UNITY BANCORP INC /NJ/
Form 10-Q
May 10, 2016

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended March 31, 2016

OR

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

For the transition period from ____ to ____.

Commission File Number 1-12431

Unity Bancorp, Inc.

(Exact name of registrant as specified in its charter)

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

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

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

Yes No

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

Large accelerated filer Accelerated filer Nonaccelerated filer Smaller reporting company

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

Yes No

The number of shares outstanding of each of the registrant's classes of common equity stock, as of April 30, 2016 common stock, no par value: 8,468,464 shares outstanding.

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PART ICONSOLIDATED FINANCIAL INFORMATION

ITEM 1Consolidated Financial Statements (Unaudited)

Unity Bancorp, Inc.

Consolidated Balance Sheets

(Unaudited)

(In thousands)	March 31, 2016	Dec. 31, 2015
ASSETS		
Cash and due from banks	$ 26,919	$ 22,681
Federal funds sold and interest-bearing deposits	99,554	65,476
Cash and cash equivalents	126,473	88,157
Securities:		
Securities available for sale	48,566	52,865
Securities held to maturity (fair value of $18,556 and $18,607, respectively)	18,163	18,471
Total securities	66,729	71,336
Loans:		
SBA loans held for sale	13,224	13,114
SBA loans held for investment	38,863	39,393
SBA 504 loans	27,482	29,353
Commercial loans	467,266	465,518
Residential mortgage loans	260,957	264,523
Consumer loans	79,198	77,057
Total loans	886,990	888,958
Allowance for loan losses	(12,634)	(12,759)
Net loans	874,356	876,199
Premises and equipment, net	19,211	15,171
Bank owned life insurance ("BOLI")	13,475	13,381
Deferred tax assets	6,029	5,968
Federal Home Loan Bank ("FHLB") stock	4,735	4,600
Accrued interest receivable	3,839	3,884
Other real estate owned ("OREO")	1,417	1,591

Goodwill and other intangibles	1,516	1,516
Other assets	3,175	3,063
Total assets	$ 1,120,955	$ 1,084,866
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities:		
Deposits:		
Noninterest-bearing demand	$ 188,026	$ 185,267
Interest-bearing demand	128,774	130,605
Savings	320,982	301,447
Time, under $100,000	145,784	134,468
Time, $100,000 and over, under $250,000	106,419	104,106
Time, $250,000 and over	36,834	38,600
Total deposits	926,819	894,493
Borrowed funds	95,000	92,000
Subordinated debentures	10,310	15,465
Accrued interest payable	390	461
Accrued expenses and other liabilities	6,160	3,977
Total liabilities	1,038,679	1,006,396
Commitments and contingencies	-	-
Shareholders' equity:		
Common stock	59,546	59,371
Retained earnings	23,431	19,566
Accumulated other comprehensive (loss)	(701)	(467)
Total shareholders' equity	82,276	78,470
Total liabilities and shareholders' equity	$ 1,120,955	$ 1,084,866
Issued and outstanding common shares	8,468	8,436

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

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Unity Bancorp, Inc.

Consolidated Statements of Income

(Unaudited)

(In thousands, except per share amounts)	For the three months ended March 31, 2016	2015
INTEREST INCOME		
Federal funds sold and interest-bearing deposits	$ 44	$ 9
FHLB stock	52	44
Securities:		
Taxable	363	387
Tax-exempt	62	72
Total securities	425	459
Loans:		
SBA loans	721	679
SBA 504 loans	385	346
Commercial loans	5,676	5,066
Residential mortgage loans	2,942	2,582
Consumer loans	931	699
Total loans	10,655	9,372
Total interest income	11,176	9,884
INTEREST EXPENSE		
Interest-bearing demand deposits	137	106
Savings deposits	366	264
Time deposits	951	686
Borrowed funds and subordinated debentures	735	808
Total interest expense	2,189	1,864
Net interest income	8,987	8,020
Provision for loan losses	200	200
Net interest income after provision for loan losses	8,787	7,820
NONINTEREST INCOME		
Branch fee income	333	346
Service and loan fee income	255	296
Gain on sale of SBA loans held for sale, net	308	363
Gain on sale of mortgage loans, net	715	344
BOLI income	94	94
Net security gains	94	-
Gain on repurchase of subordinated debt	2,264	-
Other income	217	198
Total noninterest income	4,280	1,641
NONINTEREST EXPENSE		
Compensation and benefits	3,549	3,472
Occupancy	618	672
Processing and communications	598	596
Furniture and equipment	420	373
Professional services	255	236

Loan costs	198	221
OREO expenses	24	35
Deposit insurance	160	183
Advertising	241	182
Other expenses	544	532
Total noninterest expense	6,607	6,502
Income before provision for income taxes	6,460	2,959
Provision for income taxes	2,255	1,020
Net income	$ 4,205	$ 1,939
Net income per common share - Basic	$ 0.50	$ 0.23
Net income per common share - Diluted	$ 0.48	$ 0.23
Weighted average common shares outstanding - Basic	8,459	8,417
Weighted average common shares outstanding - Diluted	8,682	8,514

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

Unity Bancorp, Inc.

Consolidated Statements of Comprehensive Income

(Unaudited)

	For the three months ended					
	March 31, 2016			March 31, 2015		
(In thousands)	Before tax amount	Income tax expense (benefit)	Net of tax amount	Before tax amount	Income tax expense (benefit)	Net of tax amount
Net income	$ 6,460	$ 2,255	$ 4,205	$ 2,959	$ 1,020	$ 1,939
Other comprehensive income (loss)						
Investment securities available for sale:						
Unrealized holding gains on securities arising during the period	152	55	97	62	25	37
Less: reclassification adjustment for gains on securities included in net income	94	33	61	-	-	-
Total unrealized gains on securities available for sale	58	22	36	62	25	37
Adjustments related to defined benefit plan:						
Amortization of prior service cost	20	-	20	-	-	-
Total adjustments related to defined benefit plan	20	-	20	-	-	-
Net unrealized gains(losses) from cash flow hedges:						
Unrealized holding loss on cash flow hedges arising during the period	(492)	(202)	(290)	-	-	-
Total unrealized loss on cash flow hedges	(492)	(202)	(290)	-	-	-
Total other comprehensive income	(414)	$ (180)	$ (234)	62	$ 25	$ 37
Total comprehensive income	$ 6,046	$ 2,075	$ 3,971	$ 3,021	$ 1,045	$ 1,976

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 three months ended March 31, 2016 and 2015

(Unaudited)

(In thousands)	Common stock Shares	Common stock Amount	Retained earnings	Accumulated other comprehensive (loss)	Total shareholders' equity
Balance, December 31, 2015	8,436	$ 59,371	$ 19,566	$ (467)	$ 78,470
Net income			4,205		4,205
Other comprehensive loss, net of tax				(234)	(234)
Dividends on common stock ($0.04 per share)		25	(340)		(315)
Common stock issued and related tax effects (1)	32	150			150
Balance, March 31, 2016	8,468	$ 59,546	$ 23,431	$ (701)	$ 82,276

(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)

	For the three months ended March 31,	
(In thousands)	2016	2015
OPERATING ACTIVITIES:		
Net income	$ 4,205	$ 1,939
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	200	200
Net amortization of purchase premiums and discounts on securities	92	140
Depreciation and amortization	247	166
Deferred income tax expense	142	92
Net security gains	(94)	-
Gain on repurchase of subordinated debentures	(2,264)	-
Stock compensation expense	132	107
Gain on sale of OREO	(88)	-
Gain on sale of mortgage loans held for sale, net	(294)	(344)
Gain on sale of SBA loans held for sale, net	(308)	(363)
Origination of mortgage loans held for sale	(25,015)	(15,034)
Origination of SBA loans held for sale	(3,734)	(5,321)
Proceeds from sale of mortgage loans held for sale, net	25,309	15,378
Proceeds from sale of SBA loans held for sale, net	3,759	3,829
BOLI income	(94)	(94)
Net change in other assets and liabilities	1,710	(134)
Net cash provided by operating activities	3,905	561
INVESTING ACTIVITIES		
Purchases of securities available for sale	(2,142)	-
Purchases of FHLB stock, at cost	(1,395)	(3,600)
Maturities and principal payments on securities held to maturity	296	555
Maturities and principal payments on securities available for sale	3,949	2,141
Proceeds from sales of securities available for sale	2,564	-
Proceeds from redemption of FHLB stock	1,260	2,250
Proceeds from sale of OREO	1,224	578
Net decrease (increase) in loans	1,078	(22,831)
Purchases of premises and equipment	(4,543)	(492)
Net cash provided by (used in) investing activities	2,291	(21,399)
FINANCING ACTIVITIES		
Net increase (decrease) in deposits	32,326	(4,900)
Proceeds from new borrowings	20,000	80,000
Repayments of borrowings	(17,000)	(50,000)

Repurchase of subordinated debentures	(2,891)	-
Dividends on common stock	(315)	(238)
Net cash provided by financing activities	32,120	24,862
Increase in cash and cash equivalents	38,316	4,024
Cash and cash equivalents, beginning of year	88,157	129,821
Cash and cash equivalents, end of year	$ 126,473	$ 133,845

Unity Bancorp, Inc.

Consolidated Statements of Cash Flows (Continued)

(Unaudited)

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(In thousands)	For the three months ended March 31, 2016	2015
SUPPLEMENTAL DISCLOSURES		
Cash:		
Interest paid	$ 2,259	$ 1,859
Income taxes paid	1,337	868
Noncash investing activities:		
Capitalization of servicing rights	529	80
Transfer of loans to OREO	852	1,391

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

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Unity Bancorp, Inc.

Notes to the Consolidated Financial Statements (Unaudited)

March 31, 2016

NOTE 1. Significant Accounting Policies

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

The interim unaudited Consolidated Financial Statements included herein have been prepared in accordance with instructions for Form 10-Q and the rules and regulations of the Securities and Exchange Commission ("SEC") and consist of normal recurring adjustments necessary for the fair presentation of interim results. The results of operations for the three months ended March 31, 2016 are not necessarily indicative of the results which may be expected for the entire year. As used in this Form 10-Q, "we" and "us" and "our" refer to Unity Bancorp, Inc., and its consolidated subsidiary, Unity Bank, depending on the context. Certain information and financial disclosures required by U.S. generally accepted accounting principles have been condensed or omitted from interim reporting pursuant to SEC rules. Interim financial statements should be read in conjunction with the Company's Consolidated Financial Statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2015.

Stock Transactions

Stock Option Plans

The Company has incentive and nonqualified option plans, which allow for the grant of options to officers, employees and members of the Board of Directors. Transactions under the Company's stock option plans for the three months ended March 31, 2016 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, 2015	475,396	$ 7.09	5.1	$ 2,562,175
Options granted	89,000	11.06		
Options exercised	-	-		
Options forfeited	-	-		
Options expired	-	-		
Outstanding at March 31, 2016	564,396	$ 7.72	5.6	$ 2,146,524
Exercisable at March 31, 2016	410,234	$ 6.76	4.2	$ 1,944,498

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 March 31, 2016, 1,920,529 shares have been reserved for issuance upon the exercise of options, 564,396 option grants are outstanding, and 1,252,548 option grants have been exercised, forfeited or expired, leaving 103,585 shares available for grant.

The fair values of the options granted during the three months ended March 31, 2016 and 2015 were estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	For the three months ended March 31, 2016	2015
Number of options granted	89,000	40,000
Weighted average exercise price	$ 11.06	$ 9.12
Weighted average fair value of options	$ 3.50	$ 3.82
Expected life in years (1)	6.85	6.69
Expected volatility (2)	31.91 %	46.76 %
Risk-free interest rate (3)	1.79 %	1.80 %
Dividend yield (4)	1.44 %	1.33 %

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

Upon exercise, the Company issues shares from its authorized but unissued common stock to satisfy the options. There were no options exercised during the three months ended March 31, 2016 and 2015.

The following table summarizes information about stock options outstanding and exercisable at March 31, 2016:

	Options outstanding			Options exercisable	
Range of exercise prices	Options outstanding	Weighted average remaining contractual life (in years)	Weighted average exercise price	Options exercisable	Weighted average exercise price
$ 0.00 - 4.00	89,000	3.0	$ 3.85	89,000	$ 3.85
4.01 - 8.00	281,950	5.1	6.73	263,785	6.66
8.01 - 12.00	102,551	9.4	9.71	15,554	9.32
12.01 - 16.00	90,895	5.6	12.32	41,895	12.62
Total	564,396	5.6	$ 7.72	410,234	$ 6.76

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 months ended March 31, 2016 and 2015 are detailed in the following table:

	For the three months ended March 31,	
	2016	2015
Compensation expense	$ 55,983	$ 29,918
Income tax benefit	22,869	11,949

As of March 31, 2016, unrecognized compensation costs related to nonvested share-based compensation arrangements granted under the Company's stock option plans totaled approximately $487 thousand. That cost is expected to be recognized over a weighted average period of 2.4 years.

Restricted Stock Awards

Restricted stock is issued under the stock bonus program to reward employees and directors and to retain them by distributing stock over a period of time. The following table summarizes nonvested restricted stock activity for the three months ended March 31, 2016:

	Shares	Average grant date fair value
Nonvested restricted stock at December 31, 2015	80,800	$ 8.50
Granted	30,350	11.21
Cancelled	(500)	-
Vested	(14,700)	8.25
Nonvested restricted stock at March 31, 2016	95,950	$ 9.35

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 March 31, 2016, 471,551 shares of restricted stock were reserved for issuance, of which 144,850 shares are available for grant.

Restricted stock awards granted during the three months ended March 31, 2016 and 2015 were as follows:

	For the three months ended March 31,	
	2016	2015
Number of shares granted	30,350	34,800
Average grant date fair value	$ 11.21	$ 9.27

Compensation expense related to restricted stock for the three months ended March 31, 2016 and 2015 is detailed in the following table:

	For the three months ended March 31,	
	2016	2015
Compensation expense	$ 76,118	$ 77,549
Income tax benefit	31,097	30,973

As of March 31, 2016, there was approximately $797 thousand of unrecognized compensation cost related to nonvested restricted stock awards granted under the Company's stock incentive plans. That cost is expected to be recognized over a weighted average period of 2.9 years.

401(k) Savings Plan

The Bank has a 401(k) savings plan covering substantially all employees. Under the Plan, an employee can contribute up to 80 percent of their salary on a tax deferred basis. The Bank may also make discretionary contributions to the Plan. The Bank contributed $89 thousand and $76 thousand to the Plan during the three months ended March 31, 2016 and 2015, respectively.

Deferred Fee Plan

The Company has a deferred fee plan for Directors and executive management. Directors of the Company have the option to elect to defer up to 100 percent of their respective retainer and Board of Director fees, and each member of executive management has the option to elect to defer 100 percent of their year end cash bonuses. Director and executive deferred fees totaled $27 thousand and $21 thousand during the three months ended March 31, 2016 and 2015, respectively. The interest paid on the deferred balances totaled $7 thousand and $6 thousand during the three months ended March 31, 2016 and 2015, respectively. No fees were distributed in 2016 and 2015, respectively.

Benefit Plans

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

On June 4, 2015, the Company approved the Supplemental Executive Retirement Plan ("SERP") pursuant to which the President and CEO is entitled to receive certain supplemental nonqualified retirement benefits. Upon separation from service after age 66, the President and CEO will be entitled to an annual benefit in the amount of $156,000 payable in fifteen annual installments subject to annual 2% increases. The future payments are estimated to total $2.7 million. A discount rate of 3.84% was used to calculate the present value of the benefit obligation.

The President and CEO commenced vesting to this retirement benefit on January 1, 2014, and vests an additional 3% each year until fully vested on January 1, 2024. In the event that the President and CEO's separation from service from the Registrant were to occur prior to full vesting, the President and CEO would be entitled to and shall be paid the vested portion of the retirement benefit calculated as of the date of separation from service. Notwithstanding the foregoing, upon a Change in Control, and provided that within 6 months following the Change in Control the President and CEO is involuntarily terminated for reasons other than "cause" or the President and CEO resigns for "good reason", as such is defined in the SERP, or the President and CEO voluntarily terminates his employment after being offered continued employment in a position that is not a "Comparable Position", as such is also defined in the SERP, the President and CEO shall become 100% vested in the full retirement benefit.

No contributions or payments have been made during the three months ended March 31, 2016. The following table summarizes the components of the net periodic pension cost of the defined benefit plan recognized during the three months ended March 31, 2016:

(In thousands)	For the three months ended March 31, 2016
Service cost	$ 15
Interest cost	10
Amortization of prior service cost	20
Net periodic benefit cost	$ 45

The following table summarizes the changes in benefit obligations of the defined benefit plan recognized during the three months ended March 31, 2016:

(In thousands)	For the three months ended March 31, 2016
Benefit obligation, beginning of year	$ 923
Service cost	15
Interest cost	10
Actuarial gain (loss)	-
Benefit obligation, end of period	$ 948

On October 22, 2015, the Company entered into an Executive Incentive Retirement Plan (the "Plan") with certain key executive officers. The Plan has an effective date of January 1, 2015.

The Plan is an unfunded, nonqualified deferred compensation plan. For any Plan Year, a guaranteed annual Deferral Award percentage of seven and one half percent (7.5%) of the participant's annual base salary will be credited to each Participant's Deferred Benefit Account. A discretionary annual Deferral Award equal to seven and one half percent (7.5%) of the participant's annual base salary may be credited to the Participant's account in addition to the guaranteed Deferral Award, if the Bank exceeds the benchmarks set forth in the Annual Executive Bonus Matrix. The total Deferral Award shall never exceed fifteen percent (15%) for any given Plan Year. Each Participant shall be one hundred percent (100%) vested in all Deferral Awards as of the date they are awarded.

As of March 31, 2016, the Company had total year to date expenses of $30 thousand related to the Plan. The Plan is reflected on the Company's balance sheet as accrued expenses.

Certain members of management are also enrolled in a split-dollar life insurance plan with a post retirement death benefit of $250 thousand. Total expenses related to this plan were $1 thousand for the three months ended March 31, 2016 and 2015, respectively.

Other-Than-Temporary Impairment

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

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

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

Transfers of Financial Assets

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

Loans

Loans Held for Sale

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

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

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

Loans Held to Maturity

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

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

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

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

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

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

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

Allowance for Loan Losses and Reserve for Unfunded Loan Commitments

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

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

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

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

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

Income Taxes

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

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

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

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

NOTE 2. Litigation

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

NOTE 3. Net Income per Share

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

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

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

	For the three months ended March 31,	
(In thousands, except per share amounts)	2016	2015
Net income	$ 4,205	$ 1,939
Weighted average common shares outstanding - Basic	8,459	8,417
Plus: Potential dilutive common stock equivalents	223	97
Weighted average common shares outstanding - Diluted	8,682	8,514
Net income per common share - Basic	$ 0.50	$ 0.23

Net income per common share - Diluted	0.48	0.23
Stock options and common stock excluded from the income per share calculation as their effect would have been anti-dilutive	185	113

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 March 31, 2016, the Company reported income tax expense of $2.3 million for an effective tax rate of 34.9 percent, compared to an income tax expense of $1.0 million and an effective tax rate of 34.5 percent for the prior year's quarter. The Company did not recognize or accrue any interest or penalties related to income taxes during the three months ended March 31, 2016 or 2015. The Company did not have an accrual for uncertain tax positions as of March 31, 2016 or December 31, 2015, 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 2011 and thereafter are subject to future examination by tax authorities.

NOTE 5. Other Comprehensive (Loss) Income (a)

The following tables show the changes in other comprehensive (loss) income for the three months ended March 31, 2016 and 2015, net of tax:

(In thousands)	For the three months ended March 31, 2016 Net unrealized gains (losses) on securities	Adjustments related to defined benefit plan	Net unrealized losses from cash flow hedges:	Accumulated other comprehensive loss	2015 Net unrealized gains on securities	Accumulated other comprehensive income
Balance, beginning of period	$ (2)	$ (448)	$ (17)	$ (467)	$ 143	$ 143
Other comprehensive (loss) income before reclassifications	97	-	(290)	(193)	37	37
Less amounts reclassified from accumulated other comprehensive loss	61	(20)	-	41	-	-
Period change	36	20	(290)	(234)	37	37
Balance at March 31,	$ 34	$ (428)	$ (307)	$ (701)	$ 180	$ 180

(a) All amounts are net of tax.

NOTE 6. Fair Value

Fair Value Measurement

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

Level 1 Inputs

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

Level 2 Inputs

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

Level 3 Inputs

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

Fair Value on a Recurring Basis

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

Securities Available for Sale

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

As of March 31, 2016, the fair value of the Company's AFS securities portfolio was $48.6 million. Approximately 51 percent of the portfolio was made up of residential mortgage-backed securities, which had a fair value of $25.0 million at March 31, 2016. Approximately $24.2 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 of the Company’s AFS securities were classified as Level 2 assets at March 31, 2016. The valuation of AFS securities using Level 2 inputs was primarily determined using the market approach, which uses quoted prices for similar assets or liabilities in active markets and all other relevant information. It includes model pricing, defined as valuing securities based upon their relationship with other benchmark securities.

There were no changes in the inputs or methodologies used to determine fair value during the period ended March 31, 2016, as compared to the periods ended December 31, 2015 and March 31, 2015.

The tables below present the balances of assets and liabilities measured at fair value on a recurring basis as of March 31, 2016 and December 31, 2015:

	March 31, 2016			
(In thousands)	Level 1	Level 2	Level 3	Total
Securities available for sale:				
U.S. Government sponsored entities	$ -	$ 7,004	$ -	$ 7,004

State and political subdivisions		-		7,573		-		7,573
Residential mortgage-backed securities		-		25,034		-		25,034
Corporate and other securities		-		8,955		-		8,955
Total securities available for sale	$	-	$	48,566	$	-	$	48,566
Interest rate swap agreements		-		(520)		-		(520)
Total	$	-	$	(520)	$	-	$	(520)

	December 31, 2015							
(In thousands)	Level 1		Level 2		Level 3		Total	
Securities available for sale:								
U.S. Government sponsored entities	$	-	$	6,581	$	-	$	6,581
State and political subdivisions		-		10,782		-		10,782
Residential mortgage-backed securities		-		26,439		-		26,439
Corporate and other securities		-		9,063		-		9,063
Total securities available for sale	$	-	$	52,865	$	-	$	52,865
Interest rate swap agreements		-		(28)		-		(28)
Total	$	-	$	(28)	$	-	$	(28)

Fair Value on a Nonrecurring Basis

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

Appraisal Policy

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

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

OREO

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

Impaired Collateral-Dependent Loans

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

The valuation allowance for impaired loans is included in the allowance for loan losses in the consolidated balance sheets. At March 31, 2016, the valuation allowance for impaired loans was $718 thousand, a decrease of $124 thousand from $842 thousand at December 31, 2015.

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

	Fair value at March 31, 2016			
(In thousands)	Level 1	Level 2	Level 3	Total
Financial assets:				
OREO	$ -	$ -	$ 1,417	$ 1,417
Impaired collateral-dependent loans	-	-	3,193	3,193

	Fair value at December 31, 2015			
(In thousands)	Level 1	Level 2	Level 3	Total
Financial assets:				
OREO	$ -	$ -	$ 1,591	$ 1,591
Impaired collateral-dependent loans	-	-	6,331	6,331

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 March 31, 2016 and December 31, 2015 have been determined using available market information and appropriate valuation methodologies. Considerable judgment is required to interpret market data to develop estimates of fair value. The estimates presented are not necessarily indicative of amounts the Company could realize in a current market exchange. The use of alternative market assumptions and estimation methodologies could have had a material effect on these estimates of fair value. The methodology for estimating the fair value of financial assets and liabilities that are measured on a recurring or nonrecurring basis are discussed above. The following methods and assumptions were used to estimate the fair value of other financial instruments for which it is practicable to estimate that value:

Cash and Cash Equivalents

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

Securities

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

SBA Loans Held for Sale

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

Loans

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

FHLB Stock

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

Servicing Assets

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

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

OREO

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

Deposit Liabilities

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

Borrowed Funds and Subordinated Debentures

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

Standby Letters of Credit

At March 31, 2016, the Bank had standby letters of credit outstanding of $2.7 million, as compared to $1.8 million at December 31, 2015. The fair value of these commitments is nominal.

The table below presents the carrying amount and estimated fair values of the Company's financial instruments presented as of March 31, 2016 and December 31, 2015:

		March 31, 2016		December 31, 2015	
(In thousands)	Fair value level	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
Financial assets:					
Cash and cash equivalents	Level 1	$ 126,473	$ 126,473	$ 88,157	$ 88,157
Securities (1)	Level 2	66,729	67,122	71,336	71,472
SBA loans held for sale	Level 2	13,224	14,738	13,114	14,324
Loans, net of allowance for loan losses (2)	Level 2	861,132	866,393	863,085	864,691
FHLB stock	Level 2	4,735	4,735	4,600	4,600
Servicing assets	Level 3	1,809	1,809	1,389	1,389
Accrued interest receivable	Level 2	3,839	3,839	3,884	3,884
OREO	Level 3	1,417	1,417	1,591	1,591
Financial liabilities:					
Deposits	Level 2	926,819	928,244	894,493	893,651
Borrowed funds and subordinated debentures	Level 2	105,310	107,647	107,465	109,549
Accrued interest payable	Level 2	390	390	461	461

(1) Includes held to maturity ("HTM") commercial mortgage-backed securities that are considered Level 3. These securities had book values of $3.9 million at March 31, 2016 and December 31, 2015, and market values of $3.9 million and $3.8 million at March 31, 2016 and December 31, 2015, respectively.

(2) Includes collateral-dependent impaired loans that are considered Level 3 and reported separately in the tables under the "Fair Value on a Nonrecurring Basis" heading. Collateral-dependent impaired loans, net of specific reserves totaled $3.2 million and $6.3 million at March 31, 2016 and December 31, 2015, respectively.

NOTE 7. Securities

This table provides the major components of AFS and HTM securities at amortized cost and estimated fair value at March 31, 2016 and December 31, 2015:

	March 31, 2016				December 31, 2015			
(In thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
Available for sale:								
U.S. Government sponsored entities	$ 7,001	$ 28	$ (25)	$ 7,004	$ 6,649	$ -	$ (68)	$ 6,581
State and political subdivisions	7,439	134	-	7,573	10,625	159	(2)	10,782
Residential mortgage-backed securities	24,635	541	(142)	25,034	26,191	449	(201)	26,439
Corporate and other securities	9,437	5	(487)	8,955	9,404	71	(412)	9,063
Total securities available for sale	$ 48,512	$ 708	$ (654)	$ 48,566	$ 52,869	$ 679	$ (683)	$ 52,865
Held to maturity:								
U.S. Government sponsored entities	$ 3,988	$ -	$ (30)	$ 3,958	$ 3,988	$ -	$ (87)	$ 3,901
State and political subdivisions	2,362	204	-	2,566	2,364	187	(1)	2,550
Residential mortgage-backed securities	5,952	159	(11)	6,100	6,232	141	(28)	6,345
Commercial mortgage-backed securities	3,876	72	-	3,948	3,902	-	(62)	3,840
Corporate and other securities	1,985	-	(1)	1,984	1,985	-	(14)	1,971
Total securities held to maturity	$ 18,163	$ 435	$ (42)	$ 18,556	$ 18,471	$ 328	$ (192)	$ 18,607

This table provides the remaining contractual maturities and yields of securities within the investment portfolios. The carrying value of securities at March 31, 2016 is distributed by contractual maturity. Mortgage-backed securities and other securities, which may have principal prepayment provisions, are distributed based on contractual maturity. Expected maturities will differ materially from contractual maturities as a result of early prepayments and calls.

(In thousands, except percentages)	Within one year		After one through five years		After five through ten years		After ten years		Total carrying value	
	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Available for sale at fair value:										
U.S. Government sponsored entities	$ 10	1.06 %	$ 3,762	1.61 %	$ 915	2.09 %	$ 2,317	2.04 %	$ 7,004	1.81 %
State and political subdivisions	-	-	1,407	2.55	3,749	2.98	2,417	2.58	7,573	2.77
Residential mortgage-backed securities	-	-	930	2.21	3,717	2.47	20,387	2.84	25,034	2.76
Corporate and other securities	1,990	1.34	659	1.51	4,284	1.39	2,022	1.75	8,955	1.46
Total securities available for sale	$ 2,000	1.34 %	$ 6,758	1.88 %	$ 12,665	2.23 %	$ 27,143	2.67 %	$ 48,566	2.39 %
Held to maturity at cost:										
U.S. Government sponsored entities	$ -	- %	$ -	- %	$ -	- %	$ 3,988	1.97 %	$ 3,988	1.97 %
State and political subdivisions	264	0.75	-	-	-	-	2,098	4.74	2,362	4.29
Residential mortgage-backed securities	59	4.26	102	4.91	176	5.22	5,615	3.19	5,952	3.29
Commercial mortgage-backed securities	-	-	-	-	-	-	3,876	2.75	3,876	2.75
Corporate and other securities	-	-	-	-	1,985	4.61	-	-	1,985	4.61
Total securities held to maturity	$ 323	1.39 %	$ 102	4.91 %	$ 2,161	4.66 %	$ 15,577	2.98 %	$ 18,163	3.16 %

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 March 31, 2016 and December 31, 2015 are as follows:

	March 31, 2016						
		Less than 12 months		12 months and greater		Total	
(In thousands, except number in a loss position)	Total number in a loss position	Estimated fair value	Unrealized loss	Estimated fair value	Unrealized loss	Estimated fair value	Unrealized loss
Available for sale:							
U.S. Government sponsored entities	4	$ 2,774	$ (9)	$ 1,538	$ (16)	$ 4,312	$ (25)
Residential mortgage-backed securities	7	2,082	(7)	4,142	(135)	6,224	(142)
Corporate and other securities	13	4,709	(196)	3,702	(291)	8,411	(487)
Total temporarily impaired securities	24	$ 9,565	$ (212)	$ 9,382	$ (442)	$ 18,947	$ (654)
Held to maturity:							
U.S. Government sponsored entities	2	$ 3,957	$ (30)	$ -	$ -	$ 3,957	$ (30)
Residential mortgage-backed securities	3	-	-	1,770	(11)	1,770	(11)
Corporate and other securities	1	$ 984	(1)	-	-	984	(1)
Total temporarily impaired securities	6	$ 4,941	$ (31)	$ 1,770	$ (11)	$ 6,711	$ (42)

	December 31, 2015						
		Less than 12 months		12 months and greater		Total	
(In thousands, except number in a loss position)	Total number in a loss position	Estimated fair value	Unrealized loss	Estimated fair value	Unrealized loss	Estimated fair value	Unrealized loss
Available for sale:							
U.S. Government sponsored entities	9	$ 4,165	$ (12)	$ 2,416	$ (56)	$ 6,581	$ (68)
State and political subdivisions	3	1,584	(2)	-	-	1,584	(2)
Residential mortgage-backed securities	11	6,195	(36)	4,508	(165)	10,703	(201)
Corporate and other securities	11	4,730	(174)	3,756	(238)	8,486	(412)
Total temporarily impaired securities	34	$ 16,674	$ (224)	$ 10,680	$ (459)	$ 27,354	$ (683)
Held to maturity:							
U.S. Government sponsored entities	2	$ -	$ -	$ 3,901	$ (87)	$ 3,901	$ (87)
State and political subdivisions	1	263	(1)	-	-	263	(1)
Residential mortgage-backed securities	3	-	-	1,853	(28)	1,853	(28)
Commercial mortgage-backed securities	2	3,840	(62)	-	-	3,840	(62)
Corporate and other securities	1	971	(14)	-	-	971	(14)
Total temporarily impaired securities	9	$ 5,074	$ (77)	$ 5,754	$ (115)	$ 10,828	$ (192)

Unrealized Losses

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

U.S. government sponsored entities and state and political subdivision securities: The unrealized losses on investments in these types of securities were caused by the increase in interest rate spreads or the increase in interest rates at the long end of the Treasury curve. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the par value of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be at maturity, the Company did not consider these investments to be other-than temporarily impaired as of March 31, 2016. There was no impairment on these securities at December 31, 2015.

Residential and commercial mortgage-backed securities: The unrealized losses on investments in mortgage-backed securities were caused by increases in interest rate spreads or the increase in interest rates at the long end of the Treasury curve. The majority of contractual cash flows of these securities are guaranteed by the FNMA, GNMA, and the FHLMC. It is expected that the securities would not be settled at a price significantly less than the par value of the investment. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be at maturity, the Company did not consider these investments to be other-than-temporarily impaired as of March 31, 2016 or December 31, 2015.

Corporate and other securities: Included in this category are corporate debt securities, Community Reinvestment Act ("CRA") investments, asset-backed securities, and one trust preferred security. The unrealized losses on corporate debt securities were due to widening credit spreads or the increase in interest rates at the long end of the Treasury curve and the unrealized losses on CRA investments were caused by decreases in the market value of underlying bonds and rate changes. The Company evaluated the prospects of the issuers and forecasted a recovery period; and as a result determined it did not consider these investments to be other-than-temporarily impaired as of March 31, 2016 or December 31, 2015. The unrealized loss on the trust preferred security was caused by an inactive trading market and changes in market credit spreads. At March 31, 2016 and December 31, 2015, 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 March 31, 2016 or December 31, 2015.

Realized Gains and Losses

Gross realized gains (losses) on securities for the three months ended March 31, 2016 and 2015 are detailed in the table below:

	For the years ended March 31,	
(In thousands)	2016	2015
Available for sale:		
Realized gains	$ 94	$ -
Realized losses	-	-
Total securities available for sale	94	-
Held to maturity:		
Realized gains	-	-
Realized losses	-	-
Total securities held to maturity	-	-
Net gains on sales of securities	$ 94	$ -

The net realized gains are included in noninterest income in the Consolidated Statements of Income as net security gains. There was a gross realized gain of $94 thousand for the three months ended March 31, 2016. For the three months ended March 31, 2015, there were no gross realized gains or losses.

· For the three months ended March 31, 2016, the net gains are attributed to the sale of three municipal securities with a total book value of $2.4 million and resulting gains of $31 thousand and the sale of one equity security totaling $40 thousand in book value, resulting in pre-tax gains of approximately $63 thousand.

Pledged Securities

Securities with a carrying value of $19.2 million and $18.5 million at March 31, 2016 and December 31, 2015, respectively, were pledged to secure Government deposits, secure other borrowings and for other purposes required or permitted by law. In March 2016, the FHLB issued a letter of credit in the name of Unity Bank naming the NJ Dept. of Banking and Insurance as beneficiary. The letter of credit will take the place of securities previously pledged to the state for the Bank's municipal deposits. For additional information on amounts pledged to secure Government deposits at March 31, 2016, see section titled "Borrowed Funds and Subordinated Debentures" under Item 2. Management Discussion and Analysis.

NOTE 8. Loans

The following table sets forth the classification of loans by class, including unearned fees, deferred costs and excluding the allowance for loan losses as of March 31, 2016 and December 31, 2015:

(In thousands)	March 31, 2016	December 31, 2015
SBA loans held for investment	$ 38,863	$ 39,393
SBA 504 loans	27,482	29,353
Commercial loans		
Commercial other	50,276	49,332
Commercial real estate	390,345	391,071
Commercial real estate construction	26,645	25,115
Residential mortgage loans	260,957	264,523
Consumer loans		
Home equity	44,573	45,042
Consumer other	34,625	32,015
Total loans held for investment	$ 873,766	$ 875,844
SBA loans held for sale	13,224	13,114
Total loans	$ 886,990	$ 888,958

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

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

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

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

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

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

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

Credit Ratings

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

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

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

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

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

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

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

At March 31, 2016, the Company owned $78 thousand of residential consumer properties that were included in OREO in the Consolidated Balance Sheets, compared to $76 thousand at December 31, 2015. Additionally, there were $3.2 million of residential consumer loans in the process of foreclosure at March 31, 2016, compared to $4.5 million at December 31, 2015.

The tables below detail the Company's loan portfolio by class according to their credit quality indicators discussed in the paragraphs above as of March 31, 2016:

	March 31, 2016 SBA, SBA 504 & Commercial loans - Internal risk ratings			
(In thousands)	Pass	Special mention	Substandard	Total
SBA loans held for investment	$ 35,008	$ 2,199	$ 1,656	$ 38,863
SBA 504 loans	23,883	2,935	664	27,482
Commercial loans				
Commercial other	46,719	2,493	1,064	50,276
Commercial real estate	371,371	18,063	911	390,345
Commercial real estate construction	25,591	698	356	26,645
Total commercial loans	443,681	21,254	2,331	467,266
Total SBA, SBA 504 and commercial loans	$ 502,572	$ 26,388	$ 4,651	$ 533,611

	Residential mortgage & Consumer loans - Performing/Nonperforming		
(In thousands)	Performing	Nonperforming	Total
Residential mortgage loans	$ 257,808	$ 3,149	$ 260,957
Consumer loans			
Home equity	44,145	428	44,573
Consumer other	34,625	-	34,625
Total consumer loans	78,770	428	79,198
Total residential mortgage and consumer loans	$ 336,578	$ 3,577	$ 340,155

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, 2015:

	December 31, 2015 SBA, SBA 504 & Commercial loans - Internal risk ratings			
(In thousands)	Pass	Special mention	Substandard	Total
SBA loans held for investment	$ 35,032	$ 2,647	$ 1,714	$ 39,393
SBA 504 loans	24,003	4,917	433	29,353
Commercial loans				

Commercial other	45,870	2,373	1,089	49,332
Commercial real estate	369,510	18,978	2,583	391,071
Commercial real estate construction	24,061	1,054	-	25,115
Total commercial loans	439,441	22,405	3,672	465,518
Total SBA, SBA 504 and commercial loans	$ 498,476	$ 29,969	$ 5,819	$ 534,264

	Residential mortgage & Consumer loans - Performing/Nonperforming		
(In thousands)	Performing	Nonperforming	Total
Residential mortgage loans	$ 262,299	$ 2,224	$ 264,523
Consumer loans			
Home equity	44,452	590	45,042
Consumer other	32,015	-	32,015
Total consumer loans	76,467	590	77,057
Total residential mortgage and consumer loans	$ 338,766	$ 2,814	$ 341,580

Nonperforming and Past Due Loans

Nonperforming loans consist of loans that are not accruing interest (nonaccrual loans) as a result of principal or interest being in default for a period of 90 days or more or when the ability to collect principal and interest according to the contractual terms is in doubt. Loans past due 90 days or more and still accruing interest are not included in nonperforming loans and generally represent loans that are well collateralized and in a continuing process expected to result in repayment or restoration to current status. The risk of loss is difficult to quantify and is subject to fluctuations in collateral values, general economic conditions and other factors. The improved state of the economy has resulted in a substantial reduction in nonperforming loans and loan delinquencies. The Company values its collateral through the use of appraisals, broker price opinions, and knowledge of its local market.

The following tables set forth an aging analysis of past due and nonaccrual loans as of March 31, 2016 and December 31, 2015:

	March 31, 2016						
(In thousands)	30-59 days past due	60-89 days past due	90+ days and still accruing	Nonaccrual (1)	Total past due	Current	Total loans
SBA loans held for investment	$ 1,048	$ 1,181	$ -	$ 1,861	$ 4,090	$ 34,773	$ 38,863
SBA 504 loans	-	-	-	513	513	26,969	27,482
Commercial loans							
Commercial other	25	548	-	91	664	49,612	50,276
Commercial real estate	570	-	-	489	1,059	389,286	390,345
Commercial real estate construction	-	-	-	356	356	26,289	26,645
Residential mortgage loans	1,426	1,113	-	3,149	5,688	255,269	260,957
Consumer loans							
Home equity	141	80	-	428	649	43,924	44,573
Consumer other	-	-	-	-	-	34,625	34,625
Total loans held for investment	$ 3,210	$ 2,922	$ -	$ 6,887	$ 13,019	$ 860,747	$ 873,766
SBA loans held for sale	-	-	-	-	-	13,224	13,224
Total loans	$ 3,210	$ 2,922	$ -	$ 6,887	$ 13,019	$ 873,971	$ 886,990

(1) At March 31, 2016, nonaccrual loans included $293 thousand of TDRs and $243 thousand of loans guaranteed by the SBA. The remaining $844 thousand of TDRs are in accrual status because they are performing in accordance with their restructured terms.

(In thousands)	December 31, 2015 30-59 days past due	60-89 days past due	90+ days and still accruing	Nonaccrual (1)	Total past due	Current	Total loans
SBA loans held for investment	$ 1,153	$ 456	$ -	$ 1,764	$ 3,373	$ 36,020	$ 39,393
SBA 504 loans	-	-	-	518	518	28,835	29,353
Commercial loans							
Commercial other	157	-	-	10	167	49,165	49,332
Commercial real estate	444	283	-	2,154	2,881	388,190	391,071
Commercial real estate construction	356	-	-	-	356	24,759	25,115
Residential mortgage loans	2,307	1,078	-	2,224	5,609	258,914	264,523
Consumer loans							
Home equity	130	3	-	590	723	44,319	45,042
Consumer other	1	-	-	-	1	32,014	32,015
Total loans held for investment	$ 4,548	$ 1,820	$ -	$ 7,260	$ 13,628	$ 862,216	$ 875,844
SBA loans held for sale	-	-	-	-	-	13,114	13,114
Total loans	$ 4,548	$ 1,820	$ -	$ 7,260	$ 13,628	$ 875,330	$ 888,958

(1) At December 31, 2015, nonaccrual loans included $293 thousand of TDRs and $288 thousand of loans guaranteed by the SBA. The remaining $3.0 million of TDRs are in accrual status because they are performing in accordance with their restructured terms.

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Impaired Loans

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

The following table provides detail on the Company's impaired loans that are individually evaluated for impairment with the associated allowance amount, if applicable, as of March 31, 2016:

	March 31, 2016		
(In thousands)	Unpaid principal balance	Recorded investment	Specific reserves
With no related allowance:			
SBA loans held for investment (1)	$ 1,127	$ 685	$ -
SBA 504 loans	513	513	-
Commercial loans			
Commercial real estate	1,297	1,296	-
Total commercial loans	1,297	1,296	-
Total impaired loans with no related allowance	2,937	2,494	-
With an allowance:			
SBA loans held for investment (1)	1,784	970	567
Commercial loans			
Commercial other	114	91	91
Commercial real estate	-	-	1
Commercial real estate construction	356	356	59
Total commercial loans	470	447	151
Total impaired loans with a related allowance	2,254	1,417	718
Total individually evaluated impaired loans:			
SBA loans held for investment (1)	2,911	1,655	567
SBA 504 loans	513	513	-
Commercial loans			
Commercial other	114	91	91
Commercial real estate	1,297	1,296	1
Commercial real estate construction	356	356	59
Total commercial loans	1,767	1,743	151
Total individually evaluated impaired loans	$ 5,191	$ 3,911	$ 718

(1) Balances are reduced by amount guaranteed by the SBA of $243 thousand at March 31, 2016.

The following table provides detail on the Company's impaired loans that are individually evaluated for impairment with the associated allowance amount, if applicable, as of December 31, 2015:

	December 31, 2015		
(In thousands)	Unpaid principal balance	Recorded investment	Specific reserves
With no related allowance:			
SBA loans held for investment (1)	$ 961	$ 518	$ -
SBA 504 loans	2,226	2,226	-
Commercial loans			
Commercial real estate	1,365	1,366	-
Total commercial loans	1,365	1,366	-
Total impaired loans with no related allowance	4,552	4,110	-
With an allowance:			
SBA loans held for investment (1)	2,203	1,389	705
Commercial loans			
Commercial other	33	10	10
Commercial real estate	1,664	1,664	127
Total commercial loans	1,697	1,674	137
Total impaired loans with a related allowance	3,900	3,063	842
Total individually evaluated impaired loans:			
SBA loans held for investment (1)	3,164	1,907	705
SBA 504 loans	2,226	2,226	-
Commercial loans			
Commercial other	33	10	10
Commercial real estate	3,029	3,030	127
Total commercial loans	3,062	3,040	137
Total individually evaluated impaired loans	$ 8,452	$ 7,173	$ 842

(1) Balances are reduced by amount guaranteed by the SBA of $288 thousand at December 31, 2015.

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 months ended March 31, 2016 and 2015. 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, and therefore no interest income is recognized. The interest income recognized on impaired loans noted below represents primarily accruing TDRs and nominal amounts of income recognized on a cash basis for well-collateralized impaired loans.

	For the three months ended March 31,			
	2016		2015	
(In thousands)	Average recorded investment	Interest income recognized on impaired loans	Average recorded investment	Interest income recognized on impaired loans
SBA loans held for investment (1)	$ 2,004	$ 2	$ 1,997	$ 133
SBA 504 loans	1,652	-	3,871	26
Commercial loans				
Commercial other	62	25	1,117	18
Commercial real estate	2,052	13	5,036	62
Commercial real estate construction	238	-	-	-
Total	$ 6,008	$ 40	$ 12,021	$ 239

(1) Balances are reduced by the average amount guaranteed by the SBA of $265 thousand and $800 thousand for the three months ended March 31, 2016 and 2015, respectively.

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TDRs

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

TDRs of $1.1 million and $3.3 million are included in the impaired loan numbers as of March 31, 2016 and December 31, 2015, respectively. The decrease was due to the payoff of two loans and principal pay downs. At March 31, 2016, there were specific reserves of $78 thousand on TDRs, $38 thousand on performing TDRs and $40 thousand on nonperforming TDRs. At December 31, 2015, there were specific reserves of $208 thousand on TDRs, $167 thousand on performing TDRs and $41 thousand on nonperforming TDRs. At March 31, 2016 and December 31, 2015, $293 thousand of TDRs were in nonaccrual status. The remaining TDRs are in accrual status since they continue to perform in accordance with their restructured terms.

To date, the Company's TDRs consisted of interest rate reductions and maturity extensions. There has been no principal forgiveness. There were no loans modified during the three months ended March 31, 2016 and 2015 that were deemed to be TDRs.

There were no loans modified as a TDR within the previous 12 months that subsequently defaulted at some point during the three months ended March 31, 2016. In this case, the subsequent default is defined as 90 days past due or transferred to nonaccrual status.

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

Allowance for Loan Losses

The Company has an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. At a minimum, the adequacy of the allowance for loan losses is reviewed by management on a quarterly basis. For purposes of determining the allowance for loan losses, the

Company has segmented the loans in its portfolio by loan type. Loans are segmented into the following pools: SBA 7(a), SBA 504, commercial, residential mortgages, and consumer loans. Certain portfolio segments are further broken down into classes based on the associated risks within those segments and the type of collateral underlying each loan. Commercial loans are divided into the following four classes: commercial real estate, commercial real estate construction, unsecured business line of credit and commercial other. Consumer loans are divided into two classes as follows: Home equity and other.

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

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

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

The allocated allowance is the total of identified specific and general reserves by loan category. The allocation is not necessarily indicative of the categories in which future losses may occur. The total allowance is available to absorb losses from any segment of the portfolio. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in methodologies for estimating allocated and general reserves in the portfolio. The unallocated portion of the allowance increased during the quarter ended March 31, 2016, to $284 thousand from $162 thousand at December 31, 2015. The increase in the unallocated portion of the allowance was due to improvements in current period charge off percentages and the rolling off of larger losses in the 2011 period offset by an increase in the environmental factors.

The following tables detail the activity in the allowance for loan losses by portfolio segment for the three months ended March 31, 2016 and 2015:

	For the three months ended March 31, 2016						
(In thousands)	SBA held for investment	SBA 504	Commercial	Residential	Consumer	Unallocated	Total
Balance, beginning of period	$ 1,961	$ 741	$ 6,309	$ 2,769	$ 817	$ 162	$ 12,759
Charge-offs	(86)	-	(228)	-	(28)	-	(342)
Recoveries	11	-	6	-	-	-	17
Net (charge-offs) recoveries	(75)	-	(222)	-	(28)	-	(325)
Provision for loan losses charged to expense	(173)	(143)	224	123	47	122	200
Balance, end of period	$ 1,713	$ 598	$ 6,311	$ 2,892	$ 836	$ 284	$ 12,634

	For the three months ended March 31, 2015						
(In thousands)	SBA held for investment	SBA 504	Commercial	Residential	Consumer	Unallocated	Total
Balance, beginning of period	$ 1,883	$ 1,337	$ 6,270	$ 2,289	$ 667	$ 105	$ 12,551
Charge-offs	(128)	(589)	(100)	-	(30)	-	(847)
Recoveries	37	-	201	39	-	-	277
Net (charge-offs) recoveries	(91)	(589)	101	39	(30)	-	(570)
Provision for loan losses charged to expense	81	414	(747)	13	73	366	200
Balance, end of period	$ 1,873	$ 1,162	$ 5,624	$ 2,341	$ 710	$ 471	$ 12,181

The following tables present loans and their related allowance for loan losses, by portfolio segment, as of March 31, 2016 and December 31, 2015:

	March 31, 2016						
(In thousands)	SBA held for investment	SBA 504	Commercial	Residential	Consumer	Unallocated	Total
Allowance for loan losses ending balance:							
Individually evaluated for impairment	$ 567	$ -	$ 151	$ -	$ -	$ -	$ 718
Collectively evaluated for impairment	1,146	598	6,160	2,892	836	284	11,916
Total	$ 1,713	$ 598	$ 6,311	$ 2,892	$ 836	$ 284	$ 12,634
Loan ending balances:							
Individually evaluated for impairment	$ 1,655	$ 513	$ 1,743	$ -	$ -	$ -	$ 3,911
Collectively evaluated for impairment	37,208	26,969	465,523	260,957	79,198	-	869,855
Total	$ 38,863	$ 27,482	$ 467,266	$ 260,957	$ 79,198	$ -	$ 873,766

	December 31, 2015						
(In thousands)	SBA held for investment	SBA 504	Commercial	Residential	Consumer	Unallocated	Total
Allowance for loan losses ending balance:							
Individually evaluated for impairment	$ 705	$ -	$ 137	$ -	$ -	$ -	$ 842
Collectively evaluated for impairment	1,256	741	6,172	2,769	817	162	11,917
Total	$ 1,961	$ 741	$ 6,309	$ 2,769	$ 817	$ 162	$ 12,759
Loan ending balances:							
Individually evaluated for impairment	$ 1,907	$ 2,226	$ 3,040	$ -	$ -	$ -	$ 7,173
Collectively evaluated for impairment	37,486	27,127	462,478	264,523	77,057	-	868,671
Total	$ 39,393	$ 29,353	$ 465,518	$ 264,523	$ 77,057	$ -	$ 875,844

Changes in Methodology:

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

Reserve for Unfunded Loan Commitments

In addition to the allowance for loan losses, the Company maintains a reserve for unfunded loan commitments at a level that management believes is adequate to absorb estimated probable losses. Adjustments to the reserve are made through other expense and applied to the reserve which is classified as other liabilities. At March 31, 2016, a $162 thousand commitment reserve was reported on the balance sheet as an “other liability”, compared to a $138 thousand commitment reserve at December 31, 2015.

NOTE 10. New Accounting Pronouncements

ASU 2014-09, “Revenue from Contracts with Customers (Topic 606).” This ASU has three sections:

Section A – Summary and amendments that creates revenue from contracts with customers (Topic 606) and Other Assets and Deferred Costs – Contracts with Customers (Subtopic 340-40);

Section B – Conforming amendments to other topics and subtopics in the codification and status tables;

Section C – Background information and basis for conclusions.

The accounting changes in this update have been revised to defer the effective date for public business entities to annual reporting periods beginning after December 15, 2017 and the interim periods within that year. Early adoption is permitted as of the first interim or annual period beginning after December 15, 2016. The Company is currently evaluating the impact of the standard.

ASU 2015-01, "Income Statement-Extraordinary and Unusual Items (Subtopic 225-20): Simplifying Income Statement Presentation by Eliminating the Concept of Extraordinary Items." ASU 2015-01 seeks to eliminate from generally accepted accounting principles ("GAAP") the concept of extraordinary items. Presently, an event or transaction is presumed to be an ordinary and usual activity of the reporting entity unless evidence clearly supports its classification as an extraordinary item. The guidance was issued as part of an initiative to reduce complexity in accounting standards. The amendments in this update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. A reporting entity may apply the amendments prospectively. A reporting entity also may apply the amendments retrospectively to all prior periods presented in the financial statements. Early adoption is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. The effective date is the same for both public business entities and all other entities. The Company does not expect adoption of this guidance to have a material effect on the financial condition or results of operations of the Company.

ASU No. 2016-01, "Financial Instruments – Overall (Subtopic 825-10) – Recognition and Measurement of Financial Assets and Financial Liabilities." ASU 2016-01 addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. This eliminates the available for sale classification of accounting for equity securities and adjusts the fair value disclosures for financial instruments carried at amortized cost such that the disclosed fair values represent an exit price as opposed to an entry price. This update requires that equity securities be carried at fair value on the balance sheet and any periodic changes in value will be adjusted through the income statement. A practical expedient is provided for equity securities without a readily determinable fair value, such that these securities can be carried at cost less any impairment. For public business entities, the amendments in this update are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently evaluating the impact of the standard.

ASU 2016-02, "Leases (Topic 842)". ASU 2016-02 was issued in three parts: (a) Section A, "Leases: Amendments to the FASB Accounting Standards Codification®," (b) Section B, "Conforming Amendments Related to Leases: Amendments to the FASB Accounting Standards Codification®," and (c) Section C, "Background Information and Basis for Conclusions." While both lessees and lessors are affected by the new guidance, the effects on lessees are much more significant. The update states that a lessee should recognize the assets and liabilities that arise from all leases with a term greater than 12 months. The core principle requires the lessee to recognize a liability to make lease payments and a "right-of-use" asset. The accounting applied by the lessor is relatively unchanged as the majority of operating leases should remain classified as operating leases and the income from them recognized, generally, on a straight-line basis over the lease term. The standards update also requires expanded qualitative and quantitative disclosures. For public business entities, ASC 2016-02 is effective for interim and annual reporting periods beginning after December 15, 2018. ASC 2016-02 mandates a modified retrospective transition for all entities. The Company is currently evaluating the impact of the adoption of ASC 2016-02 on its consolidated financial statements.

NOTE 11. Derivative Financial Instruments and Hedging Activities

Derivative Financial Instruments

The Company has 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 instrument, 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 any derivative agreement. 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 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 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 is prudent to limit the variability of a portion of its interest payments and, therefore hedges its variable-rate interest payments. To meet this objective, management enters into interest rate swap agreements whereby the Company receives variable interest rate payments and makes fixed interest rate payments during the contract period.

During the three months ended March 31, 2016, the Company received variable rate Libor payments from and paid fixed rates in accordance with its interest rate swap agreements. A summary of the Company's outstanding interest rate swap agreements used to hedge variable rate debt at March 31, 2016 and 2015, respectively is as follows:

	For the three months ended March 31,	
(In thousands, except percentages and years)	2016	2015
Notional amount	$ 40,000	$ -
Weighted average pay rate	1.36 %	0.00 %
Weighted average receive rate	0.63 %	0.00 %
Weighted average maturity in years	4.29	0.00
Unrealized loss relating to interest rate swaps	$ (520)	$ -

At March 31, 2016, the unrealized loss relating to interest rate swaps was recorded as a derivative liability. Changes in the fair value of interest rate swap designated as hedging instruments of the variability of cash flows associated with long-term debt are reported in other comprehensive income.

NOTE 12. Repurchase of Subordinated Debentures

On February 26, 2016, the Company repurchased $5.0 million of its outstanding subordinated debentures, reducing its outstanding subordinated debt to $10.3 million. The subordinated debentures were repurchased at a price of $0.5475 per dollar, resulting in a pre-tax gain of $2.3 million. This gain is included in noninterest income on the income statement.

The subordinated debentures were previously issued by Unity (NJ) Statutory Trust III, a statutory business trust and wholly-owned subsidiary of Unity Bancorp, Inc., on December 19, 2006 and were due on December 19, 2036. The floating interest rate was 3 month Libor plus 165 basis points and repriced quarterly. Upon completion of the transaction, Unity (NJ) Statutory Trust III was dissolved effective March 4, 2016.

These securities qualified as Tier 1 capital under the terms of the Dodd-Frank Wall Street Reform and Consumer Protection Act and thus repurchasing them reduced Tier 1 capital.

ITEM 2Management'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 2015 consolidated audited financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2015. 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 as well as a loan production office in Bergen County, New Jersey. These services include the acceptance of demand, savings, and time deposits and the extension of consumer, real estate, SBA and other commercial credits. The Bank has multiple subsidiaries used to hold part of its investment and loan portfolios and OREO properties.

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. 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 totaled $4.2 million, or $0.48 per diluted share for the three months ended March 31, 2016, compared to $1.9 million, or $0.23 per diluted share for the same period a year ago. Return on average assets and average common equity for the quarter were 1.54% and 21.05%, respectively, compared to 0.82% and 11.08% for the same period a year ago. Included in net income was a nonrecurring gain from the extinguishment of debt of $2.3 million or $0.17 per share.

During the quarter, the Company repurchased $5.0 million of its outstanding subordinated debentures, resulting in a pre-tax gain of $2.3 million on the transaction. This gain is included in noninterest income on the income statement.

Core operating net income, which excludes the nonrecurring gain on the repurchase of debentures was $2.7 million, or $0.31 per diluted share for the three months ended March 31, 2016, a 40.9 percent increase compared to same period a year ago. Return on average assets and average common equity net of gains on subordinated debenture were 1.00% and 13.67%, respectively. Factors contributing to the improvement in core operating results are strong loan growth over the past year, increased levels of noninterest income, improved credit quality and expense control.

First quarter highlights include:

× Noninterest-bearing demand deposits rose 1.5% and total deposits increased 3.6% since year-end 2015.
× Net interest income increased 12.1% compared to the prior year's quarter due to strong loan growth.
× Net interest margin declined to 3.48% this quarter compared to 3.64% in the prior year's quarter due to a larger Fed Funds balance.
× Credit quality continued to improve. Loan charge-offs declined and nonperforming loans fell 26.3%.

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

	For the three months ended March 31,	
	2016	2015
Net income per common share - Basic (1)	$ 0.50	$ 0.23
Net income per common share - Diluted (1)	$ 0.48	$ 0.23
Return on average assets	1.54 %	0.82 %
Return on average equity (2)	21.05 %	11.08 %
Efficiency ratio	50.16 %	67.30 %

The Company’s quarterly performance ratios, net of gain on subordinated debenture, may be found in the table below.

	For the three months ended March 31,	
	2016	2015
Net income per common share - Basic (1)	$ 0.32	$ 0.23
Net income per common share - Diluted (1)	$ 0.31	$ 0.23
Return on average assets	1.00 %	0.82 %
Return on average equity (2)	13.67 %	11.08 %
Efficiency ratio	60.05 %	67.30 %

(1) Defined as net income divided by weighted average shares outstanding.
(2) Defined as net income divided by average shareholders' equity.

Net Interest Income

The primary source of the Company’s operating income is net interest income, which is the difference between interest and dividends earned on earning assets and fees earned on loans, and interest paid on interest-bearing liabilities. Earning assets include loans to individuals and businesses, investment securities, interest-earning deposits and federal funds sold. Interest-bearing liabilities include interest-bearing demand, savings and time deposits, FHLB advances and other borrowings. Net interest income is determined by the difference between the yields earned on earning assets and the rates paid on interest-bearing liabilities (“net interest spread”) and the relative amounts of earning assets and interest-bearing liabilities. The Company’s net interest spread is affected by regulatory, economic and competitive factors that influence interest rates, loan demand, deposit flows and general levels of nonperforming assets.

During the quarter ended March 31, 2016, tax-equivalent net interest income amounted to $9.0 million, an increase of $965 thousand or 12.0 percent when compared to the same period in 2015. The net interest margin decreased 16 basis points to 3.48 percent for the quarter ended March 31, 2016, compared to 3.64 percent for the same period in 2015. The net interest spread was 3.27 percent for the first quarter of 2016, a 17 basis point decrease compared to the same period in 2015.

During the three months ended March 31, 2016, tax-equivalent interest income was $11.2 million, an increase of $1.3 million or 13.0 percent when compared to the same period in the prior year. This increase was mainly driven by the increase in the balance of average loans:

× Of the $1.3 million net increase in interest income on a tax-equivalent basis, $1.4 million of the increase was due to increased average earning assets, primarily loans, partially offset by $85 thousand in reduced interest income due to decreased yields on the loan portfolio.
× The average volume of interest-earning assets increased $145.0 million to $1.0 billion for the first quarter of 2016 compared to $896.5 million for the same period in 2015. This was due primarily to a $113.3 million increase in average loans, primarily commercial, residential mortgage and consumer loans, along with a $41.4 million increase in federal funds sold and interest-bearing deposits, partially offset by a $10.3 million decrease in average investment securities.
× The yield on interest-earning assets decreased 16 basis points to 4.33 percent for the three months ended March 31, 2016 when compared to the same period in 2015. The yield on the loan portfolio decreased 8 basis points to 4.82 percent.

Total interest expense was $2.2 million for the three months ended March 31, 2016, an increase of $325 thousand or 17.4 percent compared to the same period in 2015. This increase was driven by the increase in average time deposits and increased rates on savings deposits compared to a year ago:

- × Of the $325 thousand increase in interest expense, $375 thousand was due to an increase in the volume of average interest-bearing liabilities, primarily time and savings deposits, partially offset by $50 thousand in reduced interest expense primarily due to a decrease in the rate paid on borrowed funds and subordinated debentures.
  - × Interest-bearing liabilities averaged $828.1 million for the first quarter of 2016, an increase of $108.1 million or 15.0 percent, compared to the prior year's quarter. The increase in interest-bearing liabilities was primarily due to an increase in average time and savings deposits.
- × The average cost of interest-bearing liabilities increased 1 basis point to 1.06 percent. The cost of interest-bearing deposits increased 13 basis points to 0.81 percent for the first quarter of 2016 and the cost of borrowed funds and subordinated debentures decreased 74 basis points to 2.83 percent.

Although our net interest income has increased over the periods noted above, we have been impacted by the sustained low interest rate environment. Recent remarks by the Federal Reserve Open Market Committee ("FOMC") of the Federal Reserve Board indicate that only gradual increases in the federal funds rates will be warranted as inflation remains low in the near term but rises up to 2 percent over the medium term.

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, 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.

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					
	March 31, 2016			March 31, 2015		
	Average Balance	Interest	Rate/Yield	Average Balance	Interest	Rate/Yield
ASSETS						
Interest-earning assets:						
Federal funds sold and interest-bearing deposits	$ 78,681	$ 44	0.22 %	$ 37,280	$ 9	0.10 %
FHLB stock	4,549	52	4.60	3,847	44	4.64
Securities:						
Taxable	59,152	363	2.47	67,046	387	2.34
Tax-exempt	9,548	94	3.96	11,984	106	3.59
Total securities (A)	68,700	457	2.68	79,030	493	2.53
Loans:						
SBA loans	53,942	721	5.38	48,405	679	5.69
SBA 504 loans	29,232	385	5.30	33,397	346	4.20
Commercial loans	463,927	5,676	4.92	406,095	5,066	5.06
Residential mortgage loans	264,208	2,942	4.48	226,125	2,582	4.63
Consumer loans	78,328	931	4.78	62,355	699	4.55
Total loans (B)	889,637	10,655	4.82	776,377	9,372	4.90
Total interest-earning assets	$ 1,041,567	$ 11,208	4.33 %	$ 896,534	$ 9,918	4.49 %
Noninterest-earning assets:						
Cash and due from banks	27,006			29,908		
Allowance for loan losses	(12,926)			(12,701)		
Other assets	45,486			43,206		
Total noninterest-earning assets	59,566			60,413		
Total assets	$ 1,101,133			$ 956,947		
LIABILITIES AND SHAREHOLDERS' EQUITY						
Interest-bearing liabilities:						
Total interest-bearing demand deposits	$ 131,339	$ 137	0.42 %	$ 126,593	$ 106	0.34 %
Total savings deposits	310,251	366	0.47	290,006	264	0.37
Total time deposits	282,110	951	1.36	211,425	686	1.32
Total interest-bearing deposits	723,700	1,454	0.81	628,024	1,056	0.68
Borrowed funds and subordinated debentures	104,350	735	2.83	91,909	808	3.57
Total interest-bearing liabilities	$ 828,050	$ 2,189	1.06 %	$ 719,933	$ 1,864	1.05 %
Noninterest-bearing liabilities:						
Noninterest-bearing demand deposits	187,226			161,729		
Other liabilities	5,528			4,307		
Total noninterest-bearing liabilities	192,754			166,036		

Total shareholders' equity	80,329					70,978				
Total liabilities and shareholders' equity	$ 1,101,133					$ 956,947				
Net interest spread			$ 9,019	3.27	%			$ 8,054	3.44	%
Tax-equivalent basis adjustment			(32)					(34)		
Net interest income			$ 8,987					$ 8,020		
Net interest margin				3.48	%				3.64	%

(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 35 percent for 2016 and 34 percent for 2015, as well as all 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.

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 35 percent for 2016 and 34 percent for 2015.

	For the three months ended March 31, 2016 versus March 31, 2015 Increase (decrease) due to change in:		
(In thousands on a tax-equivalent basis)	Volume	Rate	Net
Interest income:			
Federal funds sold and interest-bearing deposits	$ 17	$ 18	$ 35
FHLB stock	8	-	8
Securities	(69)	33	(36)
Loans	1,419	(136)	1,283
Total interest income	$ 1,375	$ (85)	$ 1,290
Interest expense:			
Demand deposits	$ 4	$ 27	$ 31
Savings deposits	21	81	102
Time deposits	243	22	265
Total interest-bearing deposits	268	130	398
Borrowed funds and subordinated debentures	107	(180)	(73)
Total interest expense	375	(50)	325
Net interest income - fully tax-equivalent	$ 1,000	$ (35)	$ 965
Decrease in tax-equivalent adjustment			2
Net interest income			$ 967

Provision for Loan Losses

Provision for loan losses totaled $200 thousand for the three months ended March 31, 2016 and 2015. 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 Reserve for Unfunded Loan Commitments." The current provision is considered appropriate under management's assessment of the adequacy of the allowance for loan losses.

Noninterest Income

The following table shows the components of noninterest income for the three months ended March 31, 2016 and 2015:

	For the three months ended March 31,	
(In thousands)	2016	2015
Branch fee income	$ 333	$ 346
Service and loan fee income	255	296
Gain on sale of SBA loans held for sale, net	308	363
Gain on sale of mortgage loans, net	715	344
BOLI income	94	