

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

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2014

OR

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

For the transition period from \_\_\_\_ to \_\_\_\_.

Commission File Number 1-12431

Unity Bancorp, Inc.

(Exact name of registrant as specified in its charter)

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

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

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

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

Yes No

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

Large accelerated filer Accelerated filer Nonaccelerated filer Smaller reporting company

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

Yes No

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

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## PART I CONSOLIDATED FINANCIAL INFORMATION

## ITEM 1 Consolidated Financial Statements (Unaudited)

Unity Bancorp, Inc.

Consolidated Balance Sheets

(Unaudited)

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

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

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

Unity Bancorp, Inc.

## Consolidated Statements of Income

(Unaudited)

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

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

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



Unity Bancorp, Inc.

Consolidated Statements of Comprehensive Income

(Unaudited)

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

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

Unity Bancorp, Inc.

## Consolidated Statements of Changes in Shareholders' Equity

For the six months ended June 30, 2014 and 2013

(Unaudited)

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

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

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

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



Unity Bancorp, Inc.

## Consolidated Statements of Cash Flows

(Unaudited)

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

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

Noncash investing  
activities:

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

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

Unity Bancorp, Inc.

Notes to the Consolidated Financial Statements (Unaudited)

June 30, 2014

#### NOTE 1. Significant Accounting Policies

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

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

Stock Transactions

## Stock Option Plans

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

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

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



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

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

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

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

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

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

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

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

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

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

## Restricted Stock Awards

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

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

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

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

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

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

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

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

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

#### Perpetual Preferred Stock

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

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

## Other-Than-Temporary Impairment

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

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

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

## Transfers of Financial Assets

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

## Loans

### Loans Held for Sale

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

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

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

### Loans Held to Maturity

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

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

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

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

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

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

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

Allowance for Loan Losses and Reserve for Unfunded Loan Commitments

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

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

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

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

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



## Income Taxes

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

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

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

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

### NOTE 2. Litigation

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

### NOTE 3. Net Income per Share

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

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

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

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

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

## NOTE 4. Income Taxes

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

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

## NOTE 5. Other Comprehensive Income (Loss)

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

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

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

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

## NOTE 6. Fair Value

### Fair Value Measurement

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

#### Level 1 Inputs

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

#### Level 2 Inputs

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

#### Level 3 Inputs

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

### Fair Value on a Recurring Basis

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

#### Securities Available for Sale

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

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

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

At December 31, 2013, the Company's AFS securities included commercial mortgage-backed securities which were classified as Level 3 assets. For commercial mortgage-backed securities, the inputs used by either dealer market participants or an independent pricing service, may be derived from unobservable market information (Level 3 inputs). In these instances, management evaluates the appropriateness and quality of the assumptions and the resulting prices. In addition, management reviews the volume and level of activity for all AFS securities and attempts to identify transactions which may not be orderly or reflective of a significant level of activity and volume. For securities meeting these criteria, the quoted prices received from either market participants or an independent pricing service may be adjusted, as necessary, to estimate fair value and this results in fair values based on Level 3 inputs. In determining fair value, the Company utilizes unobservable inputs which reflect its own assumptions about the inputs that market participants would use in pricing each security. In

developing its assertion of market participant assumptions, the Company utilizes the best information that is both reasonable and available without undue cost and effort.

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

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

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

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

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

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

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

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



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

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

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

#### Fair Value on a Nonrecurring Basis

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

#### Appraisal Policy

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

The Company requires current real estate appraisals on all loans that become OREO or in-substance foreclosure, loans that are classified substandard, doubtful or loss, or loans that are over \$100,000 and nonperforming. Prior to each balance sheet date, the Company values impaired collateral-dependent loans and OREO based upon a third party appraisal, broker's price opinion, drive by appraisal, automated valuation model, updated market evaluation, or a combination of these methods. The amount is discounted for the decline in market real estate values (for original

appraisals), for any known damage or repair costs, and for selling and closing costs. The amount of the discount ranges from 10 to 25 percent and is dependent upon the method used to determine the original value. The original appraisal is generally used when a loan is first determined to be impaired. When applying the discount, the Company takes into consideration when the appraisal was performed, the collateral's location, the type of collateral, any known damage to the property and the type of business. Subsequent to entering impaired status and the Company determining that there is a collateral shortfall, the Company will generally, depending on the type of collateral, order a third party appraisal, broker's price opinion, automated valuation model or updated market evaluation. Subsequent to receiving the third party results, the Company will discount the value 8 to 10 percent for selling and closing costs.

#### Other Real Estate Owned ("OREO")

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

#### Impaired Collateral-Dependent Loans

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

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

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

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

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

Fair Value of Financial Instruments

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

assets and liabilities that are measured on a recurring or nonrecurring basis are discussed above. The following methods and assumptions were used to estimate the fair value of other financial instruments for which it is practicable to estimate that value:

#### Cash and Cash Equivalents

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

#### Securities Held to Maturity

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

#### SBA Loans Held for Sale

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

#### Loans

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

#### Federal Home Loan Bank Stock

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

#### SBA Servicing Assets

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

#### Accrued Interest

The carrying amounts of accrued interest approximate fair value.

#### Deposit Liabilities

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

#### Borrowed Funds and Subordinated Debentures

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

## Standby Letters of Credit

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

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

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

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

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

## NOTE 7. Securities

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

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

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

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



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

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

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

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

#### Unrealized Losses

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

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

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

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

#### Realized Gains and Losses

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

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

The net realized gains are included in noninterest income in the Consolidated Statements of Income as net security gains. For the three and six months ended June 30, 2014, there were gross realized gains of \$271 thousand and \$385 thousand, respectively. For the three and six months ended June 30, 2013, there were gross realized losses of \$3 thousand and \$7 thousand, respectively. The net realized gains during 2014 were a result of the following:

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

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

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

#### Pledged Securities

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

## Note 8. Loans

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

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

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

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

flow of the business and secondarily on the underlying collateral provided.

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

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

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

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

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

### Credit Ratings

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

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

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

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

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

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

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



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

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

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

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

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

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

Residential mortgage & Consumer loans -  
Performing/Nonperforming

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

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## Nonperforming and Past Due Loans

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

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

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

(1)

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

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

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

## Impaired Loans

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

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

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

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



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

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

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

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

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

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

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



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

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

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Troubled Debt Restructurings

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

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

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

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

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

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

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

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

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

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

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

Allowance for Loan Losses

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

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

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

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

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

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

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

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

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

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

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

For the six months ended June 30, 2013

SBA

held for SBA

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

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

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

(In thousands)	December 31, 2013						Unallocated	Total
	SBA held for investment SBA 504	Commercial	Residential	Consumer				
Allowance for loan losses ending balance:								
Individually evaluated for impairment	\$ 831	\$ 29	\$ 278	\$ -	\$ -	\$ -	\$ 1,138	
Collectively evaluated for impairment	1,756	928	6,562	2,132	573	52	12,003	
Total	\$ 2,587	\$ 957	\$ 6,840	\$ 2,132	\$ 573	\$ 52	\$ 13,141	
Loan ending balances:								
Individually evaluated for impairment	\$ 2,740	\$ 2,928	\$ 9,120	\$ -	\$ -	\$ -	\$ 14,788	
Collectively evaluated for impairment	46,178	28,636	354,220	182,067	46,139	-	657,240	
Total	\$ 48,918	\$ 31,564	\$ 363,340	\$ 182,067	\$ 46,139	\$ -	\$ 672,028	

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 June 30, 2014, a \$132 thousand commitment reserve was reported on the balance sheet as an “other liability”, compared to a \$103 thousand commitment reserve at December 31, 2013.

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Note 10. New Accounting Pronouncements

ASU No. 2014-04, “Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure.” ASU 2014-04 clarifies that a in-substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (a) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (b) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, ASU 2014-04 requires interim and annual disclosure of both (a) the amount of foreclosed residential real estate property held by the creditor and (b) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in ASU 2014-04 are effective for fiscal years, and interim periods within those years, beginning after December 15, 2014. An entity can elect to adopt the amendments using either a modified retrospective transition method or prospective transition method. Early adoption is permitted. The Company is currently evaluating the impact of these amendments.

ASU 2014-11, “Transfers and Servicing (Topic 860): Repurchase to Maturity Transactions, Repurchase Financings, and Disclosures.” ASU 2014-11, require two accounting changes: 1) repurchase-to-maturity transactions to secured borrowing accounting and 2) repurchase financing arrangements, amendments require separate accounting for a transfer of a financial asset executed contemporaneously with a repurchase agreement with the same counterparty, will result in secured borrowing accounting for the repurchase agreement. ASU 2014-11 also requires additional disclosures for repurchase agreements, securities lending transactions and repurchase-to-maturity transactions that are accounted for as secured borrowings. The accounting changes in this update are effective for public business entities for the first interim or annual period beginning after December 15, 2014. Early application is prohibited. The Company is currently evaluating the impact of the standard.

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 are effective for public business entities for the first interim or annual period beginning after December 15, 2016. Early application is prohibited. The Company is currently evaluating the impact of the standard.



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

The following discussion and analysis of financial condition and results of operations should be read in conjunction with the 2013 consolidated audited financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2013. When necessary, reclassifications have been made to prior period data throughout the following discussion and analysis for purposes of comparability. This Quarterly Report on Form 10-Q contains certain “forward looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995, which may be identified by the use of such words as “believe”, “expect”, “anticipate”, “should”, “planned”, “estimated” “potential”. Examples of forward looking statements include, but are not limited to, estimates with respect to the financial condition, results of operations and business of Unity Bancorp, Inc. that are subject to various factors which could cause actual results to differ materially from these estimates. These factors include, in addition to those items contained in the Company’s Annual Report on Form 10-K under Item IA-Risk Factors, as updated by our subsequent Quarterly Reports on Form 10-Q, the following: changes in general, economic, and market conditions, legislative and regulatory conditions, or the development of an interest rate environment that adversely affects Unity Bancorp, Inc.’s interest rate spread or other income anticipated from operations and investments.

Overview

Unity Bancorp, Inc. (the “Parent Company”) is incorporated in New Jersey and is registered as a bank holding company under the Bank Holding Company Act of 1956, as amended. Its wholly-owned subsidiary, Unity Bank (the “Bank” or, when consolidated with the Parent Company, the “Company”) was granted a charter by the New Jersey Department of Banking and Insurance and commenced operations on September 13, 1991. The Bank provides a full range of commercial and retail banking services through 15 branch offices located in Hunterdon, Somerset, Middlesex, Union and Warren counties in New Jersey, and Northampton County in Pennsylvania. These services include the acceptance of demand, savings, and time deposits and the extension of consumer, real estate, Small Business Administration and other commercial credits. The Bank has multiple subsidiaries used to hold part of its investment and loan portfolios and other real estate owned (“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. Unity (NJ) Statutory Trust III is a statutory business trust and wholly owned subsidiary of Unity Bancorp, Inc. On December 19, 2006, the Trust issued \$5.0 million of trust preferred securities to investors. These floating rate securities are treated as subordinated debentures on the Company’s financial statements. However, they qualify as Tier I Capital for regulatory capital compliance purposes, subject to certain limitations. The Company does not consolidate the accounts and related activity of any of its business trust subsidiaries.

Earnings Summary

Net income available to common shareholders totaled \$1.5 million, or \$0.20 per diluted share for the quarter ended June 30, 2014, a 73.2 percent increase compared to \$882 thousand, or \$0.11 per diluted share for the same period a year ago. Return on average assets and average common equity for the quarter were 0.68% and 10.31%, respectively, compared to 0.67% and 6.11% for the same period a year ago. The continued improvement in our operating results is the product of our strategic initiatives, which include expansion of our in-market loan and deposit relationships, improving credit quality and core earnings growth.

Second quarter highlights include:

- × Loan growth of 4.4% since December 31, 2013 across all product lines except SBA 7(a) loans – 9.1% growth in SBA 504 loans, 7.8% in residential mortgage loans, 6.1% in consumer loans and 3.5% growth in commercial loans.
- × Noninterest-bearing demand deposit growth of 6.5% since December 31, 2013.
- × Core earnings growth - Net interest income increased 7.4% compared to the prior year's quarter due to strong commercial and residential loan portfolio growth.
- × Controlled expenses at \$6.1 million for each quarter.
- × Announced common stock rights offering to provide capital for continued growth.

Net income available to common shareholders totaled \$2.8 million, or \$0.37 per diluted share for the six months ended June 30, 2014, a 68.2 percent increase compared to \$1.7 million, or \$0.21 per diluted share for the same period a year ago. Return on average assets and average common equity for the six month period were 0.64% and 9.70%, respectively, compared to 0.63% and 5.88% for the same period a year ago.

The Company's quarterly and year to date performance ratios may be found in the table below.

	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
Net income per common share - Basic (1)	\$ 0.20	\$ 0.12	\$ 0.37	\$ 0.22
Net income per common share - Diluted (1)	\$ 0.20	\$ 0.11	\$ 0.37	\$ 0.21
Return on average assets	0.68 %	0.67 %	0.64 %	0.63 %
Return on average equity (2)	10.31 %	6.11 %	9.70 %	5.88 %
Efficiency ratio	70.81 %	72.72 %	71.36 %	73.31 %

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

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

#### Net Interest Income

The primary source of 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, Federal Home Loan Bank 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 June 30, 2014, tax-equivalent net interest income amounted to \$7.3 million, an increase of \$485 thousand or 7.1 percent when compared to the same period in 2013. The net interest margin decreased 17 basis points to 3.49 percent for the quarter ended June 30, 2014, compared to 3.66 percent for the same period in 2013. The net interest spread was 3.31 percent for the second quarter of 2014, a 14 basis point decrease compared to the same period in 2013.

During the three months ended June 30, 2014, tax-equivalent interest income was \$9.1 million, an increase of \$683 thousand or 8.1 percent when compared to the same period in the prior year. This increase was driven by the increase in average loans, partially offset by a lower average yield on the loan portfolio:

- × Of the \$683 thousand net increase in interest income on a tax-equivalent basis, \$921 thousand of the increase was due to increased average earning assets, primarily loans, partially offset by \$238 thousand in reduced interest income due to reduced yields on our earning assets.
- × The average volume of interest-earning assets increased \$91.6 million to \$843.7 million for the second quarter of 2014 compared to \$752.1 million for the same period in 2013. This was due primarily to an \$84.8 million increase in average loans, primarily commercial and residential mortgage loans, and a \$22.5 million increase in federal funds sold and interest-bearing deposits, partially offset by a \$15.9 million decrease in average investment securities.
- × The yield on interest-earning assets decreased 17 basis points to 4.34 percent for the three months ended June 30, 2014 when compared to the same period in 2013. The yield on our loan portfolio declined 16 basis points to 4.87 percent.

Total interest expense was \$1.8 million for the three months ended June 30, 2014, an increase of \$198 thousand or 12.4 percent compared to the same period in 2013. This increase was driven by the increase in average time deposits, partially offset by lower rates on these deposits compared to a year ago:

- × Of the \$198 thousand increase in interest expense, \$311 thousand of the increase was due to an increase in the volume of average interest-bearing liabilities, primarily time deposits, partially offset by a \$113 thousand decrease due to the decrease in the rates paid on interest-bearing liabilities.
- × Interest-bearing liabilities averaged \$694.0 million for the second quarter of 2014, an increase of \$91.5 million or 15.2 percent, compared to the prior year's quarter. The increase in interest-bearing liabilities was a result of an increase in average time deposits and interest-bearing demand deposits, partially offset by a decrease in average savings deposits.
- × The average cost of interest-bearing liabilities decreased 3 basis points to 1.03 percent. The cost of interest-bearing deposits increased 4 basis points to 0.66 percent for the second quarter of 2014 and the cost of borrowed funds and subordinated debentures increased 2 basis points to 3.51 percent.

During the six months ended June 30, 2014, tax-equivalent net interest income amounted to \$14.7 million, an increase of \$1.1 million or 7.9 percent when compared to the same period in 2013. The net interest margin decreased 6 basis



points to 3.53 percent for the six months ended June 30, 2014, compared to 3.59 percent for the same period in 2013. The net interest spread was 3.35 percent for the six months ended June 30, 2014, a 2 basis point decrease compared to the same period in 2013.

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During the six months ended June 30, 2014, tax-equivalent interest income was \$18.2 million, an increase of \$1.4 million or 8.2 percent when compared to the same period in the prior year. This increase was driven by the increase in average loans, partially offset by a lower average yield on the loan portfolio:

- × Of the \$1.4 million net increase in interest income on a tax-equivalent basis, \$1.9 million of the increase was due to increased average earning assets, primarily loans, partially offset by \$479 thousand in reduced interest income due to reduced yields on these assets.
- × The average volume of interest-earning assets increased \$73.5 million to \$838.6 million for the six months ended June 30, 2014 compared to \$765.2 million for the same period in 2013. This was due primarily to an \$84.7 million increase in average loans, primarily commercial and residential mortgage loans, and a \$1.1 million increase in federal funds sold and interest-bearing deposits, partially offset by a \$12.4 million decrease in average investment securities.
- × The yield on interest-earning assets decreased 5 basis points to 4.37 percent for the six months ended June 30, 2014 when compared to the same period in 2013. The yield on our loan portfolio declined 20 basis points to 4.86 percent.

Total interest expense was \$3.5 million for the six months ended June 30, 2014, an increase of \$310 thousand or 9.6 percent compared to the same period in 2013. This increase was driven by the increase in average time deposits, partially offset by lower rates on these deposits compared to a year ago:

- × Of the \$310 thousand increase in interest expense, \$606 thousand of the increase was due to an increase in the volume of average interest-bearing liabilities, primarily time deposits, partially offset by a \$296 thousand decrease due to the decrease in the rates paid on interest-bearing liabilities.
- × Interest-bearing liabilities averaged \$693.9 million for the six months ended June 30, 2014, an increase of \$79.1 million or 12.9 percent, compared to the same period in the prior year. The increase in interest-bearing liabilities was a result of an increase in average time deposits and interest-bearing demand deposits, partially offset by a decrease in average savings deposits.
- × The average cost of interest-bearing liabilities decreased 3 basis points to 1.02 percent. The cost of interest-bearing deposits increased 2 basis points to 0.64 percent for the six months ended June 30, 2014 and the cost of borrowed funds and subordinated debentures decreased 1 basis point to 3.50 percent.

Our net interest income continues to be impacted by the sustained low interest rate environment. The Federal Open Market Committee (“FOMC”) of the Federal Reserve Board forecasts the overnight federal funds rate will continue to remain at 25 basis points through late 2015. This rate environment has resulted in a tighter net interest margin as our earning assets continue to re-price at lower rates. Partially offsetting these declines are lower funding costs; however, the reduction in yield on earning assets is anticipated to exceed the benefits of further declines in the cost of funds from already low levels.

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.

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Consolidated Average Balance Sheets

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

	For the three months ended			June 30, 2013			
	June 30, 2014			Average			
	Average			Average			
	Balance	Interest	Rate/Yield	Balance	Interest	Rate/Yield	
<b>ASSETS</b>							
Interest-earning assets:							
Federal funds sold and interest-bearing deposits	\$ 47,859	\$ 10	0.08	% \$ 25,312	\$ 7	0.11	%
Federal Home Loan Bank stock	4,149	40	3.87	4,007	35	3.50	
Securities:							
Taxable	85,598	552	2.58	95,675	620	2.59	
Tax-exempt	14,608	133	3.64	20,440	186	3.64	
Total securities (A)	100,206	685	2.73	116,115	806	2.77	
Loans:							
SBA loans	53,965	643	4.77	63,007	778	4.94	
SBA 504 loans	34,415	433	5.05	39,408	441	4.49	
Commercial loans	370,345	4,738	5.13	315,128	4,250	5.41	
Residential mortgage loans	185,016	2,052	4.44	143,835	1,649	4.59	
Consumer loans	47,737	544	4.57	45,295	496	4.39	
Total loans (B)	691,478	8,410	4.87	606,673	7,614	5.03	
Total interest-earning assets	\$ 843,692	\$ 9,145	4.34	% \$ 752,107	\$ 8,462	4.51	%
Noninterest-earning assets:							
Cash and due from banks	24,368			22,866			
Allowance for loan losses	(13,037)			(14,747)			
Other assets	45,410			41,435			
Total noninterest-earning assets	56,741			49,554			
Total assets	\$ 900,433			\$ 801,661			
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>							
Interest-bearing liabilities:							
Interest-bearing demand deposits	\$ 128,351	\$ 109	0.34	% \$ 116,414	\$ 90	0.31	%
Savings deposits	261,419	188	0.29	270,097	164	0.24	
Time deposits	213,122	693	1.30	124,285	537	1.73	
Total interest-bearing deposits	602,892	990	0.66	510,796	791	0.62	
Borrowed funds and subordinated debentures							
	91,069	807	3.51	91,653	808	3.49	
Total interest-bearing liabilities	\$ 693,961	\$ 1,797	1.03	% \$ 602,449	\$ 1,599	1.06	%
Noninterest-bearing liabilities:							
Noninterest-bearing demand deposits	143,720			122,635			
Other liabilities	3,332			3,554			
Total noninterest-bearing liabilities	147,052			126,189			

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Total shareholders' equity	59,420			73,023		
Total liabilities and shareholders' equity	\$ 900,433			\$ 801,661		
Net interest spread	\$ 7,348	3.31	%	\$ 6,863	3.45	%
Tax-equivalent basis adjustment	(43)			(61)		
Net interest income	\$ 7,305			\$ 6,802		
Net interest margin		3.49	%		3.66	%

- (A) Yields related to securities exempt from federal and state income taxes are stated on a fully tax-equivalent basis. They are reduced by the nondeductible portion of interest expense, assuming a federal tax rate of 34 percent and applicable state rates.
- (B) The loan averages are stated net of unearned income, and the averages include loans on which the accrual of interest has been discontinued.

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Consolidated Average Balance Sheets

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

	For the six months ended			June 30, 2013			
	June 30, 2014			June 30, 2013			
	Average			Average			
	Balance	Interest	Rate/Yield	Balance	Interest	Rate/Yield	
<b>ASSETS</b>							
Interest-earning assets:							
Federal funds sold and interest-bearing deposits	\$ 44,960	\$ 19	0.09 %	\$ 43,818	\$ 22	0.10 %	
Federal Home Loan Bank stock	4,069	87	4.31	3,998	78	3.93	
Securities:							
Taxable	89,183	1,278	2.87	97,856	1,267	2.59	
Tax-exempt	15,718	289	3.68	19,463	363	3.73	
Total securities (A)	104,901	1,567	2.99	117,319	1,630	2.78	
Loans:							
SBA loans	54,375	1,226	4.51	64,190	1,555	4.84	
SBA 504 loans	33,075	832	5.07	40,266	1,092	5.47	
Commercial loans	367,360	9,340	5.13	309,990	8,251	5.37	
Residential mortgage loans	183,048	4,110	4.49	139,882	3,199	4.57	
Consumer loans	46,843	1,039	4.47	45,700	1,005	4.43	
Total loans (B)	684,701	16,547	4.86	600,028	15,102	5.06	
Total interest-earning assets	\$ 838,631	\$ 18,220	4.37 %	\$ 765,163	\$ 16,832	4.42 %	
Noninterest-earning assets:							
Cash and due from banks	23,881			21,310			
Allowance for loan losses	(13,222)			(14,872)			
Other assets	44,510			39,680			
Total noninterest-earning assets	55,169			46,118			
Total assets	\$ 893,800			\$ 811,281			
<b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>							
Interest-bearing liabilities:							
Interest-bearing demand deposits	\$ 129,761	\$ 220	0.34 %	\$ 117,535	\$ 191	0.33 %	
Savings deposits	263,856	370	0.28	282,738	340	0.24	
Time deposits	209,148	1,337	1.29	123,495	1,083	1.77	
Total interest-bearing deposits	602,765	1,927	0.64	523,768	1,614	0.62	
Borrowed funds and subordinated debentures	91,167	1,606	3.50	91,063	1,609	3.51	
Total interest-bearing liabilities	\$ 693,932	\$ 3,533	1.02 %	\$ 614,831	\$ 3,223	1.05 %	
Noninterest-bearing liabilities:							
Noninterest-bearing demand deposits	137,976			117,844			

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Other liabilities	3,251	3,398
Total noninterest-bearing liabilities	141,227	121,242
Total shareholders' equity	58,641	75,208
Total liabilities and shareholders' equity	\$ 893,800	\$ 811,281

Net interest spread	\$ 14,687	3.35	%	\$ 13,609	3.37	%
Tax-equivalent basis adjustment	(94)			(118)		
Net interest income	\$ 14,593			\$ 13,491		
Net interest margin		3.53	%		3.59	%

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

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

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

(In thousands on a tax-equivalent basis)	For the three months ended June 30, 2014 versus June 30, 2013			For the six months ended June 30, 2014 versus June 30, 2013		
	Increase (decrease) due to change in:			Increase (decrease) due to change in:		
	Volume	Rate	Net	Volume	Rate	Net
Interest income:						
Federal funds sold and interest-bearing deposits	\$ 5	\$ (2)	\$ 3	\$ -	\$ (3)	\$ (3)
Federal Home Loan Bank stock	1	4	5	1	8	9
Securities	(119)	(2)	(121)	(187)	124	(63)
Loans	1,034	(238)	796	2,053	(608)	1,445
Total interest income	\$ 921	\$ (238)	\$ 683	\$ 1,867	\$ (479)	\$ 1,388
Interest expense:						
Demand deposits	\$ 10	\$ 9	\$ 19	\$ 22	\$ 7	\$ 29
Savings deposits	(6)	30	24	(23)	53	30
Time deposits	313	(157)	156	605	(351)	254
Total interest-bearing deposits	317	(118)	199	604	(291)	313
Borrowed funds and subordinated debentures	(6)	5	(1)	2	(5)	(3)
Total interest expense	311	(113)	198	606	(296)	310
Net interest income - fully tax-equivalent	\$ 610	\$ (125)	\$ 485	\$ 1,261	\$ (183)	\$ 1,078
Decrease in tax-equivalent adjustment			18			24
Net interest income			\$ 503			\$ 1,102

#### Provision for Loan Losses

The provision for loan losses totaled \$550 thousand for the three months ended June 30, 2014, compared to \$300 thousand for the three months ended June 30, 2013. For the six months ended June 30, 2014, the provision for loan losses totaled \$1.2 million, compared to \$950 thousand for the same period in 2013. 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. The provision reflects a higher level of net charge-offs for the quarter and year-to-date periods. 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 and six months ended June 30, 2014 and 2013:

(In thousands)	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
Branch fee income	\$ 342	\$ 348	\$ 718	\$ 695
Service and loan fee income	285	319	580	623
Gain on sale of SBA loans held for sale, net	255	86	337	327
Gain on sale of mortgage loans, net	188	547	553	1,025
BOLI income	96	75	192	146
Net security gains	268	108	378	334
Other income	206	175	408	332
Total noninterest income	\$ 1,640	\$ 1,658	\$ 3,166	\$ 3,482

Our noninterest income consists primarily of branch and loan fee income, gains on the sale of SBA and residential mortgage loans, gains on the sale of securities, and BOLI income. For the three months ended June 30, 2014, noninterest income amounted to \$1.6 million, a decrease of \$18 thousand from the prior year period. For the six months ended June 30, 2014, noninterest income decreased \$316 thousand to \$3.2 million when compared to the same period in 2013, primarily due to the lower volume of residential mortgage sales.

Changes in our noninterest income for the three and six months ended June 30, 2014 versus 2013 reflect:

- For the three months ended June 30 2014, branch fee income, which consists of deposit service charges and overdraft fees, decreased \$6 thousand when compared to the same period in 2013, due to lower commercial service charges. For the six months ended June 30, 2014, branch fee income increased \$23 thousand when compared to the same period in 2013, primarily due to increased overdraft fees.
- For the three and six months ended June 30, 2014, service and loan fee income decreased \$34 thousand and \$43 thousand, respectively, when compared to the same periods in the prior year. These decreases were due to lower late charges and SBA servicing income.
- Net gains on SBA loan sales amounted to \$255 thousand on \$2.3 million in sales and \$337 thousand on \$3.2 million in sales for the three and six months ended June 30, 2014, respectively, compared to net gains of \$86 thousand on \$900 thousand in sales and \$327 thousand on \$3.2 million in sales during the same periods in 2013. We anticipate an increase in the volume of originations and sales in 2014, due to the addition of SBA business developments officers.
- For the three and six months ended June 30, 2014, gains on sales of residential mortgage loans decreased \$359 thousand and \$472 thousand when compared to the same period in the prior year. Net gains on mortgage loan sales amounted to \$188 thousand on \$11.1 million in sales and \$553 thousand on \$28.6 million in sales for the three and six months ended June 30, 2014, respectively, compared to net gains of \$547 thousand on \$25.9 million in sales and \$1.0 million on \$48.5 million in sales during the same periods in 2013. Approximately, \$10.1 million of the sold loans were previously originated loans from our portfolio, with the remainder consisting of new production.
- BOLI income increased \$21 thousand and \$46 thousand for the three and six months ended June 30, 2014, respectively, when compared to the same periods in the prior year.
- Net realized gains on the sale of securities amounted to \$268 thousand for the three months ended June 30, 2014, compared to net gains of \$108 thousand for the same period in the prior year. For the six months ended June 30, 2014 and 2013, net realized security gains amounted to \$378 thousand and \$334 thousand, respectively. For additional information, see Note 7 - Securities.
- For the three and six months ended June 30, 2014, other income, which includes check card related income and miscellaneous service charges, increased \$31 thousand and \$76 thousand, respectively, when compared to the same periods in the prior year, primarily due to increases in VISA check card interchange fees and OREO rental income.

#### Noninterest Expense

The following table presents a breakdown of noninterest expense for the three and six months ended June 30, 2014 and 2013:

(In thousands)	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013
Compensation and benefits	\$ 3,122	\$ 3,166	\$ 6,340	\$ 6,341
Occupancy	619	627	1,279	1,321
Processing and communications	597	562	1,179	1,123
Furniture and equipment	379	371	735	736
Professional services	247	234	458	424

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Loan costs	174	228	344	406
OREO expenses	95	63	342	190
Deposit insurance	171	179	349	328
Advertising	287	181	438	301
Other expenses	453	463	939	1,029
Total noninterest expense	\$ 6,144	\$ 6,074	\$ 12,403	\$ 12,199

Noninterest expense increased \$70 thousand to \$6.1 million for the three months ended June 30, 2014, while year-to-date expenses increased \$204 thousand to \$12.4 million.

Changes in noninterest expense for the three and six months ended June 30, 2014 versus 2013 reflect:

- Compensation and benefits expense, the largest component of noninterest expense, decreased \$44 thousand for the three months ending June 30, 2014. Expenses decreased over the three month period as lower mortgage commission expense, due to a lower volume of originations, offset an increase in bonus accruals and benefits expense. Year-to-date compensation and benefits expense remained relatively flat.
- Occupancy expense decreased \$8 thousand and \$42 thousand for the three and six months ended June 30, 2014, respectively. The year-to-date decrease was due to the reduction in lease and leasehold depreciation expense related to the three branch sites that were purchased a year ago. These savings were partially offset by the increase in seasonal weather related expenses.
- Processing and communications expenses increased \$35 thousand and \$56 thousand for the three and six months ended June 30, 2014, respectively, primarily due to volume driven expenses such as items processing, merchant services, and postage as well as increased electronic access expenses such as data processing lines and internet access.
- Furniture and equipment expense remained relatively flat for the three and six month periods.

- Professional service fees increased \$13 thousand and \$34 thousand for the three and six months ended June 30, 2014, respectively, primarily due to increased audit related and consulting expenses.
- Loan costs decreased \$54 thousand and \$62 thousand for the three and six months ending June 30, 2014, respectively, due to lower loan legal and appraisal costs associated with collection accounts as credit quality improves, while mortgage servicing related costs have increased due to a larger portfolio.
- OREO expenses increased \$32 thousand and \$152 thousand for the three and six months ended June 30, 2014, respectively. OREO expenses remain elevated as we work through the collection process and incur expenses such as property maintenance, insurance and legal costs, as well as delinquent taxes, and losses on sale.
- Deposit insurance expense remained relatively flat for the three months ended June 30, 2014 when compared to the same period in the prior year. For the six months ended June 30, 2014, expenses increased \$21 thousand when compared to the same period in 2013 due to growth in the company's assets.
- Advertising expense increased \$106 thousand and \$137 thousand for the three and six months ended June 30, 2014, respectively. Expenses increased in both periods due to the expanded use of print, direct mail and bill board media, plus seasonal involvement in various community events.
- Other expenses decreased \$10 thousand and \$90 thousand for the three and six months ended June 30, 2014, respectively. The year-to-date decrease was due to lower director fees, printing and office supplies and provision for loan commitments.

#### Income Tax Expense

For the quarter ended June 30, 2014, the Company reported income tax expense of \$723 thousand for an effective tax rate of 32.1 percent, compared to an income tax expense of \$739 thousand and effective tax rate of 35.4 percent for the prior year's quarter. For the six months ended June 30, 2014, the Company reported income tax expense of \$1.4 million for an effective tax rate of 32.9 percent, compared to an income tax expense of \$1.3 million and effective tax rate of 33.4 percent for the six months ended June 30, 2013. The effective tax rates declined due to state tax planning.

#### Financial Condition at June 30, 2014

Total assets increased \$11.3 million or 1.2 percent, to \$932.4 million at June 30, 2014, compared to \$921.1 million at December 31, 2013. This increase was primarily due to an increase of \$30.2 million in loans, partially offset by a decrease of \$17.0 million in securities. Total deposits decreased \$10.6 million, due to decreases of \$20.2 million and \$9.5 million in interest-bearing demand deposits and savings deposits, respectively, partially offset by increases of \$10.3 million and \$8.8 million in time deposits and noninterest-bearing demand deposits. Borrowed funds increased \$18.0 million over year-end 2013 due to a \$50.0 million overnight advance at June 30, 2014 versus a \$32.0 million overnight advance at December 31, 2013. There were no changes to subordinated debentures. Total shareholders' equity increased \$3.3 million over year-end 2013, primarily due to retained earnings. These fluctuations are discussed in further detail in the paragraphs that follow.

#### Securities Portfolio

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

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

AFS securities totaled \$68.7 million at June 30, 2014, a decrease of \$12.4 million or 15.3 percent, compared to \$81.1 million at December 31, 2013. This net increase was the result of:

- \$9.9 million in purchases, consisting primarily of mortgage-backed securities, one corporate bond and one agency security, and
- \$793 thousand of appreciation in the market value of the portfolio. At June 30, 2014, the portfolio had net unrealized gains of \$15 thousand compared to net unrealized losses of \$778 thousand at December 31, 2013. These net unrealized gains (losses) are reflected net of tax in shareholders' equity as accumulated other comprehensive income (loss), partially offset by
- \$17.5 million in sales net of realized gains, which consisted of municipal securities, mortgage-backed securities, one asset-backed security, and one corporate bond,
- \$5.4 million in principal payments, maturities and called bonds, and
- \$237 thousand in net amortization of premiums

The weighted average life of AFS securities, adjusted for prepayments, amounted to 4.2 years at June 30, 2014 and 5.4 years at December 31, 2013.

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

HTM securities were \$21.7 million at June 30, 2014, a decrease of \$4.6 million or 17.6 percent, from year-end 2013. This decrease was the result of:

- \$4.6 million in principal payments and maturities, and
- \$34 thousand in net amortization of premiums.

The weighted average life of HTM securities, adjusted for prepayments, amounted to 6.5 years and 8.5 years at June 30, 2014 and December 31, 2013, respectively. As of June 30, 2014 and December 31, 2013, the fair value of HTM securities was \$21.6 million and \$25.5 million, respectively.

The average balance of taxable securities amounted to \$89.2 million for the six months ended June 30, 2014, compared to \$97.9 million for the same period in 2013. The average yield earned on taxable securities increased 28 basis points, to 2.87 percent for the six months ended June 30, 2014, from 2.59 percent for the same period in the prior year. The average balance of tax-exempt securities amounted to \$15.7 million for the six months ended June 30, 2014, compared to \$19.5 million for the same period in 2013. The average yield earned on tax-exempt securities decreased 5 basis points, to 3.68 percent for the six months ended June 30, 2014, from 3.73 percent for the same period in 2013.

Securities with a carrying value of \$61.9 million and \$74.5 million at June 30, 2014 and December 31, 2013, respectively, were pledged to secure Government deposits, secure other borrowings and for other purposes required or permitted by law.

Approximately 87 percent of the total investment portfolio had a fixed rate of interest at June 30, 2014.

See Note 7 to the accompanying Consolidated Financial Statements for more information regarding Securities.

Loan Portfolio

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

Total loans increased \$30.2 million or 4.4 percent to \$708.9 million at June 30, 2014, compared to \$678.7 million at year-end 2013. Residential mortgages, commercial loans, SBA 504 loans, and consumer loans increased \$14.1 million, \$12.6 million, \$2.9 million, and \$2.8 million respectively, partially offset by a decline of \$2.3 million in SBA loans.

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

(In thousands, except percentages)	June 30, 2014		December 31, 2013		
	Amount	% of total	Amount	% of total	
SBA loans held for investment	\$ 46,890	6.6	% \$ 48,918	7.2	%
SBA 504 loans	34,452	4.9	31,564	4.7	
Commercial loans	375,976	53.0	363,340	53.5	
Residential mortgage loans	196,184	27.7	182,067	26.8	
Consumer loans	48,943	6.9	46,139	6.8	
Total loans held for investment	702,445	99.1	672,028	99.0	
SBA loans held for sale	6,444	0.9	6,673	1.0	
Total loans	\$ 708,889	100.0	% \$ 678,701	100.0	%

Average loans increased \$84.7 million or 14.1 percent from \$600.0 million for the six months ended June 30, 2013, to \$684.7 million for the same period in 2014. The increase in average loans was due to increases in residential mortgages, commercial loans, and consumer loans, partially offset by a decline in SBA 7(a) and SBA 504 loans. The yield on the overall loan portfolio fell 20 basis points to 4.86 percent for the six months ended June 30, 2014, compared to 5.06 percent for the same period in the prior year. This decrease was the result of new loan volume at lower rates and existing variable rate loan products repricing lower as rates remain low.

SBA 7(a) loans, on which the SBA historically has provided guarantees of up to 90 percent of the principal balance, are considered a higher risk loan product for the Company than its other loan products. These loans are made for the purposes of providing working capital or financing the purchase of equipment, inventory or commercial real estate. Generally, an SBA 7(a) loan has a deficiency in its credit profile that would not allow the borrower to qualify for a traditional commercial loan, which is why the SBA provides the guarantee. The deficiency may be a higher loan to value (“LTV”) ratio, lower debt service coverage (“DSC”) ratio or weak personal financial guarantees. In addition, many SBA 7(a) loans are for start up businesses where there is no history or financial information. Finally, many SBA borrowers do not have an ongoing and continuous banking relationship with the Bank, but merely work with the Bank on a single transaction. The guaranteed portion of the Company’s SBA loans are generally sold in the secondary market with the nonguaranteed portion held in the portfolio as a loan held for investment.

SBA 7(a) loans held for sale, carried at the lower of cost or market, amounted to \$6.4 million at June 30, 2014, a decrease of \$229 thousand from \$6.7 million at December 31, 2013. SBA 7(a) loans held to maturity amounted to \$46.9 million at June 30, 2014, a decrease of \$2.0 million from \$48.9 million at December 31, 2013. The yield on SBA loans, which are generally floating and adjust quarterly to the Prime rate, was 4.51 percent for the six months ended June 30, 2014, compared to 4.84 percent in the prior year.

The guarantee rates on SBA 7(a) loans range from 50 percent to 90 percent, with the majority of the portfolio having a guarantee rate of 75 percent at origination. The guarantee rates are determined by the SBA and can vary from year to year depending on government funding and the goals of the SBA program. The carrying value of SBA loans held for sale represents the guaranteed portion to be sold into the secondary market. The carrying value of SBA loans held to maturity represents the unguaranteed portion, which is the Company's portion of SBA loans originated, reduced by the guaranteed portion that is sold into the secondary market. Approximately \$93.7 million and \$96.4 million in SBA loans were sold but serviced by the Company at June 30, 2014 and December 31, 2013, respectively, and are not included on the Company’s balance sheet. There is no relationship or correlation between the guarantee percentages and the level of charge-offs and recoveries on the Company’s SBA 7(a) loans. Charge-offs taken on SBA 7(a) loans effect the unguaranteed portion of the loan. SBA loans are underwritten to the same credit standards irrespective of the guarantee percentage.

The SBA 504 program consists of real estate backed commercial mortgages where the Company has the first mortgage and the SBA has the second mortgage on the property. Generally, the Company has a 50 percent LTV ratio on SBA 504 program loans at origination. At June 30, 2014, SBA 504 loans totaled \$34.5 million, an increase of \$2.9 million from \$31.6 million at December 31, 2013. The yield on SBA 504 loans decreased 40 basis points to 5.07 percent for the six months ended June 30, 2014, from 5.47 percent for the same period in 2013.

Commercial loans are generally made in the Company’s marketplace for the purpose of providing working capital, financing the purchase of equipment, inventory or commercial real estate and for other business purposes. These loans amounted to \$376.0 million at June 30, 2014, an increase of \$12.6 million from year-end 2013. The yield on commercial loans was 5.13 percent for the six months ended June 30, 2014, compared to 5.37 percent for the same period in 2013.



Residential mortgage loans consist of loans secured by 1 to 4 family residential properties. These loans amounted to \$196.2 million at June 30, 2014, an increase of \$14.1 million from year-end 2013. Sales of mortgage loans totaled \$28.6 million for the six months ended June 30, 2014. Approximately, \$10.1 million of the sold loans were from our portfolio, with the remainder consisting of new production. The yield on residential mortgages was 4.49 percent for the six months ended June 30, 2014, compared to 4.57 percent for the same period in 2013.

Consumer loans consist of home equity loans and loans for the purpose of financing the purchase of consumer goods, home improvements, and other personal needs, and are generally secured by the personal property being purchased. These loans amounted to \$48.9 million, an increase of \$2.8 million from year-end 2013. The yield on consumer loans was 4.47 percent for the six months ended June 30, 2014, compared to 4.43 percent for the same period in 2013.

There are no concentrations of loans to any borrowers or group of borrowers exceeding 10 percent of the total loan portfolio and no foreign loans in the portfolio. As a preferred SBA lender, a portion of the SBA portfolio is to borrowers outside the Company's lending area. During late 2008, the Company withdrew from SBA lending outside of its primary trade area, but continues to offer SBA loan products as an additional credit product within its primary trade area.

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

The majority of the Company's loans are secured by real estate. Declines in the market values of real estate in the Company's trade area impact the value of the collateral securing its loans. This could lead to greater losses in the event of defaults on loans secured by real estate. At June 30, 2014 and December 31, 2013, approximately 95 percent of the Company's loan portfolio was secured by real estate.

## Troubled Debt Restructurings

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

At June 30, 2014, there were ten loans totaling \$7.7 million that were classified as TDRs by the Company and deemed impaired, compared to ten such loans totaling \$7.9 million at December 31, 2013. Nonperforming loans included \$741 thousand of TDRs as of June 30, 2014, compared to \$467 thousand at December 31, 2013. Restructured loans that are placed in nonaccrual status may be removed after 6 months of contractual payments and the business showing the ability to service the debt going forward. The remaining TDRs are in accrual status since they are performing in accordance with the restructured terms. There are no commitments to lend additional funds on these loans.

The following table presents a breakdown of performing and nonperforming TDRs by class as of June 30, 2014 and December 31, 2013:

(In thousands)	June 30, 2014			December 31, 2013		
	Performing TDRs	Nonperforming TDRs	Total TDRs	Performing TDRs	Nonperforming TDRs	Total TDRs
SBA loans held for investment	\$ 460	\$ 499	\$ 959	\$ 534	\$ 467	\$ 1,001
SBA 504 loans	1,799	-	1,799	1,827	-	1,827
Commercial real estate	4,706	242	4,948	5,091	-	5,091
Total	\$ 6,965	\$ 741	\$ 7,706	\$ 7,452	\$ 467	\$ 7,919

Through June, 2014, our TDRs consisted of interest rate reductions, interest only periods and maturity extensions. There has been no principal forgiveness. The following table shows the types of modifications done to date by class through June 30, 2014:

(In thousands)	June 30, 2014			
	SBA held for investment	SBA	Commercial real estate	Total
Type of modification:				
Principal only	\$ 15	\$ -	\$ -	\$ 15
Interest only with reduced interest rate	-	-	2,684	2,684
Interest only with nominal principal	92	-	-	92
Interest with extra principal	-	-	1,414	1,414
Previously modified back to original terms	852	1,799	850	3,501
Total TDRs	\$ 959	\$ 1,799	\$ 4,948	\$ 7,706

#### Asset Quality

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

credit reviews by an outside firm.

The risk of loss is difficult to quantify and is subject to fluctuations in collateral values, general economic conditions and other factors. The current state of the economy and the downturn in the real estate market has resulted in increased loan delinquencies and defaults. In some cases, these factors have also resulted in significant impairment to the value of loan collateral. The Company values its collateral through the use of appraisals, broker price opinions, and knowledge of its local market.

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Nonperforming assets consist of nonperforming loans and other real estate owned ("OREO"). Nonperforming loans consist of loans that are not accruing interest (nonaccrual loans) as a result of principal or interest being in default for a period of 90 days or more or when the ability to collect principal and interest according to the contractual terms is in doubt. When a loan is classified as nonaccrual, interest accruals discontinue and all past due interest previously recognized as income is reversed and charged against current period income. Generally, until the loan becomes current, any payments received from the borrower are applied to outstanding principal, until such time as management determines that the financial condition of the borrower and other factors merit recognition of a portion of such payments as interest income. Loans past due 90 days or more and still accruing interest are not included in nonperforming loans. Loans past due 90 days or more and still accruing generally represent loans that are well collateralized and in a continuing process that are expected to result in repayment or restoration to current status.

The following table sets forth information concerning nonperforming assets and loans past due 90 days or more and still accruing interest at each of the periods presented:

(In thousands)	June 30, 2014	December 31, 2013	June 30, 2013
Nonperforming by category:			
SBA loans held for investment (1)	\$ 5,113	\$ 2,746	\$ 3,524
SBA 504 loans	433	1,101	1,986
Commercial loans	1,325	4,029	2,678
Residential mortgage loans	4,134	5,727	4,215
Consumer loans	924	1,680	954
Total nonperforming loans (2)	\$ 11,929	\$ 15,283	\$ 13,357
OREO	1,115	633	752
Total nonperforming assets	\$ 13,044	\$ 15,916	\$ 14,109
Past due 90 days or more and still accruing interest:			
SBA loans held for investment	\$ -	\$ -	\$ -
SBA 504 loans	-	-	425
Commercial loans	-	14	-
Residential mortgage loans	-	5	4
Consumer loans	-	-	-
Total past due 90 days or more and still accruing interest	\$ -	\$ 19	\$ 429
Nonperforming loans to total loans	1.68	% 2.25	% 2.15
Nonperforming loans and TDRs to total loans (3)	2.67	3.35	3.86
Nonperforming assets to total loans and OREO	1.84	2.34	2.26
Nonperforming assets to total assets	1.40	1.73	1.71
(1) Guaranteed SBA loans included above	\$ 2,305	\$ 540	\$ 736
(2) Nonperforming TDRs included above	741	467	1,658
(3) Performing TDRs	6,965	7,452	10,649

Nonperforming loans were \$11.9 million at June 30, 2014, a \$3.4 million decrease from \$15.3 million at year-end 2013 and a \$1.4 million decrease from \$13.4 million at June, 2013. Since year-end 2013, nonperforming loans in all segments decreased, except SBA loans held for investment. Included in nonperforming loans at June 30, 2014 are approximately \$2.3 million of loans guaranteed by the SBA, compared to \$540 thousand at December 31, 2013 and \$736 thousand at June 30, 2013. In addition, there were no loans past due 90 days or more and still accruing interest at June 30, 2014, compared to \$19 thousand and \$429 thousand at December 31, 2013 and June 30, 2013, respectively.

Other real estate owned (“OREO”) properties totaled \$1.1 million at June 30, 2014, an increase of \$482 thousand from \$633 thousand at year-end 2013 and a \$363 thousand increase from \$752 thousand at June 30, 2013. During the six months ended June 30, 2014, the Company took title to six new properties totaling \$2.9 million with a valuation write down on one loan totaling \$170 thousand. Four OREO properties were sold, resulting in a net loss of \$222 thousand on the sales.

The Company also monitors potential problem loans. Potential problem loans are those loans where information about possible credit problems of borrowers causes management to have doubts as to the ability of such borrowers to comply with loan repayment terms. These loans are not included in nonperforming loans as they continue to perform. Potential problem loans totaled \$6.2 million at June 30, 2014, an increase of \$453 thousand from \$5.7 million at December 31, 2013. The increase is due to the addition of seven loans totaling \$4.8 million during the year, partially offset by the removal of six loans totaling \$3.2 million.

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

Allowance for Loan Losses and Reserve for Unfunded Loan Commitments

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

When calculating the five-year historical net charge-off rate, the Company weights the past three years more heavily. The Company believes using this approach 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. The factors are evaluated separately for each type of loan. For example, commercial loans are broken down further into commercial and industrial loans, commercial mortgages, construction loans, etc. Each type of loan is risk weighted for each environmental factor based on its individual characteristics.

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

Beginning in 2013 and continuing in 2014, the Company has decreased its loan loss provision in response to improvements in the inherent credit risk within its loan portfolio. The improved inherent credit risk was evidenced by a decrease in delinquent and nonperforming loans, as the economy continued to improve.

The allowance for loan losses totaled \$12.9 million at June 30, 2014, compared to \$13.1 million and \$14.3 million at December 31, 2013 and June 30, 2013, respectively, with resulting allowance to total loan ratios of 1.81 percent, 1.94 percent, and 2.30 percent, respectively. Net charge-offs amounted to \$499 thousand for the three months ended June 30, 2014, compared to \$336 thousand for the same period in 2013. Net charge-offs amounted to \$1.4 million for the six months ended June 30, 2014 and 2013. Net charge-offs to average loan ratios are shown in the table below for each major loan category.

(In thousands, except percentages)	For the three months ended June 30,		For the six months ended June 30,	
	2014	2013	2014	2013

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Balance, beginning of period	\$ 12,807	\$ 14,345	\$ 13,141	\$ 14,758
Provision for loan losses charged to expense	550	300	1,150	950
Less: Chargeoffs				
SBA loans held for investment	199	167	253	737
SBA 504 loans	-	200	92	400
Commercial loans	134	200	588	575
Residential mortgage loans	5	-	177	125
Consumer loans	203	-	382	59
Total chargeoffs	541	567	1,492	1,896
Add: Recoveries				
SBA loans held for investment	10	8	18	145
SBA 504 loans	-	154	-	179
Commercial loans	31	65	40	166
Residential mortgage loans	-	2	-	4
Consumer loans	1	2	1	3
Total recoveries	42	231	59	497
Net chargeoffs	499	336	1,433	1,399
Balance, end of period	\$ 12,858	\$ 14,309	\$ 12,858	\$ 14,309
Selected loan quality ratios:				
Net chargeoffs to average loans:				
SBA loans held for investment	1.40	% 1.01	% 0.87	% 1.86
SBA 504 loans	-	0.47	0.56	1.11
Commercial loans	0.11	0.17	0.30	0.27
Residential mortgage loans	0.01	(0.01)	0.19	0.17
Consumer loans	1.70	(0.02)	1.64	0.25
Total loans	0.29	0.22	0.42	0.47
Allowance to total loans	1.81	2.30	1.81	2.30
Allowance to nonperforming loans	107.79	107.13	107.79	107.13

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In addition to the allowance for loan losses, the Company maintains a reserve for unfunded loan commitments that is maintained 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 maintained in other liabilities. At June 30, 2014, a \$132 thousand commitment reserve was reported on the balance sheet as an “other liability”, compared to a \$103 thousand commitment reserve at December 31, 2013.

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

## Deposits

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

Total deposits decreased \$10.6 million to \$728.1 million at June 30, 2014, from \$738.7 million at December 31, 2013. This decrease in deposits was due to decreases of \$20.2 million and \$9.5 million in interest-bearing demand deposits and savings deposits, respectively, partially offset by increases of \$10.3 million in time deposits and \$8.8 million in noninterest-bearing demand deposits. The decreases in interest-bearing demand deposits and savings deposits were due to declines in municipal deposits of \$16.4 million and \$14.2 million, respectively, from year-end.

The Company’s deposit composition at June 30, 2014, consisted of 35.3 percent savings deposits, 29.6 percent time deposits, 19.9 percent noninterest-bearing demand deposits and 15.2 percent interest-bearing demand deposits.

## Borrowed Funds and Subordinated Debentures

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

Borrowed funds and subordinated debentures totaled \$140.5 million and \$122.5 million at June 30, 2014 and December 31, 2013, respectively, and are broken down in the following table:

(In thousands)	June 30, 2014	December 31, 2013
FHLB borrowings:		
Fixed rate advances	\$ 40,000	\$ 30,000
Overnight advances	50,000	32,000
Repurchase agreements	20,000	30,000
Other repurchase agreements	15,000	15,000
Subordinated debentures	15,465	15,465

At June 30, 2014, the Company had \$47.2 million of additional credit available at the FHLB. Pledging additional collateral in the form of 1 to 4 family residential mortgages or investment securities can increase the line with the FHLB.

#### Interest Rate Sensitivity

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

The Company utilizes Modified Duration of Equity and Economic Value of Portfolio Equity (“EVPE”) models to measure the impact of longer-term asset and liability mismatches beyond two years. The modified duration of equity measures the potential price risk of equity to changes in interest rates. A longer modified duration of equity indicates a greater degree of risk to rising interest rates. Because of balance sheet optionality, an EVPE analysis is also used to dynamically model the present value of asset and liability cash flows with rate shocks of 200 basis points. The economic value of equity is likely to be different as interest rates change. Results falling outside prescribed ranges require action by the ALCO. The Company’s variance in the economic value of equity, as a percentage of assets with rate shocks of 200 basis points at June 30, 2014, is a decline of 0.87 percent in a rising-rate environment and an increase of 0.62 percent in a falling-rate environment. The variances in the EVPE at June 30, 2014 are within the Board-approved guidelines of +/- 3.00 percent. At December 31, 2013, the economic value of equity as a percentage of assets with rate shocks of 200 basis points was a decline of 1.09 percent in a rising-rate environment and an increase of 0.45 percent in a falling-rate environment.

## Liquidity

### Consolidated Bank Liquidity

Liquidity measures the ability to satisfy current and future cash flow needs as they become due. A bank’s liquidity reflects its ability to meet loan demand, to accommodate possible outflows in deposits and to take advantage of interest rate opportunities in the marketplace. Our liquidity is monitored by management and the Board of Directors through a Risk Management Committee, which reviews historical funding requirements, our current liquidity position, sources and stability of funding, marketability of assets, options for attracting additional funds, and anticipated future funding needs, including the level of unfunded commitments. Our goal is to maintain sufficient asset-based liquidity to cover potential funding requirements in order to minimize our dependence on volatile and potentially unstable funding markets.

The principal sources of funds at the Bank are deposits, scheduled amortization and prepayments of investment and loan principal, sales and maturities of investment securities and funds provided by operations. While scheduled loan payments and maturing investments are relatively predictable sources of funds, deposit inflows and outflows and loan prepayments are greatly influenced by general interest rates, economic conditions and competition. The Consolidated Statement of Cash Flows provides detail on the Company’s sources and uses of cash, as well as an indication of the Company’s ability to maintain an adequate level of liquidity. At June 30, 2014, the balance of cash and cash equivalents was \$95.3 million, a decrease of \$4.1 million from December 31, 2013. A discussion of the cash provided by and used in operating, investing and financing activities follows.

Operating activities provided \$3.6 million and \$4.3 million in net cash for the six months ended June 30, 2014 and 2013, respectively. The primary sources of funds were net income from operations and adjustments to net income, such as the provision for loan losses, depreciation and amortization, and proceeds from the sale of mortgage and SBA loans held for sale, partially offset by originations of mortgage and SBA loans held for sale.

Investing activities used \$14.8 million and \$45.9 million in net cash for the six months ended June 30, 2014 and 2013, respectively. Cash was primarily used to purchase securities, and fund new loans, partially offset by cash inflows from maturities and paydowns on securities and proceeds from the sale of securities and OREO.

- × Securities. The Consolidated Bank's available for sale investment portfolio amounted to \$68.6 million and \$81.0 million at June 30, 2014 and December 31, 2013, respectively. This excludes the Parent Company's securities discussed under the heading "Parent Company Liquidity" below. Projected cash flows from securities over the next twelve months are \$17.4 million.
- × Loans. The SBA loans held for sale portfolio amounted to \$6.4 million and \$6.7 million at June 30, 2014 and December 31, 2013, respectively. Sales of these loans provide an additional source of liquidity for the Company.
- × Outstanding Commitments. The Company was committed to advance approximately \$132.0 million to its borrowers as of June 30, 2014, compared to \$103.2 million at December 31, 2013. At June 30, 2014, \$45.3 million of these commitments expire within one year, compared to \$45.6 million at December 31, 2013. The Company had \$1.4 million in standby letters of credit at both June 30, 2014 and December 31, 2013, which are included in the commitments amount noted above. The estimated fair value of these guarantees is not significant. The Company believes it has the necessary liquidity to honor all commitments. Many of these commitments will expire and never be funded.

Financing activities provided \$7.2 million in net cash for the six months ended June 30, 2014, compared to \$3.7 million for the same period in the prior year, primarily due to an increase in the Company's deposits and proceeds from new borrowings partially offset by repayments of borrowings.

- × Deposits. As of June 30, 2014, deposits included \$54.7 million of Government deposits, as compared to \$82.5 million at year-end 2013. These deposits are generally short in duration and are very sensitive to price competition. The Company believes that the current level of these types of deposits is appropriate. Included in the portfolio were \$49.1 million of deposits from ten municipalities. The withdrawal of these deposits, in whole or in part, would not create a liquidity shortfall for the Company.
- × Borrowed Funds. Total FHLB borrowings amounted to \$110.0 million and \$92.0 million as of June 30, 2014 and December 31, 2013, respectively. Third party repurchase agreements totaled \$15.0 million as of both June 30, 2014 and December 31, 2013. As a member of the Federal Home Loan Bank of New York ("FHLB"), the Company can borrow additional funds based on the market value of collateral pledged. At June 30, 2014, pledging provided an additional \$47.2 million in borrowing potential from the FHLB. In addition, the Company can pledge additional collateral in the form of 1 to 4 family residential mortgages or investment securities to increase this line with the FHLB.

#### Parent Company Liquidity

The Parent Company's cash needs are funded by dividends paid by the Bank. Other than its investment in the Bank and Unity Statutory Trusts II and III, the Parent Company does not actively engage in other transactions or business. Only expenses specifically for the benefit of the Parent Company are paid using its cash, which typically includes the payment of operating expenses and cash dividends on common stock and, prior to the redemption of the preferred stock issued as part of the CPP, cash dividends on the preferred stock issued to the U.S. Treasury.

At June 30, 2014, the Parent Company had \$623 thousand in cash and cash equivalents and \$175 thousand in investment securities valued at fair market value, compared to \$724 thousand in cash and cash equivalents and \$167 thousand in investment securities at December 31, 2013.

#### Regulatory Capital

A significant measure of the strength of a financial institution is its capital base. Federal regulators have classified and defined capital into the following components: (1) tier 1 capital, which includes tangible shareholders' equity for common stock, qualifying preferred stock and certain qualifying hybrid instruments, and (2) tier 2 capital, which includes a portion of the allowance for loan losses, subject to limitations, certain qualifying long-term debt, preferred stock and hybrid instruments, which do not qualify for tier 1 capital. The parent company and its subsidiary bank are subject to various regulatory capital requirements administered by banking regulators. Quantitative measures of capital adequacy include the leverage ratio (tier 1 capital as a percentage of tangible assets), tier 1 risk-based capital ratio (tier 1 capital as a percent of risk-weighted assets) and total risk-based capital ratio (total risk-based capital as a percent of total risk-weighted assets).

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

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

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On April 15, 2014, the Company filed an S-1 registration statement announcing a common stock rights offering to existing shareholders. On June 30, 2014, the Company filed a press release announcing that it has commenced the previously disclosed rights offering. On or about July 7, 2014, the company distributed to holders of its common stock 1 right for each share of common stock owned as of June 26, 2014. Each subscription right entitles its holder to purchase 0.10 shares of common stock of the Company at a subscriptions price of \$8.30 per share. Assuming the rights offering is fully subscribed, the Company estimates that it will receive net proceeds of approximately \$6.2 million. The Company intends to use the proceeds for general corporate purposes, which may include, among other things, funding our expansion plans, working capital and pursuing strategic opportunities which may be presented to us from time to time.

(In thousands)	Actual		For capital adequacy purposes		To be well-capitalized under prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of June 30, 2014						
Leverage ratio	\$ 74,108	8.24	% ≥ \$35,965	4.00	%	N/A
Tier I risk-based capital ratio	74,108	10.86	27,284	4.00	N/A	N/A
Total risk-based capital ratio	82,690	12.12	54,569	8.00	N/A	N/A
As of December 31, 2013						
Leverage ratio	\$ 70,852	8.08	% ≥ \$35,084	4.00	%	N/A
Tier I risk-based capital ratio	70,852	10.74	26,400	4.00	N/A	N/A
Total risk-based capital ratio	79,164	11.99	52,800	8.00	N/A	N/A

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

(In thousands)	Actual		For capital adequacy purposes		To be well-capitalized under prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of June 30, 2014						
Leverage ratio	\$ 64,836	7.22	% ≥ \$35,940	4.00	% ≥ \$44,925	5.00
Tier I risk-based capital ratio	64,836	9.51	27,259	4.00	40,888	6.00
Total risk-based capital ratio	81,909	12.02	54,517	8.00	68,146	10.00
As of December 31, 2013						
Leverage ratio	\$ 61,493	7.02	% ≥ \$35,058	4.00	% ≥ \$43,823	5.00
Tier I risk-based capital ratio	61,493	9.33	26,373	4.00	39,560	6.00
Total risk-based capital ratio	78,296	11.88	52,747	8.00	65,933	10.00

The Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, adopted Basel III in September 2010, which constitutes a set of capital reform measures designed to strengthen the regulation, supervision and risk management of banking organizations worldwide. In order to implement Basel III and certain additional capital changes required by the Dodd-Frank Act, on July 9, 2013, the FDIC approved, as an interim final rule, the regulatory capital requirements for U.S. state nonmember banks, such as us, substantially similar to final rules issued by the Board of Governors of the Federal Reserve System (“Federal Reserve”) and the Office of the Comptroller of the Currency.

The interim final rule includes new risk-based capital and leverage ratios that will be phased-in from 2015 to 2019 for most state nonmember banks, including us. The rule includes a new common equity Tier 1 capital to risk-weighted assets ratio of 4.5% and a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets, which is in addition to the Tier 1 and Total risk-based capital requirements. The interim final rule also raises the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0% and requires a minimum leverage ratio of 4.0%. The required minimum ratio of total capital to risk-weighted assets will remain 8.0%. The new risk-based capital requirements (except for the capital conservation buffer) will become effective for the Bank on January 1, 2015. The capital conservation buffer will be phased in over four years beginning on January 1, 2016, with a maximum buffer of 0.625% of risk-weighted assets for 2016, 1.25% for 2017, 1.875% for 2018, and 2.5% for 2019 and thereafter. Failure to maintain the required capital conservation buffer will result in limitations on capital distributions and on discretionary bonuses to executive officers.



The following chart compares the risk-based capital required under existing rules to those prescribed under the interim final rule under the phase-in period described above:

	Current Treatment		Treatment in Final Rule	
Leverage ratio	4.00	%	4.00	%
Common equity tier 1 capital (CET1) ratio	N/A		4.50	%
Additional tier 1	N/A		1.50	%
Tier 1 capital ratio	4.00	%	6.00	%
Tier 2	4.00	%	2.00	%
Total capital ratio	8.00	%	8.00	%
Capital conservation buffer	N/A		2.50	%

The interim final rule also implements revisions and clarifications consistent with Basel III regarding the various components of Tier 1 capital, including common equity, unrealized gains and losses and instruments that will no longer qualify as Tier 1 capital. The interim final rule also sets forth certain changes for the calculation of risk-weighted assets that the Bank will be required to implement beginning January 1, 2015. Management is currently evaluating the provisions of the interim final rule and its expected impact. Based on our current capital composition and levels, management does not presently anticipate that the interim final rule presents a material risk to our financial condition or results of operations.

#### Shareholders' Equity

Shareholders' equity increased \$3.3 million to \$60.5 million at June 30, 2014 compared to \$57.2 million at December 31, 2013. Items impacting shareholders' equity included net income of \$2.8 million, \$284 thousand from the issuance of common stock under employee benefit plans, and a \$483 thousand increase in other comprehensive income related to unrealized gains on available for sale securities, partially offset by a decrease of \$284 thousand due to common stock dividends paid. The issuance of common stock under employee benefit plans includes nonqualified stock options and restricted stock expense related entries, employee option exercises and the tax benefit of options exercised.

#### Repurchase Plan

On October 21, 2002, the Company authorized the repurchase of up to 10 percent of its outstanding common stock. The amount and timing of purchases is dependent upon a number of factors, including the price and availability of the Company's shares, general market conditions and competing alternate uses of funds. There were no shares repurchased during the three and six month periods ended June 30, 2014 or 2013.

## Impact of Inflation and Changing Prices

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

## ITEM 3 Quantitative and Qualitative Disclosures about Market Risk

During the six months ended June 30, 2014, there have been no significant changes in the Company's assessment of market risk as reported in Item 6 of the Company's Annual Report on Form 10-K for the year ended December 31, 2013. (See Interest Rate Sensitivity in Management's Discussion and Analysis Herein.)

## ITEM 4 Controls and Procedures

- a) The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures as of June 30, 2014. Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective for recording, processing, summarizing and reporting the information the Company is required to disclose in the reports it files under the Securities Exchange Act of 1934, within the time periods specified in the SEC's rules and forms.
- b) No significant change in the Company's internal control over financial reporting has occurred during the quarterly period covered by this report that has materially affected, or is reasonably likely to materially affect, the Company's controls over financial reporting.

PART II OTHER INFORMATION

ITEM 1 Legal Proceedings

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

ITEM 1A Risk Factors

Information regarding this item as of June 30, 2014 appears under the heading, "Risk Factors" within the Company's Form 10-K for the year ended December 31, 2013.

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

ITEM 3 Defaults upon Senior Securities - None

ITEM 4 Mine Safety Disclosures - N/A

ITEM 5 Other Information - None

ITEM 6 Exhibits

(a) Exhibits	Description
Exhibit 31.1	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a) and Section 302 of the Sarbanes-Oxley Act of 2002
Exhibit 31.2	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a) and Section 302 of the Sarbanes-Oxley Act of 2002

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

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SIGNATURES

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

UNITY BANCORP, INC.

Dated: August 8, 2014 /s/ Alan J. Bedner, Jr.  
Alan J. Bedner, Jr.  
Executive Vice President and Chief Financial Officer

EXHIBIT INDEX

QUARTERLY REPORT ON FORM 10-Q

Exhibit No.	Description
31.1	Exhibit 31.1-Certification of James A. Hughes. Required by Rule 13a-14(a) or Rule 15d-14(a) and Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Exhibit 31.2-Certification of Alan J. Bedner, Jr. Required by Rule 13a-14(a) or Rule 15d-14(a) and Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Exhibit 32.1-Certification of James A. Hughes and Alan J. Bedner, Jr. Required by Rule 13a-14(b) or Rule 15d-14(b) and Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definitions Linkbase Document