,482
NONINTEREST EXPENSE				
Compensation and benefits	3,122	3,166	6,340	6,341
Occupancy	619	627	1,279	1,321
Processing and communications	597	562	1,179	1,123
Furniture and equipment	379	371	735	736

Professional services	247	234	458	424
Loan costs	174	228	344	406
OREO expenses	95	63	342	190
Deposit insurance	171	179	349	328
Advertising	287	181	438	301
Other expenses	453	463	939	1,029
Total noninterest expense	6,144	6,074	12,403	12,199
Income before provision for income taxes	2,251	2,086	4,206	3,824
Provision for income taxes	723	739	1,385	1,278
Net income	1,528	1,347	2,821	2,546
Preferred stock dividends and discount accretion	-	465	-	869
Income available to common shareholders	$ 1,528	$ 882	$ 2,821	$ 1,677
Net income per common share - Basic	$ 0.20	$ 0.12	$ 0.37	$ 0.22
Net income per common share - Diluted	$ 0.20	$ 0.11	$ 0.37	$ 0.21
Weighted average common shares outstanding - Basic	7,605	7,544	7,596	7,541
Weighted average common shares outstanding - Diluted	7,690	7,911	7,672	7,881

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

Unity Bancorp, Inc.

Consolidated Statements of Comprehensive Income

(Unaudited)

(In thousands)	For the three months ended June 30, 2014	2013	For the six months ended June 30, 2014	2013
Net income	$ 1,528	$ 1,347	$ 2,821	$ 2,546
Other comprehensive income (loss), net of tax:				
Unrealized holding gains (losses) on securities arising during period	351	(654)	734	(884)
Less: Reclassification adjustment for gains on securities included in net income	178	72	251	222
Total other comprehensive income (loss)	173	(726)	483	(1,106)
Total comprehensive income	$ 1,701	$ 621	$ 3,304	$ 1,440

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

Unity Bancorp, Inc.

Consolidated Statements of Changes in Shareholders' Equity

For the six months ended June 30, 2014 and 2013

(Unaudited)

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

(In thousands)	Preferred stock	Common stock Shares	Common stock Amount	Retained earnings	Accumulated other comprehensive income	Total shareholders' equity
Balance, December 31, 2012	$ 20,115	7,534	$ 54,274	$ 1,788	$ 1,333	$ 77,510
Net income				2,546		2,546
Other comprehensive loss, net of tax					(1,106)	(1,106)
Redemption of perpetual preferred stock from U.S. Treasury	(10,324)					(10,324)
Accretion of discount on preferred stock	418			(418)		-
Dividends on common stock ($0.01 per share)				(75)		(75)
Dividends on preferred stock (5% annually)				(451)		(451)
Common stock issued and related tax effects (1)		10	187			187
Balance, June 30, 2013	$ 10,209	7,544	$ 54,461	$ 3,390	$ 227	$ 68,287

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

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

6

Unity Bancorp, Inc.

Consolidated Statements of Cash Flows

(Unaudited)

(In thousands)	For the six months ended June 30, 2014		2013	
OPERATING ACTIVITIES:				
Net income	$	2,821	$	2,546
Adjustments to reconcile net income to net cash provided by operating activities:				
Provision for loan losses		1,150		950
Net amortization of purchase premiums and discounts on securities		270		399
Depreciation and amortization		610		659
Deferred income tax expense		293		23
Net security gains		(378)		(334)
Stock compensation expense		206		169
Loss on sale of OREO		99		107
Gain on sale of mortgage loans held for sale, net		(406)		(1,025)
Gain on sale of SBA loans held for sale, net		(337)		(327)
Origination of mortgage loans held for sale		(28,597)		(48,525)
Origination of SBA loans held for sale		(4,009)		(4,060)
Proceeds from sale of mortgage loans held for sale, net		29,003		49,550
Proceeds from sale of SBA loans held for sale, net		3,534		3,519
Net change in other assets and liabilities		(649)		672
Net cash provided by operating activities		3,610		4,323
INVESTING ACTIVITIES				

Purchases of securities held to maturity		-		(8,252)
Purchases of securities available for sale		(9,947)		(19,274)
Purchases of Federal Home Loan Bank stock, at cost		(4,451)		(1,575)
Maturities and principal payments on securities held to maturity		4,611		2,610
Maturities and principal payments on securities available for sale		5,360		13,320
Proceeds from sales of securities available for sale		17,919		9,482
Proceeds from redemption of Federal Home Loan Bank stock		3,465		37
Proceeds from sale of OREO		2,351		967
Net increase in loans		(33,830)		(35,883)
Purchase of BOLI		-		(3,000)
Purchases of premises and equipment		(317)		(4,347)
Net cash used in investing activities		(14,839)		(45,915)
FINANCING ACTIVITIES				
Net decrease in deposits		(10,615)		(20,391)
Proceeds from new borrowings		50,000		35,000
Repayments of borrowings		(32,000)		-
Redemption of perpetual preferred stock from U.S. Treasury		-		(10,324)
Proceeds from exercise of stock options		62		-
Dividends on preferred stock		-		(516)
Dividends on common stock		(284)		(59)
Net cash provided by financing activities		7,163		3,710
Decrease in cash and cash equivalents		(4,066)		(37,882)
Cash and cash equivalents, beginning of period		99,404		94,192
Cash and cash equivalents, end of period	$	95,338	$	56,310
SUPPLEMENTAL DISCLOSURES				
Cash:				
Interest paid	$	3,521	$	3,214
Income taxes paid		1,069		1,612

Noncash investing activities:		
Transfer of SBA loans held for sale to held to maturity	83	33
Transfer of loans to OREO	2,932	-
Purchase of leased branch locations	-	3,893

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

Unity Bancorp, Inc.

Notes to the Consolidated Financial Statements (Unaudited)

June 30, 2014

NOTE 1. Significant Accounting Policies

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

The interim unaudited Consolidated Financial Statements included herein have been prepared in accordance with instructions for Form 10-Q and the rules and regulations of the Securities and Exchange Commission (“SEC”) and consist of normal recurring adjustments necessary for the fair presentation of interim results. The results of operations for the three and six months ended June 30, 2014 are not necessarily indicative of the results which may be expected for the entire year. As used in this Form 10-Q, “we” and “us” and “our” refer to Unity Bancorp, Inc., and its consolidated subsidiary, Unity Bank, depending on the context. Certain information and financial disclosures required by U.S. generally accepted accounting principles have been condensed or omitted from interim reporting pursuant to SEC rules. Interim financial statements should be read in conjunction with the Company’s Consolidated Financial Statements and notes thereto included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2013.

Stock Transactions

Stock Option Plans

The Company has incentive and nonqualified option plans, which allow for the grant of options to officers, employees and members of the Board of Directors. Transactions under the Company's stock option plans for the six months ended June 30, 2014 are summarized in the following table:

	Shares	Weighted average exercise price	Weighted average remaining contractual life in years	Aggregate intrinsic value
Outstanding at December 31, 2013	448,975	$ 6.70	5.6	$ 739,951
Options granted	41,000	7.90		
Options exercised	(19,950)	4.62		
Options cancelled	(7,619)	10.84		
Outstanding at June 30, 2014	462,406	$ 6.83	5.6	$ 1,327,395
Exercisable at June 30, 2014	360,575	$ 6.77	4.6	$ 1,092,251

Grants under the Company's incentive and nonqualified option plans generally vest over 3 years and must be exercised within 10 years of the date of grant. The exercise price of each option is the market price on the date of grant. As of June 30, 2014, 1,720,529 shares have been reserved for issuance upon the exercise of options, 462,406 option grants are outstanding, and 1,205,431 option grants have been exercised, forfeited or expired, leaving 52,692 shares available for grant.

The fair values of the options granted during the three and six months ended June 30, 2014 and 2013 were estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
Number of options granted	1,000	-	41,000	25,000
Weighted average exercise price	$ 7.94	$ -	$ 7.90	$ 6.02
Weighted average fair value of options	$ 2.69	$ -	$ 3.03	$ 2.91
Expected life in years (1)	5.40	-	5.40	5.11
Expected volatility (2)	38.76 %	- %	45.05 %	52.81 %
Risk-free interest rate (3)	1.61 %	- %	1.52 %	0.77 %
Dividend yield (4)	1.01 %	- %	1.02 %	- %

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

Upon exercise, the Company issues shares from its authorized but unissued common stock to satisfy the options. The following table presents information about options exercised during the three and six months ended June 30, 2014 and 2013:

	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
Number of options exercised	-	-	19,950	-
Total intrinsic value of options exercised	$ -	$ -	$ 67,417	$ -
Cash received from options exercised	-	-	62,445	-
Tax deduction realized from options exercised	-	-	26,926	-

The following table summarizes information about stock options outstanding and exercisable at June 30, 2014:

	Options outstanding			Options exercisable	
Range of exercise prices	Options outstanding	Weighted average remaining contractual life (in years)	Weighted average exercise price	Options exercisable	Weighted average exercise price
$ 0.00 - 4.00	107,000	4.9	$ 3.87	107,000	$ 3.87
4.01 - 7.00	167,000	7.2	6.14	118,669	6.14
7.01 - 10.00	139,882	5.4	7.96	86,382	8.03
10.01 - 13.00	48,524	2.3	12.46	48,524	12.46
Total	462,406	5.6	$ 6.83	360,575	$ 6.77

Financial Accounting Standards Board Accounting Standards Codification ("FASB ASC") Topic 718, “Compensation - Stock Compensation,” requires an entity to recognize the fair value of equity awards as compensation expense over the period during which an employee is required to provide service in exchange for such an award (vesting period). Compensation expense related to stock options and the related income tax benefit for the three and six months ended June 30, 2014 and 2013 are detailed in the following table:

	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
Compensation expense	$ 43,834	$ 39,625	$ 84,397	$ 74,645
Income tax benefit	17,507	15,826	33,708	29,813

As of June 30, 2014, unrecognized compensation costs related to nonvested share-based compensation arrangements granted under the Company’s stock option plans totaled approximately $233 thousand. That cost is expected to be recognized over a weighted average period of 2.2 years.

Restricted Stock Awards

Restricted stock is issued under the stock bonus program to reward employees and directors and to retain them by distributing stock over a period of time. The following table summarizes nonvested restricted stock activity for the six months ended June 30, 2014:

	Shares	Average grant date fair value
Nonvested restricted stock at December 31, 2013	95,625	$ 6.67
Granted	11,000	7.92
Vested	(8,125)	6.47
Forfeited	-	-
Nonvested restricted stock at June 30, 2014	98,500	$ 6.83

Restricted stock awards granted to date vest over a period of 4 years and are recognized as compensation to the recipient over the vesting period. The awards are recorded at fair market value at the time of grant and amortized into salary expense on a straight line basis over the vesting period. As of June 30, 2014, 471,551 shares of restricted stock were reserved for issuance, of which 221,838 shares are available for grant.

Restricted stock awards granted during the three and six months ended June 30, 2014 and 2013 were as follows:

	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
Number of shares granted	1,000	-	11,000	14,000
Average grant date fair value	$ 8.78	$ -	$ 7.92	$ 6.02

Compensation expense related to restricted stock for the three and six months ended June 30, 2014 and 2013 is detailed in the following table:

For the three months ended June 30,		For the six months ended June 30,	
2014	2013	2014	2013

Compensation expense	$ 62,380	$ 46,450	$ 121,650	$ 94,386
Income tax benefit	24,915	18,552	48,587	37,698

As of June 30, 2014, there was approximately $547 thousand of unrecognized compensation cost related to nonvested restricted stock awards granted under the Company's stock incentive plans. That cost is expected to be recognized over a weighted average period of 2.7 years.

Perpetual Preferred Stock

On October 3, 2008, Congress passed the Emergency Economic Stabilization Act of 2008 ("EESA"), which provided the U.S. Secretary of the Treasury with broad authority to implement certain actions to help restore stability and liquidity to the U.S. markets. One of the programs resulting from the EESA was the Treasury's Capital Purchase Program ("CPP") which provided direct equity investment of perpetual preferred stock by the U.S. Treasury in qualified financial institutions. The Company received an investment in perpetual preferred stock of $20.6 million on December 5, 2008.

On May 9, 2013, the Company announced that it received approval of its application from the U.S. Department of Treasury to redeem half of the 20,649 shares of preferred stock issued in connection with the Company's participation in the Treasury's CPP. On May 15, 2013, the Company paid $10.3 million to the Treasury to repurchase 10,324 shares of the preferred stock, including accrued and unpaid dividends for the shares. On July 1, 2013, the Company announced that it received approval to redeem the remaining 10,325 shares of preferred stock. On July 3, 2013, the Company paid $10.4 million to the Treasury to repurchase the remaining shares of the preferred stock, including accrued and unpaid dividends for the shares. On August 28, 2013, the Company completed the $2.7 million repurchase of the warrant to purchase 764,788 shares of the Company's common stock issued to the U.S. Department of the Treasury as part of the Company's participation in the Treasury's CPP.

Other-Than-Temporary Impairment

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

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

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

Transfers of Financial Assets

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

Loans

Loans Held for Sale

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

Servicing assets represent the estimated fair value of retained servicing rights, net of servicing costs, at the time loans are sold. Servicing assets are amortized in proportion to, and over the period of, estimated net servicing revenues. Impairment is evaluated based on stratifying the underlying financial assets by date of origination and term. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. Any impairment, if temporary, would be reported as a valuation allowance.

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

Loans Held to Maturity

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

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

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

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

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

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

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

Allowance for Loan Losses and Reserve for Unfunded Loan Commitments

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

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

Although management attempts to maintain the allowance at a level deemed adequate to provide for probable losses, future additions to the allowance may be necessary based upon certain factors including changes in market conditions and underlying collateral values. In addition, various regulatory agencies periodically review the adequacy of the Company’s allowance for loan losses. These agencies may require the Company to make additional provisions based on their judgments about information available to them at the time of their examination.

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

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

Income Taxes

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

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

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

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

NOTE 2. Litigation

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

NOTE 3. Net Income per Share

Basic net income per common share is calculated as net income available to common shareholders divided by the weighted average common shares outstanding during the reporting period. Net income available to common shareholders is calculated as net income less accrued dividends and discount accretion related to preferred stock.

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

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

	For the three months ended June 30,		For the six months ended June 30,	
(In thousands, except per share amounts)	2014	2013	2014	2013
Net income	$ 1,528	$ 1,347	$ 2,821	$ 2,546
Less: Preferred stock dividends and discount accretion	-	465	-	869
Income available to common shareholders	$ 1,528	$ 882	$ 2,821	$ 1,677
Weighted average common shares outstanding - Basic	7,605	7,544	7,596	7,541
Plus: Potential dilutive common stock equivalents	85	367	76	340
Weighted average common shares outstanding - Diluted	7,690	7,911	7,672	7,881
Net income per common share - Basic	$ 0.20	$ 0.12	$ 0.37	$ 0.22
Net income per common share - Diluted	0.20	0.11	0.37	0.21
Stock options and common stock excluded from the income per share calculation as their effect would have been anti-dilutive	126	396	114	387

The "potential dilutive common stock equivalents" shown in the table above for June 30, 2013 includes the impact of 764,778 common stock warrants issued to the U.S. Department of Treasury under the Capital Purchase Program in December 2008, utilizing the Treasury stock method. These warrants were repurchased on August 28, 2013 for a price of $2.7 million utilizing the Treasury Stock Method for the period outstanding.

NOTE 4. Income Taxes

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

For the quarter ended June 30, 2014, the Company reported income tax expense of $723 thousand for an effective tax rate of 32.1 percent, compared to an income tax expense of $739 thousand and effective tax rate of 35.4 percent for the prior year's quarter. For the six months ended June 30, 2014, the Company reported income tax expense of $1.4 million for an effective tax rate of 32.9 percent, compared to an income tax expense of $1.3 million and effective tax rate of 33.4 percent for the six months ended June 30, 2013. The Company did not recognize or accrue any interest or penalties related to income taxes during the three or six months ended June 30, 2014 or 2013. The Company did not have an accrual for uncertain tax positions as of June 30, 2014 or December 31, 2013, as deductions taken and benefits accrued are based on widely understood administrative practices and procedures and are based on clear and unambiguous tax law. Tax returns for all years 2009 and thereafter are subject to future examination by tax authorities.

NOTE 5. Other Comprehensive Income (Loss)

The following table shows the changes in other comprehensive income for the three months ended June 30, 2014 and 2013:

	For the three months ended June 30,					
	2014			2013		
(In thousands)	Pre-tax	Tax	After-tax	Pre-tax	Tax	After-tax
Balance, beginning of period			$ (166)			$ 953
Unrealized holding gains (losses) on securities arising during period	$ 553	$ 202	351	$ (1,090)	$ (436)	(654)
Less: Reclassification adjustment for gains on securities included in net income	268	90	178	108	36	72
Net unrealized gains (losses) on securities arising during the period	$ 285	$ 112	$ 173	$ (1,198)	$ (472)	$ (726)
Balance, end of period			$ 7			$ 227

The following table shows the changes in other comprehensive income for the six months ended June 30, 2014 and 2013:

	For the six months ended June 30,					
	2014			2013		
(In thousands)	Pre-tax	Tax	After-tax	Pre-tax	Tax	After-tax
Balance, beginning of period			$ (476)			$ 1,333
Unrealized holding gains (losses) on securities arising during the period	$ 1,171	$ 437	734	$ (1,499)	$ (615)	(884)
Less: Reclassification adjustment for gains on securities included in net income	378	127	251	334	112	222
Net unrealized gains (losses) on securities arising during the period	$ 793	$ 310	$ 483	$ (1,833)	$ (727)	$ (1,106)
Balance, end of period			$ 7			$ 227

14

NOTE 6. Fair Value

Fair Value Measurement

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

Level 1 Inputs

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

Level 2 Inputs

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

Level 3 Inputs

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

Fair Value on a Recurring Basis

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

Securities Available for Sale

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

As of June 30, 2014, the fair value of the Company's AFS securities portfolio was $68.7 million. Approximately 56 percent of the portfolio was made up of residential mortgage-backed securities, which had a fair value of $38.2 million at June 30, 2014. Approximately $37.0 million of the residential mortgage-backed securities are guaranteed by the Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA") or the Federal Home Loan Mortgage Corporation ("FHLMC"). The underlying loans for these securities are residential mortgages that are geographically dispersed throughout the United States.

All of the Company’s AFS securities were classified as Level 2 assets at June 30, 2014. The valuation of AFS securities using Level 2 inputs was primarily determined using the market approach, which uses quoted prices for similar assets or liabilities in active markets and all other relevant information. It includes model pricing, defined as valuing securities based upon their relationship with other benchmark securities.

At December 31, 2013, the Company’s AFS securities included commercial mortgage-backed securities which were classified as Level 3 assets. For commercial mortgage-backed securities, the inputs used by either dealer market participants or an independent pricing service, may be derived from unobservable market information (Level 3 inputs). In these instances, management evaluates the appropriateness and quality of the assumptions and the resulting prices. In addition, management reviews the volume and level of activity for all AFS securities and attempts to identify transactions which may not be orderly or reflective of a significant level of activity and volume. For securities meeting these criteria, the quoted prices received from either market participants or an independent pricing service may be adjusted, as necessary, to estimate fair value and this results in fair values based on Level 3 inputs. In determining fair value, the Company utilizes unobservable inputs which reflect its own assumptions about the inputs that market participants would use in pricing each security. In developing its assertion of market participant assumptions, the Company utilizes the best information that is both reasonable and available without undue cost and effort.

In calculating the fair value for AFS securities under Level 3, management prepared present value cash flow models for certain private label commercial mortgage-backed securities. Private label commercial mortgage-backed securities owned by the Bank are A1 and A2 tranche sequential structures and are currently paying principal. The cash flows for the commercial mortgage-backed securities incorporated the expected cash flow of each security adjusted for default rates, loss severities and prepayments of the individual loans collateralizing the security. The following table presents quantitative information about Level 3 inputs used to measure the fair value of commercial mortgage-backed securities at December 31, 2013:

December 31, 2013					
Valuation Technique	Unobservable Input	Range		Weighted Average	
Discounted Cash Flow	Prepayment rate	8 through 15	%	10.0	%
	Default rate	10 through 15	%	12.5	%
	Loss severity	10 through 25	%	18.0	%

Significant increases or decreases in any of the unobservable inputs in the table above in isolation would result in a significantly lower or higher fair value measurement of the securities. Generally, a change in the assumption used for the default rate is accompanied by a directionally similar change in the assumption used for the loss severity and a directionally opposite change in the assumption used for prepayment rates.

For the Level 3 available for sale private label commercial mortgage-backed securities, cash flow assumptions incorporate independent third party market participant data based on vintage year for each security. The discount rate utilized in determining the present value of cash flows for the commercial mortgage-backed securities was arrived at by combining the yield on orderly transactions for similar maturity government sponsored mortgage-backed securities with (i) the historical average risk premium of similar structured private label securities, (ii) a risk premium reflecting current market conditions, including liquidity risk and (iii) if applicable, a forecasted loss premium derived from the expected cash flows of each security. The estimated cash flows for each private label commercial mortgage-backed security are then discounted at the aforementioned effective rate to determine the fair value. The quoted prices received from either market participants or independent pricing services are weighted with the internal price estimate to determine the fair value of each instrument.

There were no changes in the inputs or methodologies used to determine fair value during the period ended June 30, 2014, as compared to the periods ended December 31, 2013 and June 30, 2013.

The tables below present the balances of assets and liabilities measured at fair value on a recurring basis as of June 30, 2014 and December 31, 2013:

	June 30, 2014			
(In thousands)	Level 1	Level 2	Level 3	Total
Securities available for sale:				
U.S. Government sponsored entities	$ -	$ 5,160	$ -	$ 5,160
State and political subdivisions	-	13,290	-	13,290
Residential mortgage-backed securities	-	38,197	-	38,197
Corporate and other securities	-	12,087	-	12,087
Total securities available for sale	$ -	$ 68,734	$ -	$ 68,734

	December 31, 2013			
(In thousands)	Level 1	Level 2	Level 3	Total
Securities available for sale:				
U.S. Government sponsored entities	$ -	$ 6,418	$ -	$ 6,418
State and political subdivisions	-	16,598	-	16,598
Residential mortgage-backed securities	-	44,389	-	44,389
Commercial mortgage-backed securities	-	-	888	888
Corporate and other securities	-	12,840	-	12,840
Total securities available for sale	$ -	$ 80,245	$ 888	$ 81,133

The following table summarizes changes in Level 3 assets during the three and six months ended June 30, 2014 and 2013, consisting of commercial mortgage-backed available for sale securities, measured at fair value on a recurring basis:

(In thousands)	For the three months ended June 30, 2014	2013	For the six ended June 30, 2014	2013
Commercial mortgage-backed securities:				
Balance, beginning of period	$ 499	$ 3,681	$ 888	$ 4,463
Payoffs	(342)	(32)	(714)	(566)
Principal paydowns	(153)	(2,041)	(173)	(2,256)
Total net losses included in:				
Other comprehensive income	(4)	(14)	(1)	(47)
Balance, end of period	$ -	$ 1,594	$ -	$ 1,594

There were no gains or losses (realized or unrealized) on Level 3 securities included in earnings for assets and liabilities held at June 30, 2014 or 2013.

Fair Value on a Nonrecurring Basis

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

Appraisal Policy

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

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

Other Real Estate Owned ("OREO")

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

Impaired Collateral-Dependent Loans

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

The valuation allowance for impaired loans is included in the allowance for loan losses in the consolidated balance sheets. At June 30, 2014 and December 31, 2013, the valuation allowance for impaired loans was $1.1 million.

The following tables present the assets and liabilities carried on the balance sheet by caption and by level within the hierarchy (as described above) as of June 30, 2014 and the fair value gains (losses) recognized during the three and six months ended June 30, 2014 and 2013:

(In thousands)	Fair value at June 30, 2014 Level 1	Level 2	Level 3	Total	Gains (losses) from fair value changes for the three months ended June 30, 2014	Gains (losses) from fair value changes for the six months ended June 30, 2014
Financial assets:						
OREO	$ -	$ -	$ 634	$ 634	$ (280)	$ (680)
Impaired collateral-dependent loans	-	-	1,771	1,771	(1)	-

(In thousands)	Fair value at June 30, 2013 Level 1	Level 2	Level 3	Total	Gains (losses) from fair value changes for the three months ended June 30, 2013	Gains (losses) from fair value changes for the six months ended June 30, 2013
Financial assets:						
OREO	$ -	$ -	$ 300	$ 300	$ -	$ (70)
Impaired collateral-dependent loans	-	-	5,970	5,970	(54)	268

Fair Value of Financial Instruments

FASB ASC Topic 825, "Financial Instruments," requires the disclosure of the estimated fair value of certain financial instruments, including those financial instruments for which the Company did not elect the fair value option. These estimated fair values as of June 30, 2014 and December 31, 2013 have been determined using available market information and appropriate valuation methodologies. Considerable judgment is required to interpret market data to develop estimates of fair value. The estimates presented are not necessarily indicative of amounts the Company could realize in a current market exchange. The use of alternative market assumptions and estimation methodologies could have had a material effect on these estimates of fair value. The methodology for estimating the fair value of financial assets and liabilities that are measured on a recurring or nonrecurring basis are discussed above. The following methods and assumptions were used to estimate the fair value of other financial instruments for which it is practicable to estimate that value:

Cash and Cash Equivalents

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

Securities Held to Maturity

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

SBA Loans Held for Sale

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

Loans

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

Federal Home Loan Bank Stock

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

SBA Servicing Assets

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

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Deposit Liabilities

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

Borrowed Funds and Subordinated Debentures

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

Standby Letters of Credit

At June 30, 2014, the Bank had standby letters of credit outstanding of $1.4 million, consistent with December 31, 2013. The fair value of these commitments is nominal.

The table below presents the carrying amount and estimated fair values of the Company’s financial instruments not previously presented as of June 30, 2014 and December 31, 2013:

		June 30, 2014		December 31, 2013	
(In thousands)	Fair value level	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
Financial assets:					
Cash and cash equivalents	Level 1	$ 95,338	$ 95,338	$ 99,404	$ 99,404
Securities held to maturity (1)	Level 2	21,736	21,591	26,381	25,549
SBA loans held for sale	Level 2	6,444	7,029	6,673	7,267
Loans, net of allowance for loan losses (2)	Level 2	689,587	678,871	658,887	645,582
Federal Home Loan Bank stock	Level 2	6,378	6,378	5,392	5,392
Servicing assets	Level 3	618	618	437	437
Accrued interest receivable	Level 2	3,283	3,283	3,272	3,272
Financial liabilities:					
Deposits	Level 2	728,083	728,507	738,698	738,337
Borrowed funds and subordinated debentures	Level 2	140,465	146,707	122,465	129,732
Accrued interest payable	Level 2	466	466	454	454

(1) Includes held to maturity commercial mortgage-backed securities that are considered Level 3. These securities had book values of $4.1 million and $6.8 million at June 30, 2014 and December 31, 2013, respectively, and market values of $3.8 million and $6.4 million at June 30, 2014 and December 31, 2013, respectively.

(2) Includes collateral-dependent impaired loans that are considered Level 3 and reported separately in the tables under the “Fair Value on a Nonrecurring Basis” heading. Collateral-dependent impaired loans, net of specific reserves totaled $1.8 million and $4.5 million at June 30, 2014 and December 31, 2013, respectively.

NOTE 7. Securities

This table provides the major components of securities available for sale ("AFS") and held to maturity ("HTM") at amortized cost and estimated fair value at June 30, 2014 and December 31, 2013:

	June 30, 2014				December 31, 2013			
(In thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
Available for sale:								
U.S. Government sponsored entities	$ 5,349	$ -	$ (189)	$ 5,160	$ 6,723	$ 27	$ (332)	$ 6,418
State and political subdivisions	13,301	184	(195)	13,290	16,960	192	(554)	16,598
Residential mortgage-backed securities	37,742	671	(216)	38,197	44,168	696	(475)	44,389
Commercial mortgage-backed securities	-	-	-	-	887	2	(1)	888
Corporate and other securities	12,327	44	(284)	12,087	13,173	67	(400)	12,840
Total securities available for sale	$ 68,719	$ 899	$ (884)	$ 68,734	$ 81,911	$ 984	$ (1,762)	$ 81,133
Held to maturity:								
U.S. Government sponsored entities	$ 4,626	$ -	$ (254)	$ 4,372	$ 5,814	$ -	$ (460)	$ 5,354
State and political subdivisions	2,437	244	-	2,681	2,441	121	(17)	2,545
Residential mortgage-backed securities	9,636	206	(84)	9,758	10,395	145	(198)	10,342
Commercial mortgage-backed securities	4,055	-	(230)	3,825	6,750	87	(437)	6,400
Corporate and other securities	982	-	(27)	955	981	-	(73)	908
Total securities held to maturity	$ 21,736	$ 450	$ (595)	$ 21,591	$ 26,381	$ 353	$ (1,185)	$ 25,549

This table provides the remaining contractual maturities and yields of securities within the investment portfolios. The carrying value of securities at June 30, 2014 is distributed by contractual maturity. Mortgage-backed securities and other securities, which may have principal prepayment provisions, are distributed based on contractual maturity. Expected maturities will differ materially from contractual maturities as a result of early prepayments and calls.

(In thousands, except percentages)	Within one year			After one through five years			After five through ten years			After ten years			Total carrying value		
	Amount	Yield		Amount	Yield		Amount	Yield		Amount	Yield		Amount	Yield	
Available for sale at fair value:															
U.S. Government sponsored entities	$ -	-	%	$ 1,013	1.00	%	$ 964	2.05	%	$ 3,183	2.03	%	$ 5,160	1.83	%
State and political subdivisions	-	-		1,132	2.69		8,255	2.66		3,903	2.70		13,290	2.68	
Residential mortgage-backed securities	-	-		2,123	1.61		2,652	1.91		33,422	2.85		38,197	2.71	
Corporate and other securities	-	-		2,413	0.99		3,580	2.08		6,094	1.44		12,087	1.54	
Total securities available for sale	$ -	-	%	$ 6,681	1.47	%	$ 15,451	2.36	%	$ 46,602	2.60	%	$ 68,734	2.44	%
Held to maturity at cost:															
U.S. Government sponsored entities	$ -	-	%	$ -	-	%	$ -	-	%	$ 4,626	1.97	%	$ 4,626	1.97	%
State and political subdivisions	326	0.75		-	-		-	-		2,111	4.71		2,437	4.18	
Residential mortgage-backed securities	-	-		612	4.90		210	5.22		8,814	4.61		9,636	4.64	
Commercial mortgage-backed securities	-	-		-	-		-	-		4,055	2.76		4,055	2.76	
Corporate and other securities	-	-		-	-		982	2.95		-	-		982	2.95	
Total securities held to maturity	$ 326	0.75	%	$ 612	4.90	%	$ 1,192	3.35	%	$ 19,606	3.61	%	$ 21,736	3.59	%

20

The fair value of securities with unrealized losses by length of time that the individual securities have been in a continuous unrealized loss position at June 30, 2014 and December 31, 2013 are as follows:

	June 30, 2014						
		Less than 12 months		12 months and greater		Total	
(In thousands, except number in a loss position)	Total number in a loss position	Estimated fair value	Unrealized loss	Estimated fair value	Unrealized loss	Estimated fair value	Unrealized loss
Available for sale:							
U.S. Government sponsored entities	5	$ -	$ -	$ 5,126	$ (189)	$ 5,126	$ (189)
State and political subdivisions	10	-	-	6,001	(195)	6,001	(195)
Residential mortgage-backed securities	13	9,644	(46)	7,569	(170)	17,213	(216)
Corporate and other securities	8	3,063	(60)	3,758	(224)	6,821	(284)
Total temporarily impaired securities	36	$ 12,707	$ (106)	$ 22,454	$ (778)	$ 35,161	$ (884)
Held to maturity:							
U.S. Government sponsored entities	2	$ -	$ -	$ 4,372	$ (254)	$ 4,372	$ (254)
Residential mortgage-backed securities	4	914	(16)	2,901	(68)	3,815	(84)
Commercial mortgage-backed securities	2	-	-	3,825	(230)	3,825	(230)
Corporate and other securities	1	-	-	955	(27)	955	(27)
Total temporarily impaired securities	9	$ 914	$ (16)	$ 12,053	$ (579)	$ 12,967	$ (595)

	December 31, 2013						
		Less than 12 months		12 months and greater		Total	
(In thousands, except number in a loss position)	Total number in a loss position	Estimated fair value	Unrealized loss	Estimated fair value	Unrealized loss	Estimated fair value	Unrealized loss
Available for sale:							
U.S. Government sponsored entities	5	$ 5,591	$ (332)	$ -	$ -	$ 5,591	$ (332)
State and political subdivisions	19	8,575	(453)	934	(101)	9,509	(554)
Residential mortgage-backed securities	13	13,226	(398)	1,474	(77)	14,700	(475)
Commercial mortgage-backed securities	3	368	(1)	-	-	368	(1)
Corporate and other securities	9	3,994	(105)	3,088	(295)	7,082	(400)
Total temporarily impaired securities	49	$ 31,754	$ (1,289)	$ 5,496	$ (473)	$ 37,250	$ (1,762)
Held to maturity:							
U.S. Government sponsored entities	3	$ 5,355	$ (460)	$ -	$ -	$ 5,355	$ (460)
State and political subdivisions	2	986	(17)	-	-	986	(17)

Residential mortgage-backed securities	7	6,333	(193)	114	(5)	6,447	(198)
Commercial mortgage-backed securities	2	3,668	(437)	-	-	3,668	(437)
Corporate and other securities	1	907	(73)	-	-	907	(73)
Total temporarily impaired securities	15	$ 17,249	$ (1,180)	$ 114	$ (5)	$ 17,363	$ (1,185)

Unrealized Losses

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

U.S. government sponsored entities and state and political subdivision securities: The unrealized losses on investments in these types of securities were caused by the increase in interest rate spreads or the increase in interest rates at the long end of the Treasury curve. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the par value of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be at maturity, the Company did not consider these investments to be other-than temporarily impaired as of June 30, 2014. There was no impairment on these securities at December 31, 2013.

Residential and commercial mortgage-backed securities: The unrealized losses on investments in mortgage-backed securities were caused by increases in interest rate spreads or the increase in interest rates at the long end of the Treasury curve. The majority of contractual cash flows of these securities are guaranteed by Fannie Mae, Ginnie Mae and the Federal Home Loan Mortgage Corporation. It is expected that the securities would not be settled at a price significantly less than the par value of the investment. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be at maturity, the Company did not consider these investments to be other-than-temporarily impaired as of June 30, 2014 or December 31, 2013.

Corporate and other securities: Included in this category are corporate debt securities, Community Reinvestment Act ("CRA") investments, asset-backed securities, and one trust preferred security. The unrealized losses on corporate debt securities were due to widening credit spreads or the increase in interest rates at the long end of the Treasury curve and the unrealized losses on CRA investments were caused by decreases in the market prices of the shares. The Company evaluated the prospects of the issuers and forecasted a recovery period; and as a result determined it did not consider these investments to be other-than-temporarily impaired as of June 30, 2014 or December 31, 2013. The unrealized loss on the trust preferred security was caused by an inactive trading market and changes in market credit spreads. At June 30, 2014 and December 31, 2013, this category consisted of one single-issuer trust preferred security. The contractual terms do not allow the security to be settled at a price less than the par value. Because the Company does not intend to sell the security and it is not more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis, which may be at maturity, the Company did not consider this security to be other-than-temporarily impaired as of June 30, 2014 or December 31, 2013.

Realized Gains and Losses

Gross realized gains (losses) on securities for the three and six months ended June 30, 2014 and 2013 are detailed in the table below:

	For the three months ended June 30,		For the six months ended June 30,	
(In thousands)	2014	2013	2014	2013
Available for sale:				
Realized gains	$ 271	$ 108	$ 385	$ 338
Realized losses	(3)	-	(7)	(4)
Total securities available for sale	268	108	378	334
Held to maturity:				
Realized gains	-	-	-	-
Realized losses	-	-	-	-
Total securities held to maturity	-	-	-	-
Net gains on sales of securities	$ 268	$ 108	$ 378	$ 334

The net realized gains are included in noninterest income in the Consolidated Statements of Income as net security gains. For the three and six months ended June 30, 2014, there were gross realized gains of $271 thousand and $385 thousand, respectively. For the three and six months ended June 30, 2014, there were gross realized losses of $3 thousand and $7 thousand, respectively The net realized gains during 2014 were a result of the following:

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

For the three and six months ended June 30, 2013, there were gross realized gains of $108 thousand and $338 thousand, respectively. There were no realized losses during the second quarter of 2013 and gross realized losses of $4 thousand in the first quarter. The net realized gains during 2013 were a result of the following:

· For the six months ended June 30, 2013, the Company sold approximately $9.1 million in book value of available for sale asset-backed securities and corporate bonds, resulting in pre-tax gains of approximately $338 thousand.

Pledged Securities

Securities with a carrying value of $61.9 million and $74.5 million at June 30, 2014 and December 31, 2013, respectively, were pledged to secure Government deposits, secure other borrowings and for other purposes required or permitted by law. Included in these figures was $18.5 million and $19.9 million pledged against municipal deposits at June 30, 2014 and December 31, 2013, respectively.

Note 8. Loans

The following table sets forth the classification of loans by class, including unearned fees, deferred costs and excluding the allowance for loan losses as of June 30, 2014 and December 31, 2013:

(In thousands)	June 30, 2014	December 31, 2013
SBA loans held for investment	$ 46,890	$ 48,918
SBA 504 loans	34,452	31,564
Commercial loans		
Commercial other	37,536	37,611
Commercial real estate	326,231	317,471
Commercial real estate construction	12,209	8,258
Residential mortgage loans	196,184	182,067
Consumer loans		
Home equity	47,784	43,704
Consumer other	1,159	2,435
Total loans held for investment	$ 702,445	$ 672,028
SBA loans held for sale	6,444	6,673
Total loans	$ 708,889	$ 678,701

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

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

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

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

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

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

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

Credit Ratings

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

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

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

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

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

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

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

The tables below detail the Company’s loan portfolio by class according to their credit quality indicators discussed in the paragraphs above as of June 30, 2014:

	June 30, 2014			
	SBA, SBA 504 & Commercial loans - Internal risk ratings			
(In thousands)	Pass	Special mention	Substandard	Total
SBA loans held for investment	$ 41,732	$ 1,438	$ 3,720	$ 46,890
SBA 504 loans	24,394	9,418	640	34,452
Commercial loans				
Commercial other	35,032	1,371	1,133	37,536
Commercial real estate	300,827	20,969	4,435	326,231
Commercial real estate construction	11,891	318	-	12,209
Total commercial loans	347,750	22,658	5,568	375,976
Total SBA, SBA 504 and commercial loans	$ 413,876	$ 33,514	$ 9,928	$ 457,318

	Residential mortgage & Consumer loans - Performing/Nonperforming		
(In thousands)	Performing	Nonperforming	Total
Residential mortgage loans	$ 192,050	$ 4,134	$ 196,184
Consumer loans			
Home equity	46,860	924	47,784
Consumer other	1,159	-	1,159
Total consumer loans	48,019	924	48,943
Total residential mortgage and consumer loans	$ 240,069	$ 5,058	$ 245,127

The tables below detail the Company’s loan portfolio by class according to their credit quality indicators discussed in the paragraphs above as of December 31, 2013:

	December 31, 2013			
	SBA, SBA 504 & Commercial loans - Internal risk ratings			
(In thousands)	Pass	Special mention	Substandard	Total
SBA loans held for investment	$ 43,778	$ 2,035	$ 3,105	$ 48,918
SBA 504 loans	20,641	9,595	1,328	31,564
Commercial loans				

Commercial other	34,946	1,499	1,166	37,611
Commercial real estate	289,220	21,137	7,114	317,471
Commercial real estate construction	8,081	-	177	8,258
Total commercial loans	332,247	22,636	8,457	363,340
Total SBA, SBA 504 and commercial loans	$ 396,666	$ 34,266	$ 12,890	$ 443,822

	Residential mortgage & Consumer loans - Performing/Nonperforming		
(In thousands)	Performing	Nonperforming	Total
Residential mortgage loans	$ 176,340	$ 5,727	$ 182,067
Consumer loans			
Home equity	42,029	1,675	43,704
Consumer other	2,430	5	2,435
Total consumer loans	44,459	1,680	46,139
Total residential mortgage and consumer loans	$ 220,799	$ 7,407	$ 228,206

Nonperforming and Past Due Loans

Nonperforming loans consist of loans that are not accruing interest (nonaccrual loans) as a result of principal or interest being in default for a period of 90 days or more or when the ability to collect principal and interest according to the contractual terms is in doubt. Loans past due 90 days or more and still accruing interest are not included in nonperforming loans and generally represent loans that are well collateralized and in a continuing process expected to result in repayment or restoration to current status. The risk of loss is difficult to quantify and is subject to fluctuations in collateral values, general economic conditions and other factors. The current state of the economy and the downturn in the real estate market has resulted in increased loan delinquencies and defaults. In some cases, these factors have also resulted in significant impairment to the value of loan collateral. The Company values its collateral through the use of appraisals, broker price opinions, and knowledge of its local market. In response to the credit risk in its portfolio, the Company has increased staffing in its credit monitoring department and increased efforts in the collection and analysis of borrowers' financial statements and tax returns.

The following tables set forth an aging analysis of past due and nonaccrual loans as of June 30, 2014 and December 31, 2013:

	June 30, 2014						
(In thousands)	30-59 days past due	60-89 days past due	90+ days and still accruing	Nonaccrual (1)	Total past due	Current	Total loans
SBA loans held for investment	$ 15	$ 185	$ -	$ 5,113	$ 5,313	$ 41,577	$ 46,890
SBA 504 loans	-	-	-	433	433	34,019	34,452
Commercial loans							
Commercial other	70	-	-	73	143	37,393	37,536
Commercial real estate	907	425	-	1,252	2,584	323,647	326,231
Commercial real estate construction	-	-	-	-	-	12,209	12,209
Residential mortgage loans	2,341	386	-	4,134	6,861	189,323	196,184
Consumer loans							
Home equity	201	16	-	924	1,141	46,643	47,784
Consumer other	7	-	-	-	7	1,152	1,159
Total loans held for investment	$ 3,541	$ 1,012	$ -	$ 11,929	$ 16,482	$ 685,963	$ 702,445
SBA loans held for sale	-	58	-	-	58	6,386	6,444
Total loans	$ 3,541	$ 1,070	$ -	$ 11,929	$ 16,540	$ 692,349	$ 708,889

(1)

At June 30, 2014, nonaccrual loans included $741 thousand of troubled debt restructurings ("TDRs") and $2.3 million of loans guaranteed by the SBA. The remaining $7.0 million of TDRs are in accrual status because they are performing in accordance with their restructured terms.

	December 31, 2013						
(In thousands)	30-59 days past due	60-89 days past due	90+ days and still accruing	Nonaccrual (1)	Total past due	Current	Total loans
SBA loans held for investment	$ 4,314	$ 264	$ -	$ 2,746	$ 7,324	$ 41,594	$ 48,918
SBA 504 loans	-	-	-	1,101	1,101	30,463	31,564
Commercial loans							
Commercial other	123	-	-	67	190	37,421	37,611
Commercial real estate	347	190	14	3,785	4,336	313,135	317,471
Commercial real estate construction	-	-	-	177	177	8,081	8,258
Residential mortgage loans	3,050	-	5	5,727	8,782	173,285	182,067
Consumer loans							
Home equity	142	69	-	1,675	1,886	41,818	43,704
Consumer other	9	1	-	5	15	2,420	2,435
Total loans held for investment	$ 7,985	$ 524	$ 19	$ 15,283	$ 23,811	$ 648,217	$ 672,028
SBA loans held for sale	65	-	-	-	65	6,608	6,673
Total loans	$ 8,050	$ 524	$ 19	$ 15,283	$ 23,876	$ 654,825	$ 678,701

(1) At December 31, 2013, nonaccrual loans included $467 thousand of TDRs and $540 thousand of loans guaranteed by the SBA. The remaining $7.5 million of TDRs are in accrual status because they are performing in accordance with their restructured terms.

26

Impaired Loans

The Company has defined impaired loans to be all nonperforming loans individually evaluated for impairment and troubled debt restructurings. Management considers a loan impaired when, based on current information and events, it is determined that the Company will not be able to collect all amounts due according to the loan contract. Impairment is evaluated on an individual basis for SBA, SBA 504, and commercial loans.

The following table provides detail on the Company's impaired loans that are individually evaluated for impairment with the associated allowance amount, if applicable, as of June 30, 2014:

	June 30, 2014		
(In thousands)	Unpaid principal balance	Recorded investment	Specific reserves
With no related allowance:			
SBA loans held for investment (1)	$ 1,158	$ 1,017	$ -
SBA 504 loans	2,232	2,232	-
Commercial loans			
Commercial other	55	56	-
Commercial real estate	5,406	5,317	-
Total commercial loans	5,461	5,373	-
Total impaired loans with no related allowance	8,851	8,622	-
With an allowance:			
SBA loans held for investment (1)	2,428	2,251	1,049
Commercial loans			
Commercial other	30	17	17
Commercial real estate	691	641	72
Total commercial loans	721	658	89
Total impaired loans with a related allowance	3,149	2,909	1,138
Total individually evaluated impaired loans:			
SBA loans held for investment (1)	3,586	3,268	1,049
SBA 504 loans	2,232	2,232	-
Commercial loans			
Commercial other	85	73	17
Commercial real estate	6,097	5,958	72
Total commercial loans	6,182	6,031	89
Total individually evaluated impaired loans	$ 12,000	$ 11,531	$ 1,138

(1) Balances are reduced by amount guaranteed by the SBA of $2.3 million at June 30, 2014.

The following table provides detail on the Company's impaired loans that are individually evaluated for impairment with the associated allowance amount, if applicable, as of December 31, 2013:

	December 31, 2013		
(In thousands)	Unpaid principal balance	Recorded investment	Specific reserves
With no related allowance:			
SBA loans held for investment (1)	$ 1,123	$ 835	$ -
SBA 504 loans	2,251	2,251	-
Commercial loans			
Commercial other	56	55	-
Commercial real estate	6,116	5,969	-
Total commercial loans	6,172	6,024	-
Total impaired loans with no related allowance	9,546	9,110	-
With an allowance:			
SBA loans held for investment (1)	2,282	1,905	831
SBA 504 loans	1,277	677	29
Commercial loans			
Commercial other	24	12	12
Commercial real estate	3,557	2,907	230
Commercial real estate construction	202	177	36
Total commercial loans	3,783	3,096	278
Total impaired loans with a related allowance	7,342	5,678	1,138
Total individually evaluated impaired loans:			
SBA loans held for investment (1)	3,405	2,740	831
SBA 504 loans	3,528	2,928	29
Commercial loans			
Commercial other	80	67	12
Commercial real estate	9,673	8,876	230
Commercial real estate construction	202	177	36
Total commercial loans	9,955	9,120	278
Total individually evaluated impaired loans	$ 16,888	$ 14,788	$ 1,138

(1) Balances are reduced by amount guaranteed by the SBA of $540 thousand at December 31, 2013.

The following tables present the average recorded investments in impaired loans and the related amount of interest recognized during the time period in which the loans were impaired for the three and six months ended June 30, 2014 and 2013. The average balances are calculated based on the month-end balances of impaired loans. When the ultimate collectability of the total principal of an impaired loan is in doubt and the loan is on nonaccrual status, all payments are applied to principal under the cost recovery method, therefore no interest income is recognized. The interest income recognized on impaired loans noted below represents primarily accruing troubled debt restructurings and nominal amounts of income recognized on a cash basis for well-collateralized impaired loans.

	For the three months ended June 30,			
	2014		2013	
(In thousands)	Average recorded investment	Interest income recognized on impaired loans	Average recorded investment	Interest income recognized on impaired loans
SBA loans held for investment (1)	$ 3,167	$ 21	$ 3,421	$ 85
SBA 504 loans	2,238	27	5,372	55
Commercial loans				
Commercial other	75	1	2,049	24
Commercial real estate	6,256	54	10,418	86
Commercial real estate construction	115	-	194	-
Total	$ 11,851	$ 103	$ 21,454	$ 250

(1) Balances are reduced by the average amount guaranteed by the Small Business Administration of $2.0 million and $921 thousand for the three months ended June 30, 2014 and 2013, respectively.

	For the six months ended June 30,			
	2014		2013	
(In thousands)	Average recorded investment	Interest income recognized on impaired loans	Average recorded investment	Interest income recognized on impaired loans
SBA loans held for investment (1)	$ 3,108	$ 56	$ 3,482	$ 141
SBA 504 loans	2,468	55	6,428	139
Commercial loans				
Commercial other	71	2	2,045	85
Commercial real estate	7,143	123	10,722	139
Commercial real estate construction	146	-	164	-

Total	$ 12,936	$ 236	$ 22,841	$ 504

(1) Balances are reduced by the average amount guaranteed by the Small Business Administration of $2.3 million and $1.3 million for the six months ended June 30, 2014 and 2013, respectively.

29

Troubled Debt Restructurings

The Company's loan portfolio also includes certain loans that have been modified in a troubled debt restructuring ("TDR"). TDRs occur when a creditor, for economic or legal reasons related to a debtor's financial condition, grants a concession to the debtor that it would not otherwise consider, unless it results in a delay in payment that is insignificant. These concessions typically include reductions in interest rate, extending the maturity of a loan, or a combination of both. When the Company modifies a loan, management evaluates for any possible impairment using either the discounted cash flows method, where the value of the modified loan is based on the present value of expected cash flows, discounted at the contractual interest rate of the original loan agreement, or by using the fair value of the collateral less selling costs if the loan is collateral-dependent. If management determines that the value of the modified loan is less than the recorded investment in the loan, impairment is recognized by segment or class of loan, as applicable, through an allowance estimate or charge-off to the allowance. This process is used, regardless of loan type, and for loans modified as TDRs that subsequently default on their modified terms.

TDRs of $7.7 million and $7.9 million are included in the impaired loan numbers as of June 30, 2014 and December 31, 2013, respectively. Specific reserves for these TDRs were $291 thousand and $363 thousand as of June, 2014 and December 31, 2013, respectively. At June 30, 2014, $741 thousand of TDRs were in nonaccrual status, compared to $467 thousand at December 31, 2013. The remaining TDRs are in accrual status since they continue to perform in accordance with their restructured terms.

There were no loans modified during the three or six months ended June 30, 2014 that were deemed to be TDRs. There were no loans modified during the three months ended June 30, 2013 that were deemed to be TDRs. There was one such loan modified in the quarter ended March 31, 2013.

The following table details loans modified during the six months ended June 30, 2014 and 2013, including the number of modifications and the recorded investment at the time of the modification.

	For the six months ended June 30,					
	2014			2013		
(In thousands, except number of contracts)	Number of contracts	Recorded investment at time of modification	Impact of interest rate change on income	Number of contracts	Recorded investment at time of modification	Impact of interest rate change on income

Commercial real estate	$	-	$	-		-	$	1	$	2,684		17
Total	$	-	$	-	$	-	$	1	$	2,684	$	17

There was one loan modified as a TDR within the previous 12 months where a concession was made and the loan subsequently defaulted at some point during the three months ended June 30, 2014. In this case, subsequent default is defined as being transferred to nonaccrual status. There were no additional defaults during the current year to date period. In addition, there were no qualifying subsequent defaults to TDRs for the three and six months ended June 30, 2013. These defaults are detailed in the following table:

	For the three months ended June 30,					
	2014			2013		
(In thousands, except number of contracts)	Number of contracts	Recorded investment		Number of contracts	Recorded investment	
SBA loans held for investment	1	$	131	-	$	-
Total	1	$	131	-	$	-

To date, the Company's TDRs consisted of interest rate reductions and maturity extensions. There has been no principal forgiveness. There were no TDR modifications done during the six months ended June 30, 2014. The following table shows the types of modifications done during the six months ended June 30, 2013, with the respective loan balances as of the period ending:

(In thousands)	For the six months ended June 30, 2013 Commercial real estate	Total
Type of modification:		
Interest only with reduced interest rate	$ 2,684	$ 2,684
Total TDRs	$ 2,684	$ 2,684

Note 9. Allowance for Loan Losses and Reserve for Unfunded Loan Commitments

Allowance for Loan Losses

The Company has an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. At a minimum, the adequacy of the allowance for loan losses is reviewed by management on a quarterly basis. For purposes of determining the allowance for loan losses, the Company has segmented the loans in its portfolio by loan type. Loans are segmented into the following pools: SBA 7(a), SBA 504, commercial, residential mortgages, and consumer loans. Certain portfolio segments are further broken down into classes based on the associated risks within those segments and the type of collateral underlying each loan. Commercial loans are divided into the following three classes: commercial real estate, commercial real estate construction and commercial other. Consumer loans are divided into two classes as follows: Home equity and other.

The standardized methodology used to assess the adequacy of the allowance includes the allocation of specific and general reserves. The same standard methodology is used, regardless of loan type. Specific reserves are made to individual impaired loans and troubled debt restructurings (see Note 1 for additional information on this term). The general reserve is set based upon a representative average historical net charge-off rate adjusted for the following environmental factors: delinquency and impairment trends, charge-off and recovery trends, changes in the volume of restructured loans, volume and loan term trends, changes in risk and underwriting policy trends, staffing and experience changes, national and local economic trends, industry conditions and credit concentration changes. Within the five-year historical net charge-off rate, the Company weights the past three years more heavily as it believes it is more indicative of future charge-offs. All of the environmental factors are ranked and assigned a basis points value based on the following scale: low, low moderate, moderate, high moderate and high risk. Each environmental factor is evaluated separately for each class of loans and risk weighted based on its individual characteristics.

- For SBA 7(a), SBA 504 and commercial loans, the estimate of loss based on pools of loans with similar characteristics is made through the use of a standardized loan grading system that is applied on an individual loan level and updated on a continuous basis. The loan grading system incorporates reviews of the financial performance of the borrower, including cash flow, debt-service coverage ratio, earnings power, debt level and equity position, in conjunction with an assessment of the borrower's industry and future prospects. It also incorporates analysis of the type of collateral and the relative loan to value ratio.
- For residential mortgage and consumer loans, the estimate of loss is based on pools of loans with similar characteristics. Factors such as credit score, delinquency status and type of collateral are evaluated. Factors are updated frequently to capture the recent behavioral characteristics of the subject portfolios, as well as any changes in loss mitigation or credit origination strategies, and adjustments to the reserve factors are made as needed.

According to the Company’s policy, a loss (“charge-off”) is to be recognized and charged to the allowance for loan losses as soon as a loan is recognized as uncollectable. All credits which are 90 days past due must be analyzed for the Company’s ability to collect on the credit. Once a loss is known to exist, the charge-off approval process is immediately expedited. This charge-off policy is followed for all loan types.

The allocated allowance is the total of identified specific and general reserves by loan category. The allocation is not necessarily indicative of the categories in which future losses may occur. The total allowance is available to absorb losses from any segment of the portfolio. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in methodologies for estimating allocated and general reserves in the portfolio. The unallocated portion of the allowance increased for the six months ended June 30, 2014 due to changes in environmental factors such as charge-off and recovery trends and improvements in industry conditions partially offset by growth in the loan portfolio and credits transferred into nonaccrual status needing a specific reserve.

The following tables detail the activity in the allowance for loan losses by porfolio segment for the three months ended June 30, 2014 and 2013:

	For the three months ended June 30, 2014						
(In thousands)	SBA held for investment	SBA 504	Commercial	Residential	Consumer	Unallocated	Total
Balance, beginning of period	$ 2,346	$ 947	$ 6,402	$ 2,062	$ 705	$ 345	$ 12,807
Charge-offs	(199)	-	(134)	(5)	(203)	-	(541)
Recoveries	10	-	31	-	1	-	42
Net charge-offs	(189)	-	(103)	(5)	(202)	-	(499)
Provision for loan losses charged to expense	348	(18)	(17)	114	238	(115)	550
Balance, end of period	$ 2,505	$ 929	$ 6,282	$ 2,171	$ 741	$ 230	$ 12,858

	For the three months ended June 30, 2013						
(In thousands)	SBA held for investment	SBA 504	Commercial	Residential	Consumer	Unallocated	Total
Balance, beginning of period	$ 3,408	$ 1,296	$ 6,879	$ 1,877	$ 556	$ 329	$ 14,345
Charge-offs	(167)	(200)	(200)	-	-	-	(567)
Recoveries	8	154	65	2	2	-	231
Net charge-offs	(159)	(46)	(135)	2	2	-	(336)
Provision for loan losses charged to expense	(114)	238	62	75	(69)	108	300
Balance, end of period	$ 3,135	$ 1,488	$ 6,806	$ 1,954	$ 489	$ 437	$ 14,309

The following tables detail the activity in the allowance for loan losses by porfolio segment for the six months ended June 30, 2014 and 2013:

	For the six months ended June 30, 2014						
(In thousands)	SBA held for investment	SBA 504	Commercial	Residential	Consumer	Unallocated	Total
Balance, beginning of period	$ 2,587	$ 957	$ 6,840	$ 2,132	$ 573	$ 52	$ 13,141
Charge-offs	(253)	(92)	(588)	(177)	(382)	-	(1,492)
Recoveries	18	-	40	-	1	-	59
Net charge-offs	(235)	(92)	(548)	(177)	(381)	-	(1,433)
Provision for loan losses charged to expense	153	64	(10)	216	549	178	1,150

Balance, end of period	$ 2,505	$ 929	$ 6,282	$ 2,171	$ 741	$ 230	$ 12,858

	For the six months ended June 30, 2013						
(In thousands)	SBA held for investment	SBA 504	Commercial	Residential	Consumer	Unallocated	Total
Balance, beginning of period	$ 3,378	$ 1,312	$ 7,091	$ 1,769	$ 524	$ 684	$ 14,758
Charge-offs	(737)	(400)	(575)	(125)	(59)	-	(1,896)
Recoveries	145	179	166	4	3	-	497
Net charge-offs	(592)	(221)	(409)	(121)	(56)	-	(1,399)
Provision for loan losses charged to expense	349	397	124	306	21	(247)	950
Balance, end of period	$ 3,135	$ 1,488	$ 6,806	$ 1,954	$ 489	$ 437	$ 14,309

32

The following tables present loans and their related allowance for loan losses, by portfolio segment, as of June 30, 2014 and December 31, 2013:

(In thousands)	June 30, 2014 SBA held for investment	SBA 504	Commercial	Residential	Consumer	Unallocated	Total
Allowance for loan losses ending balance:							
Individually evaluated for impairment	$ 1,049	$ -	$ 89	$ -	$ -	$ -	$ 1,138
Collectively evaluated for impairment	1,456	929	6,193	2,171	741	230	11,720
Total	$ 2,505	$ 929	$ 6,282	$ 2,171	$ 741	$ 230	$ 12,858
Loan ending balances:							
Individually evaluated for impairment	$ 3,268	$ 2,232	$ 6,031	$ -	$ -	$ -	$ 11,531
Collectively evaluated for impairment	43,622	32,220	369,945	196,184	48,943	-	690,914
Total	$ 46,890	$ 34,452	$ 375,976	$ 196,184	$ 48,943	$ -	$ 702,445