

UNITY BANCORP INC /NJ/
Form 10-Q
August 10, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED June 30, 2012

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
(State or Other Jurisdiction of Incorporation or Organization)

22-3282551
(I.R.S. Employer Identification No.)

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64 Old Highway 22, Clinton, NJ
(Address of Principal Executive Offices)

08809
(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, or a nonaccelerated filer (as defined in Exchange Act Rule 12b-2):

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 August 1, 2012
common stock, no par value: 7,460,572 shares outstanding

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PART I CONSOLIDATED FINANCIAL INFORMATION

ITEM 1 Consolidated Financial Statements (Unaudited)

Unity Bancorp, Inc.

Consolidated Balance Sheets

(Unaudited)

| (In thousands) | June 30, 2012 | December 31, 2011 | June 30, 2011 |
|---|------------------|----------------------|------------------|
| ASSETS | | | |
| Cash and due from banks | \$ 18,600 | \$ 17,688 | \$ 12,915 |
| Federal funds sold and interest-bearing deposits | 19,235 | 64,886 | 33,367 |
| Cash and cash equivalents | 37,835 | 82,574 | 46,282 |
| Securities: | | | |
| Securities available for sale | 97,965 | 88,765 | 101,872 |
| Securities held to maturity (fair value of \$18,301, \$19,879 and \$13,855, respectively) | 16,881 | 18,771 | 13,316 |
| Total securities | 114,846 | 107,536 | 115,188 |
| Loans: | | | |
| SBA loans held for sale | 6,087 | 7,668 | 13,753 |
| SBA loans held to maturity | 60,382 | 64,175 | 71,429 |
| SBA 504 loans | 45,247 | 55,108 | 55,810 |
| Commercial loans | 310,331 | 283,104 | 287,785 |
| Residential mortgage loans | 136,514 | 134,090 | 134,782 |
| Consumer loans | 46,340 | 48,447 | 51,546 |
| Total loans | 604,901 | 592,592 | 615,105 |
| Allowance for loan losses | (16,284) | (16,348) | (16,018) |
| Net loans | 588,617 | 576,244 | 599,087 |
| Premises and equipment, net | 12,146 | 11,350 | 10,650 |
| Bank owned life insurance ("BOLI") | 9,253 | 9,107 | 8,959 |
| Deferred tax assets | 6,977 | 6,878 | 6,756 |
| Federal Home Loan Bank stock | 3,989 | 4,088 | 4,088 |
| Accrued interest receivable | 3,415 | 3,703 | 3,692 |
| Other real estate owned ("OREO") | 2,355 | 3,032 | 2,722 |
| Prepaid FDIC Insurance | 2,230 | 2,545 | 2,720 |
| Goodwill and other intangibles | 1,522 | 1,530 | 1,537 |
| Other assets | 1,926 | 2,259 | 4,482 |
| Total assets | \$ 785,111 | \$ 810,846 | \$ 806,163 |

LIABILITIES AND SHAREHOLDERS' EQUITY

Liabilities:

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| | | | |
|--|------------|------------|------------|
| Deposits: | | | |
| Noninterest-bearing demand deposits | \$ 107,497 | \$ 101,193 | \$ 94,547 |
| Interest-bearing demand deposits | 101,420 | 104,749 | 93,730 |
| Savings deposits | 273,395 | 278,603 | 285,651 |
| Time deposits, under \$100,000 | 83,138 | 102,809 | 106,880 |
| Time deposits, \$100,000 and over | 50,993 | 56,617 | 60,359 |
| Total deposits | 616,443 | 643,971 | 641,167 |
| | | | |
| Borrowed funds | 75,000 | 75,000 | 75,000 |
| Subordinated debentures | 15,465 | 15,465 | 15,465 |
| Accrued interest payable | 470 | 523 | 570 |
| Accrued expenses and other liabilities | 2,832 | 2,329 | 1,754 |
| Total liabilities | 710,210 | 737,288 | 733,956 |
| Commitments and contingencies | - | - | - |
| Shareholders' equity: | | | |
| Cumulative perpetual preferred stock | 19,824 | 19,545 | 19,278 |
| Common stock | 53,917 | 53,746 | 53,590 |
| Retained earnings (deficit) | 231 | (854) | (1,757) |
| Accumulated other comprehensive income | 929 | 1,121 | 1,096 |
| Total shareholders' equity | 74,901 | 73,558 | 72,207 |
| | | | |
| Total liabilities and shareholders' equity | \$ 785,111 | \$ 810,846 | \$ 806,163 |
| | | | |
| Preferred shares | 21 | 21 | 21 |
| Issued common shares | 7,461 | 7,459 | 7,412 |
| Outstanding common shares | 7,461 | 7,459 | 7,412 |

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, | | For the six months ended June 30, | |
|---|---|--------|--------------------------------------|--------|
| | 2012 | 2011 | 2012 | 2011 |
| INTEREST INCOME | | | | |
| Federal funds sold and interest-bearing deposits | \$ 11 | \$ 9 | \$ 43 | \$ 20 |
| Federal Home Loan Bank stock | 44 | 35 | 95 | 101 |
| Securities: | | | | |
| Available for sale | 690 | 891 | 1,410 | 1,754 |
| Held to maturity | 163 | 180 | 336 | 468 |
| Total securities | 853 | 1,071 | 1,746 | 2,222 |
| Loans: | | | | |
| SBA loans | 846 | 1,191 | 1,770 | 2,427 |
| SBA 504 loans | 691 | 834 | 1,451 | 1,789 |
| Commercial loans | 4,216 | 4,581 | 8,397 | 8,887 |
| Residential mortgage loans | 1,582 | 1,846 | 3,237 | 3,677 |
| Consumer loans | 529 | 629 | 1,089 | 1,315 |
| Total loans | 7,864 | 9,081 | 15,944 | 18,095 |
| Total interest income | 8,772 | 10,196 | 17,828 | 20,438 |
| INTEREST EXPENSE | | | | |
| Interest-bearing demand deposits | 123 | 143 | 259 | 283 |
| Savings deposits | 287 | 584 | 641 | 1,165 |
| Time deposits | 689 | 1,045 | 1,603 | 2,140 |
| Borrowed funds and subordinated debentures | 816 | 953 | 1,662 | 1,904 |
| Total interest expense | 1,915 | 2,725 | 4,165 | 5,492 |
| Net interest income | 6,857 | 7,471 | 13,663 | 14,946 |
| Provision for loan losses | 1,000 | 1,750 | 2,200 | 4,250 |
| Net interest income after provision for loan losses | 5,857 | 5,721 | 11,463 | 10,696 |
| NONINTEREST INCOME | | | | |
| Branch fee income | 362 | 337 | 748 | 680 |
| Service and loan fee income | 287 | 384 | 588 | 627 |
| Gain on sale of SBA loans held for sale, net | 223 | 399 | 381 | 510 |
| Gain on sale of mortgage loans, net | 453 | 87 | 864 | 256 |
| BOLI income | 73 | 74 | 146 | 147 |
| Net security gains (losses) | 283 | (39) | 507 | 87 |
| Other income | 160 | 205 | 322 | 395 |
| Total noninterest income | 1,841 | 1,447 | 3,556 | 2,702 |
| NONINTEREST EXPENSE | | | | |
| Compensation and benefits | 3,133 | 2,880 | 6,315 | 5,937 |
| Occupancy | 740 | 827 | 1,348 | 1,546 |
| Processing and communications | 553 | 537 | 1,087 | 1,044 |
| Furniture and equipment | 355 | 410 | 717 | 794 |

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| | | | | |
|--|---------|---------|----------|---------|
| Professional services | 211 | 192 | 402 | 394 |
| Loan collection costs | 91 | 201 | 271 | 425 |
| OREO expenses | 237 | 223 | 362 | 445 |
| Deposit insurance | 168 | 282 | 339 | 601 |
| Advertising | 302 | 205 | 448 | 323 |
| Other expenses | 414 | 490 | 872 | 897 |
| Total noninterest expense | 6,204 | 6,247 | 12,161 | 12,406 |
| Income before provision for income taxes | 1,494 | 921 | 2,858 | 992 |
| Provision for income taxes | 518 | 277 | 977 | 129 |
| Net income | 976 | 644 | 1,881 | 863 |
| Preferred stock dividends and discount accretion | 401 | 395 | 797 | 778 |
| Income available to common shareholders | \$ 575 | \$ 249 | \$ 1,084 | \$ 85 |
| Net income per common share - Basic | \$ 0.08 | \$ 0.03 | \$ 0.15 | \$ 0.01 |
| Net income per common share - Diluted | \$ 0.07 | \$ 0.03 | \$ 0.14 | \$ 0.01 |
| Weighted average common shares outstanding - Basic | 7,462 | 7,271 | 7,461 | 7,245 |
| Weighted average common shares outstanding - Diluted | 7,784 | 7,710 | 7,788 | 7,688 |

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 | | For the six months ended June 30, | |
|--|-------------------------------|----------|--------------------------------------|----------|
| | June 30, 2012 | 2011 | 2012 | 2011 |
| Net income | \$ 976 | \$ 644 | \$ 1,881 | \$ 863 |
| Other comprehensive income (loss), net of tax: | | | | |
| Unrealized gains (losses) on securities: | | | | |
| Unrealized holding gains arising during period | 299 | 643 | 119 | 918 |
| Less: Reclassification adjustment for gains included in net income | 188 | 20 | 337 | 103 |
| Total unrealized gains (losses) on securities | 111 | 623 | (218) | 815 |
| Unrealized gains on cash flow hedge derivatives: | | | | |
| Unrealized holding gains arising during period | - | 74 | 26 | 158 |
| Total other comprehensive income (loss) | 111 | 697 | (192) | 973 |
| Total comprehensive income | \$ 1,087 | \$ 1,341 | \$ 1,689 | \$ 1,836 |

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, 2012 and 2011

(Unaudited)

| (In thousands) | Preferred stock | Common stock Shares | Common stock Amount | Retained earnings (deficit) | Accumulated other comprehensive income | Total shareholders' equity |
|---|-----------------|------------------------|------------------------|--------------------------------|--|----------------------------------|
| Balance, December 31, 2011 | \$ 19,545 | 7,459 | \$ 53,746 | \$ (854) | \$ 1,121 | \$ 73,558 |
| Net income | | | | 1,881 | | 1,881 |
| Unrealized holding losses on securities and cash flow hedge derivatives | | | | | (192) | (192) |
| Accretion of discount on preferred stock | 279 | | | (279) | | - |
| Dividends on preferred stock (5% annually) | | | | (517) | | (517) |
| Common stock issued and related tax effects (1) | | 2 | 171 | | | 171 |
| Balance, June 30, 2012 | \$ 19,824 | 7,461 | \$ 53,917 | \$ 231 | \$ 929 | \$ 74,901 |

| (In thousands) | Preferred stock | Common stock Shares | Common stock Amount | Accumulated Treasury deficit | Treasury stock | Accumulated other comprehensive income | Total shareholders' equity |
|--|-----------------|------------------------|------------------------|---------------------------------|-------------------|--|----------------------------------|
| Balance, December 31, 2010 | \$ 19,019 | 7,211 | \$ 55,884 | \$ (772) | \$ (4,169) | \$ 123 | \$ 70,085 |
| Net income | | | | 863 | | | 863 |
| Unrealized holding gains on securities and cash flow hedge derivatives | | | | | | 973 | 973 |
| Accretion of discount on preferred stock | 259 | | | (259) | | | - |
| Dividends on preferred stock (5% annually) | | | | (521) | | | (521) |
| Retire Treasury stock | | | (3,101) | (1,068) | 4,169 | | - |
| Common stock issued and related tax effects (1) | | 201 | 807 | | | | 807 |
| Balance, June 30, 2011 | \$ 19,278 | 7,412 | \$ 53,590 | \$ (1,757) | \$ - | \$ 1,096 | \$ 72,207 |

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

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

Unity Bancorp, Inc.

Consolidated Statements of Cash Flows

(Unaudited)

| (In thousands) | For the six months ended June 30, | |
|---|-----------------------------------|----------|
| | 2012 | 2011 |
| OPERATING ACTIVITIES: | | |
| Net income | \$ 1,881 | \$ 863 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 2,200 | 4,250 |
| Net amortization of purchase premiums and discounts on securities | 458 | 265 |
| Depreciation and amortization | 622 | 721 |
| Deferred income tax expense | 28 | 147 |
| Net security gains | (507) | (87) |
| Stock compensation expense | 157 | 77 |
| Loss (gain) on sale of OREO | 168 | (51) |
| Gain on sale of mortgage loans held for sale, net | (864) | (256) |
| Gain on sale of SBA loans held for sale, net | (381) | (510) |
| Origination of mortgage loans held for sale | (41,509) | (15,692) |
| Origination of SBA loans held for sale | (2,637) | (9,347) |
| Proceeds from sale of mortgage loans held for sale, net | 42,373 | 15,948 |
| Proceeds from sale of SBA loans held for sale, net | 4,599 | 6,501 |
| Loss on sale or disposal of premises and equipment | 20 | 199 |
| Net change in other assets and liabilities | 1,770 | (1,243) |
| Net cash provided by operating activities | 8,378 | 1,785 |
| INVESTING ACTIVITIES | | |
| Purchases of securities available for sale | (32,802) | (22,685) |
| | 1,818 | 5,606 |

| | | | |
|--|-----------|----|----------|
| Maturities and principal payments on securities held to maturity | | | |
| Maturities and principal payments on securities available for sale | 16,723 | | 18,868 |
| Proceeds from sales of securities held to maturity | - | | 2,168 |
| Proceeds from sales of securities available for sale | 6,638 | | 10,273 |
| Proceeds from redemption of Federal Home Loan Bank stock | 99 | | 118 |
| Proceeds from sale of OREO | 2,046 | | 306 |
| Net decrease (increase) in loans | (18,285) | | 99 |
| Proceeds from sale or disposal of premises and equipment | 11 | | - |
| Purchases of premises and equipment | (1,338) | | (488) |
| Net cash provided by (used in) investing activities | (25,090) | | 14,265 |
| FINANCING ACTIVITIES | | | |
| Net decrease in deposits | (27,528) | | (13,621) |
| Proceeds from exercise of stock options | 17 | | 443 |
| Dividends on preferred stock | (516) | | (516) |
| Net cash used in financing activities | (28,027) | | (13,694) |
| Increase (decrease) in cash and cash equivalents | (44,739) | | 2,356 |
| Cash and cash equivalents, beginning of period | 82,574 | | 43,926 |
| Cash and cash equivalents, end of period | \$ 37,835 | \$ | 46,282 |
| SUPPLEMENTAL DISCLOSURES | | | |
| Cash: | | | |
| Interest paid | \$ 4,218 | \$ | 5,478 |
| Income taxes paid | 739 | | 345 |
| Noncash investing activities: | | | |
| Transfer of loans to OREO | 2,027 | | 1,385 |

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, 2012

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. Unity Investment Services, Inc., a wholly-owned subsidiary of the Bank, is used to hold part of the Bank's investment portfolio. 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. 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. 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 issued.

Estimates that are particularly susceptible to significant changes relate to the determination of the allowance for loan losses, the valuation of deferred income tax assets and the fair value of financial instruments. 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 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"). The results of operations for the six months ended June 30, 2012 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 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, 2011.

Stock Transactions

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. In addition, 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.

Stock Option Plans

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, 2012, 1,720,529 shares have been reserved for issuance upon the exercise of options, 628,807 option grants are outstanding, and 961,398 option grants have been exercised, forfeited or expired, leaving 130,324 shares available for grant.

No options were granted during the six months ended June 30, 2012, compared to 67,000 options during the six months ended June 30, 2011. The fair value of the options granted in 2011 was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

| | For the six months ended June 30, | | |
|--|--------------------------------------|---------|---|
| | 2012 | 2011 | |
| Number of options granted | - | 67,000 | |
| Weighted average exercise price | \$ - | \$ 6.66 | |
| Weighted average fair value of options | \$ - | \$ 3.20 | |
| Expected life (years) | - | 4.62 | |
| Expected volatility | - % | 57.69 % | % |
| Risk-free interest rate | - % | 1.28 % | % |
| Dividend yield | - % | - | % |

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. 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. The risk-free interest rate is the U.S. Treasury rate commensurate with the expected life of the options on the date of grant. The expected dividend yield is the projected annual yield based on the grant date stock price.

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, 2012 and 2011 is detailed in the following table:

| | For the three months ended June 30, | | For the six months ended June 30, | |
|----------------------|--|-----------|--------------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| Compensation expense | \$ 35,249 | \$ 26,383 | \$ 75,464 | \$ 45,778 |
| Income tax benefit | 14,079 | 9,230 | 28,397 | 16,853 |

As of June 30, 2012, unrecognized compensation costs related to nonvested share-based compensation arrangements granted under the Company's stock option plans totaled approximately \$262 thousand. That cost is expected to be recognized over a weighted average period of 2.1 years.

Transactions under the Company's stock option plans for the six months ended June 30, 2012 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, 2011 | 642,647 | \$ 6.80 | 5.3 | \$ 517,867 |
| Options granted | - | - | | |
| Options exercised | (3,841) | 4.44 | | |
| Options forfeited | (9,666) | 6.16 | | |
| Options expired | (333) | 3.98 | | |
| Outstanding at June 30, 2012 | 628,807 | \$ 6.82 | 4.6 | \$ 402,547 |
| Exercisable at June 30, 2012 | 516,225 | \$ 6.97 | 3.7 | \$ 369,720 |

The following table summarizes information about stock options outstanding at June 30, 2012:

| Range of exercise prices | Options outstanding | | Options exercisable | | |
|-----------------------------|---------------------|---|--|------------------------|--|
| | Options outstanding | Weighted average remaining contractual life (in years) | Weighted average exercise price | Options exercisable | Weighted average exercise price |
| \$ 0.00 - 4.00 | 122,083 | 6.8 | \$ 3.87 | 105,832 | \$ 3.86 |
| 4.01 - 8.00 | 328,466 | 5.0 | 6.05 | 232,135 | 5.85 |
| 8.01 - 12.00 | 121,617 | 1.7 | 9.22 | 121,617 | 9.22 |
| 12.01 - 16.00 | 56,641 | 4.2 | 12.54 | 56,641 | 12.54 |

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| | | | | | |
|-------|---------|-----|---------|---------|---------|
| Total | 628,807 | 4.6 | \$ 6.82 | 516,225 | \$ 6.97 |
|-------|---------|-----|---------|---------|---------|

The following table presents information about options exercised during the three and six months ended June 30, 2012 and 2011:

| | For the three months ended June 30, | | For the six months ended June 30, | |
|---|---|------------|--------------------------------------|------------|
| | 2012 | 2011 | 2012 | 2011 |
| Number of options exercised | - | 191,895 | 3,841 | 232,367 |
| Total intrinsic value of options exercised | \$ - | \$ 669,799 | \$ 6,055 | \$ 751,146 |
| Cash received from options exercised | - | 440,541 | 17,046 | 442,905 |
| Tax deduction realized from options exercised | - | 262,223 | 513 | 294,713 |

Upon exercise, the Company issues shares from its authorized but unissued common stock to satisfy the options.

Restricted Stock Awards

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, 2012, 221,551 shares of restricted stock were reserved for issuance, of which 47,162 shares are available for grant.

Restricted stock awards granted during the six months ended June 30, 2012 and 2011 were as follows:

| | For the six months ended June 30, | |
|-------------------------------|---|---------|
| | 2012 | 2011 |
| Number of shares granted | - | 22,500 |
| Average grant date fair value | \$ - | \$ 6.66 |

Compensation expense related to the restricted stock for the three and six months ended June 30, 2012 and 2011 is detailed in the following table:

| | For the three months ended June 30, | | For the six months ended June 30, | |
|----------------------|--|-----------|--------------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| Compensation expense | \$ 37,754 | \$ 15,214 | \$ 81,112 | \$ 31,418 |

As of June 30, 2012, there was approximately \$422 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 3.0 years.

The following table summarizes nonvested restricted stock activity for the six months ended June 30, 2012:

| | Shares | Average grant date fair value |
|---|---------|--|
| Nonvested restricted stock at December 31, 2011 | 93,684 | \$ 6.06 |
| Granted | - | - |
| Vested | (7,859) | 6.93 |
| Forfeited | (2,000) | 6.25 |
| Nonvested restricted stock at June 30, 2012 | 83,825 | \$ 5.97 |

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. 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 are recognized in income tax expense on the income statement.

Derivative Instruments and Hedging Activities

The Company may use derivative instruments, such as interest rate swaps, to manage interest rate risk. The Company recognizes all derivative instruments at fair value as either assets or liabilities in other assets or other liabilities. The accounting for changes in the fair value of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as an accounting hedge, the gain or loss is recognized in trading noninterest income. The Company had no derivative instruments at June 30, 2012, and all of the Company's derivative instruments qualified as hedging instruments at December 31, 2011.

For those derivative instruments that are designated and qualify as hedging instruments, the Company must designate the hedging instrument, based on the exposure being hedged, as a fair value hedge, a cash flow hedge or a hedge of a net investment in a foreign operation. The Company does not have any fair value hedges or hedges of foreign operations.

The Company formally documents the relationship between the hedging instruments and hedged item, as well as the risk management objective and strategy before undertaking a hedge. To qualify for hedge accounting, the derivatives and hedged items must be designated as a hedge. For hedging relationships in which effectiveness is measured, the Company formally assesses both at inception and on an ongoing basis, if the derivatives are highly effective in offsetting changes in fair values or cash flows of the hedged item. If it is determined that the derivative instrument is not highly effective as a hedge, hedge accounting is discontinued.

For derivatives that are designated as cash flow hedges, the effective portion of the gain or loss on derivatives is reported as a component of other comprehensive income or loss and subsequently reclassified in interest income in the same period during which the hedged transaction affects earnings. As a result, the change in fair value of any ineffective portion of the hedging derivative is recognized immediately in earnings.

The Company will discontinue hedge accounting when it is determined that the derivative is no longer qualifying as an effective hedge; the derivative expires or is sold, terminated or exercised; or the derivative is de-designated as a fair value or cash flow hedge or it is no longer probable that the forecasted transaction will occur by the end of the originally specified time period. If the Company determines that the derivative no longer qualifies as a cash flow or fair value hedge and therefore hedge accounting is discontinued, the derivative will continue to be recorded on the balance sheet at its fair value with changes in fair value included in current earnings.

Loans Held to Maturity and Loans Held for Sale

Loans held to maturity are stated at the unpaid principal balance, net of unearned discounts and net of deferred loan origination fees and costs. Loan origination fees, net of direct loan origination costs, are deferred and are recognized over the estimated life of the related loans as an adjustment to the loan yield utilizing the level yield method.

Interest is credited to operations primarily based upon the principal amount outstanding. When management believes there is sufficient doubt as to the ultimate ability to collect interest on a loan, interest accruals are discontinued and all past due interest, previously recognized as income, is reversed and charged against current period earnings. Payments received on nonaccrual loans are applied as principal. Loans are 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 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.

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.

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. When a loan is classified as nonaccrual, interest accruals discontinue and all past due interest previously recognized as income is reversed and charged against current period income. 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.

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 troubled debt restructurings and nonperforming loans. Impairment is evaluated in total for smaller-balance loans of a similar nature (consumer and residential mortgage loans), and on an individual basis for other loans. 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. Impairment of a loan is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate. Impairment can also be measured 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 measure 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 or credit to the provision for loan losses.

Loans held for sale are SBA loans and are reflected at the lower of aggregate cost or market value. 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.

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. 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.

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.

For additional information see the section titled "Loan Portfolio" under Item 2. Management's Discussion and Analysis.

Allowance for Loan Losses and 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 troubled debt restructurings, 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, see the sections titled "Asset Quality" and "Allowance for Loan Losses and Unfunded Loan Commitments" under Item 2. Management's Discussion and Analysis.

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 where management has no intent to sell and the Company has 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.

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.

NOTE 2. Litigation

From time to time, the Company is subject to legal proceedings and claims in the ordinary course of business. The Company currently is not aware of any such legal proceedings or claims that it believes will have, individually or in the aggregate, a material adverse effect on the business, financial condition, or the results of operations of the Company.

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.

| (In thousands, except per share amounts) | For the three months ended | | For the six months ended June 30, | |
|---|----------------------------|---------|-----------------------------------|---------|
| | June 30, 2012 | 2011 | 2012 | 2011 |
| Net income | \$ 976 | \$ 644 | \$ 1,881 | \$ 863 |
| Less: Preferred stock dividends and discount accretion | 401 | 395 | 797 | 778 |
| Income available to common shareholders | \$ 575 | \$ 249 | \$ 1,084 | \$ 85 |
| Weighted average common shares outstanding - Basic | 7,462 | 7,271 | 7,461 | 7,245 |
| Plus: Potential dilutive common stock equivalents | 322 | 439 | 327 | 443 |
| Weighted average common shares outstanding - Diluted | 7,784 | 7,710 | 7,788 | 7,688 |
| Net income per common share - Basic | \$ 0.08 | \$ 0.03 | \$ 0.15 | \$ 0.01 |
| Net income per common share - Diluted | 0.07 | 0.03 | 0.14 | 0.01 |
| Stock options and common stock excluded from the income per share calculation as their effect would have been anti-dilutive | 505 | 346 | 504 | 345 |

The "potential dilutive common stock equivalents" and the "stock options and common stock excluded from the income per share calculation as their effect would have been anti-dilutive" shown in the table above include the impact of 764,778 common stock warrants issued to the U.S. Department of Treasury under the Capital Purchase Program in December 2008, as applicable. These warrants were dilutive for the three and six months ended June 30, 2012 and 2011.

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, 2012, the Company reported income tax expense of \$518 thousand for an effective tax rate of 34.7 percent, compared to an income tax expense of \$277 thousand and effective tax rate of 30.1 percent for the prior year's quarter. For the six months ended June 30, 2012, the Company reported income tax expense of \$977 thousand for an effective tax rate of 34.2 percent, compared to an income tax expense of \$129 thousand and effective tax rate of 13.0 percent for the six months ended June 30, 2011. The provision for income taxes for the six months ended June 30, 2011 included the reversal of \$150 thousand of a valuation reserve for deferred taxes related to the net operating loss carry-forward deferred tax asset. Excluding this valuation adjustment, our effective tax rate would have been 28.1 percent.

The Company did not recognize or accrue any interest or penalties related to income taxes during the six months ended June 30, 2012 or 2011. The Company does not have an accrual for uncertain tax positions as of June 30, 2012 or December 31, 2011, 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 2008 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 (loss) for the three months ended June 30, 2012 and 2011:

| (In thousands) | For the three months ended June 30, | | | | | |
|---|-------------------------------------|--------|-----------|----------|--------|-----------|
| | 2012 | | 2011 | | | |
| | Pre-tax | Tax | After-tax | Pre-tax | Tax | After-tax |
| Net unrealized gains on securities: | | | | | | |
| Balance, beginning of period | | | \$ 818 | | | \$ 615 |
| Unrealized holding gains arising during period | \$ 469 | \$ 170 | 299 | \$ 1,065 | \$ 422 | 643 |
| Less: Reclassification adjustment for gains included in net income | 283 | 95 | 188 | 30 | 10 | 20 |
| Net unrealized gains on securities arising during the period | 186 | 75 | 111 | 1,035 | 412 | 623 |
| Balance, end of period | | | 929 | | | 1,238 |
| Net unrealized gains (losses) on cash flow hedges: | | | | | | |
| Balance, beginning of period | | | \$ - | | | \$ (216) |
| Unrealized holding gain on cash flow hedges arising during the period | \$ - | \$ - | - | \$ 124 | \$ 50 | 74 |
| Balance, end of period | | | - | | | (142) |
| Total accumulated other comprehensive income | | | \$ 929 | | | \$ 1,096 |

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The following table shows the changes in other comprehensive income (loss) for the six months ended June 30, 2012 and 2011:

| (In thousands) | For the six months ended June 30, | | | | | |
|---|-----------------------------------|-------|-----------|----------|--------|-----------|
| | 2012 | | | 2011 | | |
| | Pre-tax | Tax | After-tax | Pre-tax | Tax | After-tax |
| Net unrealized gains (losses) on securities: | | | | | | |
| Balance, beginning of period | | | \$ 1,147 | | | \$ 423 |
| Unrealized holding gains arising during period | \$ 145 | \$ 26 | 119 | \$ 1,511 | \$ 593 | 918 |
| Less: Reclassification adjustment for gains included in net income | 507 | 170 | 337 | 155 | 52 | 103 |
| Net unrealized gains (losses) on securities arising during the period | (362) | (144) | (218) | 1,356 | 541 | 815 |
| Balance, end of period | | | 929 | | | 1,238 |
| Net unrealized gains (losses) on cash flow hedges: | | | | | | |
| Balance, beginning of period | | | \$ (26) | | | \$ (300) |
| Unrealized holding gain on cash flow hedges arising during the period | \$ 43 | \$ 17 | 26 | \$ 263 | \$ 105 | 158 |
| Balance, end of period | | | - | | | (142) |
| Total accumulated other comprehensive income | | | \$ 929 | | | \$ 1,096 |

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. Based on the observability of the inputs used in valuation techniques, the Company is required to provide the following information according to the fair value hierarchy. 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 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

14

- 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, 2012, the fair value of the Company's AFS securities portfolio was \$98.0 million. Approximately 55 percent of the portfolio was made up of residential mortgage-backed securities, which had a fair value of \$53.7 million at June 30, 2012. Approximately \$52.2 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 AFS securities were classified as Level 2 assets at June 30, 2012. 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.

Interest Rate Swap Agreements

Based on the complex nature of interest rate swap agreements, the markets these instruments trade in are not as efficient and are less liquid than that of Level 1 markets. These markets do, however, have comparable, observable inputs in which an alternative pricing source values these assets or liabilities in order to arrive at a fair value. The fair values of any interest swaps are measured based on the difference between the yield on the existing swaps and the yield on current swaps in the market (i.e. The Yield Book); consequently, they are classified as Level 2 instruments.

There were no changes in the inputs or methodologies used to determine fair value during the period ended June 30, 2012, as compared to the periods ended December 31, 2011 and June 30, 2011. The tables below present the balances

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of assets and liabilities measured at fair value on a recurring basis as of June 30, 2012 and December 31, 2011.

| (In thousands) | June 30, 2012 | | | Total |
|--|---------------|-----------|---------|-----------|
| | Level 1 | Level 2 | Level 3 | |
| Financial assets: | | | | |
| Securities available for sale: | | | | |
| U.S. Government sponsored entities | \$ - | \$ 2,289 | \$ - | \$ 2,289 |
| State and political subdivisions | - | 14,385 | - | 14,385 |
| Residential mortgage-backed securities | - | 53,732 | - | 53,732 |
| Commercial mortgage-backed securities | - | 6,997 | - | 6,997 |
| Corporate and other securities | - | 20,562 | - | 20,562 |
| Total securities available for sale | \$ - | \$ 97,965 | \$ - | \$ 97,965 |

| (In thousands) | December 31, 2011 | | | Total |
|--|-------------------|-----------|---------|-----------|
| | Level 1 | Level 2 | Level 3 | |
| Financial assets: | | | | |
| Securities available for sale: | | | | |
| U.S. Government sponsored entities | \$ - | \$ 5,376 | \$ - | \$ 5,376 |
| State and political subdivisions | - | 17,878 | - | 17,878 |
| Residential mortgage-backed securities | - | 57,924 | - | 57,924 |
| Commercial mortgage-backed securities | - | 210 | - | 210 |
| Corporate and other securities | - | 7,377 | - | 7,377 |
| Total securities available for sale | \$ - | \$ 88,765 | \$ - | \$ 88,765 |
| Financial liabilities: | | | | |
| Interest rate swap agreements | \$ | \$ 43 | \$ | \$ 43 |

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:

Other Real Estate Owned ("OREO")

The fair value was determined using appraisals, which may be discounted based on management's review and changes in market conditions (Level 3 Inputs). 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 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 6-10% for selling and closing costs.

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 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.

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. The valuation allowance for impaired loans is included in the allowance for loan losses in the consolidated balance sheets. At June 30, 2012, the valuation allowance for impaired loans was \$3.7 million, a decrease of \$179 thousand

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from \$3.9 million at March 31, 2012 and \$747 thousand from \$4.4 million at December 31, 2011.

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, 2012 and June 30, 2011 and the fair value gains (losses) recognized during the three and six months ended June 30, 2012 and 2011:

| (In thousands) | Fair value at June 30, 2012 | | | | Gains (losses) from fair value changes for the three months ended June 30, 2012 | Gains (losses) from fair value changes for the six months ended June 30, 2012 |
|-------------------------------------|-----------------------------|---------|----------|----------|---|---|
| | Level 1 | Level 2 | Level 3 | Total | | |
| Financial assets: | | | | | | |
| OREO | \$ - | \$ - | \$ 1,416 | \$ 1,416 | \$ (524) | \$ (880) |
| Impaired collateral-dependent loans | - | - | 11,581 | 11,581 | 179 | 747 |

| (In thousands) | Fair value at June 30, 2011 | | | | Losses from fair value changes for the three months ended June 30, 2011 | Losses from fair value changes for the six months ended June 30, 2011 |
|-------------------------------------|-----------------------------|---------|----------|----------|--|--|
| | Level 1 | Level 2 | Level 3 | Total | | |
| Financial assets: | | | | | | |
| OREO | \$ - | \$ - | \$ 2,364 | \$ 2,364 | \$ (405) | \$ (754) |
| Impaired collateral-dependent loans | - | - | 13,086 | 13,086 | (1,120) | (1,440) |

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, 2012 and December 31, 2011 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.

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 & Subordinated Debentures

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

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Standby Letters of Credit

At June 30, 2012, the Bank had standby letters of credit outstanding of \$1.3 million, as compared to \$1.8 million at December 31, 2011. 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, 2012 and December 31, 2011:

| (In thousands) | Fair value level | June 30, 2012 | | December 31, 2011 | |
|---|------------------|-----------------|----------------------|-------------------|----------------------|
| | | Carrying amount | Estimated fair value | Carrying amount | Estimated fair value |
| Financial assets: | | | | | |
| Cash and cash equivalents | Level 1 | \$ 37,835 | \$ 37,835 | \$ 82,574 | \$ 82,574 |
| Securities held to maturity | Level 2 | 16,881 | 18,301 | 18,771 | 19,879 |
| SBA loans held for sale | Level 2 | 6,087 | 6,518 | 7,668 | 8,192 |
| Loans, net of allowance for loan losses | Level 2 | 582,530 | 582,973 | 568,576 | 572,165 |
| Federal Home Loan Bank stock | Level 2 | 3,989 | 3,989 | 4,088 | 4,088 |
| SBA servicing assets | Level 3 | 424 | 424 | 418 | 418 |

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| | | | | | |
|--|---------|---------|---------|---------|---------|
| Accrued interest receivable | Level 2 | 3,415 | 3,415 | 3,703 | 3,703 |
| Financial liabilities: | | | | | |
| Deposits | Level 2 | 616,443 | 618,868 | 643,971 | 647,281 |
| Borrowed funds and subordinated debentures | Level 2 | 90,465 | 100,915 | 90,465 | 102,533 |
| Accrued interest payable | Level 2 | 470 | 470 | 523 | 523 |

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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, 2012 and December 31, 2011:

| (In thousands) | June 30, 2012 | | | | December 31, 2011 | | | |
|--|----------------|------------------------|-------------------------|----------------------|-------------------|------------------------|-------------------------|----------------------|
| | Amortized cost | Gross unrealized gains | Gross unrealized losses | Estimated fair value | Amortized cost | Gross unrealized gains | Gross unrealized losses | Estimated fair value |
| Securities available for sale: | | | | | | | | |
| U.S. Government sponsored entities | \$ 2,193 | \$ 96 | \$ - | \$ 2,289 | \$ 5,274 | \$ 102 | \$ - | \$ 5,376 |
| State and political subdivisions | 13,867 | 526 | (8) | 14,385 | 17,031 | 856 | (9) | 17,878 |
| Residential mortgage-backed securities | 52,454 | 1,476 | (198) | 53,732 | 56,546 | 1,655 | (277) | 57,924 |
| Commercial mortgage-backed securities | 7,034 | 8 | (45) | 6,997 | 208 | 2 | - | 210 |
| Corporate and other securities | 20,872 | 192 | (502) | 20,562 | 7,799 | 5 | (427) | 7,377 |
| Total securities available for sale | \$ 96,420 | \$ 2,298 | \$ (753) | \$ 97,965 | \$ 86,858 | \$ 2,620 | \$ (713) | \$ 88,765 |
| Securities held to maturity: | | | | | | | | |
| State and political subdivisions | \$ 2,989 | \$ 311 | \$ - | \$ 3,300 | \$ 2,992 | \$ 192 | \$ - | \$ 3,184 |
| Residential mortgage-backed securities | 11,208 | 379 | (13) | 11,574 | 13,083 | 329 | (31) | 13,381 |
| Commercial mortgage-backed securities | 2,684 | 743 | - | 3,427 | 2,696 | 618 | - | 3,314 |
| Total securities held to maturity | \$ 16,881 | \$ 1,433 | \$ (13) | \$ 18,301 | \$ 18,771 | \$ 1,139 | \$ (31) | \$ 19,879 |

This table provides the remaining contractual maturities and yields of securities within the investment portfolios. The carrying value of securities at June 30, 2012 is primarily distributed by contractual maturity. Mortgage-backed securities and other securities, which may have principal prepayment provisions, are distributed based on contractual

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maturity. Expected maturities will differ materially from contractual maturities as a result of early prepayments and calls. The total weighted average yield excludes equity securities.

| (In thousands) | 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 | | | | | | | | | | |
| | \$ - | - % | \$ 1,353 | 1.73 % | \$ 8 | 0.97 % | \$ 928 | 3.66 % | \$ 2,289 | 2.51 % |
| State and political subdivisions | | | | | | | | | | |
| | - | - | 148 | 6.50 | 9,100 | 2.97 | 5,136 | 2.44 | 14,385 | 3.18 |
| Residential mortgage-backed securities | | | | | | | | | | |
| | 48 | 3.85 | 159 | 3.49 | 1,248 | 4.48 | 52,277 | 2.98 | 53,732 | 3.01 |
| Commercial mortgage-backed securities | | | | | | | | | | |
| | - | - | - | - | - | - | 6,997 | 1.95 | 6,997 | 1.95 |
| Corporate and other securities | | | | | | | | | | |
| | - | - | 3,300 | 2.58 | 3,968 | 3.81 | 13,294 | 2.24 | 20,562 | 2.60 |
| Total securities available for sale | | | | | | | | | | |
| | \$ 48 | 3.85 % | \$ 4,960 | 2.49 % | \$ 14,324 | 3.33 % | \$ 78,632 | 2.77 % | \$ 97,965 | 2.86 % |
| Held to maturity at cost: | | | | | | | | | | |
| State and political subdivisions | | | | | | | | | | |
| | \$ - | - % | \$ - | - % | \$ - | - % | \$ 2,989 | 4.59 % | \$ 2,989 | 4.59 % |
| Residential mortgage-backed securities | | | | | | | | | | |
| | - | - | 821 | 4.64 | 1,160 | 4.95 | 9,227 | 2.95 | 11,208 | 3.28 |
| Commercial mortgage-backed securities | | | | | | | | | | |
| | - | - | - | - | - | - | 2,684 | 5.40 | 2,684 | 5.40 |
| Total securities held to maturity | | | | | | | | | | |
| | \$ - | - % | \$ 821 | 4.64 % | \$ 1,160 | 4.95 % | \$ 14,900 | 3.72 % | \$ 16,881 | 3.85 % |

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, 2012 and December 31, 2011 are as follows:

| (In thousands) | June 30, 2012 | | | | | | | |
|--|---------------------------------|----------------------|-----------------|-----------------------|-----------------|----------------------|-----------------|--|
| | Total number in a loss position | Less than 12 months | | 12 months and greater | | Total | | |
| | | Estimated fair value | Unrealized loss | Estimated fair value | Unrealized loss | Estimated fair value | Unrealized loss | |
| Securities available for sale: | | | | | | | | |
| State and political subdivisions | 3 | \$ 1,057 | \$ (8) | \$ - | \$ - | \$ 1,057 | \$ (8) | |
| Residential mortgage-backed securities | 8 | 5,747 | (59) | 1,220 | (139) | 6,967 | (198) | |
| Commercial mortgage-backed securities | 7 | 4,312 | (45) | - | - | 4,312 | (45) | |
| Corporate and other securities | 9 | 9,578 | (182) | 1,219 | (320) | 10,797 | (502) | |
| Total temporarily impaired investments | 27 | \$ 20,694 | \$ (294) | \$ 2,439 | \$ (459) | \$ 23,133 | \$ (753) | |
| Securities held to maturity: | | | | | | | | |
| Residential mortgage-backed securities | 1 | \$ - | \$ - | \$ 345 | \$ (13) | \$ 345 | \$ (13) | |
| Total temporarily impaired investments | 1 | \$ - | \$ - | \$ 345 | \$ (13) | \$ 345 | \$ (13) | |
| | December 31, 2011 | | | | | | | |
| | Total number in a loss position | Less than 12 months | | 12 months and greater | | Total | | |
| | | Estimated fair value | Unrealized loss | Estimated fair value | Unrealized loss | Estimated fair value | Unrealized loss | |
| (In thousands) | | | | | | | | |
| Securities available for sale: | | | | | | | | |
| State and political subdivisions | 2 | \$ 424 | \$ (9) | \$ - | \$ - | \$ 424 | \$ (9) | |
| Residential mortgage-backed securities | 6 | 4,512 | (80) | 871 | (197) | 5,383 | (277) | |
| Corporate and other securities | 8 | 5,038 | (173) | 1,334 | (254) | 6,372 | (427) | |
| Total temporarily impaired investments | 16 | \$ 9,974 | \$ (262) | \$ 2,205 | \$ (451) | \$ 12,179 | \$ (713) | |
| Securities held to maturity: | | | | | | | | |
| Residential mortgage-backed securities | 3 | \$ 2,545 | \$ (4) | \$ 542 | \$ (27) | \$ 3,087 | \$ (31) | |
| Total temporarily impaired investments | 3 | \$ 2,545 | \$ (4) | \$ 542 | \$ (27) | \$ 3,087 | \$ (31) | |

Unrealized Losses

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

State and political subdivision securities: The unrealized losses on investments in this type of security were caused by the increase in interest rate spreads. 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 bases, which may be at maturity, the Company did not consider these investments to be other-than-temporarily impaired as of June 30, 2012 or December 31, 2011.

Residential and commercial mortgage-backed securities: The unrealized losses on investments in mortgage-backed securities were caused by increases in interest rate spreads or faster prepayment speeds. 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 bases, which may be at maturity, the Company did not consider these investments to be other-than-temporarily impaired as of June 30, 2012 or December 31, 2011.

Corporate and other securities: Included in this category are corporate debt securities, stock of other financial institutions, Community Reinvestment Act ("CRA") investments, asset-backed securities, and trust preferred securities. The unrealized losses on corporate debt securities were due to widening credit spreads and the unrealized losses on stock of other financial institutions and 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; therefore it did not consider these investments to be other-than-temporarily impaired as of June 30, 2012 or December 31, 2011. The unrealized losses on asset-backed securities were caused by increases in interest rate spreads. The majority of contractual cash flows of these securities are guaranteed by Sallie Mae as part of the Federal Family Education Loan ("FFEL") Program. 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 bases, which may be at maturity, the Company did not consider these investments to be other-than-temporarily impaired as of June 30, 2012 or December 31, 2011. The unrealized losses on trust preferred securities were caused by an inactive trading market and changes in market credit spreads. At June 30, 2012 and December 31, 2011, 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, 2012 or December 31, 2011.

Realized Gains and Losses

Gross realized gains (losses) on securities for the three and six months ended June 30, 2012 and 2011 are detailed in the table below:

| (In thousands) | For the three months ended June 30, | | For the six months ended June 30, | |
|---|---|---------|---|--------|
| | 2012 | 2011 | 2012 | 2011 |
| Securities available for sale: | | | | |
| Realized gains | \$ 283 | \$ 41 | \$ 511 | \$ 168 |
| Realized losses | - | (12) | (4) | (13) |
| Total securities available for sale | 283 | 29 | 507 | 155 |
| Securities held to maturity: | | | | |
| Realized gains | - | - | - | - |
| Realized losses | - | (68) | - | (68) |
| Total securities held to maturity | - | (68) | - | (68) |
| Net gains (losses) on sales of securities | \$ 283 | \$ (39) | \$ 507 | \$ 87 |

The net realized gains (losses) are included in noninterest income in the Consolidated Statements of Income as net security gains (losses). For the three and six months ended June 30, 2012, there were gross realized gains of \$283 thousand and \$511 thousand, respectively. There were no realized losses during the second quarter of 2012 and gross realized losses of \$4 thousand in the first quarter. The net realized gains during 2012 were a result of the following:

- The Company sold approximately \$6.1 million in book value of available for sale mortgage-backed and municipal securities, resulting in pre-tax gains of approximately \$511 thousand, partially offset by

- Losses of \$4 thousand on the partial call of \$64 thousand in book value of one available for sale municipal security.

For the three and six months ended June 30, 2011, there were gross realized gains of \$41 thousand and \$168 thousand, respectively, and gross realized losses of \$80 thousand and \$81 thousand, respectively. The net gains during the six months ended June 30, 2011 were primarily attributed to:

- The Company selling approximately \$9.1 million in book value of mortgage-backed securities, resulting in pretax gains of approximately \$168 thousand, partially offset by
- Losses of \$13 thousand on the sale of approximately \$1.0 million in book value of five available for sale mortgage-backed securities and losses of \$68 thousand on the sale of approximately \$2.1 million in book value of three held to maturity private label mortgage backed securities. Although designated as held to maturity, these securities were sold due to the deterioration in the underlying credit, as evidenced by downgrades in their credit ratings.

Pledged Securities

Securities with a carrying value of \$63.2 million and \$81.1 million at June 30, 2012 and December 31, 2011, respectively, were pledged to secure Government deposits, secure other borrowings and for other purposes required or permitted by law. Included in these figures was \$12.4 million and \$27.7 million pledged against Government deposits at June 30, 2012 and December 31, 2011, 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, 2012 and December 31, 2011:

| (In thousands) | June 30, 2012 | December 31, 2011 |
|-------------------------------------|------------------|----------------------|
| SBA loans | \$ 66,469 | \$ 71,843 |
| SBA 504 loans | 45,247 | 55,108 |
| Commercial loans | | |
| Commercial other | 28,134 | 26,542 |
| Commercial real estate | 271,542 | 246,824 |
| Commercial real estate construction | 10,655 | 9,738 |
| Residential mortgage loans | | |
| Residential mortgages | 128,652 | 123,843 |
| Residential construction | - | 2,205 |
| Purchased residential mortgages | 7,862 | 8,042 |

| | | |
|----------------|------------|------------|
| Consumer loans | | |
| Home equity | 45,097 | 46,935 |
| Consumer other | 1,243 | 1,512 |
| Total loans | \$ 604,901 | \$ 592,592 |

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, excluding SBA loans, 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. 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 Company's SBA loans are 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. 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.

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. 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.

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 regulatory 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 start up 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 sound worth and 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, 2012:

| June 30, 2012 | | | | |
|---|------------|-----------------|-------------|------------|
| SBA, SBA 504 & Commercial loans - Internal risk ratings | | | | |
| (In thousands) | Pass | Special mention | Substandard | Total |
| SBA loans | \$ 49,412 | \$ 9,419 | \$ 7,638 | \$ 66,469 |
| SBA 504 loans | 33,214 | 4,076 | 7,957 | 45,247 |
| Commercial loans | | | | |
| Commercial other | 21,229 | 2,167 | 4,738 | 28,134 |
| Commercial real estate | 216,243 | 43,031 | 12,268 | 271,542 |
| Commercial real estate construction | 9,775 | 880 | - | 10,655 |
| Total commercial loans | 247,247 | 46,078 | 17,006 | 310,331 |
| Total SBA, SBA 504 and commercial loans | \$ 329,873 | \$ 59,573 | \$ 32,601 | \$ 422,047 |

| Residential mortgage & Consumer loans - Performing/Nonperforming | | | |
|--|------------|---------------|------------|
| (In thousands) | Performing | Nonperforming | Total |
| Residential mortgage loans | | | |
| Residential mortgages | \$ 127,168 | \$ 1,484 | \$ 128,652 |
| Purchased residential mortgages | 4,693 | 3,169 | 7,862 |
| Total residential mortgage loans | 131,861 | 4,653 | 136,514 |
| Consumer loans | | | |
| Home equity | 44,786 | 311 | 45,097 |
| Consumer other | 1,232 | 11 | 1,243 |
| Total consumer loans | \$ 46,018 | \$ 322 | \$ 46,340 |
| Total loans | | | \$ 604,901 |

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, 2011:

| December 31, 2011 | | | | |
|---|-----------|-----------------|-------------|-----------|
| SBA, SBA 504 & Commercial loans - Internal risk ratings | | | | |
| (In thousands) | Pass | Special mention | Substandard | Total |
| SBA loans | \$ 49,568 | \$ 8,900 | \$ 13,375 | \$ 71,843 |
| SBA 504 loans | 39,566 | 5,543 | 9,999 | 55,108 |
| Commercial loans | | | | |
| Commercial other | 20,921 | 1,160 | 4,461 | 26,542 |

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| | | | | |
|---|------------|-----------|-----------|------------|
| Commercial real estate | 187,680 | 49,231 | 9,913 | 246,824 |
| Commercial real estate construction | 8,255 | 883 | 600 | 9,738 |
| Total commercial loans | 216,856 | 51,274 | 14,974 | 283,104 |
| Total SBA, SBA 504 and commercial loans | \$ 305,990 | \$ 65,717 | \$ 38,348 | \$ 410,055 |

Residential mortgage & Consumer loans -
Performing/Nonperforming

| (In thousands) | Performing | Nonperforming | Total |
|----------------------------------|------------|---------------|------------|
| Residential mortgage loans | | | |
| Residential mortgages | \$ 122,012 | \$ 1,831 | \$ 123,843 |
| Residential construction | 36 | 2,169 | 2,205 |
| Purchased residential mortgages | 6,005 | 2,037 | 8,042 |
| Total residential mortgage loans | 128,053 | 6,037 | 134,090 |
| Consumer loans | | | |
| Home equity | 46,676 | 259 | 46,935 |
| Consumer other | 1,503 | 9 | 1,512 |
| Total consumer loans | \$ 48,179 | \$ 268 | \$ 48,447 |
| Total loans | | | \$ 592,592 |

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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. When a loan is classified as nonaccrual, interest accruals discontinue and all past due interest previously recognized as income is reversed and charged against current period income. 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 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, 2012 and December 31, 2011:

| | June 30, 2012 | | | Nonaccrual (1) | Total past due | Current | Total loans |
|-------------------------------------|---------------------------|---------------------------|-----------------------------------|-------------------|-------------------|------------|-------------|
| | 30-59 days past due | 60-89 days past due | 90+ days and still accruing | | | | |
| (In thousands) | | | | | | | |
| SBA loans | \$ 506 | \$ 169 | \$ 241 | \$ 3,345 | \$ 4,262 | \$ 62,207 | \$ 66,469 |
| SBA 504 loans | 2,201 | - | - | 1,775 | 3,975 | 41,272 | 45,247 |
| Commercial loans | | | | | | | |
| Commercial other | 55 | - | 2 | 1,100 | 1,157 | 26,977 | 28,134 |
| Commercial real estate | 1,538 | 172 | 286 | 8,636 | 10,631 | 260,911 | 271,542 |
| Commercial real estate construction | - | - | - | - | - | 10,655 | 10,655 |
| Residential mortgage loans | | | | | | | |
| Residential mortgages | 1,665 | 228 | 1,881 | 1,484 | 5,258 | 123,394 | 128,652 |
| Purchased residential mortgages | 142 | 621 | 34 | 3,169 | 3,965 | 3,897 | 7,862 |
| Consumer loans | | | | | | | |
| Home equity | 761 | 106 | - | 311 | 1,178 | 43,919 | 45,097 |
| Consumer other | 2 | - | - | 11 | 13 | 1,230 | 1,243 |
| Total loans | \$ 6,870 | \$ 1,296 | \$ 2,443 | \$ 19,831 | \$ 30,441 | \$ 574,460 | \$ 604,901 |

(1) At June 30, 2012, nonaccrual loans included \$871 thousand of troubled debt restructurings ("TDRs") and \$526 thousand of loans guaranteed by the SBA. The remaining \$20.5 million of TDRs are in accrual status because they are performing in accordance with their restructured terms.

| (In thousands) | December 31, 2011 | | | Nonaccrual (1) | Total past due | Current | Total loans |
|-------------------------------------|---------------------------|---------------------------|-----------------------------------|-------------------|-------------------|------------|-------------|
| | 30-59 days past due | 60-89 days past due | 90+ days and still accruing | | | | |
| SBA loans | \$ 879 | \$ 225 | \$ 247 | \$ 5,858 | \$ 7,208 | \$ 64,635 | \$ 71,843 |
| SBA 504 loans | 2,006 | - | - | 2,086 | 4,092 | 51,016 | 55,108 |
| Commercial loans | | | | | | | |
| Commercial other | 1,158 | - | 192 | 815 | 2,165 | 24,377 | 26,542 |
| Commercial real estate | 2,493 | 3,119 | 949 | 7,104 | 13,666 | 233,158 | 246,824 |
| Commercial real estate construction | - | - | - | 600 | 600 | 9,138 | 9,738 |
| Residential mortgage loans | | | | | | | |
| Residential mortgages | 3,519 | 1,310 | - | 1,831 | 6,660 | 117,183 | 123,843 |
| Residential construction | - | - | 36 | 2,169 | 2,205 | 0 | 2,205 |
| Purchased residential mortgages | 149 | - | - | 2,037 | 2,187 | 5,855 | 8,042 |
| Consumer loans | | | | | | | |
| Home equity | 338 | 199 | 988 | 259 | 1,784 | 45,151 | 46,935 |
| Consumer other | 1 | 3 | - | 9 | 14 | 1,498 | 1,512 |
| Total loans | \$ 10,545 | \$ 4,856 | \$ 2,411 | \$ 22,769 | \$ 40,581 | \$ 552,011 | \$ 592,592 |

(1) At December 31, 2011, nonaccrual loans included \$3.6 million of TDRs and \$939 thousand of loans guaranteed by the SBA. The remaining \$17.4 million of TDRs are in accrual status because they are performing in accordance with their restructured terms.

Impaired Loans:

The Company has defined impaired loans to be all nonperforming loans 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 in total for smaller-balance loans of a similar nature, (consumer and residential mortgage loans), and on an individual basis for other loans.

The following tables provide detail on the Company's impaired loans with the associated allowance amount, if applicable, as of June 30, 2012 and December 31, 2011:

| (In thousands) | June 30, 2012 | | Net exposure (balance less specific reserves) |
|--|-------------------------------|-------------------|--|
| | Outstanding principal balance | Specific reserves | |
| With no related allowance: | | | |
| SBA loans (1) | \$ 1,573 | \$ - | \$ 1,573 |
| SBA 504 loans | 4,668 | - | 4,668 |
| Commercial loans | | | |
| Commercial other | 4,261 | - | 4,261 |
| Commercial real estate | 6,513 | - | 6,513 |
| Total commercial loans | 10,774 | - | 10,774 |
| Total impaired loans with no related allowance | 17,015 | - | 17,015 |
| With an allowance: | | | |
| SBA loans (1) | 2,184 | 847 | 1,337 |
| SBA 504 loans | 1,443 | 132 | 1,311 |
| Commercial loans | | | |
| Commercial other | 62 | 62 | - |
| Commercial real estate | 14,167 | 2,661 | 11,506 |
| Total commercial loans | 14,229 | 2,723 | 11,506 |
| Total impaired loans with a related allowance | 17,856 | 3,702 | 14,154 |
| Total individually evaluated impaired loans: | | | |
| SBA loans (1) | 3,757 | 847 | 2,910 |
| SBA 504 loans | 6,111 | 132 | 5,979 |
| Commercial loans | | | |
| Commercial other | 4,323 | 62 | 4,261 |
| Commercial real estate | 20,680 | 2,661 | 18,019 |
| Total commercial loans | 25,003 | 2,723 | 22,280 |
| Total individually evaluated impaired loans | 34,871 | 3,702 | 31,169 |

Homogeneous collectively evaluated impaired loans:

| | | | |
|---|-----------|----------|-----------|
| Residential mortgage loans | | | |
| Residential mortgages | 1,484 | - | 1,484 |
| Purchased residential mortgages | 3,169 | - | 3,169 |
| Total residential mortgage loans | 4,653 | - | 4,653 |
| Consumer loans | | | |
| Home equity | 311 | - | 311 |
| Consumer other | 11 | - | 11 |
| Total consumer loans | 322 | - | 322 |
| Total homogeneous collectively evaluated impaired loans | 4,975 | - | 4,975 |
| | | | |
| Total impaired loans | \$ 39,846 | \$ 3,702 | \$ 36,144 |

(1) Balances are reduced by amount guaranteed by the Small Business Administration of \$526 thousand at June 30, 2012.

| | December 31, 2011 | | |
|---|-------------------|----------|----------------------------------|
| | Outstanding | Specific | Net |
| (In thousands) | principal | reserves | exposure |
| | balance | reserves | (balance less specific reserves) |
| With no related allowance: | | | |
| SBA loans (1) | \$ 1,553 | \$ - | \$ 1,553 |
| SBA 504 loans | 5,331 | - | 5,331 |
| Commercial loans | | | |
| Commercial other | 1,725 | - | 1,725 |
| Commercial real estate | 6,197 | - | 6,197 |
| Total commercial loans | 7,922 | - | 7,922 |
| Total impaired loans with no related allowance | 14,806 | - | 14,806 |
| With an allowance: | | | |
| SBA loans (1) | 4,763 | 1,694 | 3,069 |
| SBA 504 loans | 1,127 | 1 | 1,126 |
| Commercial loans | | | |
| Commercial other | 75 | 75 | - |
| Commercial real estate | 11,589 | 2,530 | 9,059 |
| Commercial real estate construction | 600 | 149 | 451 |
| Total commercial loans | 12,264 | 2,754 | 9,510 |
| Total impaired loans with a related allowance | 18,154 | 4,449 | 13,705 |
| Total individually evaluated impaired loans: | | | |
| SBA loans (1) | 6,316 | 1,694 | 4,622 |
| SBA 504 loans | 6,458 | 1 | 6,457 |
| Commercial loans | | | |
| Commercial other | 1,800 | 75 | 1,725 |
| Commercial real estate | 17,786 | 2,530 | 15,256 |
| Commercial real estate construction | 600 | 149 | 451 |
| Total commercial loans | 20,186 | 2,754 | 17,432 |
| Total individually evaluated impaired loans | 32,960 | 4,449 | 28,511 |
| Homogeneous collectively evaluated impaired loans: | | | |
| Residential mortgage loans | | | |
| Residential mortgages | 1,831 | - | 1,831 |
| Residential construction | 2,169 | - | 2,169 |
| Purchased residential mortgages | 2,037 | - | 2,037 |
| Total residential mortgage loans | 6,037 | - | 6,037 |
| Consumer loans | | | |
| Home equity | 259 | - | 259 |
| Consumer other | 9 | - | 9 |
| Total consumer loans | 268 | - | 268 |
| Total homogeneous collectively evaluated impaired loans | 6,305 | - | 6,305 |

| | | | |
|----------------------|-----------|----------|-----------|
| Total impaired loans | \$ 39,265 | \$ 4,449 | \$ 34,816 |
|----------------------|-----------|----------|-----------|

(1) Balances are reduced by amount guaranteed by the SBA of \$939 thousand at December 31, 2011.

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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, 2012 and 2011. 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. Any interest income recognized on a cash basis during the three and six months ended June 30, 2012 and 2011 was immaterial. The interest recognized on impaired loans noted below represents accruing troubled debt restructurings only.

| | For the three months ended June 30, | | | |
|-------------------------------------|-------------------------------------|--|-----------------------------|--|
| | 2012 | | 2011 | |
| | Average recorded investment | Interest income recognized on impaired loans | Average recorded investment | Interest income recognized on impaired loans |
| (In thousands) | | | | |
| SBA loans (1) | \$ 4,150 | \$ 36 | \$ 6,343 | \$ 44 |
| SBA 504 loans | 6,443 | 69 | 9,131 | 92 |
| Commercial loans | | | | |
| Commercial other | 4,344 | 47 | 1,457 | 8 |
| Commercial real estate | 19,853 | 169 | 15,520 | 99 |
| Commercial real estate construction | - | - | 789 | - |
| Residential mortgage loans | | | | |
| Residential mortgages | 1,959 | - | 2,079 | - |
| Residential construction | 1,446 | - | - | - |
| Purchased residential mortgages | 2,362 | - | 2,101 | - |
| Consumer loans | | | | |
| Home equity | 328 | - | 348 | - |
| Consumer other | 10 | - | 3 | - |
| Total | \$ 40,895 | \$ 321 | \$ 37,771 | \$ 243 |

(1) Balances are reduced by the average amount guaranteed by the Small Business Administration of \$529 thousand and \$2.6 million for the three months ended June 30, 2012 and 2011, respectively.

| | For the six months ended June 30, | | | |
|----------------|-----------------------------------|--|-----------------------------|--|
| | 2012 | | 2011 | |
| | Average recorded investment | Interest income recognized on impaired loans | Average recorded investment | Interest income recognized on impaired loans |
| (In thousands) | | | | |
| SBA loans (1) | \$ 4,952 | \$ 85 | \$ 6,563 | \$ 101 |

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| | | | | |
|-------------------------------------|-----------|--------|-----------|--------|
| SBA 504 loans | 6,453 | 140 | 9,693 | 232 |
| Commercial loans | | | | |
| Commercial other | 3,556 | 69 | 983 | 9 |
| Commercial real estate | 19,107 | 299 | 13,125 | 158 |
| Commercial real estate construction | 267 | - | 920 | - |
| Residential mortgage loans | | | | |
| Residential mortgages | 1,804 | - | 2,148 | - |
| Residential construction | 1,808 | - | - | - |
| Purchased residential mortgages | 2,184 | - | 2,122 | - |
| Consumer loans | | | | |
| Home equity | 306 | - | 288 | - |
| Consumer other | 10 | - | 2 | - |
| Total | \$ 40,447 | \$ 593 | \$ 35,844 | \$ 500 |

(1) Balances are reduced by the average amount guaranteed by the Small Business Administration of \$584 thousand and \$2.8 million for the six months ended June 30, 2012 and 2011, respectively.

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 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. Effective September 30, 2011, the Company adopted the amendments in Accounting Standards Update ("ASU") No. 2011-02, Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring, and did not identify any additional TDRs as a result of this adoption.

TDRs of \$21.4 million are included in the impaired loan numbers listed above, of which \$871 thousand are in nonaccrual status. The remaining TDRs are in accrual status since they continue to perform in accordance with their restructured terms. There are no commitments to lend additional funds on these loans.

There were no loans modified during the three months ended June 30, 2012 that were deemed to be TDRs. In addition, there were no loans modified as TDRs 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, 2012. In this case, subsequent default is defined as being transferred to nonaccrual status.

The following table details loans modified during the six months ended June 30, 2012, including the number of modifications, the recorded investment at the time of the modification and the year-to-date impact to interest income as a result of the modification. There were no loans modified as TDRs within the previous 12 months where a concession was made and the loan subsequently defaulted at some point during the six months ended June 30, 2012. In this case, subsequent default is defined as being transferred to nonaccrual status.

| (In thousands, except number of contracts) | For the six months ended June 30, 2012 | | |
|--|---|--|--|
| | Number of contracts | Recorded investment at time of modification | Impact of interest rate change on income |
| Commercial loans | | | |
| Commercial other | 3 | \$ 1,291 | \$ - |
| Commercial real estate | 3 | 1,856 | - |
| Total | 6 | \$ 3,147 | \$ - |

During the six months ended June 30, 2012, TDRs consisted of interest only periods; there was no principal forgiveness. The following table shows the types of modifications done during the six months ended June 30, 2012, with the respective loan balances as of June 30, 2012:

June 30, 2012

Commercial

| (In thousands) | Commercial other | Commercial real estate | Total |
|-----------------------|---------------------|---------------------------|----------|
| Type of modification: | | | |
| Interest only | \$ 1,289 | \$ 1,856 | \$ 3,145 |
| Total | \$ 1,289 | \$ 1,856 | \$ 3,145 |

Note 9. Allowance for Loan Losses & 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: Real Estate, Real Estate Construction and Other. Residential Mortgage loans are divided into the following two classes: Residential Mortgages and Purchased Mortgages. 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, restructured loans, volume and loan term trends, risk and underwriting policy trends, staffing and experience changes, national and local economic trends, industry conditions and credit concentration changes. Beginning in the third quarter of 2009, when calculating the five-year historical net charge-off rate, the Company weights the past three years more heavily due to the higher amount of charge-offs experienced during those years. 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.

The following tables detail the activity in the allowance for loan losses by portfolio segment for the three months ended June 30, 2012 and 2011.

| (In thousands) | For the three months ended June 30, 2012 | | | | | | |
|--|--|----------|------------|-------------|----------|-------------|-----------|
| | SBA | | Commercial | Residential | Consumer | Unallocated | Total |
| | SBA | 504 | | | | | |
| Beginning balance | \$ 3,639 | \$ 1,285 | \$ 8,361 | \$ 1,770 | \$ 527 | \$ 757 | \$ 16,339 |
| Charge-offs | (213) | (100) | (540) | (494) | (25) | - | (1,372) |
| Recoveries | 249 | 15 | 53 | - | - | - | 317 |
| Net charge-offs | 36 | (85) | (487) | (494) | (25) | - | (1,055) |
| Provision for loan losses charged to expense | (474) | 131 | 882 | 560 | 20 | (119) | 1,000 |
| Ending balance | \$ 3,201 | \$ 1,331 | \$ 8,756 | \$ 1,836 | \$ 522 | \$ 638 | \$ 16,284 |

| (In thousands) | For the three months ended June 30, 2011 | | | | | | |
|-------------------|--|----------|------------|-------------|----------|-------------|-----------|
| | SBA | | Commercial | Residential | Consumer | Unallocated | Total |
| | SBA | 504 | | | | | |
| Beginning balance | \$ 4,254 | \$ 1,622 | \$ 6,785 | \$ 1,799 | \$ 527 | \$ 288 | \$ 15,275 |
| Charge-offs | (592) | (125) | (521) | - | (131) | - | (1,369) |
| Recoveries | 71 | 77 | 214 | - | - | - | 362 |

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| | | | | | | | |
|--|----------|----------|----------|----------|--------|--------|-----------|
| Net charge-offs | (521) | (48) | (307) | - | (131) | - | (1,007) |
| Provision for loan losses charged to expense | 564 | (164) | 1,191 | (37) | 173 | 23 | 1,750 |
| Ending balance | \$ 4,297 | \$ 1,410 | \$ 7,669 | \$ 1,762 | \$ 569 | \$ 311 | \$ 16,018 |

The following tables detail the activity in the allowance for loan losses by portfolio segment for the six months ended June 30, 2012 and 2011:

For the six months ended June 30, 2012

| (In thousands) | SBA | | | | | | Total |
|--|----------|----------|------------|-------------|----------|-------------|-----------|
| | SBA | 504 | Commercial | Residential | Consumer | Unallocated | |
| Beginning balance | \$ 4,088 | \$ 1,423 | \$ 8,129 | \$ 1,703 | \$ 536 | \$ 469 | \$ 16,348 |
| Charge-offs | (828) | (327) | (886) | (607) | (25) | - | (2,673) |
| Recoveries | 302 | 43 | 64 | - | - | - | 409 |
| Net charge-offs | (526) | (284) | (822) | (607) | (25) | - | (2,264) |
| Provision for loan losses charged to expense | (361) | 192 | 1,449 | 740 | 11 | 169 | 2,200 |
| Ending balance | \$ 3,201 | \$ 1,331 | \$ 8,756 | \$ 1,836 | \$ 522 | \$ 638 | \$ 16,284 |

For the six months ended June 30, 2011

| (In thousands) | SBA | | | | | | Total |
|--|----------|----------|------------|-------------|----------|-------------|-----------|
| | SBA | 504 | Commercial | Residential | Consumer | Unallocated | |
| Beginning balance | \$ 4,198 | \$ 1,551 | \$ 6,011 | \$ 1,679 | \$ 586 | \$ 339 | \$ 14,364 |
| Charge-offs | (1,303) | (425) | (1,069) | (142) | (131) | - | (3,070) |
| Recoveries | 79 | 77 | 312 | 4 | 2 | - | 474 |
| Net charge-offs | (1,224) | (348) | (757) | (138) | (129) | - | (2,596) |
| Provision for loan losses charged to expense | 1,323 | 207 | 2,415 | 221 | 112 | (28) | 4,250 |
| Ending balance | \$ 4,297 | \$ 1,410 | \$ 7,669 | \$ 1,762 | \$ 569 | \$ 311 | \$ 16,018 |

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The following tables present loans and their related allowance for loan losses, by portfolio segment, as of June 30, 2012 and December 31, 2011:

| (In thousands) | June 30, 2012 | | | | | | Unallocated Total |
|---|---------------|-----------|------------|-------------|-----------|--------|-------------------|
| | SBA | SBA 504 | Commercial | Residential | Consumer | | |
| Allowance for loan losses ending balance: | | | | | | | |
| Individually evaluated for impairment | \$ 847 | \$ 132 | \$ 2,723 | \$ - | \$ - | \$ - | \$ 3,702 |
| Collectively evaluated for impairment | 2,354 | 1,199 | 6,033 | 1,836 | 522 | 638 | 12,582 |
| Total | \$ 3,201 | \$ 1,331 | \$ 8,756 | \$ 1,836 | \$ 522 | \$ 638 | \$ 16,284 |
| Loan ending balances: | | | | | | | |
| Individually evaluated for impairment | \$ 3,757 | \$ 6,111 | \$ 25,003 | \$ - | \$ - | \$ - | \$ 34,871 |
| Collectively evaluated for impairment | 62,712 | 39,136 | 285,328 | 136,514 | 46,340 | - | 570,030 |
| Total | \$ 66,469 | \$ 45,247 | \$ 310,331 | \$ 136,514 | \$ 46,340 | \$ - | \$ 604,901 |

| (In thousands) | December 31, 2011 | | | | | | Unallocated Total |
|---|-------------------|-----------|------------|-------------|-----------|--------|-------------------|
| | SBA | SBA 504 | Commercial | Residential | Consumer | | |
| Allowance for loan losses ending balance: | | | | | | | |
| Individually evaluated for impairment | \$ 1,694 | \$ 1 | \$ 2,754 | \$ - | \$ - | \$ - | \$ 4,449 |
| Collectively evaluated for impairment | 2,394 | 1,422 | 5,375 | 1,703 | 536 | 469 | 11,899 |
| Total | \$ 4,088 | \$ 1,423 | \$ 8,129 | \$ 1,703 | \$ 536 | \$ 469 | \$ 16,348 |
| Loan ending balances: | | | | | | | |
| Individually evaluated for impairment | \$ 6,316 | \$ 6,458 | \$ 20,186 | \$ - | \$ - | \$ - | \$ 32,960 |
| Collectively evaluated for impairment | 65,527 | 48,650 | 262,918 | 134,090 | 48,447 | - | 559,632 |
| Total | \$ 71,843 | \$ 55,108 | \$ 283,104 | \$ 134,090 | \$ 48,447 | \$ - | \$ 592,592 |

Changes in Methodology:

The Company did not make any changes to its allowance for loan losses methodology in the current period.

Unfunded Loan Commitments:

In addition to the allowance for loan losses, 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 expense and applied to the allowance which is maintained in other liabilities. At June 30, 2012, a \$69 thousand commitment reserve was reported on the balance sheet as an “other liability”, compared to a \$79 thousand commitment reserve at December 31, 2011.

Note 10. New Accounting Pronouncements

ASU No. 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. In December 2011, the FASB issued ASU No. 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. This ASU will require companies to disclose gross and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting arrangement. The scope will include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements, and securities borrowing and securities lending arrangements. The amendments are effective for interim and annual periods beginning on or after January 1, 2012. The amendment is not expected to impact the Company's financial condition, results of operations or cash flows.

ASU No. 2011-08, Intangibles - Goodwill and Other (Topic 350): Testing Goodwill for Impairment. In September 2011, the FAS issued ASU No. 2011-08, Intangibles - Goodwill and Other (Topic 350): Testing Goodwill for Impairment. This ASU allows companies to use a qualitative approach to test goodwill for impairment. An entity is permitted to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350. The more likely than not threshold is defined as having a likelihood of more than 50 percent. The amendments are effective for interim and annual goodwill

impairment tests performed for fiscal years beginning after December 15, 2011. The amendment is not expected to impact the Company's financial condition, results of operations or cash flows.

ASU No. 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. In May 2011, the FASB issued ASU No. 2011-04, with the intent of converging U.S. GAAP and International Financial Reporting Standards ("IFRS") requirements for measurement of and disclosures about fair value. Key provisions of the amendment include: a prohibition on grouping financial instruments for purposes of determining fair value, except when an entity manages market and credit risks on the basis of the entity's net exposure to the group; an extension of the prohibition against the use of a blockage factor to all fair value measurements (that prohibition currently applies only to financial instruments with quoted prices in active markets); and a requirement that for recurring Level 3 fair value measurements, entities disclose quantitative information about unobservable inputs, a description of the valuation process used and qualitative details about the sensitivity of the measurements. In addition, for items not carried at fair value but for which fair value is disclosed, entities are required to disclose the level within the fair value hierarchy that applies to the fair value measurement disclosed. The Company adopted this amendment effective March 31, 2012 with no impact to the Company's fair value measurements, financial condition, results of operations or cash flows.

ASU No. 2011-03, Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements. In April 2011, the FASB issued ASU No. 2011-03, which amends the sale accounting requirement concerning a transferor's ability to repurchase transferred financial assets even in the event of default by the transferee, which typically is facilitated in a repurchase agreement by the presence of a collateral maintenance provision. Specifically, the level of cash collateral received by a transferor is no longer relevant in determining whether a repurchase agreement constitutes a sale. As a result of this amendment, more repurchase agreements are treated as secured financings rather than sales. The Company adopted this amendment effective March 31, 2012, however, since all repurchase agreements entered into by the Company are deemed secured financing transactions, this amendment did not impact the Company's financial condition, results of operations or cash flows.

ITEM 2 Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of financial condition and results of operations should be read in conjunction with the 2011 consolidated audited financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2011. When necessary, reclassifications have been made to prior period data throughout the following discussion and analysis for purposes of comparability. This Quarterly Report on Form 10-Q contains certain "forward looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, which may be identified by the use of such words as "believe", "expect", "anticipate", "should", "planned", "estimated" "potential". Examples of forward looking statements include, but are not limited to, estimates with respect to the financial condition, results of operations and business of Unity Bancorp, Inc. that are subject to various factors which could cause actual results to differ materially from these estimates. These factors include, in addition to those items contained in the Company's Annual Report on Form 10-K under Item IA-Risk Factors, as updated by our subsequent Quarterly Reports on Form 10-Q, the following: changes in general, economic, and market conditions, legislative and regulatory conditions, or the development of an interest rate environment that adversely affects Unity Bancorp, Inc.'s

interest-rate spread or other income anticipated from operations and investments.

Overview

Unity Bancorp, Inc. (the “Parent Company”) is incorporated in New Jersey and is registered as a bank holding company under the Bank Holding Company Act of 1956, as amended. Its wholly-owned subsidiary, Unity Bank (the “Bank” or, when consolidated with the Parent Company, the “Company”) was granted a charter by the New Jersey Department of Banking and Insurance and commenced operations on September 13, 1991. The Bank provides a full range of commercial and retail banking services through 15 branch offices located in Hunterdon, Somerset, Middlesex, Union and Warren counties in New Jersey, and Northampton County in Pennsylvania. These services include the acceptance of demand, savings, and time deposits and the extension of consumer, real estate, Small Business Administration and other commercial credits. Unity Investment Services, Inc., a wholly-owned subsidiary of the Bank, is used to hold part of the Bank’s investment portfolio.

Unity (NJ) Statutory Trust II is a statutory business trust and wholly owned subsidiary of Unity Bancorp, Inc. On July 24, 2006, the Trust issued \$10.0 million of trust preferred securities to investors. Unity (NJ) Statutory Trust III is a statutory business trust and wholly owned subsidiary of Unity Bancorp, Inc. On December 19, 2006, the Trust issued \$5.0 million of trust preferred securities to investors. These floating rate securities are treated as subordinated debentures on the Company’s financial statements. However, they qualify as Tier I Capital for regulatory capital compliance purposes, subject to certain limitations. The Company does not consolidate the accounts and related activity of any of its business trust subsidiaries.

Earnings Summary

Net income available to common shareholders totaled \$575 thousand, or \$0.07 per diluted share, for the quarter ended June 30, 2012, compared to \$249 thousand, or \$0.03 per diluted share for the same period a year ago. For the six months ended June 30, 2012, net income available to common shareholders totaled \$1.1 million or \$0.14 per diluted share compared to \$85 thousand, or \$0.01 per diluted share for the same period a year ago.

Net income available to common shareholders for the prior year’s periods was adversely impacted by the Company’s decision during the second quarter of 2011 to close two of its underperforming branches. As a result of this decision, \$215 thousand in residual

lease and fixed asset disposal expenses were realized in the second quarter of 2011. Excluding these expenses, net income available to common shareholders for the three month period ending June 30, 2011, would have been \$399 thousand or \$0.05 per diluted share. For the six month period, net income available to common shareholders would have been \$236 thousand or \$0.03 per diluted share.

Highlights for the quarterly and year-to-date periods include:

- Continued reductions in loan loss provisions due to improvement in asset quality.
- Significant increases in residential mortgage originations resulting in increases in gains on sale of mortgage loans.
- Significant commercial loan growth.
- Planned reduction in SBA loans outstanding from our National Program.
- Continued growth in noninterest-bearing demand deposits to 17.4 percent of total deposits.
- Continued reduction in higher costing time deposits. Time deposits now represent 22 percent of total deposits.
- Further improvement in our equity to assets ratio.

The Company's quarterly and six month performance ratios may be found in the table below.

| | For the three months ended June 30, | | For the six months ended June 30, | |
|---|--|---------|--------------------------------------|---------|
| | 2012 | 2011 | 2012 | 2011 |
| Net income per common share - Basic (1) | \$ 0.08 | \$ 0.03 | \$ 0.15 | \$ 0.01 |
| Net income per common share - Diluted (1) | \$ 0.07 | \$ 0.03 | \$ 0.14 | 0.01 |
| Return on average assets | 0.49 % | 0.32 % | 0.47 % | 0.21 % |
| Return on average equity (2) | 4.25 % | 1.95 % | 4.03 % | 0.34 % |
| Efficiency ratio | 73.72 % | 69.74 % | 72.76 % | 70.64 % |

(1) Defined as net income adjusted for dividends accrued and accretion of discount on perpetual preferred stock divided by weighted average shares outstanding.

(2) Defined as net income adjusted for dividends accrued and accretion of discount on perpetual preferred stock divided by average shareholders' equity (excluding preferred stock).

Net Interest Income

The primary source of income for the Company is net interest income, the difference between the interest earned on earning assets such as investments and loans, and the interest paid on deposits and borrowings. Factors that impact the Company's net interest income include the interest rate environment, the volume and mix of interest-earning assets and interest-bearing liabilities, and the competitive nature of the Company's marketplace.

Our net interest income continues to be impacted by the sustained low interest rate environment, which the Federal Open Market Committee (“FOMC”) forecasts will continue through 2014, due to continued weak economic conditions. This rate environment has resulted in a tighter net interest margin as our earning assets continue to re-price at lower rates. Partially offsetting these declines are lower funding costs; however the reduction in yield on earning assets is anticipated to exceed the benefits of further declines in the cost of funds.

During the three months ended June 30, 2012, tax-equivalent interest income decreased \$1.4 million or 13.8 percent to \$8.8 million when compared to the same period in the prior year. This decrease was driven by the lower average yield on earning assets and a shift in the mix of earning assets as average loans decreased:

- × Of the \$1.4 million decrease in interest income on a tax-equivalent basis, \$1.3 million was attributed to reduced yields on average interest-earning assets and \$138 thousand was attributable to the decrease in volume of average interest-earning assets.
- × The average volume of interest-earning assets decreased \$22 million to \$755.1 million for the second quarter of 2012 compared to \$777.1 million for the same period in 2011. This was due primarily to a \$15.1 million decrease in average loans and a \$9.7 million decrease in Federal funds sold and interest-bearing deposits, partially offset by a \$2.9 million increase in average investment securities.
- × The yield on interest-earning assets decreased 58 basis points to 4.70 percent for the three months ended June 30, 2012 when compared to the same period in 2011, due to continued re-pricing in a lower overall interest rate environment. Yields on most earning assets, particularly those with variable rates, fell due to these lower market rates.

Total interest expense was \$1.9 million for the three months ended June 30, 2012, a decrease of \$810 thousand or 29.7 percent compared to the same period in 2011. This decrease was driven by the lower overall interest rate environment combined with the shift in deposit mix away from higher priced products and a decrease in the average volume of interest-bearing liabilities:

- × Of the \$810 thousand decrease in interest expense, \$618 thousand was attributed to a decrease in the rates paid on interest-bearing liabilities and \$192 thousand was due to the decrease in the volume of average interest-bearing liabilities.
- × Interest-bearing liabilities averaged \$610.4 million for the second quarter of 2012, a decrease of \$39.4 million or 6.1 percent, compared to the prior year’s quarter. The decrease in interest-bearing liabilities was a result of a decrease in average time deposits and average savings deposits, partially offset by an increase in interest-bearing demand deposits.

- × The average cost of interest-bearing liabilities decreased 42 basis points to 1.25 percent, primarily due to the repricing of deposits in a lower interest rate environment. The cost of interest-bearing deposits decreased 42 basis points to 0.85 percent for the first quarter of 2012 and the cost of borrowed funds and subordinated debentures decreased 60 basis points to 3.57 percent.
- × The lower cost of funding was also attributed to a shift in the mix of deposits from higher cost time deposits to lower cost products as part of management's strategy to restructure the deposit portfolio.

During the quarter ended June 30, 2012, tax-equivalent net interest income amounted to \$6.9 million, a decrease of \$609 thousand or 8.1 percent when compared to the same period in 2011. Net interest margin decreased 20 basis points to 3.68 percent for the quarter ended June 30, 2012, compared to 3.88 percent for the same period in 2011. The net interest spread was 3.45 percent for the second quarter of 2012, a 16 basis point decrease from 3.61 for the same period in 2011.

During the six months ended June 30, 2012, tax-equivalent interest income was \$18.0 million, a decrease of \$2.6 million or 12.6 percent when compared to the same period in 2011.

- × Of the \$2.6 million decrease in interest income on a tax-equivalent basis, \$2.1 million was attributed to reduced yields on average interest-earning assets and \$524 thousand was attributable to the decrease in volume of average interest-earning assets.
- × The average volume of interest-earning assets decreased \$11.3 million to \$766.2 million for the six months ended June 30, 2012, compared to \$777.6 million for the same period in 2011. This was due primarily to a \$21.5 million decrease in average loans, partially offset by a \$10.9 million increase in federal funds sold and interest-bearing deposits.
- × The yield on interest-earning assets decreased 60 basis points to 4.71 percent for the six months ended June 30, 2012 when compared to the same period in 2011, due to continued re-pricing in a lower overall interest rate environment. Yields on most earning assets, particularly those with variable rates, fell due to these lower market rates.

Total interest expense was \$4.2 million for the six months ended June 30, 2012, a decrease of \$1.3 million or 24.2 percent compared to the same period in 2011. This decrease was driven by the lower overall interest rate environment combined with the shift in deposit mix away from higher priced products and a decrease in the average volume of interest-bearing liabilities:

- × Of the \$1.3 million decrease in interest expense, \$1.0 million was due to a decrease in the rates paid on interest-bearing liabilities and \$300 thousand was attributed to the decrease in the volume of average interest-bearing liabilities.
- × Interest-bearing liabilities averaged \$625.0 million for the six months ended June 30, 2012, a decrease of \$29.1 million or 4.4 percent, compared to the same period in 2011. The decrease in interest-bearing liabilities was a result of a decrease in average time deposits and savings deposits, partially offset by an increase in interest-bearing deposits.
- × The average cost of interest-bearing liabilities decreased 36 basis points to 1.33 percent, primarily due to the re-pricing of deposits in a lower interest rate environment. The cost of interest-bearing deposits decreased 34 basis points to 0.94 percent for the six months ended June 30, 2012 and the cost of borrowed funds and subordinated

debentures decreased 56 basis points to 3.63 percent.

- × The lower cost of funding was also attributed to a shift in the mix of deposits from higher cost time deposits to lower cost savings deposits and interest-bearing demand deposits.

During the six months ended June 30, 2012, tax-equivalent net interest income amounted to \$13.8 million, a decrease of \$1.3 million or 8.4 percent, compared to the same period in 2011. Net interest margin decreased 28 basis points to 3.62 percent for the six months ended June 30, 2012, compared to 3.90 percent for the same period in 2011. The net interest spread was 3.38 percent for the six months ended June 30, 2011, a 24 basis point decrease from 3.62 percent for the same period in 2011.

The following table reflects the components of net interest income, setting forth for the periods presented herein: (1) average assets, liabilities and shareholders' equity, (2) interest income earned on interest-earning assets and interest expense paid on interest-bearing liabilities, (3) average yields earned on interest-earning assets and average rates paid on interest-bearing liabilities, (4) net interest spread (which is the average yield on interest-earning assets less the average rate on interest-bearing liabilities), and (5) net interest income/margin on average earning assets. Rates/Yields are computed on a fully tax-equivalent basis, assuming a federal income tax rate of 34 percent.

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Consolidated Average Balance Sheets

(Dollar amounts in thousands, interest amounts and interest rates/yields on a fully tax-equivalent basis)

| | For the three months ended June 30, | | | | | | |
|--|-------------------------------------|----------|------------|------------|-----------|------------|--|
| | 2012 | | | 2011 | | | |
| | Average | | | Average | | | |
| | Balance | Interest | Rate/Yield | Balance | Interest | Rate/Yield | |
| ASSETS | | | | | | | |
| Interest-earning assets: | | | | | | | |
| Federal funds sold and interest-bearing deposits | \$ 30,832 | \$ 11 | 0.14 % | \$ 40,499 | \$ 9 | 0.09 % | |
| Federal Home Loan Bank stock | 3,993 | 44 | 4.43 | 4,097 | 35 | 3.43 | |
| Securities: | | | | | | | |
| Securities available for sale | 103,958 | 741 | 2.85 | 103,750 | 939 | 3.62 | |
| Securities held to maturity | 17,499 | 170 | 3.89 | 14,841 | 185 | 4.99 | |
| Total securities (A) | 121,457 | 911 | 3.00 | 118,591 | 1,124 | 3.79 | |
| Loans: | | | | | | | |
| SBA loans | 69,273 | 846 | 4.89 | 85,678 | 1,191 | 5.56 | |
| SBA 504 loans | 46,804 | 691 | 5.94 | 58,999 | 834 | 5.67 | |
| Commercial loans | 303,409 | 4,216 | 5.59 | 284,503 | 4,581 | 6.46 | |
| Residential mortgage loans | 133,643 | 1,582 | 4.74 | 132,386 | 1,846 | 5.58 | |
| Consumer loans | 45,658 | 529 | 4.66 | 52,316 | 629 | 4.82 | |
| Total loans (B) | 598,787 | 7,864 | 5.28 | 613,882 | 9,081 | 5.93 | |
| Total interest-earning assets | \$ 755,069 | \$ 8,830 | 4.70 % | \$ 777,069 | \$ 10,249 | 5.28 % | |
| Noninterest-earning assets: | | | | | | | |
| Cash and due from banks | 16,101 | | | 16,243 | | | |
| Allowance for loan losses | (16,980) | | | (16,050) | | | |
| Other assets | 39,774 | | | 39,903 | | | |
| Total noninterest-earning assets | 38,895 | | | 40,096 | | | |
| Total assets | \$ 793,964 | | | \$ 817,165 | | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | | | | |
| Interest-bearing liabilities: | | | | | | | |
| Interest-bearing demand deposits | \$ 110,343 | \$ 123 | 0.45 % | \$ 104,149 | \$ 143 | 0.55 % | |
| Savings deposits | 270,990 | 287 | 0.43 | 286,738 | 584 | 0.82 | |
| Time deposits | 138,554 | 689 | 2.00 | 168,448 | 1,045 | 2.49 | |
| Total interest-bearing deposits | 519,887 | 1,099 | 0.85 | 559,335 | 1,772 | 1.27 | |
| Borrowed funds and subordinated debentures | 90,465 | 816 | 3.57 | 90,465 | 953 | 4.17 | |
| Total interest-bearing liabilities | \$ 610,352 | \$ 1,915 | 1.25 % | \$ 649,800 | \$ 2,725 | 1.67 % | |
| Noninterest-bearing liabilities: | | | | | | | |
| Noninterest-bearing demand deposits | 106,043 | | | 92,090 | | | |
| Other liabilities | 3,438 | | | 4,760 | | | |
| Total noninterest-bearing liabilities | 109,481 | | | 96,850 | | | |
| Total shareholders' equity | 74,131 | | | 70,515 | | | |
| Total liabilities and shareholders' equity | \$ 793,964 | | | \$ 817,165 | | | |

| | | | | | | |
|---------------------------------|----------|------|---|----------|------|---|
| Net interest spread | \$ 6,915 | 3.45 | % | \$ 7,524 | 3.61 | % |
| Tax-equivalent basis adjustment | (58) | | | (53) | | |
| Net interest income | \$ 6,857 | | | \$ 7,471 | | |
| Net interest margin | | 3.68 | % | | 3.88 | % |

(A) Yields related to securities exempt from federal and state income taxes are stated on a fully tax-equivalent basis. They are reduced by the nondeductible portion of interest expense, assuming a federal tax rate of 34 percent and applicable state rates.

(B) The loan averages are stated net of unearned income, and the averages include loans on which the accrual of interest has been discontinued.

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Consolidated Average Balance Sheets

(Dollar amounts in thousands, interest amounts and interest rates/yields on a fully tax-equivalent basis)

| | For the six months ended June 30, | | | | | | |
|--|-----------------------------------|-----------|------------|----------------------------|-----------|------------|--|
| | 2012 Average Balance | Interest | Rate/Yield | 2011 Average Balance | Interest | Rate/Yield | |
| ASSETS | | | | | | | |
| Interest-earning assets: | | | | | | | |
| Federal funds sold and interest-bearing deposits | \$ 47,746 | \$ 43 | 0.18 % | \$ 36,896 | \$ 20 | 0.11 % | |
| Federal Home Loan Bank stock | 4,041 | 95 | 4.73 | 4,151 | 101 | 4.91 | |
| Securities: | | | | | | | |
| Securities available for sale | 103,030 | 1,523 | 2.96 | 104,385 | 1,849 | 3.54 | |
| Securities held to maturity | 17,936 | 349 | 3.89 | 17,166 | 478 | 5.57 | |
| Total securities (A) | 120,966 | 1,872 | 3.10 | 121,551 | 2,327 | 3.83 | |
| Loans: | | | | | | | |
| SBA loans | 70,516 | 1,770 | 5.02 | 85,769 | 2,427 | 5.66 | |
| SBA 504 loans | 49,257 | 1,451 | 5.92 | 60,490 | 1,789 | 5.96 | |
| Commercial loans | 293,823 | 8,397 | 5.75 | 283,559 | 8,887 | 6.32 | |
| Residential mortgage loans | 133,234 | 3,237 | 4.86 | 131,570 | 3,677 | 5.59 | |
| Consumer loans | 46,633 | 1,089 | 4.70 | 53,576 | 1,315 | 4.95 | |
| Total loans (B) | 593,463 | 15,944 | 5.40 | 614,964 | 18,095 | 5.92 | |
| Total interest-earning assets | \$ 766,216 | \$ 17,954 | 4.71 % | \$ 777,562 | \$ 20,543 | 5.31 % | |
| Noninterest-earning assets: | | | | | | | |
| Cash and due from banks | 16,025 | | | 16,999 | | | |
| Allowance for loan losses | (16,884) | | | (15,555) | | | |
| Other assets | 40,030 | | | 39,835 | | | |
| Total noninterest-earning assets | 39,171 | | | 41,279 | | | |
| Total assets | \$ 805,387 | | | \$ 818,841 | | | |
| LIABILITIES AND SHAREHOLDERS' EQUITY | | | | | | | |
| Interest-bearing liabilities: | | | | | | | |
| Interest-bearing demand deposits | \$ 109,665 | \$ 259 | 0.47 % | \$ 103,851 | \$ 283 | 0.55 % | |
| Savings deposits | 277,125 | 641 | 0.47 | 288,263 | 1,165 | 0.81 | |
| Time deposits | 147,778 | 1,603 | 2.18 | 171,517 | 2,140 | 2.52 | |
| Total interest-bearing deposits | 534,568 | 2,503 | 0.94 | 563,631 | 3,588 | 1.28 | |
| Borrowed funds and subordinated debentures | 90,465 | 1,662 | 3.63 | 90,465 | 1,904 | 4.19 | |
| Total interest-bearing liabilities | \$ 625,033 | \$ 4,165 | 1.33 % | \$ 654,096 | \$ 5,492 | 1.69 % | |
| Noninterest-bearing liabilities: | | | | | | | |
| Noninterest-bearing demand deposits | 103,269 | | | 90,453 | | | |
| Other liabilities | 3,344 | | | 4,148 | | | |
| Total noninterest-bearing liabilities | 106,613 | | | 94,601 | | | |
| Total shareholders' equity | 73,741 | | | 70,144 | | | |
| Total liabilities and shareholders' equity | \$ 805,387 | | | \$ 818,841 | | | |

| | | | | | | |
|---------------------------------|-----------|------|---|-----------|------|---|
| Net interest spread | \$ 13,789 | 3.38 | % | \$ 15,051 | 3.62 | % |
| Tax-equivalent basis adjustment | (126) | | | (105) | | |
| Net interest income | \$ 13,663 | | | \$ 14,946 | | |
| Net interest margin | | 3.62 | % | | 3.90 | % |

(A) Yields related to securities exempt from federal and state income taxes are stated on a fully tax-equivalent basis. They are reduced by the nondeductible portion of interest expense, assuming a federal tax rate of 34 percent and applicable state rates.

(B) The loan averages are stated net of unearned income, and the averages include loans on which the accrual of interest has been discontinued.

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The rate volume table below presents an analysis of the impact on interest income and expense resulting from changes in average volume and rates over the periods presented. Changes that are not due to volume or rate variances have been allocated proportionally to both, based on their relative absolute values. Amounts have been computed on a tax-equivalent basis, assuming a federal income tax rate of 34 percent.

| (In thousands on a tax-equivalent basis) | For the three months ended June 30, 2012 versus June 30, 2011 | | | For the six months ended June 30, 2012 versus June 30, 2011 | | |
|--|---|------------|------------|--|------------|------------|
| | Increase (decrease) due to change in: | | | Increase (decrease) due to change in: | | |
| | Volume | Rate | Net | Volume | Rate | Net |
| Interest income: | | | | | | |
| Federal funds sold and interest-bearing deposits | \$ (2) | \$ 4 | \$ 2 | \$ 7 | \$ 16 | \$ 23 |
| Federal Home Loan Bank stock | (1) | 10 | 9 | (3) | (3) | (6) |
| Securities | 32 | (245) | (213) | (4) | (451) | (455) |
| Loans | (167) | (1,050) | (1,217) | (524) | (1,627) | (2,151) |
| Total interest income | \$ (138) | \$ (1,281) | \$ (1,419) | \$ (524) | \$ (2,065) | \$ (2,589) |
| Interest expense: | | | | | | |
| Demand deposits | \$ 8 | \$ (28) | \$ (20) | \$ 16 | \$ (40) | \$ (24) |
| Savings deposits | (31) | (266) | (297) | (44) | (480) | (524) |
| Time deposits | (169) | (187) | (356) | (272) | (265) | (537) |
| Total interest-bearing deposits | (192) | (481) | (673) | (300) | (785) | (1,085) |
| Borrowed funds and subordinated debentures | - | (137) | (137) | - | (242) | (242) |
| Total interest expense | (192) | (618) | (810) | (300) | (1,027) | (1,327) |
| Net interest income - fully tax-equivalent | \$ 54 | \$ (663) | \$ (609) | \$ (224) | \$ (1,038) | \$ (1,262) |
| Increase in tax-equivalent adjustment | | | (5) | | | (21) |
| Net interest income | | | \$ (614) | | | \$ (1,283) |

Provision for Loan Losses

The provision for loan losses totaled \$1.0 million for the three months ended June 30, 2012, compared to \$1.8 million for the three months ended June 30, 2011. For the six months ended June 30, 2012, the provision for loan losses totaled \$2.2 million, compared to \$4.3 million for the same period in 2011. Each period's loan loss provision is the result of management's analysis of the loan portfolio and reflects changes in the size and composition of the portfolio, the level of net charge-offs, delinquencies, current economic conditions and other internal and external factors impacting the risk within the loan portfolio. Additional information may be found under the captions "Financial Condition-Asset Quality" and "Financial Condition - Allowance for Loan Losses and Unfunded Loan Commitments." The current provision is considered appropriate under management's assessment of the adequacy of the allowance for loan losses.

Noninterest Income

Our noninterest income consists primarily of branch and loan fee income, gains on the sale of SBA and residential mortgage loans and BOLI income. For the three months ended June 30 2012, noninterest income amounted to \$1.8 million, an increase of \$394 thousand from the prior year period. Noninterest income was \$3.6 million for the six months ended June 30, 2012, an increase of \$854 thousand when compared to the same period in 2011. The increase during both periods was primarily due to increased gains on sales of residential mortgages and investment securities.

The following table shows the components of noninterest income for the three and six months ended June 30, 2012 and 2011:

| (In thousands) | For the three months ended June 30, | | For the six months ended June 30, | |
|--|---|----------|--------------------------------------|----------|
| | 2012 | 2011 | 2012 | 2011 |
| Branch fee income | \$ 362 | \$ 337 | \$ 748 | \$ 680 |
| Service and loan fee income | 287 | 384 | 588 | 627 |
| Gain on sale of SBA loans held for sale, net | 223 | 399 | 381 | 510 |
| Gain on sale of mortgage loans, net | 453 | 87 | 864 | 256 |
| BOLI income | 73 | 74 | 146 | 147 |
| Net security gains (losses) | 283 | (39) | 507 | 87 |
| Other income | 160 | 205 | 322 | 395 |
| Total noninterest income | \$ 1,841 | \$ 1,447 | \$ 3,556 | \$ 2,702 |

Changes in our noninterest income for the three and six months ended June 30, 2012 versus 2011 reflect:

- For the three and six months ended June 30, 2012, branch fee income, which consists of deposit service charges and overdraft fees, increased \$25 thousand and \$68 thousand, respectively, when compared to the same periods in 2011. The increases were due to higher levels of overdraft fees partially offset by reduced deposit account service charges.
- For the three and six months ended June 30, 2012, service and loan fee income decreased \$97 thousand and \$39 thousand, respectively, when compared to the same periods in the prior year. These decreases were primarily due to reduced late charges, payoff charges, and other processing fees.
- Net gains on SBA loan sales amounted to \$223 thousand on \$2.3 million in sales and \$381 thousand on \$4.2 million in sales for the three and six months ended June 30, 2012, respectively, compared to net gains of \$399 thousand on \$4.9 million in sales and \$510 thousand on \$6.0 million in sales during the same periods in 2011.
- For the three and six months ended June 30, 2012, gains on the sale of residential mortgage loans increased \$366 and \$608 thousand compared to the same periods in the prior year. The increased gains are due to a significantly higher volume of loan sales. Net gains on mortgage loan sales amounted to \$453 thousand on \$20.3 million in sales and \$864 thousand on \$41.5 million in sales for the three and six months ended June 30, 2012, respectively, compared to net gains of \$87 thousand on \$6.0 million in sales and \$256 thousand on \$15.7 million in sales during the same periods in 2011.
- The increase in the cash surrender value of BOLI remained relatively flat when compared to the same periods in the prior year, with income of \$73 thousand and \$146 thousand for the three and six months ended June 30, 2012, respectively.
- For the three months ended June 30, 2012, net realized gains on the sale of securities amounted to \$283 thousand, compared to net security losses of \$39 thousand for the same period in the prior year. For the six months ended June 30, 2012 and 2011, net realized gains on sales of securities amounted to \$507 thousand and \$87 thousand, respectively. For additional information, see Note 7 - Securities.
- For the three and six months ended June 30, 2012, other income decreased \$45 thousand and \$73 thousand, respectively, when compared to the same periods in the prior year.

Noninterest Expense

Total noninterest expense was \$6.2 million for the three months ended June 30, 2012 and 2011, and \$12.2 million and \$12.4 million for the six months ended June 30, 2012 and 2011, respectively. Current year figures include expenses related to opening our fifteenth branch in Washington Township, New Jersey in March 2012. Prior period figures include the recognition of \$215 thousand in residual lease obligation and fixed asset disposals related to closing two underperforming branches in 2011.

The following table presents a breakdown of noninterest expense for the three and six months ended June 30, 2012 and 2011:

| (In thousands) | For the three months ended June 30, | | For the six months ended June 30, | |
|----------------|---|------|--------------------------------------|------|
| | 2012 | 2011 | 2012 | 2011 |

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| | | | | |
|-------------------------------|----------|----------|-----------|-----------|
| Compensation and benefits | \$ 3,133 | \$ 2,880 | \$ 6,315 | \$ 5,937 |
| Occupancy | 740 | 827 | 1,348 | 1,546 |
| Processing and communications | 553 | 537 | 1,087 | 1,044 |
| Furniture and equipment | 355 | 410 | 717 | 794 |
| Professional services | 211 | 192 | 402 | 394 |
| Loan collection costs | 91 | 201 | 271 | 425 |
| OREO expenses | 237 | 223 | 362 | 445 |
| Deposit insurance | 168 | 282 | 339 | 601 |
| Advertising | 302 | 205 | 448 | 323 |
| Other expenses | 414 | 490 | 872 | 897 |
| Total noninterest expense | \$ 6,204 | \$ 6,247 | \$ 12,161 | \$ 12,406 |

Changes in noninterest expense for the three and six months ended June 30, 2012 versus 2011 reflect:

- Compensation and benefits expense, the largest component of noninterest expense, increased \$253 thousand and \$378 thousand for the three and six months ended June 30, 2012, respectively, when compared to the same periods in 2011. These increases were due to higher payroll costs for merit increases, mortgage origination commissions, equity compensation and medical benefits expenses.
- Occupancy expense decreased \$87 thousand and \$198 thousand for the three and six months ended June 30, 2012, respectively, when compared to the same periods in 2011. These decreases were primarily due to the branch closure cost savings noted above, partially offset by expenses related to our new Washington branch. The year over year decrease also includes savings in snow removal costs due to a milder winter.
- Processing and communications expenses increased \$16 thousand and \$43 thousand for the three and six months ended June 30, 2012, respectively, when compared to the same periods in 2011. The quarter over quarter increase was primarily due to higher delivery expenses and ATM charges. The year over year increase was primarily due to increased check card and merchant services expenses.
- Furniture and equipment expense decreased \$55 thousand and \$77 thousand for the three and six months ended June 30, 2012, respectively, when compared to the same periods in 2011. This decrease was primarily due to the branch closure cost savings noted above, partially offset by expenses related to our new Washington branch.
- Professional service fees increased \$19 thousand and \$8 thousand for the three and six months ended June 30, 2012, respectively, when compared to the same periods in 2011. The increases were primarily due to higher consulting expenses.

The year over year increase also included higher accounting and tax expenses.

- Loan collection costs decreased \$110 thousand and \$154 thousand for the three and six months ended June 30, 2012, respectively, when compared to the same periods in 2011. These decreases were primarily due to lower loan legal, appraisal and other collection related expenses.
 - OREO expenses increased \$14 thousand for the three months ended June 30, 2012 compared to the three months ended June 30, 2011, primarily due to increased insurance expenses on OREO properties. OREO expenses decreased \$83 thousand for the six months ended June 30, 2012 when compared to the same period in 2011, primarily due to lower OREO maintenance, utility and legal expenses and decreased losses on the sale of OREO properties.
 - Deposit insurance expense decreased \$114 thousand and \$262 thousand for the three and six months ended June 30, 2012, respectively, when compared to the same periods in 2011, due to the new asset-based assessment method which the FDIC put into place April 1, 2011.
 - Advertising expense increased \$97 thousand and \$125 thousand for the three and six months ended June 30, 2012, respectively, when compared to the same periods in 2011. These increases are in response to promotional activities related to the new branch, increased participation in community events and direct mail costs.
- Other expenses decreased \$76 thousand and \$25 thousand for the three and six months ended June 30, 2012, respectively, when compared to the same periods in 2011, primarily due to lower reserves on outstanding loan commitments.

Income Tax Expense

For the quarter ended June 30, 2012, the Company reported income tax expense of \$518 thousand for an effective tax rate of 34.7 percent, compared to an income tax expense of \$277 thousand and effective tax rate of 30.1 percent for the prior year's quarter. For the six months ended June 30, 2012, the Company reported income tax expense of \$977 thousand for an effective tax rate of 34.2 percent, compared to an income tax expense of \$129 thousand and effective tax rate of 13.0 percent for the six months ended June 30, 2011. The provision for income taxes for the six months ended June 30, 2011 included the reversal of \$150 thousand of a valuation reserve for deferred taxes related to the net operating loss carry-forward deferred tax asset. Excluding this valuation adjustment, our effective tax rate would have been 28.1 percent.

Financial Condition at June 30, 2012

Total assets decreased \$25.7 million or 3.2 percent, to \$785.1 million at June 30, 2012, compared to \$810.8 million at December 31, 2011. This decrease was primarily due to a decrease of \$44.7 million in cash and cash equivalents, partially offset by a \$12.3 million increase in loans and a \$7.3 million increase in securities. Total deposits decreased \$27.5 million, primarily due to a decrease of \$15.4 million in municipal deposits. There were no changes to borrowed funds and subordinated debentures. Total shareholders' equity increased \$1.3 million over year-end 2011. These fluctuations are discussed in further detail in the paragraphs that follow.

Investment Securities Portfolio

The Company's securities portfolio consists of available for sale ("AFS") and held to maturity ("HTM") investments. Management determines the appropriate security classification of available for sale or held to maturity at the time of purchase. The investment securities portfolio is maintained for asset-liability management purposes, as well as for liquidity and earnings purposes.

AFS securities are investments carried at fair value that may be sold in response to changing market and interest rate conditions or for other business purposes. Activity in this portfolio is undertaken primarily to manage liquidity and interest rate risk, to take advantage of market conditions that create economically attractive returns and as an additional source of earnings. AFS securities consist primarily of obligations of U.S. Government sponsored entities, obligations of state and political subdivisions, mortgage-backed securities, trust preferred securities, corporate securities, asset-backed securities and equity securities.

HTM securities, which are carried at amortized cost, are investments for which there is the positive intent and ability to hold to maturity. The portfolio is comprised of obligations of state and political subdivisions and mortgage-backed securities.

AFS securities totaled \$98.0 million at June 30, 2012, an increase of \$9.2 million or 10.4 percent, compared to \$88.8 million at December 31, 2011. This net increase was the result of:

- \$32.8 million in purchases, primarily of mortgage-backed securities and asset-backed securities, partially offset by
- \$16.7 million in principal payments, maturities and called bonds,
- \$6.1 million in sales net of realized gains, which consisted of municipal securities and mortgage-backed securities,
- \$387 thousand in net amortization of premiums, and
- \$362 thousand of depreciation in the market value of the portfolio. At June 30, 2012, the portfolio had a net unrealized gain of \$1.5 million compared to a net unrealized gain of \$1.9 million at December 31, 2011. These net unrealized gains are reflected net of tax in shareholders' equity as accumulated other comprehensive income.

The average balance of AFS securities amounted to \$103.0 million for the six months ended June 30, 2012, compared to \$104.4 million for the same period in 2011. The average yield earned on the AFS portfolio decreased 58 basis points, to 2.96 percent for the six months ended June 30, 2012, from 3.54 percent for the same period in the prior year. The weighted average repricing of AFS securities, adjusted for prepayments, amounted to 2.2 years at June 30, 2012 and 2.4 years at December 31, 2011.

HTM securities were \$16.9 million at June 30, 2012, a decrease of \$1.9 million or 10.1 percent, from year-end 2011. This net

decrease was the result of:

- \$1.8 million in principal payments, and
- \$71 thousand in net amortization of premiums.

As of June 30, 2012 and December 31, 2011, the fair value of HTM securities was \$18.3 million and \$19.9 million, respectively. The average balance of HTM securities amounted to \$17.9 million for the six months ended June 30, 2012, compared to \$17.2 million for the same period in 2011. The average yield earned on HTM securities decreased 168 basis points, to 3.89 percent for the six months ended June 30, 2012, from 5.57 percent for the same period in 2011. The weighted average repricing of HTM securities, adjusted for prepayments, amounted to 4.8 years and 5.2 years at June 30, 2012 and December 31, 2011, respectively.

Securities with a carrying value of \$63.2 million and \$81.1 million at June 30, 2012 and December 31, 2011, respectively, were pledged to secure Government deposits, secure other borrowings and for other purposes required or permitted by law.

Approximately 80 percent of the total investment portfolio had a fixed rate of interest at June 30, 2012.

Loan Portfolio

The loan portfolio, which represents the Company's largest asset group, is a significant source of both interest and fee income. The portfolio consists of SBA, SBA 504, commercial, residential mortgage and consumer loans. Different segments of the loan portfolio are subject to differing levels of credit and interest rate risk.

Total loans increased \$12.3 million or 2.1 percent to \$604.9 million at June 30, 2012, compared to \$592.6 million at year-end 2011. Commercial and residential mortgage loans increased \$27.2 million and \$2.4 million, respectively, partially offset by declines in all other loan categories.

The following table sets forth the classification of loans by major category, including unearned fees, deferred costs and excluding the allowance for loan losses as of June 30, 2012 and December 31, 2011:

| | June 30, 2012 | | December 31, 2011 | | |
|-------------------------|---------------|------------|-------------------|------------|---|
| | Amount | % of Total | Amount | % of Total | |
| (In thousands) | | | | | |
| SBA loans held for sale | \$ 6,087 | 1.0 | % \$ 7,668 | 1.3 | % |

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| | | | | |
|----------------------------|------------|---------|------------|---------|
| SBA loans held to maturity | 60,382 | 10.0 | 64,175 | 10.8 |
| SBA 504 loans | 45,247 | 7.5 | 55,108 | 9.3 |
| Commercial loans | 310,331 | 51.2 | 283,104 | 47.8 |
| Residential mortgage loans | 136,514 | 22.6 | 134,090 | 22.6 |
| Consumer loans | 46,340 | 7.7 | 48,447 | 8.2 |
| Total loans | \$ 604,901 | 100.0 % | \$ 592,592 | 100.0 % |

Average loans decreased \$21.5 million or 3.5 percent from \$615.0 million for the six months ended June 30, 2011, to \$593.5 million for the same period in 2012. The decrease in average loans was due to declines in all portfolio types except commercial and residential mortgage loans. The yield on the overall loan portfolio fell 52 basis points to 5.40 percent for the six months ended June 30, 2012, compared to 5.92 percent for the same period in the prior year. This decrease was the result of new loan volume at lower rates and existing variable rate loan products repricing lower as rates remain low.

SBA 7(a) loans, on which the SBA historically has 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. These loans are made for the purposes of providing working capital, financing the purchase of equipment, inventory or commercial real estate, and may be made inside or outside the Company's market place. Generally, an SBA 7(a) loan has a deficiency in its credit profile that would not allow the borrower to qualify for a traditional commercial loan, which is why the government provides the guarantee. The deficiency may be a higher loan to value ("LTV") ratio, lower debt service coverage ("DSC") ratio or weak personal financial guarantees. In addition, many SBA 7(a) loans are for start up businesses where there is no history of financial information. Finally, many SBA borrowers do not have an ongoing and continuous banking relationship with the Bank, but merely work with the Bank on a single transaction. The Company's SBA loans are generally sold in the secondary market with the nonguaranteed portion held in the portfolio as a loan held for investment.

SBA 7(a) loans held for sale, carried at the lower of cost or market, amounted to \$6.1 million at June 30, 2012, a decrease of \$1.6 million from \$7.7 million at December 31, 2011. SBA 7(a) loans held to maturity amounted to \$60.4 million at June 30, 2012, a decrease of \$3.8 million from \$64.2 million at December 31, 2011. In 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. The yield on SBA loans, which are generally floating and adjust quarterly to the Prime rate, was 5.02 percent for the six months ended June 30, 2012, compared to 5.66 percent for the same period in the prior year.

The guarantee rates on SBA 7(a) loans range from 50 percent to 90 percent, with the majority of the portfolio having a guarantee rate of 75 percent. The guarantee rates are determined by the SBA and can vary from year to year depending on government funding and the goals of the SBA program. The table below details the loan balances which appear on the Company's balance sheet and their respective guarantee rates as of June 30, 2012 and December 31, 2011. The loan balances shown in the table represent the unguaranteed portion, which is the Company's portion of SBA loans originated, reduced by the guaranteed portion that is sold into the

secondary market. The guarantee rates shown in the table represent the percentage of the loans that were sold into the secondary market, but the servicing was retained by the Company. Approximately \$117.7 million and \$128.7 million in SBA loans were sold but serviced by the Company at June 30, 2012 and December 31, 2011, respectively, and are not included in the following balances:

| | June 30, 2012 | | | December 31, 2011 | | |
|-----------------|-------------------|----------------------|-----------|-------------------|----------------------|-----------|
| | SBA held for sale | SBA held to maturity | Total | SBA held for sale | SBA held to maturity | Total |
| (In thousands) | | | | | | |
| < 75% guarantee | \$ 100 | \$ 5,216 | \$ 5,316 | \$ 100 | \$ 6,373 | \$ 6,473 |
| 75% guarantee | 4,939 | 51,764 | 56,703 | 6,074 | 54,150 | 60,224 |
| > 75% guarantee | 1,048 | 3,402 | 4,450 | 1,494 | 3,652 | 5,146 |
| Total | \$ 6,087 | \$ 60,382 | \$ 66,469 | \$ 7,668 | \$ 64,175 | \$ 71,843 |

There is no relationship or correlation between the guarantee percentages and the level of charge-offs and recoveries. Charge-offs taken on SBA 7(a) loans represent the unguaranteed portion of the loan. SBA loans are underwritten to the same credit standards irrespective of the guarantee percentage.

At June 30, 2012, SBA 504 loans totaled \$45.2 million, a decrease of \$9.9 million from \$55.1 million at December 31, 2011. 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. Generally, the Company has a 50 percent LTV ratio on SBA 504 program loans at origination. The yield on SBA 504 loans fell 4 basis points to 5.92 percent for the six months ended June 30, 2012 from 5.96 percent for the six months ended June 30, 2011, due primarily to paydowns on higher yielding SBA 504 loans.

Commercial loans are generally made in the Company's marketplace for the purpose of providing working capital, financing the purchase of equipment, inventory or commercial real estate and for other business purposes. These loans amounted to \$310.3 million at June 30, 2012, an increase of \$27.2 million from year-end 2011. The yield on commercial loans was 5.75 percent for the six months ended June 30, 2012, compared to 6.32 percent for the six months ended June 30, 2011 due to the low rate environment.

Residential mortgage loans consist of loans secured by 1 to 4 family residential properties. These loans amounted to \$136.5 million at June 30, 2012, an increase of \$2.4 million from year-end 2011. New loan volume during the six months ended June 30, 2012 was partially offset by the sale of mortgage loans totaling \$41.5 million. The yield on residential mortgages was 4.86 percent for the six months ended June 30, 2012, compared to 5.59 percent for the same period in 2011.

Consumer loans consist of home equity loans and loans for the purpose of financing the purchase of consumer goods, home improvements, and other personal needs, and are generally secured by the personal property being purchased.

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These loans amounted to \$46.3 million at June 30, 2012, a decrease of \$2.1 million from December 31, 2011. The yield on consumer loans was 4.70 percent for the six months ended June 30, 2012, compared to 4.95 percent for the same period in 2011.

There are no concentrations of loans to any borrowers or group of borrowers exceeding 10 percent of the total loan portfolio and no foreign loans in the portfolio. As a preferred SBA lender, a portion of the SBA portfolio is to borrowers outside the Company's lending area. 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.

In the normal course of business, the Company may originate loan products whose terms could give rise to additional credit risk. Interest-only loans, loans with high LTV ratios, construction loans with payments made from interest reserves and multiple loans supported by the same collateral (e.g. home equity loans) are examples of such products. However, these products are not material to the Company's financial position and are closely managed via credit controls that mitigate their additional inherent risk. Management does not believe that these products create a concentration of credit risk in the Company's loan portfolio. The Company does not have any option adjustable rate mortgage loans.

The majority of the Company's loans are secured by real estate. Declines in the market values of real estate in the Company's trade area impact the value of the collateral securing its loans. This could lead to greater losses in the event of defaults on loans secured by real estate. The detailed allocation of the Company's loan portfolio collateral as of June 30, 2012 and December 31, 2011 is shown in the tables below:

| (In thousands) | June 30, 2012 | | | | | | | | | | | |
|--|---------------|--------|-----------|--------|------------|--------|-------------|-------|----------|------|------------|--|
| | SBA | | SBA 504 | | Commercial | | Residential | | Consumer | | Total | |
| Commercial real estate - owner occupied | \$ 36,379 | 54.0 % | \$ 13,728 | 30.0 % | \$ 158,367 | 51.1 % | \$ - | - % | \$ - | - % | \$ 208,474 | |
| Commercial real estate - investment property | 15,746 | 24.0 | 31,519 | 70.0 | 108,122 | 34.8 | - | - | - | - | 155,387 | |
| Residential real estate - owner occupied | 6,332 | 10.0 | - | - | 14,998 | 4.8 | 136,514 | 100.0 | 45,097 | 98.0 | 202,941 | |
| Construction and land development | 997 | 1.0 | - | - | 15,494 | 5.0 | - | - | - | - | 16,491 | |
| | 7,015 | 11.0 | - | - | 13,350 | 4.3 | - | - | 1,243 | 2.0 | 21,608 | |

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| | | | | | | |
|---|-------------------|-------------------|--------------------|--------------------|-------------------|------------|
| Other nonreal estate collateral Total | \$ 66,469 100.0 % | \$ 45,247 100.0 % | \$ 310,331 100.0 % | \$ 136,514 100.0 % | \$ 46,340 100.0 % | \$ 604,901 |
|---|-------------------|-------------------|--------------------|--------------------|-------------------|------------|

December 31, 2011

| (In thousands) | SBA | SBA 504 | Commercial | Residential | Consumer | Total |
|---|-------------------|-------------------|--------------------|--------------------|-------------------|------------|
| Commercial real estate - owner occupied | \$ 40,106 55.8 % | \$ 18,770 34.0 % | \$ 138,046 48.8 % | \$ - | \$ - | \$ 196,922 |
| Commercial real estate - investment property | 17,110 23.8 | 36,338 66.0 | 101,950 36.0 | - | - | 155,398 |
| Residential real estate - owner occupied | 6,423 8.9 | - | 15,504 5.5 | 134,090 100.0 | 46,935 97.0 | 202,952 |
| Construction and land development | 100 0.1 | - | 15,513 5.5 | - | - | 15,613 |
| Other nonreal estate collateral | 8,104 11.3 | - | 12,091 4.3 | - | 1,512 3.0 | 21,707 |
| Total | \$ 71,843 100.0 % | \$ 55,108 100.0 % | \$ 283,104 100.0 % | \$ 134,090 100.0 % | \$ 48,447 100.0 % | \$ 592,592 |

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Troubled Debt Restructurings

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. 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 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.

At June 30, 2012, there were twenty-three loans totaling \$21.4 million that were classified as TDRs by the Company and are deemed impaired, compared to twenty-four such loans totaling \$21.1 million at December 31, 2011. Nonperforming loans included \$871 thousand of TDRs as of June 30, 2012, compared to \$3.6 million at December 31, 2011. Restructured loans that are placed in nonaccrual status may be removed after 6 months of contractual payments and the business showing the ability to service the debt going forward. The remaining TDRs are in accrual status since they are performing in accordance with the restructured terms. There are no commitments to lend additional funds on these loans. The following table presents a breakdown of performing and nonperforming TDRs by class as of June 30, 2012:

| (In thousands) | June 30, 2012 | | | December 31, 2011 | | |
|------------------------|--------------------|-----------------------|---------------|--------------------|-----------------------|---------------|
| | Performing TDRs | Nonperforming TDRs | Total TDRs | Performing TDRs | Nonperforming TDRs | Total TDRs |
| SBA loans | \$ 938 | \$ 281 | \$ 1,219 | \$ 1,398 | \$ 80 | \$ 1,478 |
| SBA 504 loans | 4,336 | - | 4,336 | 4,371 | 1,754 | 6,125 |
| Commercial loans | | | | | | |
| Commercial other | 3,223 | - | 3,223 | 985 | - | 985 |
| Commercial real estate | 12,044 | 590 | 12,634 | 10,682 | 1,811 | 12,493 |
| Total | \$ 20,541 | \$ 871 | \$ 21,412 | \$ 17,436 | \$ 3,645 | \$ 21,081 |

Through June 30, 2012, our TDRs consisted of interest rate reductions, interest only periods and maturity extensions. There has been no principal forgiveness. The following table shows the types of modifications done to date by class through June 30, 2012:

| (In thousands) | June 30, 2012 SBA | Total |
|----------------|----------------------|-------|
|----------------|----------------------|-------|

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| Type of modification: | | SBA 504 | Commercial other | Commercial real estate | |
|--|----------|------------|---------------------|---------------------------|-----------|
| Interest only | \$ 446 | \$ - | \$ 2,238 | \$ 2,522 | \$ 5,206 |
| Principal only | 24 | - | - | - | 24 |
| Reduced interest rate | - | - | - | 590 | 590 |
| Interest only with reduced interest rate | - | - | 985 | 5,512 | 6,497 |
| Interest only with nominal principal | 295 | 3,018 | - | 1,134 | 4,447 |
| Extended maturity with reduced interest rate | - | - | - | 2,876 | 2,876 |
| Previously modified back to original terms | 454 | 1,318 | - | - | 1,772 |
| Total | \$ 1,219 | \$ 4,336 | \$ 3,223 | \$ 12,634 | \$ 21,412 |

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Asset Quality

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 strict 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 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.

Nonperforming assets consist of nonperforming loans and other real estate owned ("OREO"). 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. When a loan is classified as nonaccrual, interest accruals discontinue and all past due interest previously recognized as income is reversed and charged against current period income. 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 past due 90 days or more and still accruing interest are not included in nonperforming loans. Loans past due 90 days or more and still accruing generally represent loans that are well collateralized and in a continuing process that are expected to result in repayment or restoration to current status.

The following table sets forth information concerning nonperforming loans and nonperforming assets at each of the periods presented:

| (In thousands) | June 30, 2012 | December 31, 2011 | June 30, 2011 |
|----------------------------|------------------|----------------------|------------------|
| Nonperforming by category: | | | |
| SBA loans (1) | \$ 3,345 | \$ 5,859 | \$ 7,941 |

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| | | | |
|--|-----------|-----------|-----------|
| SBA 504 loans | 1,775 | 2,086 | 3,952 |
| Commercial loans | 9,736 | 8,519 | 8,896 |
| Residential mortgage loans | 4,653 | 6,037 | 4,040 |
| Consumer loans | 322 | 268 | 270 |
| Total nonperforming loans (2) | \$ 19,831 | \$ 22,769 | \$ 25,099 |
| OREO | 2,355 | 3,032 | 2,722 |
| Total nonperforming assets | \$ 22,186 | \$ 25,801 | \$ 27,821 |
| Past due 90 days or more and still accruing interest: | | | |
| SBA loans | \$ 240 | \$ 246 | \$ 207 |
| SBA 504 loans | - | - | - |
| Commercial loans | 288 | 1,141 | 1,925 |
| Residential mortgage loans | 1,915 | 36 | 726 |
| Consumer loans | - | 988 | - |
| Total past due 90 days or more and still accruing interest | \$ 2,443 | \$ 2,411 | \$ 2,858 |
| Nonperforming loans to total loans | 3.28 | % 3.84 | % 4.08 |
| Nonperforming loans and TDRs to total loans (3) | 6.67 | 6.78 | 6.93 |
| Nonperforming assets to total loans and OREO | 3.65 | 4.33 | 4.50 |
| Nonperforming assets to total assets | 2.83 | 3.18 | 3.45 |
| (1) Guaranteed SBA loans included above | \$ 526 | \$ 939 | \$ 2,857 |
| (2) Nonperforming TDRs included above | 871 | 3,645 | 3,065 |
| (3) Performing TDRs included above | 20,541 | 17,436 | 17,509 |

The current state of the economy impacts the Company's level of delinquent and nonperforming loans by putting a strain on the Company's borrowers and their ability to pay their loan obligations. Unemployment rates continue to be at elevated levels and businesses are reluctant to hire. Consequently, the Company's nonperforming loans remain at an elevated level.

Nonperforming loans were \$19.8 million at June 30, 2012, a \$2.9 million decrease from \$22.8 million at year-end 2011 and a \$5.3 million decrease from \$25.1 million at June 30, 2011. Since year-end 2011, nonperforming loans in the SBA, SBA 504 and residential mortgage segments decreased, partially offset by an increase in the commercial and consumer segments. Included in nonperforming loans at June 30, 2012 are approximately \$526 thousand of loans guaranteed by the SBA, compared to \$939 thousand at December 31, 2011 and \$2.9 million at June 30, 2011. In addition, there were \$2.4 million in loans past due 90 days or more and still accruing interest at June 30, 2012 and December 31, 2011, compared to \$2.9 million at June 30, 2011.

Other real estate owned ("OREO") properties totaled \$2.4 million at June 30, 2012, a decrease of \$677 thousand from \$3.0 million at year-end 2011 and a \$367 thousand decrease from \$2.7 million at June 30, 2011. During the six months ended June 30, 2012, the Company took title to nine properties totaling \$2.0 million and recorded valuation adjustments of \$490 thousand on four OREO properties. The Company sold seven OREO properties, resulting in a net loss of \$168 thousand on the sales.

The Company also monitors potential problem loans. Potential problem loans are those loans where information about possible credit problems of borrowers causes management to have doubts as to the ability of such borrowers to comply with loan repayment terms. These loans are not included in nonperforming loans as they continue to perform. Potential problem loans totaled \$7.4 million at June 30, 2012, an increase of \$1.7 million from \$5.7 million at December 31, 2011. The increase is due to the addition of fourteen loans totaling \$7.9 million during the quarter, partially offset by the removal of ten loans totaling \$6.2 million.

See Note 8 to the accompanying Consolidated Financial Statements for more information regarding Asset Quality.

Allowance for Loan Losses and Unfunded Loan Commitments

Management reviews the level of the allowance for loan losses on a quarterly basis. The standardized methodology used to assess the adequacy of the allowance includes the allocation of specific and general reserves. Specific reserves are made to individual impaired loans, which have been defined to include all nonperforming loans and troubled debt restructurings. The general reserve is set based upon a representative average historical net charge-off rate adjusted for certain environmental factors such as: delinquency and impairment trends, charge-off and recovery trends, volume and loan term trends, risk and underwriting policy trends, staffing and experience changes, national and local economic trends, industry conditions and credit concentration changes.

Beginning in the third quarter of 2009, when calculating the five-year historical net charge-off rate, the Company weights the past three years more heavily due to the higher amount of charge-offs experienced during those years. 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. The factors are evaluated separately for each type of loan. For example, commercial loans are broken down further into commercial and industrial loans, commercial mortgages, construction loans, etc. Each type of loan is risk weighted for each environmental factor based on its individual characteristics.

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.

Beginning in 2011, the Company significantly increased its loan loss provision in response to the inherent credit risk within its loan portfolio and changes to some of the environmental factors noted above. The inherent credit risk was evidenced by the increase in delinquent and nonperforming loans in recent quarters, as the downturn in the economy impacted borrowers' ability to pay and factors, such as a weakened housing market, eroded the value of underlying collateral. In addition, net charge-offs are higher than normal, as the Company is proactively addressing these issues.

The allowance for loan losses totaled \$16.3 million at June 30, 2012 and December 31, 2011, compared to \$16.0 million at June 30, 2011, with resulting allowance to total loan ratios of 2.69 percent, 2.76 percent, and 2.60 percent, respectively. Net charge-offs amounted to \$1.1 million for the three months ended June 30, 2012, compared to \$1.0 million for the same period in 2011. Net charge-offs amounted to \$2.3 million for the six months ended June 30, 2012, compared to \$2.6 million for the same period in 2011. Net charge-offs to average loan ratios are shown in the table below for each major loan category.

| (In thousands, except percentages) | For the three months ended June 30, | | For the six months ended June 30, | |
|--|--|-----------|--------------------------------------|-----------|
| | 2012 | 2011 | 2012 | 2011 |
| Balance, beginning of period | \$ 16,339 | \$ 15,275 | \$ 16,348 | \$ 14,364 |
| Provision for loan losses charged to expense | 1,000 | 1,750 | 2,200 | 4,250 |
| Less: Chargeoffs | | | | |
| SBA loans | 213 | 592 | 828 | 1,303 |
| SBA 504 loans | 100 | 125 | 327 | 425 |
| Commercial loans | 540 | 521 | 886 | 1,069 |
| Residential mortgage loans | 494 | - | 607 | 142 |
| Consumer loans | 25 | 131 | 25 | 131 |
| Total chargeoffs | 1,372 | 1,369 | 2,673 | 3,070 |
| Add: Recoveries | | | | |
| SBA loans | 249 | 71 | 302 | 79 |
| SBA 504 loans | 15 | 77 | 43 | 77 |
| Commercial loans | 53 | 214 | 64 | 312 |
| Residential mortgage loans | - | - | - | 4 |
| Consumer loans | - | - | - | 2 |
| Total recoveries | 317 | 362 | 409 | 474 |
| Net chargeoffs | 1,055 | 1,007 | 2,264 | 2,596 |
| Balance, end of period | \$ 16,284 | \$ 16,018 | \$ 16,284 | \$ 16,018 |
| Selected loan quality ratios: | | | | |
| Net chargeoffs to average loans: | | | | |
| SBA loans | (0.21) % | 2.44 % | 1.50 % | 2.88 % |
| SBA 504 loans | 0.73 | 0.33 | 1.16 | 1.16 |
| Commercial loans | 0.65 | 0.43 | 0.56 | 0.54 |
| Residential mortgage loans | 1.49 | - | 0.92 | 0.13 |
| Consumer loans | 0.22 | 1.00 | 0.11 | 0.49 |
| Total loans | 0.71 | 0.66 | 0.77 | 0.85 |
| Allowance to total loans | 2.69 | 2.60 | 2.69 | 2.60 |
| Allowance to nonperforming loans | 82.11 | 63.82 | 82.11 | 63.82 |

In addition to the allowance for loan losses, 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 expense and applied to the allowance which is maintained in other liabilities. At June 30, 2012, a \$69 thousand commitment reserve was reported on the balance sheet as an "other liability", compared to a \$79 thousand commitment reserve at December 31, 2011.

See Note 9 to the accompanying Consolidated Financial Statements for more information regarding the Allowance for Loan Losses.

Deposits

Deposits, which include noninterest-bearing demand deposits, interest-bearing demand deposits, savings deposits and time deposits, are the primary source of the Company's funds. The Company offers a variety of products designed to attract and retain customers, with primary focus on building and expanding relationships. The Company continues to focus on establishing a comprehensive relationship with business borrowers, seeking deposits as well as lending relationships.

Total deposits decreased \$27.5 million to \$616.4 million at June 30, 2012, from \$644.0 million at December 31, 2011. This decrease in deposits was due to decreases of \$25.3 million, \$5.2 million and \$3.3 million in time deposits, savings deposits and interest-bearing demand deposits, respectively, partially offset by an increase of \$6.3 million in noninterest-bearing demand deposits. The decline in time deposits was due to the planned run off of brokered CDs and a maturing high rate promotion done at the end of 2008 to bolster liquidity and the decline in savings deposits included a \$5.0 million decrease in municipal deposits. The increase in noninterest-bearing deposits was a result of new sales initiatives and efforts by branch personnel to bring in deposit relationships.

The mix of deposits at June 30, 2012 was favorable when compared to December 31, 2011, as noninterest-bearing demand deposits increased from 15.7 percent of total deposits to 17.4 percent and time deposits decreased from 24.8 percent of total deposits to 21.8 percent.

Borrowed Funds and Subordinated Debentures

Borrowed funds consist primarily of fixed rate advances from the Federal Home Loan Bank ("FHLB") of New York and repurchase agreements. These borrowings are used as a source of liquidity or to fund asset growth not supported by deposit generation. Residential mortgages and investment securities collateralize the borrowings from the FHLB, while investment securities

are pledged against the repurchase agreements.

Borrowed funds and subordinated debentures totaled \$90.5 million at both June 30, 2012 and December 31, 2011 and are broken down in the following table:

| (In thousands) | June 30, 2012 | December 31, 2011 |
|-----------------------------|------------------|----------------------|
| FHLB borrowings: | | |
| Fixed rate advances | \$ 30,000 | \$ 30,000 |
| Repurchase agreements | 30,000 | 30,000 |
| Other repurchase agreements | 15,000 | 15,000 |
| Subordinated debentures | 15,465 | 15,465 |

At June 30, 2012, the Company had \$48.8 million of additional credit available at the FHLB. Pledging additional collateral in the form of 1 to 4 family residential mortgages or investment securities can increase the line with the FHLB.

Interest Rate Sensitivity

The principal objectives of the asset and liability management function are to establish prudent risk management guidelines, evaluate and control the level of interest-rate risk in balance sheet accounts, determine the level of appropriate risk given the business focus, operating environment, capital, and liquidity requirements, and actively manage risk within the Board approved guidelines. The Company seeks to reduce the vulnerability of the operations to changes in interest rates, and actions in this regard are taken under the guidance of the Asset/Liability Management Committee (“ALCO”) of the Board of Directors. The ALCO reviews the maturities and re-pricing of loans, investments, deposits and borrowings, cash flow needs, current market conditions, and interest rate levels.

The Company utilizes Modified Duration of Equity and Economic Value of Portfolio Equity (“EVPE”) models to measure the impact of longer-term asset and liability mismatches beyond two years. The modified duration of equity measures the potential price risk of equity to changes in interest rates. A longer modified duration of equity indicates a greater degree of risk to rising interest rates. Because of balance sheet optionality, an EVPE analysis is also used to dynamically model the present value of asset and liability cash flows with rate shocks of 200 basis points. The economic value of equity is likely to be different as interest rates change. Like the simulation model, results falling outside prescribed ranges require action by the ALCO. The Company’s variance in the economic value of equity, as a percentage of assets with rate shocks of 200 basis points at June 30, 2012, is a decline of 0.70 percent in a rising-rate environment and a decline of 1.02 percent in a falling-rate environment. The variances in the EVPE at June 30, 2012 are within the Board-approved guidelines of +/- 3.00 percent. At December 31, 2011, the economic value of equity as a percentage of assets with rate shocks of 200 basis points was a decline of 0.40 percent in a rising-rate environment and a decline of 1.38 percent in a falling-rate environment.

Operating, Investing and Financing

The Consolidated Statements of Cash Flows present the changes in cash from operating, investing and financing activities. At June 30, 2012, the balance of cash and cash equivalents was \$37.8 million, a decrease of \$44.7 million from December 31, 2011.

Net cash provided by operating activities totaled \$8.4 million and \$1.8 million for the six months ended June 30, 2012 and 2011, respectively. The primary sources of funds were net income from operations and adjustments to net income, such as the provision for loan losses, depreciation and amortization, proceeds from the sale of mortgage and SBA loans held for sale, partially offset by originations of SBA and mortgage loans held for sale.

Net cash used by investing activities amounted to \$25.1 million for the six months ended June 30, 2012, compared to net cash provided by investing activities amounting to \$14.3 million for the six months ended June 30, 2011. The cash used by investing activities was primarily a result of the purchase of securities and equipment and funding new loans, partially offset by maturities and paydowns on securities and proceeds from the sale of securities and OREO.

Net cash used by financing activities amounted to \$28.0 million and \$13.7 million for the six months ended June 30, 2012 and 2011, respectively. The cash used by financing activities was primarily due to dividends paid on preferred stock and a decrease in the Company's deposit base, partially offset by proceeds from the exercise of stock options.

Liquidity

The Company's liquidity is a measure of its ability to fund loans, withdrawals or maturities of deposits and other cash outflows in a cost-effective manner.

Parent Company

Generally, the Parent Company's cash is used for the payment of operating expenses and cash dividends on the preferred stock issued to the U.S. Treasury. The principal sources of funds for the Parent Company are dividends paid by the Bank. The Parent Company only pays expenses that are specifically for the benefit of the Parent Company. Other than its investment in the Bank, Unity Statutory Trust II and Unity Statutory Trust III, the Parent Company does not actively engage in other transactions or business. The majority of expenses paid by the Parent Company are related to Unity Statutory Trust II and Unity Statutory Trust III.

At June 30, 2012, the Parent Company had \$3.1 million in cash and \$104 thousand in marketable securities valued at fair market value compared to \$3.5 million in cash and \$88 thousand in marketable securities at December 31, 2011. The decrease in cash at the Parent Company was primarily due to the payment of dividends on preferred stock.

Consolidated Bank

The principal sources of funds at the Bank are deposits, scheduled amortization and prepayments of loan and investment principal, sales and maturities of investment securities and funds provided by operations. While scheduled loan payments and maturing investments are relatively predictable sources of funds, deposit flows and loan prepayments are greatly influenced by general interest rates, economic conditions and competition.

Total FHLB borrowings amounted to \$60.0 million and third party repurchase agreements totaled \$15.0 million as of both June 30, 2012 and December 31, 2011. At June 30, 2012, \$48.8 million was available for additional borrowings from the FHLB. Pledging additional collateral in the form of 1 to 4 family residential mortgages or investment securities can increase the line with the FHLB. An additional source of liquidity is the securities available for sale portfolio and SBA loans held for sale portfolio, which amounted to \$97.9 million and \$6.1 million, respectively, at June 30, 2012.

As of June 30, 2012, deposits included \$39.0 million of Government deposits, as compared to \$54.6 million at year-end 2011. These deposits are generally short in duration and are very sensitive to price competition. The Company believes that the current level of these types of deposits is appropriate. Included in the portfolio were \$35.3 million of deposits from seven municipalities. The withdrawal of these deposits, in whole or in part, would not create a liquidity shortfall for the Company.

The Company was committed to advance approximately \$69.4 million to its borrowers as of June 30, 2012, compared to \$79.4 million at December 31, 2011. At June 30, 2012, \$27.0 million of these commitments expire within one year, compared to \$37.4 million at December 31, 2011. At June 30, 2012, the Company had \$1.3 million in standby letters of credit compared to \$1.8 million at December 31, 2011, which are included in the commitments amount noted above. The estimated fair value of these guarantees is not significant. The Company believes it has the necessary liquidity to honor all commitments. Many of these commitments will expire and never be funded.

Regulatory Capital

A significant measure of the strength of a financial institution is its capital base. Federal regulators have classified and defined capital into the following components: (1) tier 1 capital, which includes tangible shareholders' equity for

common stock, qualifying preferred stock and certain qualifying hybrid instruments, and (2) tier 2 capital, which includes a portion of the allowance for loan losses, subject to limitations, certain qualifying long-term debt, preferred stock and hybrid instruments, which do not qualify for tier 1 capital. The parent company and its subsidiary bank are subject to various regulatory capital requirements administered by banking regulators. Quantitative measures of capital adequacy include the leverage ratio (tier 1 capital as a percentage of tangible assets), tier 1 risk-based capital ratio (tier 1 capital as a percent of risk-weighted assets) and total risk-based capital ratio (total risk-based capital as a percent of total risk-weighted assets).

Minimum capital levels are regulated by risk-based capital adequacy guidelines, which require the Company and the Bank to maintain certain capital as a percentage of assets and certain off-balance sheet items adjusted for predefined credit risk factors (risk-weighted assets). Failure to meet minimum capital requirements can initiate certain mandatory and possibly discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines. However, prompt corrective action provisions are not applicable to bank holding companies. At a minimum, tier 1 capital as a percentage of risk-weighted assets of 4 percent and combined tier 1 and tier 2 capital as a percentage of risk-weighted assets of 8 percent must be maintained.

In addition to the risk-based guidelines, regulators require that a bank, which meets the regulator's highest performance and operation standards, maintain a minimum leverage ratio of 3 percent. For those banks with higher levels of risk or that are experiencing or anticipating significant growth, the minimum leverage ratio will be proportionately increased. Minimum leverage ratios for each institution are evaluated through the ongoing regulatory examination process.

The Company's capital amounts and ratios are presented in the following table:

| (In thousands) | Actual | | For capital adequacy purposes | | To be well-capitalized under prompt corrective action provisions | |
|---------------------------------|-----------|---------|-------------------------------|--------|--|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| As of June 30, 2012 | | | | | | |
| Leverage ratio | \$ 87,631 | 11.08 % | ≥ \$31,644 | 4.00 % | N/A | N/A |
| Tier I risk-based capital ratio | 87,631 | 14.22 | 24,647 | 4.00 | N/A | N/A |
| Total risk-based capital ratio | 95,440 | 15.49 | 49,294 | 8.00 | N/A | N/A |
| As of December 31, 2011 | | | | | | |
| Leverage ratio | \$ 86,077 | 10.44 % | ≥ \$32,979 | 4.00 % | N/A | N/A |
| Tier I risk-based capital ratio | 86,077 | 14.33 | 24,027 | 4.00 | N/A | N/A |
| Total risk-based capital ratio | 93,696 | 15.60 | 48,055 | 8.00 | N/A | N/A |

The Bank's capital amounts and ratios are presented in the following table:

| (In thousands) | Actual | | For capital adequacy purposes | | To be well-capitalized under prompt corrective action provisions | |
|---------------------------------|-----------|-------|-------------------------------|-------|--|--------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| As of June 30, 2012 | | | | | | |
| Leverage ratio | \$ 76,132 | 9.63 | % ≥ \$31,618 | 4.00 | % ≥ \$39,523 | 5.00 % |
| Tier I risk-based capital ratio | 76,132 | 12.37 | 24,623 | 4.00 | 36,935 | 6.00 |
| Total risk-based capital ratio | 92,434 | 15.02 | 49,246 | 8.00 | 61,558 | 10.00 |
| As of December 31, 2011 | | | | | | |
| Leverage ratio | \$ 74,191 | 9.01 | % ≥ \$32,953 | 4.00 | % ≥ \$41,192 | 5.00 % |
| Tier I risk-based capital ratio | 74,191 | 12.36 | 24,003 | 4.00 | 36,004 | 6.00 |
| Total risk-based capital ratio | 90,302 | 15.05 | 48,006 | 8.00 | 60,007 | 10.00 |

Shareholders' Equity

Shareholders' equity increased \$1.3 million to \$74.9 million at June 30, 2012 compared to \$73.6 million at December 31, 2011, due to net income of \$1.9 million and \$171 thousand from the issuance of common stock under employee benefit plans, partially offset by \$192 thousand depreciation in the net unrealized gains on available for sale securities and cash flow hedge derivatives and \$517 thousand in dividends accrued on preferred stock. The issuance of common stock under employee benefit plans includes nonqualified stock options and restricted stock expense related entries, employee option exercises and the tax benefit of options exercised.

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. This program was voluntary and requires an institution to comply with several restrictions and provisions, including limits on executive compensation, stock redemptions, and declaration of dividends. The perpetual preferred stock has a dividend rate of 5 percent per year until the fifth anniversary of the Treasury investment and a dividend of 9 percent thereafter. The Company received an investment in perpetual preferred stock of \$20.6 million on December 5, 2008.

As part of the CPP, the Company's future ability to pay cash dividends is limited for so long as the Treasury holds the preferred stock. As so limited the Company may not increase its quarterly cash dividend above \$0.05 per share, the

quarterly rate in effect at the time the CPP program was announced, without the prior approval of the Treasury. The Company did not declare or pay any dividends during the three or six months ended June 30, 2012 or 2011. The Company is currently preserving capital and may resume paying dividends when earnings and credit quality improve.

The Company has suspended its share repurchase program, as required by the CPP. On October 21, 2002, the Company authorized the repurchase of up to 10% of its outstanding common stock. The amount and timing of purchases would be dependent upon a number of factors, including the price and availability of the Company's shares, general market conditions and competing alternate uses of funds. As of June 30, 2012, the Company had repurchased a total of 556 thousand shares, of which 131 thousand shares have been retired, leaving 153 thousand shares remaining to be repurchased under the plan when and if it is reinstated. There were no shares repurchased during the three or six month periods ended June 30, 2012 or 2011.

Derivative Financial Instruments

The Company may use stand alone derivative financial instruments in the form of interest rate swap agreements, which derive their value from underlying interest rates. These transactions involve both credit and market risk. The notional amounts are amounts on which calculations, payments, and the value of the derivatives are based. Notional amounts do not represent direct credit exposures. Direct credit exposure is limited to the net difference between the calculated amounts to be received and paid, if any. Such difference, which represents the fair value of the derivative instruments, is reflected on the Company's balance sheet as other assets or other liabilities.

The Company is exposed to credit-related losses in the event of nonperformance by the counterparties to these agreements. The Company controls the credit risk of its financial contracts through credit approvals, limits and monitoring procedures, and does not expect any counterparties to fail their obligations. The Company deals only with primary dealers.

Derivative instruments are generally either negotiated over the counter ("OTC") contracts or standardized contracts executed

on a recognized exchange. Negotiated OTC derivative contracts are generally entered into between two counterparties that negotiate specific agreement terms, including the underlying instrument, amount, exercise prices and maturity.

Risk Management Policies – Hedging Instruments

The primary focus of the Company's asset/liability management program is to monitor the sensitivity of the Company's net portfolio value and net income under varying interest rate scenarios to take steps to control its risks. On a quarterly basis, the Company evaluates the effectiveness of entering into any derivative agreement by measuring the cost of such an agreement in relation to the reduction in net portfolio value and net income volatility within an assumed range of interest rates.

Interest Rate Risk Management – Cash Flow Hedging Instruments

The Company has long-term variable rate debt as a source of funds for use in the Company's lending and investment activities and for other general business purposes. These debt obligations expose the Company to variability in interest payments due to changes in interest rates. If interest rates increase, interest expense increases. Conversely, if interest rates decrease, interest expense decreases. Management believes it may be prudent to limit the variability of a portion of its interest payments and, therefore, may hedge a portion of its variable-rate interest payments. To meet this objective, management has historically entered into interest rate swap agreements whereby the Company received variable interest rate payments and made fixed interest rate payments during the contract period.

The Company was not a party to any interest rate swap agreements as of June 30, 2012, as the remaining interest rate swap agreement with a notional amount of \$5.0 million expired during the first quarter of 2012. At December 31, 2011, the information pertaining to outstanding interest rate swap agreements used to hedge variable rate debt was as follows:

| | December |
|---|----------|
| (In thousands, except percentages and years) | 31, 2011 |
| Notional amount | \$ 5,000 |
| Weighted average pay rate | 3.94 % |
| Weighted average receive rate (three-month LIBOR) | 0.32 % |
| Weighted average maturity in years | 0.25 |
| Unrealized loss relating to interest rate swaps | \$ (43) |

The previous agreements provided for the Company to receive payments at a variable rate determined by a specific index (three-month LIBOR) in exchange for making payments at a fixed rate.

At December 31, 2011, the net unrealized loss relating to interest rate swaps was recorded as a derivative liability. Changes in the fair value of interest rate swaps designated as hedging instruments of the variability of cash flows

associated with long-term debt are reported in other comprehensive income. The net spread between the fixed rate of interest which is paid and the variable interest received is classified in interest expense as a yield adjustment in the same period in which the related interest on the long-term debt affects earnings.

Impact of Inflation and Changing Prices

The financial statements and notes thereto, presented elsewhere herein have been prepared in accordance with generally accepted accounting principles, which require the measurement of financial position and operating results in terms of historical dollars without considering the change in the relative purchasing power of money over time and due to inflation. The impact of inflation is reflected in the increased cost of the operations. Unlike most industrial companies, nearly all the Company's assets and liabilities are monetary. As a result, interest rates have a greater impact on performance than do the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

ITEM 3 Quantitative and Qualitative Disclosures about Market Risk

During 2012, there have been no significant changes in the Company's assessment of market risk as reported in Item 6 of the Company's Annual Report on Form 10-K for the year ended December 31, 2011. (See Interest Rate Sensitivity in Management's Discussion and Analysis Herein.)

ITEM 4 Controls and Procedures

- a) The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures as of June 30, 2012. Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective for recording, processing, summarizing and reporting the information the Company is required to disclose in the reports it files under the Securities Exchange Act of 1934, within the time periods specified in the SEC's rules and forms.
- b) Changes in internal controls over financial reporting – No significant change in the Company's internal control over financial reporting has occurred during the quarterly period covered by this report that has materially affected, or is reasonably likely to materially affect, the Company's control over financial reporting.

PART II OTHER INFORMATION

ITEM 1 Legal Proceedings

From time to time, the Company is subject to other legal proceedings and claims in the ordinary course of business. The Company currently is not aware of any such legal proceedings or claims that it believes will have, individually or in the aggregate, a material adverse effect on the business, financial condition, or the results of the operation of the Company.

ITEM 1A Risk Factors

Information regarding this item as of June 30, 2012 appears under the heading, "Risk Factors" within the Company's Form 10-K for the year ended December 31, 2011.

ITEM 2 Unregistered Sales of Equity Securities and Use of Proceeds - None

ITEM 3 Defaults upon Senior Securities - None

ITEM 4 Mine Safety Disclosures - N/A

ITEM 5 Other Information - None

ITEM 6 Exhibits

| (a) Exhibits | Description |
|-----------------|--|
| Exhibit 31.1 | Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a) and Section 302 of the Sarbanes-Oxley Act of 2002 |
| Exhibit 31.2 | Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a) and Section 302 of the Sarbanes-Oxley Act of 2002 |
| Exhibit 32.1 | Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Rule 13a-14(b) or Rule 15d-14(b) and 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 |

SIGNATURES

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

UNITY BANCORP, INC.

Dated: August 10, 2012 /s/ Alan J. Bedner, Jr.
Alan J. Bedner, Jr.
Executive Vice President and Chief Financial Officer

EXHIBIT INDEX

QUARTERLY REPORT ON FORM 10-Q

Exhibit No. Description

- 31.1 Exhibit 31.1-Certification of James A. Hughes. Required by Rule 13a-14(a) or Rule 15d-14(a) and section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Exhibit 31.2-Certification of Alan J. Bedner, Jr. Required by Rule 13a-14(a) or Rule 15d-14(a) and section 302 of the Sarbanes-Oxley Act of 2002
- 32.1 Exhibit 32.1-Certification of James A. Hughes and Alan J. Bedner, Jr. Required by Rule 13a-14(b) or Rule 15d-14(b) and section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350
- 101.INS XBRL Instance Document
- 101.SCH XBRL Taxonomy Extension Schema Document
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase Document
- 101.LAB XBRL Taxonomy Extension Label Linkbase Document
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase Document
- 101.DEF XBRL Taxonomy Extension Definitions Linkbase Document