VSB BANCORP INC
Form 10-K
March 25, 2009

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

x ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED **DECEMBER 31, 2008**

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

COMMISSION FILE NUMBER 0-50237

VSB Bancorp, Inc.

(Exact name of registrant as specified in its charter)

New York

(State or other jurisdiction of incorporation or organization)

11 - 3680128

(I. R. S. Employer Identification No.)

4142 Hylan Boulevard, Staten Island, New York 10308

(Address of principal executive offices)

(718) 979-1100

Issuer s telephone number

Common Stock

(Title of Class)

Indicate by check mark whether the registrant (1) filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act 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 **x** No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K x.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definition of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer o Accelerated Filer o Non-Accelerated Filer o Smaller Reporting Company **x**

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act):
Yes o No **x**

The aggregate market value of the voting stock held by non-affiliates of the registrant at June 30, 2008 was $12,301,888. Number of shares of the registrant s common stock outstanding as of March 18, 2009: 1,836,432 shares.

Documents incorporated by reference:

Portions of the registrant s definitive proxy statement filed on or about March 27, 2009 into Part III of this Form 10-K.

Forward-Looking Statements

When used in this Form 10-K, or in any written or oral statement made by us or our officers, directors or employees, the words and phrases will result, expect, will continue, anticipate, estimate, project, or similar terms are intended to identify forward-looking statemer variety of factors could cause our actual results and experiences to differ materially from the anticipated results or other expectations expressed in any forward-looking statements. Some of the risks and uncertainties that may affect our operations, performance, development and results, the interest rate sensitivity of our assets and liabilities, and the adequacy of our loan loss allowance, include, but are not limited to:

- deterioration in local, regional, national or global economic conditions which could result in, among other things, an increase in loan delinquencies, a decrease in property values, or a change in the real estate turnover rate;
- changes in market interest rates or changes in the speed at which market interest rates change;
- changes in laws and regulations affecting the financial service industry;
- changes in competition; and
- changes in consumer preferences by our customers or the customers of our business borrowers.

Please do not place undue reliance on any forward-looking statement, which speaks only as of the date made. There are many factors, including those described above, that could affect our future business activities or financial performance and could cause our actual future results or circumstances to differ materially from those we anticipate or project. We do not undertake any obligation to update any forward-looking statement after it is made.

PART I

Item 1. Description of Business.

Business of VSB Bancorp, Inc.

VSB Bancorp, Inc. (referred to using terms such as we, us, or the Company) became the holding company for Victory State Bank (the Bank), a New York chartered commercial bank, upon the completion of a reorganization of the Bank into the holding company form of organization. The reorganization was effective in May 2003. All the outstanding stock of Victory State Bank was exchanged for stock of VSB Bancorp, Inc. on a three for two basis so that the stockholders of Victory State Bank became the owners of VSB Bancorp, Inc. and VSB Bancorp, Inc. owns all the stock of Victory State Bank. The common stock we issued in the transaction qualifies as exempt securities under Section 3(a)(12) of the Securities Act of 1933. Our primary business is owning all of the issued and outstanding stock of the Bank. Our common stock is listed on the NASDAQ Global Market, effective on August 4, 2008. We continue to trade under the symbol VSBN .

The main office of the Company and the Bank is at 4142 Hylan Boulevard, Staten Island, New York 10308, telephone (718) 979-1100. We maintain an Internet web site at www.victorystatebank.com.

Victory State Bank

Victory State Bank is a New York State chartered commercial bank, founded in November 1997. The Bank is supervised by the New York State Banking Department and the Federal Deposit Insurance Corporation (FDIC). The Bank s principal business has been and continues to be attracting commercial deposits from primarily the general public and investing those deposits, together with funds generated from operations and repayments on existing investments, primarily in loans for business purposes and investment securities. The Bank s revenues are derived principally from interest on our commercial loan and investment securities portfolios. The Bank s primary sources of funds are deposits and principal and interest payments on loans and investment securities.

Victory State Bank serves its primary market of Staten Island, New York through its five banking offices. The Bank opened its original main office in the Oakwood section of Staten Island in November 1997 which was closed in February 2007 as the lease expired at that location; its first branch was opened in the West Brighton section of Staten Island in June 1999; its second branch in the St. George section of Staten Island in January 2000; its third branch in the Dongan Hills section of Staten Island in December 2002 and its fourth branch in the Rosebank section of Staten Island in April 2006. In February 2007, the Bank opened its new main office in the Great Kills section of Staten Island. The Bank s deposits are insured by the Federal Deposit Insurance Corporation up to the maximum amounts permitted by law. Victory State Bank also serves its customers through its website, www.victorystatebank.com.

Market Area and Competition

Victory State Bank has been, and continues to be, a community-oriented, state-chartered commercial bank offering a variety of traditional financial services to meet the needs of the communities in which it operates. Management considers our reputation for customer service as its major competitive advantage in attracting and retaining customers in its market area.

Our primary market area is concentrated in the neighborhoods surrounding our branches in the New York City Borough of Staten Island. Management believes that our branch offices are located in communities that can generally be characterized as stable, residential neighborhoods of predominantly one- to four-family residences and middle income families.

From 1990 to 2000, Staten Island s population grew to 443,728 from 378,977, or a 17% increase. According to U.S. Census Department estimates, this growth rate has slowed, with the population estimated to have increased by only an additional 8.5% through July 1, 2007. The decline in the growth rate has itself accelerated, with the Census Department s estimated year to year rate of increase generally declining throughout this decade. There was a modest shift from the 20 to 44 year age group to the 45 to 64 year age group during the decade of the 1990s. As a percentage of population, the 45 to 64 year age group increased from 19.8% to 23.4% during the decade. The Census Department estimates that this trend continued through at least 2006, when the 45 to 64 year age group increased to 26.3% of the total population. The largest age group continued to be the 20 to 44 age group, at 35.2% of total population in 2006, down from 37.0% in 2000.

However, the population news is not all negative when compared to the rest of New York State. Most notably, Staten Island fairs the highest among all 62 New York Counties when natural internal population growth is excluded and migration into the county is estimated. The U.S. Census estimates that net migration into the county was the highest in the entire state. Only 13 counties had an estimated net migration into the county during the period from the end of the 2000 census through July 1, 2007, and Staten Island was the best of those.

Median household income increased to $55,039 from $50,064 during the decade of the 90 s. Per capita income in 1999 was $23,905 in Staten Island, slightly higher than $23,389, the per capita income of New York State. One third of the households in Staten Island had household income of more than $75,000 in 1999. These income levels compare favorably with the national household median of $41,994 and the national per capita median of $21,587. The Census Department has not published comparable data for recent years, but management believes that median household income continues to be strong and that these income levels in Staten Island provide satisfactory support for personal home ownership, in turn supporting the home building industry, which is a major industry focus for Victory State Bank. However, recent economic disruption will have an adverse effect on local income levels because of increased unemployment, a reduction in wage increases, and possible wage reductions for employed persons. Although according to the United States Bureau of Labor Statistics, the unemployment rate in Staten Island and the New York metro area is below the national average, the unemployment rate has increased substantially in the past year and may increase in the future as financial service firms report continuing layoffs.

Until the recent decline in the residential housing market, the median sales price of existing single family homes increased steadily from 2000 through 2006. According to the New York State Association of Realtors, the median price increased from $211,000 to $425,000 during that period. According to a report by the Center for an Urban Future, this means that the cost of a single family home on Staten Island is now out of reach to many middle-class families. As the population grew during the 1990s, total housing units increased as well, to 163,993 in 2000, as compared to 139,726 in 1990, an increase of 17.4%. However, perhaps confirming the reduction in affordability to the middle class, the growth in housing units has slowed, with an estimate 177,368 housing units at June 30, 2006, an increase of 8.2% since April 1, 2000. This slowing growth presents challenges to management because of our focus on the home building industry and related sectors of the local economy.

Declines in the residential housing market in the past year or two create one potential problem faced by Staten Island, its residents and its businesses. According to Zillow.com, a real estate information service, the estimated median home value has declined 5.6% in the past year. The Center for an Urban Future report already noted an increase in foreclosures on Staten Island during 2006 which exceeded the increase in the rest of New York City. The decline in the price of homes and the economic downturn may accelerate this increase in foreclosed properties, which could exacerbate the decline in real estate values.

The New York City metropolitan area has a high density of financial institutions, many of which are significantly larger and have greater financial resources than we have, and all of which are our competitors to varying degrees. Our competition for loans comes principally from commercial banks, savings banks and insurance companies. Our most direct competition for deposits has come from commercial banks and savings banks. In addition, we face increasing competition for deposits from non-bank institutions such as brokerage firms and insurance companies in such areas as short-term money market funds, corporate and government securities funds, mutual funds and annuities.

RISK FACTORS

Bank lending is an inherently risky business. A substantial portion of our assets are invested in loans, and loans necessarily present many risks. We must first rely on our borrowers to repay their loans, and if they are unable to do so, we must rely on the value of the collateral, if any, for the loan. Changing business conditions, increases in unemployment, personal problems that a borrower may experience, changes in the regulations that apply to a borrower s business, changes in the political climate or in public policy, and many other factors outside our control, could adversely affect the ability of our borrowers to repay their loans or the value of the collateral we have received. Although we seek to reduce these risks through underwriting procedures that we believe are prudent, it is impossible for us to completely eliminate the risks which arise from making loans except by eliminating our lending operations.

The current turmoil in the economy in general and among financial institutions in particular could adversely affect our customers and thus have an indirect adverse effect on us. The economy in the United States, including the economy in Staten Island, is in a recession and there is substantial stress on many financial institutions and financial products. The federal government has intervened by making hundreds of billions of dollars in capital contributions to the banking industry. We draw a substantial portion of our customer base from local businesses, especially those in the building trades and related industries. Our customers are already being adversely affected by the economic downturn, and if the recession continues, it will become more difficult for us to conduct prudent and profitable business in our community.

Making permanent residential mortgage loans is not a material part of our business, and our investments in mortgage-backed securities and collateralized mortgage obligations have been made with a view towards avoiding the types of securities that are backed by low quality mortgage-related assets. However, one of the primary focuses of our local business is receiving deposits from, and making loans to, businesses involved in the construction and building trades industry on Staten Island. Construction loans represented a significant component of our loan portfolio, reaching 39.8% of total loans at year end 2005. As we monitored the economy and the strength of the local construction industry, we elected to reduce our portfolio of construction loans. However, developers and builders provide not only a source of loans, but they also provide us with deposits and other business. If the weakness in the economy continues or worsens, then that could have a substantial adverse effect on our customers and potential customers, making it more difficult for us to find satisfactory loan opportunities and low-cost deposits. This could compel us to invest in lower yielding securities instead of higher-yielding loans and could also reduce low cost funding sources such as checking accounts and require that we replace them with higher cost deposits such as time deposits. Either or both of those shifts could reduce our net income.

Fluctuations in interest rates could have an adverse affect on our profitability. Our principal source of income is the difference between the interest income we earn on interest-earning assets, such as loans and securities, and our cost of funds, principally interest paid on deposits. These rates of interest change from time to time, depending upon a number of factors, including general market interest rates. However, the frequency of the changes varies among different types of assets and liabilities. For example, for a five-year loan with an interest rate based upon the prime rate, the interest rate may change every time the prime rate changes. In contrast, the rate of interest we pay on a five-year certificate of deposit adjusts only every five years, based upon changes in market interest rates.

In general, the interest rates we pay on deposits adjust more slowly than the interest rates we earn on loans because the largest part of our loan portfolio consist of loans with interest rates that fluctuate based upon the prime rate. In contrast, although many of our deposit categories have interest rates that could adjust immediately, such as interest checking accounts and savings accounts, changes in the interest rates on those accounts are at our discretion and tend to occur more slowly. As a result, recent declines in market interest rates have had an adverse effect on our net income because the yields we earn on our loans have declined more rapidly than our cost of funds. Further declines in market interest rates could have a further adverse effect on our net income, while increases in market interest rates could increase our net interest income because our cost of deposits would probably increase more slowly than the yields on our loans. However, customer preferences and competitive pressures may negate this positive effect because customers may choose to move funds into higher-earning deposit types as higher interest rates make them more attractive, or competitors offer premium rates to attract deposits. We also have a substantial portfolio of investment securities with fixed rates of interest, most of which are mortgage-backed securities with an estimated average life of not more than 5 years.

There is only a very limited trading market for our common stock. Our common stock is listed on the NASDAQ Global Market, which listing was effective on August 4, 2008. Our common stock was previously traded on the NASDAQ Capital Market. We continue to trade under the symbol VSBN. We applied for the listing on the Global Market in the hope that it would increase the trading market in our stock and make it easier for individuals to buy and sell our stock. However, our stock does not trade every day and the average daily trading volume is limited. During the twelve months ended March 18, 2009, there were trades reported on only 82 out of 252 trading days, or slightly more than one out of every three trading days, and our average daily trading volume during that period was 1,250 shares for all trading days and 3,840 shares per day for the 82 days on which trades occurred. This data is comparable to the trading volume data for the previous year when we were not quoted on the NASDAQ Capital Market. We currently have approximately 151 stockholders of record and we believe based upon reports we have received from broker/dealers, that there are approximately an additional 250 stockholders who own their shares in street name.

The geographic concentration of our loans increases the risk that adverse economic conditions could affect our net income. Substantially all of our loans are mortgage loans on property located in Staten Island, New York, or loans to residents of or businesses on Staten Island. Staten Island has experienced an economic down turn in recent years. In addition, due to the importance of the home building trade on Staten Island, the recent adverse conditions in the residential real estate market has had an additional negative impact on many local businesses that make up our core customer base. A continued economic slow-down or decline in the local economy could have an adverse effect on us for a number of reasons. Adverse economic conditions could hurt the ability of our borrowers to repay their loans. If real estate values decline, reductions in the value of real estate collateral could make it more difficult for us to recover the full amount due on loans which go into default. Furthermore, economic difficulties can also increase deposit outflows as customers must use savings to pay bills. This could increase our cost of funds because of the need to replace the deposit outflow. All of these factors might combine to reduce significantly our net income.

Adverse Financial Results of Other Financial Institutions Could Adversely Affect Our Net Income. In the past year, there have been many failures and near-failures among financial institutions. The number of FDIC-insured banks that have failed has increased, and the FDIC insurance fund reserve ratio, representing the ratio of the fund to the level of insured deposits, has declined due to losses caused by bank failures. As a result, the FDIC has increased its deposit insurance premiums on remaining institutions, including well-capitalized institutions like Victory State Bank, in order to replenish the insurance fund. If bank failures continue to occur, and more so if the level of failures increases, the FDIC insurance fund will further decline, and the FDIC is likely to continue to impose higher premiums on healthy banks. Thus, despite the prudent steps we may take to avoid the mistakes made by other banks, our costs of operations may increase as a result of those mistakes by others.

Our FDIC insurance premium was $122,869 in 2008. In 2009, the FDIC has already announced an increase in deposit insurance premiums so institutions like our Bank, even though we are in the lowest regulatory risk category, will be subject to an assessment rate between seven (7) and twelve (12) basis points per annum, which is higher than the assessment rate in 2008 of from five (5) to seven (7) basis points. Additionally, the FDIC has proposed a special 20 basis point assessment, payable on September 30, 2009, in order to continue the process of replenishing the insurance fund, and the FDIC has also stated that they are considering an additional 10 basis point special assessment at each quarter end thereafter, depending on the viability of the insurance fund. These assessments will significantly increase our deposit insurance expense 2009. We estimate that if our deposits remain constant, our FDIC insurance assessment in 2009 will be at least $260,000 and, if the 20 basis point special assessment is imposed, that will increase to $600,000.

Changes in the federal or state regulation of financial institutions could have an adverse effect on future operations. Federal and New York State banking laws and regulations exert substantial control over our operations. Federal and state regulatory authorities have extensive discretion in connection with their supervision of Victory State Bank, such as the right to impose restrictions on operations and the insistence that we increase our allowance for loan losses. Furthermore, federal and state laws affecting banks are constantly being revised, often imposing new restrictions or increasing competitive pressures through de-regulation. Any change in the regulatory structure or statutes or regulations applicable to banks, bank holding companies, or their competitors, whether by the Congress, the FDIC, the Federal Reserve System, the New York State legislature, the New York State Banking Department or any other regulator, could have a material impact on our operations and profitability.

Similarly, there have recently been a number of proposals at both the state and the federal level, to impose additional requirements on residential mortgage lenders and other entities in the residential real estate business. We are not a residential mortgage lender and we do not expect that these proposals, if adopted, will have a direct negative effect on us. However, the proposals could reduce residential development, increase the cost of housing, and restrict the ability of small local businesses in that sector to compete with larger companies with greater resources. That could have an adverse effect on our customer base. Furthermore, proposals to permit what are commonly known as cram downs in bankruptcies involving residential mortgage loans could have a direct adverse effect on the value of the collateral for existing residential mortgage loans, and thus an indirect effect on mortgage-backed securities in which we invest.

We operate in an extremely competitive environment. We operate in one of the most competitive environments for financial products in the world. Many of the world s largest financial institutions have offices in our local communities, and they have far greater financial resources than we have. We seek to distinguish ourselves from those institutions by providing personalized service and providing the same level of care to small community based businesses that only Fortune 500 companies can obtain from the largest banks.

The loss of key personnel could impair our future success. Our future success depends in part on the service of our executive officer, other key management officers, as well as our staff, and our ability to continue to attract, motivate, and retain additional highly qualified employees. The loss of one or more of our key personnel or our inability to timely recruit replacements for such personnel, or otherwise attract, motivate, or retain qualified personnel could have an adverse effect on our business, operating results and financial condition.

Lending Activities

Loan Portfolio Composition. Our loan portfolio consists primarily of commercial mortgage loans and unsecured commercial loans. At December 31, 2008, we had total unsecured commercial loans outstanding of $9,558,296, or 14.4% of total loans, and commercial real estate loans of $39,918,879, or 60.1% of total loans. There were $11,896,432 of construction loans secured by real estate, $10,996,432 of which were construction loans to businesses for the construction of either commercial property or residential property for sale, representing 16.5% of total loans. Other loans in our portfolio principally included commercial loans secured by assets other than real estate totaling $1,177,796 or 1.8% of total loans at December 31, 2008; residential mortgage loans of $2,548,159, or 3.8% of total loans and consumer non-mortgage loans of $599,293 or 0.9% of total loans. Although we generally do not make traditional permanent residential mortgage loans, we occasionally make residential mortgage loans to the principals of commercial customers. For the year ended December 31, 2008, approximately $51,560,377, or 77.6%, of loans for business purposes had adjustable interest rates based on the prime rate of interest.

The following table sets forth the composition of our loan portfolio in dollar amounts and in percentages at the dates indicated.

	At December 31,									
	2008		2007		2006		2005		2004	
	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total
Commercial loans:										
Commercial secured	$ 1,177,796	1.8%	$ 1,171,152	1.9%	$ 1,231,880	1.8%	$ 1,584,484	2.1%	$ 1,572,824	2.3%
Commercial unsecured	9,558,296	14.4	10,981,044	17.5	10,882,002	16.3	11,078,101	14.9	9,620,243	14.1
Total commercial loans	10,736,092	16.2	12,152,196	19.4	12,113,882	18.1	12,662,585	17.0	11,193,067	16.4
Real Estate loans:										
Commercial	39,918,879	60.1	31,607,039	50.6	33,215,627	49.9	29,794,108	40.1	31,741,069	46.5
One-to-four family	2,548,159	3.8	2,314,716	3.7	165,801	0.2	298,779	0.4	1,112,032	1.6
Total real estate loans	42,467,038	63.9	33,921,755	54.3	33,381,428	50.1	30,092,887	40.5	32,853,101	48.1
Construction loans:										
Commercial	10,996,432	16.5	13,585,698	21.7	17,552,797	26.4	26,623,846	35.8	19,893,858	29.1
Owner occupied one-to-four family	900,000	1.4	1,523,895	2.4	1,825,000	2.7	2,987,500	4.0	2,960,000	4.3
Total construction loans	11,896,432	17.9	15,109,593	24.1	19,377,797	29.1	29,611,346	39.8	22,853,858	33.4
Other loans:										
Consumer loans	599,293	0.9	566,356	0.9	826,528	1.2	1,477,366	2.0	1,048,448	1.5
Other loans	757,481	1.1	827,122	1.3	974,278	1.5	486,009	0.7	435,837	0.6
Total other loans	1,356,774	2.0	1,393,478	2.2	1,800,806	2.7	1,963,375	2.7	1,484,285	2.1
Total loans	66,456,336	100.0%	62,577,022	100.0%	66,673,913	100.0%	74,330,193	100.0%	68,384,311	100.0%

Less:

Unearned discounts, net and deferred loan fees, net	209,684	203,944	263,236	386,088	337,426
Allowance for loan losses	987,876	927,161	1,128,824	1,153,298	1,299,520
Loans, net	$ 65,258,776	$ 61,445,917	$ 65,281,853	$ 72,790,807	$ 66,747,365

The following table sets forth our loan originations and principal repayments for the periods indicated. We did not purchase or sell any loans in 2008, 2007 or 2006.

	Year Ended December 31, 2008	Year Ended December 31, 2007	Year Ended December 31, 2006
Commercial Loans (gross):			
At beginning of period	$ 12,152,196	$ 12,113,882	$ 12,662,585
Commercial loans originated:			
Secured	1,841,943	857,106	997,696
Unsecured	30,451,244	66,749,010	65,961,375
Total commercial loans	32,293,187	67,606,116	66,959,071
Principal repayments	(33,709,291)	(67,567,802)	(67,507,774)
At end of period	$ 10,736,092	$ 12,152,196	$ 12,113,882
Real Estate loans:			
At beginning of period	$ 33,921,755	$ 33,381,428	$ 30,092,887
Real estate loans originated:			
Commercial	12,217,500	7,735,374	17,983,000
One-to-four family	4,180,000	2,200,000	365,000
Total real estate loans	16,397,500	9,935,374	18,348,000
Principal repayments	(7,852,217)	(9,395,047)	(15,059,459)
At end of period	$ 42,467,038	$ 33,921,755	$ 33,381,428
Construction loans			
At beginning of period	$ 15,109,593	$ 19,377,797	$ 29,611,346
Construction loans originated	8,422,000	17,280,000	9,940,000
Principal repayments	(11,635,161)	(21,548,204)	(20,173,549)
At end of period	$ 11,896,432	$ 15,109,593	$ 19,377,797
Other loans (gross):			
At beginning of period	$ 1,393,478	$ 1,800,806	$ 1,963,375
Other loans originated	769,067	717,098	1,251,666
Principal repayments	(805,771)	(1,124,426)	(1,414,235)
At end of period	$ 1,356,774	$ 1,393,478	$ 1,800,806

Loan Maturity. The following table shows the contractual maturity of our loans at December 31, 2008. As we have decreased construction loans as a percentage of our loan portfolio and increased other real estate mortgage loans, we have increased the average contractual maturity of our loan portfolio. However, to limit interest rate risk, we have continued to concentrate our efforts principally on the origination of loans with adjustable interest rates.

	At December 31, 2008					
	Commercial Unsecured	**Commercial Secured**	**Construction**	**Real Estate**	**Other Loans**	**Total**
Amounts due:						
Within one year	$ 5,714,776	$ 798,596	$ 7,328,932	$ 9,293,526	$ 1,017,616	$ 24,153,446
After one year:						
One to five years	3,843,520	379,200	4,567,500	8,739,115	339,158	17,868,493
After five years				24,434,397		24,434,397
Total amount due	9,558,296	1,177,796	11,896,432	42,467,038	1,356,774	66,456,336
Less:						
Unearned fees			54,816	154,868		209,684
Allowance for loan losses	372,803	7,451	100,737	475,211	31,674	987,876
Loans, net	$ 9,185,493	$ 1,170,345	$ 11,740,879	$ 41,836,959	$ 1,325,100	$ 65,258,776

The following table sets forth at December 31, 2008, the dollar amount of all loans, due after December 31, 2009, and whether such loans have fixed or variable interest rates.

	Due After December 31, 2009		
	Fixed	**Variable**	**Total**
Commercial Business Loans:			
Unsecured	$ 182,575	$ 3,660,945	$ 3,843,520
Secured	137,701	241,499	379,200
Real Estate			
Commercial	2,010,010	30,815,343	32,825,353
One-to-four	348,159		348,159
Construction	900,000	3,667,500	4,567,500
Other loans	339,158		339,158
Total loans	$ 3,917,603	$ 38,385,287	$ 42,302,890

Commercial Business Lending. We originate commercial business loans directly to the professional and business community in our market area. We target small to medium sized business, and professionals such as lawyers, doctors and accountants. Applications for commercial business loans are obtained primarily from the efforts of our directors and senior management, who have extensive contacts in the local business community, or from branch referrals. As of December 31, 2008, commercial business loans totaled $10,736,092 or 16.2% of total loans.

Commercial business loans we originate generally have terms of five years or less and have adjustable interest rates tied to the Wall Street Journal Prime Rate plus a margin. Most of our commercial business loans have terms of less than one year and one of the challenges facing management is the constant effort to originate commercial business loans as existing loans are repaid. Such loans may be secured or unsecured. Secured commercial business loans can be collateralized by receivables, inventory and other assets. All these loans are either loans to individuals for which they have personal liability or loans to entities backed by the personal guarantee of principals of the borrower. The loans generally have shorter maturities and higher yields than real estate mortgage loans. Management has extensive experience in originating commercial business loans within our marketplace.

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Commercial business loans generally carry the greatest credit risks of the loans in our portfolio because repayment is more dependent on the success of the business operations of the borrower. Some of these loans are unsecured and those that are secured frequently have collateral that rapidly depreciates or is difficult to control in the event of a default.

Commercial Real Estate Lending. We originate commercial real estate loans that are generally secured by properties used for business purposes such as retail stores, other mixed-use (business and residential) properties, restaurants, light industrial and small office buildings located in our primary market area. Our commercial real estate loans are generally made in amounts up to 70% of the appraised value of the property. These loans are most commonly made with terms up to five years with interest rates that adjust to 100 or 150 basis points above the floating prime rate. A significant portion of these loans are subject to an interest rate floor ranging between 7.00% and 8.00%. Our underwriting standards consider the collateral of the borrower, the net operating income of the property and the borrower s expertise, credit history and profitability. We require personal guarantees from the borrower or the principals of the borrowing entity. At December 31, 2008, our commercial real estate loans totaled $42,467,038, or 63.9% of total loans.

Loans secured by commercial real estate are generally larger and have traditionally been considered to involve greater risks than one-to-four family residential mortgage loans, but generally lesser risks than commercial business loans. Because payments on loans secured by commercial real estate properties are often dependent on the successful operation and management of the properties, repayment of such loans may be subject to adverse conditions in the real estate market or the economy, to a greater extent than other types of loans. We seek to minimize these risks through our lending policies and underwriting standards, which restrict new originations of such loans to our primary lending area and qualify such loans on the basis of the property s income stream, collateral value and debt service ratio.

Construction Lending. Our construction loans primarily have been made to builders and developers to finance the construction of one- to four-family residential properties and, to a lesser extent, multi-family residential real estate properties. Our policies provide that construction loans may be made in amounts up to the lesser of 80% of the total hard and soft costs of the project or Victory State Bank s loans to-one borrower limitation. We generally require personal guarantees. Construction loans generally are made with prime-based interest rates with terms up to 18 months. Loan proceeds are disbursed in increments as construction progresses and as inspections warrant. At December 31, 2008, our construction loans totaled $11,896,432 or 17.9% of total loans. This represents a reduction of our construction loan portfolio over the past three years as economic conditions in the construction industry combined to cause us to be more cautious in originating these loans while also reducing the number of satisfactory loan opportunities available to us.

Construction loans on non-owner occupied real estate generally carry greater credit risks than permanent mortgage loans on comparable completed properties because their repayment is more dependent on the borrower s ability to sell or rent units under construction and the general as well as local economic conditions. Because payments on construction loans are often dependent on the successful completion of construction project and the management of the project, repayment of such loans may be subject to adverse conditions in the real estate market or the economy, to a greater extent than other types of loans.

Loan Approval Procedures and Authority. All unsecured loans in excess of $250,000 and all secured loans over $400,000, are reviewed and approved by the Loan Committee, which consists of seven directors of Victory State Bank, prior to commitment. Smaller loans may be approved by underwriters designated by the Bank s Chief Executive Officer. Consumer loans not secured by real estate and unsecured consumer loans, depending on the amount of the loan and the loan to value ratio, where applicable, require the approval of the Bank s Chief Lending Officer and/or Chief Executive Officer.

Upon receipt of a completed loan application from a prospective borrower, we order a credit report and we verify other information. If necessary, we request additional financial information. An independent appraiser we designate performs an appraisal of the real estate intended to secure the proposed loan. The Board of Victory State Bank annually approves the independent appraisers and approves the Bank s appraisal policy. It is our policy to obtain title insurance on all real estate first mortgage loans and on substantially all subordinate mortgage loans. Borrowers must also obtain hazard insurance prior to closing. Some borrowers are required to make monthly escrow deposits which we then use to pay items such as real estate taxes.

Delinquencies and Classified Assets

Delinquent Loans. Our collection procedures for mortgage loans include sending a past due notice at 15 days and a late notice after payment is 30 days past due. In the event that payment is not received after the late notice, letters are sent or phone calls are made to the borrower. We attempt to obtain full payment or work out a repayment schedule with the borrower to avoid foreclosure. Generally, we authorize foreclosure proceedings when a loan is over 90 days delinquent. We record property acquired in foreclosure as real estate owned at the lower of its appraised value less costs to dispose, or cost. We cease to accrue interest on all loans 90 days past due and reverse all accrued but unpaid interest when the loan becomes non-accrual. We continue to accrue interest on construction loans that are 90 days past the maturity date of the loan if we expect the loan to be paid in full in the next 60 days and all interest is paid up to date.

The collection procedures for non-mortgage other loans generally include telephone calls to the borrower after ten days of the delinquency and late notices at 15 and 25 days past due. Letters and telephone calls generally continue until the matter is referred to a collection attorney or resolved. After the loan is 90 days past due, the loan is referred to counsel and is written-off.

Classified Assets. Federal regulations and our Loan Review and Risk Rating Policy provide for the classification of loans and other assets we consider to be of lesser quality as Substandard , Doubtful or Loss assets. An asset is considered Substandard if it is inadequately protected by th current net worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets include those characterized by the distinct possibility that the insured institution will sustain some loss if the deficiencies are not corrected. Assets classified as Doubtful have all of the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses present make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. Assets classified as Loss are those considered uncollectible and of such little value that their continuance as assets without the establishment of a specific loss reserve is not warranted. Assets which do not currently expose us to sufficient risk to warrant classification but which possess weaknesses are designated Special Mention by management. At December 31, 2008, we had twenty three (23) loans, in the aggregate amount of $4,402,731, classified as special mention. We had eighteen (18) loans, in the aggregate amount of $3,993,240, classified as substandard, nine of which, in the aggregate amount of $3,133,193, are secured by real estate. The Bank is actively collecting the substandard loans and expects to collect substantially all the amounts due. We had one (1) loan, in the amount of $7,187, classified as doubtful, and no loans classified as loss as of December 31, 2008.

When we classify an asset as Substandard or Doubtful, we provide, as part of our general allowance for loan losses, an amount management deems prudent to recognize the risks pertaining to the asset. A general allowance represents a loss allowance which has been established to recognize the inherent risk associated with lending activities, but which, unlike a specific allowance, has not been allocated to particular problem assets. When we classify an asset as Loss, we either establish a specific allowance for losses equal to 100% of the amount of the asset or charge off that amount.

Victory State Bank s Loan Review Officer and Board of Directors regularly review problem loans and review all classified assets on a quarterly basis. We believe our policies are consistent with the regulatory requirements regarding classified assets. Our determination as to the classification of our assets and the amount of our valuation allowances is subject to review by the New York State Banking Department and the FDIC, which can order the establishment of additional general or specific loss allowances.

The following table sets forth delinquencies in our loan portfolio as of the dates indicated:

	At December 31, 2008					
	60-89 Days			90 Days or more		
	Number		Principal	Number		Principal
Commercial real estate	2	$	207,047	5	$	1,453,846
Commercial construction				2		480,000
Commercial unsecured				7		345,221
Total	2	$	207,047	14	$	2,279,067
Delinquent loans to total loans			0.31%			3.43%

	At December 31, 2007					
	60-89 Days			90 Days or more		
	Number		Principal	Number		Principal
Commercial real estate	2	$	1,406,936	3	$	459,371
Commercial construction	2		2,944,000	6		2,505,134
Commercial unsecured	1		300,000	2		14,970
Other				1		5,877
Total	5	$	4,650,936	12	$	2,985,352
Delinquent loans to total loans			7.43%			4.77%

	At December 31, 2006					
	60-89 Days			90 Days or more		
	Number		Principal	Number		Principal
Commercial real estate		$		3	$	773,924
Commercial unsecured	2		29,648	1		20,709
Other	1		9,676			
Total	3	$	39,324	4	$	794,633
Delinquent loans to total loans			0.06%			1.19%

	At December 31, 2005					
	60-89 Days			90 Days or more		
	Number		Principal	Number		Principal
Commercial real estate		$		6	$	1,123,081

Commercial construction				2		579,000
Commercial unsecured	1		8,420			
Total	1	$	8,420	8	$	1,702,081
Delinquent loans to total loans			0.01%			2.29%

	At December 31, 2004					
	60-89 Days			90 Days or more		
	Number		Principal	Number		Principal
Commercial real estate	2	$	256,137	4	$	160,310
Commercial unsecured				1		20,112
Other				1		2,476
Total	2	$	256,137	6	$	182,898
Delinquent loans to total loans			0.37%			0.27%

Loans 90 days or more past due represent non-accrual loans and loans that are contractually past due maturity but are still accruing interest.

Non-performing Assets. The following table sets forth information about our non-performing assets at December 31, 2008, 2007 and 2006.

	At December 31, 2008	At December 31, 2007	At December 31, 2006
Non-performing assets:			
Commercial loans:			
Unsecured	$ 345,221	$ 14,970	$ 20,709
Commercial real estate	1,453,846	459,371	188,872
Construction	480,000	480,000	
Consumer loan		5,877	
Total non-performing assets	$ 2,279,067	$ 960,218	$ 209,581
Non-performing loans to total loans	3.43%	1.53%	0.31%
Non-performing loans to total assets	1.07%	0.47%	0.10%
Non-performing assets to total assets	1.07%	0.47%	0.10%

The gross interest income that would have been recorded in 2008 if the non-accrual loans had been current in accordance with their original terms was $114,464. The amount of interest income on those loans that was included in net income for 2008 was $27,115.

The following table sets forth the aggregate carrying value of our assets classified as Substandard, Doubtful and Loss according to asset type:

	At December 31, 2008			
	Substandard		Doubtful	
	Number	Amount	Number	Amount
Classification of assets:				
Commercial Loans:				
Unsecured	7	$ 380,047		$
Commercial Real Estate	9	3,133,193	1	7,187
Construction	2	480,000		
Consumer Loan				
Total loans	18	$ 3,993,240	1	$ 7,187

No assets were classified as Loss at year end 2008 or 2007.

Non-Performing Loans

Management closely monitors non-performing loans and other assets with potential problems on a regular basis. We had thirteen non-performing loans, totaling $2,279,067, at December 31, 2008, compared to six non-performing loans, totaling $960,218, at December 31, 2007. The following is information about the six largest non-performing loans, totaling $1,928,726 in outstanding principal balance. Management believes it has taken appropriate steps with a view towards maximizing recovery and minimizing loss on these loans.

$859,968 in three loans to a builder secured and cross-collateralized by first mortgage liens on three lots in Staten Island on which single family houses are being built. The loans are past maturity and we have commenced foreclosure actions. A motion to appoint a referee was submitted and we are awaiting the court s decision.

$396,321 in a loan to a business that has ceased operations but which loan is secured by a first mortgage on real property in Suffolk County and personally guaranteed by the principals. The property is listed for sale at a price substantially in excess of the loan amount. The loan was past due during 2008 and we negotiated and extended an interim work out, pending the completion of a sale of the property. The borrowers and the guarantors signed the work out documents in October and paid interest through December 31, 2008.

$525,128 in a loan to a local business. The loan is in arrears but the borrower continues to make partial payments. The loan is secured by a first mortgage on a commercial building, a third mortgage on the borrower s personal residence, a security interest in the business, and the personal guaranties of the principals. The commercial property is listed for sale at a price in excess of all amounts owed.

Allowance for Loan Losses

It is our policy to provide a valuation allowance for probable incurred losses on loans based on our past loan loss experience, known and inherent risks in the loan portfolio, adverse situations which may affect the borrower s ability to repay, estimated value of underlying collateral and current economic conditions in our lending area. The allowance is increased by provisions for loan losses charged to earnings and is reduced by charge-offs, net of recoveries. While management uses available information to estimate losses on loans, future additions to the allowance may be necessary based upon any changes in economic conditions or if our loan portfolio increases. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank s allowance for loan losses. Such agencies may require the Bank to recognize additions to the allowance based on judgments different from those of management. Management believes, based upon all relevant and available information, that the allowance for loan losses is appropriate.

When analyzing whether the level of the allowance for loan losses is appropriate, management considers performing loans in our loan portfolio that have no material identified weaknesses. Management establishes an amount equal to a fixed percentage of the performing loans in each of our five principal loan categories to be included in the allowance to cover inherent weaknesses in the broad category of loans. Management also analyzes each loan that has been identified as having specific weaknesses to determine the appropriate level of the allowance for that loan. This analysis considers both the general factors which are considered in assessing performing loans as well as specific facts pertinent to each loan, such as collateral value, borrower s income and ability to repay, payment history, the reasons for and length of the delinquency, and the value of any credit support. Although loans may be analyzed individually or in groups to determine the allowance, the entire allowance is available for any losses that occur.

In order to assist in determining the allowance, an independent loan review firm, senior management and the Bank s Board of Directors review the allowance for loan losses quarterly. If they determine that the allowance is inappropriate, then management increases or decreases the provision for loan losses to bring the allowance to the appropriate level.

As of December 31, 2008, our allowance for loan losses was $987,876 or 1.49% of total loans. Based upon all relevant and presently available information, management believes that the allowance for loan losses is appropriate. We continue to monitor and modify the level of the allowance for loan losses in order to maintain the allowance at a level which management considers appropriate. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary, based on changes in economic and local market conditions beyond management s control. In addition, federal and state bank regulatory agencies periodically review Victory State Bank s loan loss allowance as part of their periodic safety and soundness examinations of the Bank. They may recommend or seek to compel increases in the allowance if they believe that weaknesses in the loan portfolio are more significant than management s assessment.

The following table sets forth the activity in our allowance for loan losses:

	For the Year Ended December 31,				
	2008	2007	2006	2005	2004
Allowance for Loan Losses:					
Balance at beginning of period	$ 927,161	$ 1,128,824	$ 1,153,298	$ 1,299,520	$ 1,162,776
Charge-offs:					
Commercial loans:					
Unsecured	(483,326)	(254,986)	(62,181)	(318,399)	(180,125)
Consumer loan	(7,959)		(17,511)		
Other loans	(3,503)	(8,639)	(28,111)	(25,302)	(4,940)
Total charge-offs	(494,788)	(263,625)	(107,803)	(343,701)	(185,065)
Recoveries	270,503	66,962	148,329	257,479	171,809
Net (charge-offs) / recoveries	(224,285)	(196,663)	40,526	(86,222)	(13,256)
Provision charged to income	285,000	(5,000)	(65,000)	(60,000)	150,000
Balance at end of period	$ 987,876	$ 927,161	$ 1,128,824	$ 1,153,298	$ 1,299,520
Ratio of net charge-offs / (recoveries) during the period to average loans outstanding during the period	0.35%	0.32%	-0.06%	0.12%	0.02%
Ratio of allowance for loan losses to total loans at the end of period	1.49%	1.48%	1.69%	1.55%	1.90%
Ratio of allowance for loan losses to non-performing loans at the end of the period	43.35%	96.56%	538.61%	72.03%	899.96%
Ratio of allowance for loan losses to non-performing assets at the end of the period	43.35%	96.56%	538.61%	72.03%	899.96%

The following table sets forth the allocation of our allowance for loan losses among each of the categories listed.

	At December 31, 2008		At December 31, 2007		At December 31, 2006		At December 31, 2005		At December 31, 2004	
	Amount	% of Loans in Category to Total Loans	Amount	% of Loans in Category to Total Loans	Amount	% of Loans in Category to Total Loans	Amount	% of Loans in Category to Total Loans	Amount	% of Loans in Category to Total Loans
Allowance:										
Commercial loans:										
Unsecured	$ 372,803	14.4%	$ 330,355	17.5%	$ 337,054	16.3%	$ 360,532	14.9%	$ 351,215	14.1%
Secured	7,451	1.8	19,877	1.9	10,859	1.8	2,349	2.1	17,660	2.3

Commercial real estate	449,525	60.1	345,407	50.6	518,620	49.9	363,072	40.1	490,488	46.5
Residential real estate	25,686	3.8	15,887	3.7	12,501	0.2	7,835	0.4	11,296	1.6
Construction loans	100,737	17.9	166,437	24.1	198,901	29.1	362,590	39.8	358,632	33.4
Other loans	31,674	2.0	49,198	2.2	50,889	2.7	56,920	2.7	70,229	2.1
Total allowances	$ 987,876	100.0%	$ 927,161	100.0%	$ 1,128,824	100.0%	$ 1,153,298	100.0%	$ 1,299,520	100.0%

Investment Activities

State-chartered banking institutions have the authority to invest in various types of liquid assets, including United States Treasury Obligations, securities of various federal agencies, certain certificates of deposits of insured banks and savings institutions, certain bankers acceptances, repurchase agreements and federal funds. Additionally, it is appropriate for us to maintain investments for ongoing liquidity needs and we have maintained liquid assets at a level believed to be adequate to meet our normal daily activities.

Our investment policy, established by the Board of Directors of Victory State Bank and implemented by its Asset/Liability Committee, attempts to provide and maintain liquidity, generate a favorable return on investments without incurring undue interest rate and credit risk, and complement our lending activities. Although we classify most of our securities portfolio as available for sale, it is our practice to retain most of our securities until they mature.

Our policies generally limit investments to government and federal agency securities or AAA rated securities, including corporate debt obligations, which are investment grade with weighted average lives of seven years or less. Our policies provide that all investment purchases be ratified by the Bank s Board and may only be initiated by the President or Chief Financial Officer of the Bank. Investment securities consist of collateralized mortgage obligations (CMO) with estimated average lives, based upon prepayment assumptions that management believes are reasonable, of 4.5 years or less, mortgage-backed securities (MBS) with maturities of seven years or less and U.S. Agency notes with a maturity of less than 15 years. These CMOs and MBS are backed by federal agencies such as Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation (FHLMC) or are AAA rated whole loan securities. No investment securities in our portfolio have experienced ratings down grades. At December 31, 2008, we had investment securities with a cost basis of $119,212,790 and a fair value of $120,288,588. All investment securities at December 31, 2008, were either CMO s or MBS s. The entire investment portfolio at December 31, 2008 was classified as available for sale and is accounted on a fair market value basis.

The following table sets forth certain information regarding the amortized cost and fair values of the investment securities, available for sale portfolio at the dates indicated:

	At December 31,					
	2008		2007		2006	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Investments securities, available for sale						
US Government Agency	$	$	$	$	$ 8,500,000	$ 8,443,906
FNMA	6,646,320	6,690,593	5,762,683	5,746,955	7,607,408	7,397,799
FHLMC	37,411	37,643	161,513	162,752	228,986	229,625
GNMA	1,576,764	1,632,790	1,892,949	1,849,267	2,264,561	2,171,125
Whole Loan MBS	2,620,965	2,559,037	3,135,102	3,103,907	3,554,783	3,453,363
Collateralized mortgage obligations	108,331,330	109,368,525	107,571,610	106,951,236	94,198,430	92,074,793
	$ 119,212,790	$ 120,288,588	$ 118,523,857	$ 117,814,117	$ 116,354,168	$ 113,770,611

The table below sets forth certain information regarding the amortized cost, weighted average yields and stated maturities of our investment securities at December 31, 2008 and 2007.

	At December 31, 2008								
	Less Than 1 Year	Weighted Average Yield	1 To 5 Years	Weighted Average Yield	5 To 10 Years	Weighted Average Yield	Over 10 Years	Weighted Average Yield	Total
Investment Securities:									
US Government Agency Agency	$	%$		%$		%$		%$	
FNMA 7 Year Balloon			1,897,587	4.47	2,190,239	4.41	2,558,494	3.74	6,646,320
FHLMC	37,411	2.79							37,411
GNMA					1,576,764	4.39			1,576,764
Whole Loan MBS					2,620,965	4.44			2,620,965
Collateralized Mortgage Obligations			2,187,168	5.13	47,617,983	4.41	58,526,179	4.76	108,331,330

Total	$ 37,411	2.79%	$ 4,084,755	4.82%	$ 54,005,951	4.41%	$ 61,084,673	4.72%	$ 119,212,790

	At December 31, 2007								
	Less Than 1 Year	Weighted Average Yield	1 To 5 Years	Weighted Average Yield	5 To 10 Years	Weighted Average Yield	Over 10 Years	Weighted Average Yield	Total
Investment Securities:									
US Government Agency Agency	$	%	$	%	$	%	$	%	$
FNMA 7 Year Balloon			2,235,724	4.51			3,526,959	3.90	5,762,683
FHLMC	81,608	4.93	79,905	4.98					161,513
GNMA							1,892,949	4.39	1,892,949
Whole Loan MBS							3,135,102	4.66	3,135,102
Collateralized Mortgage Obligations					26,652,356	4.70	80,919,254	4.61	107,571,610
Total	$ 81,608	4.93%	$ 2,315,629	4.53%	$ 26,652,356	4.70%	$ 89,474,264	4.58%	$ 118,523,857

Source of Funds

General. Deposits are the primary source of our funds for use in lending, investing and for other general purposes. In addition to deposits, we obtain funds from principal repayments and prepayments on loans and securities. Loan and securities repayments are a relatively stable source of funds, while deposit inflows and outflows as well as unscheduled prepayments are influenced by general interest rates and money market conditions.

Deposits. We offer a variety of deposit accounts having a range of interest rates and terms. Our deposits consist of non-interest bearing checking accounts, money market accounts, time deposit (certificate) accounts, statement savings and NOW accounts. The flow of deposits is influenced significantly by general economic conditions, changes in money market rates, prevailing interest rates and competition. Our deposits are obtained primarily from the areas in which our offices are located. We do not actively solicit certificate accounts in excess of $100,000, nor do we use brokers to obtain deposits. However, in connection with our efforts in establishing banking development districts in Staten Island, we accept large balance municipal deposits as part of the New York State and New York City banking development district programs. These municipal deposits total $35 million, are at a subsidized rate, and mature on an annual basis. There can be no assurance that the Bank will be able to retain these municipal deposits or be able to renew them at subsidized rates as compared to current market rates at that time. Management constantly monitors our deposit accounts and, based on historical experience, management believes it will retain a large portion of such accounts upon maturity. Deposit account terms we offer vary according to the minimum balance required, the time periods that the funds must remain on deposit and the interest rates, among other factors. In determining the characteristics of the deposit account programs we offer, we consider potential profitability, matching terms of the deposits with loan products, the attractiveness to the customers and the rates offered by our competitors.

Our focus on customer service, primarily for the business and professional community in our marketplace, has facilitated our retention of non-interest bearing checking accounts and low costing NOW and savings accounts, which generally have interest rates substantially less than certificate of deposits. At December 31, 2008, these types of low cost deposit accounts amounted to $88,647,294, or 47.1% of total deposits.

The following table presents deposit activity for the periods indicated.

	Year Ended December 31, 2008	Year Ended December 31, 2007	Year Ended December 31, 2006
Beginning balance	$ 176,334,443	$ 186,683,150	$ 193,251,159
Net increase/(decrease) before interest credited	9,646,073	(13,454,165)	(9,416,115)
Interest credited on deposits	2,128,933	3,105,458	2,848,106
Ending balance	$ 188,109,449	$ 176,334,443	$ 186,683,150

The following table provides information regarding the remaining term to maturity of our time deposits over $100,000 at December 31, 2008:

Maturity Period	Amount
Three months or less	$ 47,372,390
Over three through six months	13,876,894
Over six through 12 months	4,276,902
Over 12 months	
Total	$ 65,526,186

The following table presents by various rate categories, the amount and the periods to maturity of the certificate accounts outstanding at December 31, 2008.

	Six Months And Less	Over Six Mos. Through One Year	Over One Year Through Two Years	Over Two Years Through Three Years	Over Three Years	Total
Certificate accounts:						
0.50% to 1.99%	$ 30,528,457	$	$	$	$	$ 30,528,457
2.00% to 2.99%	21,578,360	18,189,364	582,851			40,350,575
3.00% to 3.99%	551,151	2,001,826		559,100	1,651,855	4,763,932
4.00% to 4.99%	519,695	160,835				680,530
	$ 53,177,663	$ 20,352,025	$ 582,851	$ 559,100	$ 1,651,855	$ 76,323,494

Borrowings

We do not routinely utilize borrowings, but in connection with the issuance of $5 million in trust preferred securities in August 2003, we issued a $5.2 million subordinated note to VSB Capital Trust I. Therefore, at December 31, 2007, we had $5.2 million in subordinated debt. On August 8, 2008, we repaid the subordinated debenture in full at par, received payment of $155,000 on account of our common securities of the Trust, and all the outstanding Trust Preferred Capital Securities were likewise redeemed, thereby ending the entire arrangement.

Personnel

As of December 31, 2008, we had 46 full-time employees and 15 part-time employees. These employees are not represented by a collective bargaining unit and we consider our relationship with our employees to be good.

REGULATION AND SUPERVISION

Regulation of VSB Bancorp, Inc.

VSB Bancorp, Inc., is a New York corporation and is subject to and governed by the New York Business Corporation Law. It is a bank holding company and thus is subject to regulation, supervision, and examination by the Federal Reserve.

Bank Holding Company Regulation. As a bank holding company, we are required to file periodic reports and other information with the Federal Reserve and the Federal Reserve may conduct examinations of us.

We are subject to capital adequacy guidelines of the Federal Reserve. The guidelines apply on a consolidated basis and require bank holding companies to maintain a minimum ratio of Tier 1 capital to total assets of 4.0%. The minimum ratio is 3.0% for the most highly rated bank holding companies. The Federal Reserve s capital adequacy guidelines also require bank holding companies to maintain a minimum ratio of qualifying total capital to risk-weighted assets of 8.0%, and a minimum ratio of Tier 1 capital to risk-weighted assets of 4.0%. As of December 31, 2008, the ratio of Tier 1 capital to total assets was 10.70%, the ratio of Tier 1 capital to risk-weighted assets was 24.51%, and the ratio of qualifying total capital to risk-weighted assets was 25.58%.

Our ability to pay dividends can be restricted if overall capital falls below levels established by the Federal Reserve s guidelines.

Federal Reserve approval is required if we seek to acquire direct or indirect ownership or control of 5% or more of the voting shares of a bank or bank holding company. We must obtain Federal Reserve approval before we acquire all or substantially all the assets of a bank or merge or consolidate with another bank holding company. These provisions also would apply to a bank holding company that sought to acquire 5% or more of the common stock of or to merge or consolidate with us.

Bank holding companies like us may not engage in activities other than banking and activities so closely related to banking or managing or controlling banks as to be a proper incident thereto. Federal Reserve regulations contain a list of permissible non-banking activities that are closely related to banking or managing or controlling banks and the Federal Reserve has identified a limited number of additional activities by order. These activities include lending activities, certain data processing activities, and securities brokerage and investment advisory services, trust activities and leasing activities. A bank holding company must file an application or a notice with the Federal Reserve prior to acquiring more than 5% of the voting shares of a company engaged in such activities. A bank holding company that is well capitalized and well managed and meets other conditions may provide notice after making the acquisition.

We have the right to elect to be treated as a financial holding company if the Bank is well capitalized and well managed and has at least a satisfactory record of performance under the Community Reinvestment Act. Financial holding companies that meet certain conditions may engage in activities that are financial in nature or incidental to financial activities, or activities that are complementary to a financial activity and do not pose a substantial risk to the safety and soundness of depository institutions or the financial system generally. Federal law identifies certain activities that are deemed to be financial in nature, including non-banking activities currently permissible for bank holding companies to engage in both within and outside the United States, as well as insurance and securities underwriting and merchant banking activities. The Federal Reserve may identify additional activities that are permissible financial activities. No prior notice to the Federal Reserve is required for a financial holding company to acquire a company engaged in these activities or to commence these activities directly or indirectly through a subsidiary.

We have not elected to be treated as a financial holding company since we have no current plans to use the authority to engage in expanded activities. However, we may elect to do so in the future.

The Sarbanes-Oxley Act. The Sarbanes-Oxley Act of 2002 (Sarbanes-Oxley) imposes a broad range of corporate governance and accounting requirements for public companies (including VSB Bancorp, Inc.) designed to promote honesty and transparency in corporate America. Among many other provisions, Section 404 of Sarbanes-Oxley requires that public company annual reports describe the responsibility of management to establish and maintain an internal control structure and contain an assessment of the effectiveness of the internal control structure and procedures of the issuer for financial reporting. The Securities and Exchange Commission had extended the deadline for non-accelerated filers (such as VSB Bancorp, Inc.) to comply with the requirements under Section 404. This is our second Annual Report for which we are required to include a report under Section 404 and we have included such a report as Item 8A of this Annual Report. We are not yet required to include an attestation by our independent registered public accountants as to management s assessment under Section 404. Management s assessment did not result in substantial additional cost because the financial nature of our business makes internal control and monetary reporting a fundamental component of the operation of much of our business. However, we anticipate that if the Securities and Exchange Commission requires that we include an accountant s attestation of management s assessment, as is currently planned for next year that would result in a substantial increase in our accounting and auditing expense.

Statutory Restrictions on Acquisition of VSB Bancorp, Inc., and Victory State Bank

Applicable provisions of the New York Banking Law, the federal Bank Holding Company Act, and other federal statutes, restrict the ability of persons or entities to acquire control of a bank holding company. Under the Change in Bank Control Act, persons who intend to acquire control of a bank holding company, either directly or indirectly or through or in concert with one or more persons must give 60 days prior written notice to the Federal Reserve. Control would exist when an acquiring party directly or indirectly has voting control of at least 25% of our voting securities or the power to direct our management or policies. Under Federal Reserve regulations, a rebuttable presumption of control would arise with respect to an acquisition where, after the transaction, the acquiring party has ownership control, or the power to vote at least 10% (but less than 25%) of our common stock.

The New York Banking Law requires prior approval of the New York Banking Board before any action is taken that causes any company to acquire direct or indirect control of a banking institution that is organized in the State of New York. The term control is defined generally to mean the power to direct or cause the direction of the management and policies of the banking institution and is presumed to exist if the company owns, controls or holds with power to vote 10% or more of the voting stock of the banking institution.

Section 912 of the New York Business Corporation Law, known as the New York Anti-Takeover Law, restricts the ability of interested stockholders to engage in business combinations with a New York corporation. In general terms, Section 912 prohibits any New York corporation covered by the statute from merging with an interested shareholder (i.e., one who owns 20% or more of the outstanding voting stock) for five years following the date on which the interested shareholder first acquired 20% of the stock, unless before that date the Board of Directors of the corporation had approved either the merger or the interested shareholder s stock purchase.

Section 912 defines an interested stockholder as the beneficial owner, directly or indirectly, of 20% or more of the outstanding voting stock of a corporation; and certain other entities that have owned 20% or more of a corporation s stock during the past five years. A business combination is defined as a merger, consolidation, sale of 10% or more of the assets, or similar transaction.

Unless an interested stockholder waits five years after becoming an interested stockholder to engage in a business combination, the business combination is prohibited unless our Board of Directors has approved either (a) the business combination or (b) the acquisition of stock by the interested stockholder, before the interested stockholder acquired its 20% interest. Even though the interested stockholder waits five years, the business combination is prohibited unless either:

(i) the business combination or the acquisition of stock by the interested stockholder was approved by the Board of Directors before the interested stockholder acquired its 20% interest;

(ii) the business combination is approved by a majority vote of all outstanding shares of stock not beneficially owned by the interested stockholder or its affiliates or associates at a meeting held at least five years after the interested stockholder becomes an interested stockholder; or

(iii) the price paid for common stock acquired in the business combination is, in general terms, at least as much as the greater of (a) highest price paid by the interested stockholder for any stock since the interested stockholder first owned 5% of the stock of the corporation, or (b) the market value of the stock as of the date of announcement of the business combination; and the price paid for stock other than common stock is subject to comparable minimum standards.

Regulation of Victory State Bank

The Bank is subject to extensive regulation and examination by the New York State Banking Department (Department), as its chartering authority, and by the FDIC, as the insurer of its deposits. The federal and state laws and regulations which are applicable to banks regulate, among other things, the scope of their business, their investments, their reserves against deposits, the timing of the availability of deposited funds and the nature and amount of and collateral for certain loans. The Bank must file reports with the Department and the FDIC concerning its activities and financial condition, in addition to obtaining regulatory approvals prior to entering into certain transactions such as establishing branches and mergers with, or acquisitions of, other depository institutions. There are periodic examinations by the Department and the FDIC to test the Bank s compliance with various regulatory requirements. This regulation and supervision establishes a comprehensive framework of activities in which an institution can engage and is intended primarily for the protection of the insurance fund and depositors. The regulatory structure also gives the regulatory authorities extensive discretion in connection with their supervisory and enforcement activities and examination policies, including policies with respect to the classification of assets and the establishment of adequate loan loss reserves for regulatory purposes. Any change in such regulation, whether by the Department, the FDIC or as a result of the enactment of legislation, could have a material adverse impact on the Bank and its operations.

Capital Requirements

The FDIC imposes capital adequacy standards on state-chartered banks, which, like the Bank, are not members of the Federal Reserve System.

The FDIC s capital regulations establish a minimum 3.0% Tier I leverage capital requirement for the most highly-rated state-chartered, non-member banks, with an additional cushion of at least 100 basis points for all other state-chartered, non-member banks, which effectively will increase the minimum Tier I leverage ratio for such other banks to 4.0%. Under the FDIC s regulation, the highest-rated banks are those that the FDIC determines are not anticipating or experiencing significant growth and have well diversified risk, including no undue interest rate risk exposure, excellent asset quality, high liquidity, good earnings and, in general, which are considered a strong banking organization and are rated composite 1 under the Uniform Financial Institutions Rating System. Tier I or core capital is defined as the sum of common stockholders equity (including retained earnings), non-cumulative perpetual preferred stock and related surplus, and minority interests in consolidated subsidiaries, minus all intangible assets other than certain qualifying supervisory goodwill and certain mortgage servicing rights.

The FDIC also requires that banks meet a risk-based capital standard. The risk-based capital standard for banks requires the maintenance of a ratio of total capital (which is defined as Tier I capital and supplementary capital) to risk-weighted assets of 8.0% and Tier I capital to risk-weighted assets of 4%. In determining the amount of risk-weighted assets, all assets, plus certain off-balance sheet assets, are multiplied by a risk-weight of 0% to 100%, based on the risks the FDIC believes are inherent in the type of asset or item. The components of Tier I capital are the same as for the leverage capital standard. The components of supplementary capital include certain perpetual preferred stock, certain mandatory convertible securities, certain subordinated debt and intermediate preferred stock and general allowances for loan and lease losses. Allowance for loan and lease losses includable in supplementary capital is limited to a maximum of 1.25%of risk-weighted assets. Overall, the amount of capital counted toward supplementary capital cannot exceed 100% of core capital.

The FDIC has an additional, higher capital level, known as well-capitalized. In order to be classified as well-capitalized, a bank must have a Tier 1 leverage ratio of at least 5%, a Tier 1 risk-based capital ratio of at least 6% and a total risk-based capital ratio of at least 10%.

At December 31, 2008, the Bank exceeded all of the capital ratio standards for a well-capitalized bank.

The following table shows the Bank s actual capital amounts and ratios.

	Actual		For capital adequacy purposes		To be well-capitalized under prompt corrective action provisions	
	Amount	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
As of December 31, 2008						
Tier 1 Capital (to Average Assets)	$ 22,087,000	10.45%	$ 8,516,543	4.00%	$ 10,645,678	5.00%
Tier 1 Capital (to Risk Weighted Assets)	22,087,000	24.34%	3,681,128	4.00%	5,521,692	6.00%
Total Capital (to Risk Weighted Assets)	23,075,000	25.43%	7,362,255	8.00%	9,202,819	10.00%

Activities and Investments of New York-Chartered Banks.

The Bank derives its lending, investment and other authority primarily from the applicable provisions of New York State Banking Law and the regulations of the Department, as limited by FDIC regulations and other federal laws and regulations. See Activities and Investments of FDIC Insured State-Chartered Banks below. These New York laws and regulations authorize the Bank to invest in real estate mortgages, consumer and commercial loans, certain types of debt securities, including certain corporate debt securities and obligations of federal, State and local governments and agencies, and certain other assets. A bank s aggregate lending powers are not subject to percentage of asset limitations, although there are limits applicable to single borrowers. A New York-chartered bank may also exercise trust powers upon approval of the Department. The Bank does not have trust powers.

The New York Banking Board has the power to adopt regulations that enable state chartered banks to exercise the rights, powers and privileges permitted for a national bank. The Bank has not engaged in material activities authorized by such regulations.

With certain limited exceptions, the Bank may not make loans or extend credit for commercial, corporate or business purposes (including lease financing) to a single borrower, the aggregate amount of which would be in excess of 15% of the Bank s net worth, on an unsecured basis, and 25% of the net worth if the excess is collateralized by readily marketable collateral or collateral otherwise having a value equal to the amount by which the loan exceeds 15% of the Bank s net worth. Theses limits do not apply to loans made by VSB Bancorp, Inc. directly at the holding company level. The Bank currently complies with all applicable loans-to-one-borrower limitations and VSB Bancorp, Inc. has not made any loans in its own name except for its loan to its Employee Stock Ownership Plan.

Activities and Investments of FDIC-Insured State-Chartered Banks.

The activities and equity investments of FDIC-insured, state-chartered banks are generally limited to those that are permissible for national banks. Under regulations dealing with equity investments, an insured state bank generally may not directly or indirectly acquire or retain any equity investment of a type, or in an amount, that is not permissible for a national bank. An insured state bank is not prohibited from, among other things, (i) acquiring or retaining a majority interest in a subsidiary, (ii) investing as a limited partner in a partnership the sole purpose of which is direct or indirect investment in the acquisition, rehabilitation or new construction of a qualified housing project, provided that such limited partnership investments may not exceed 2% of the bank s total assets, (iii) acquiring up to 10% of the voting stock of a company that solely provides or reinsures directors , trustees and officers liability insurance coverage or bankers blanket bond group insurance coverage for insured depository institutions, and (iv) acquiring or retaining the voting shares of a depository institution if certain requirements are met. In addition, an FDIC-insured state-chartered bank may not directly, or indirectly through a subsidiary, engage as principal in any activity that is not permissible for a national bank unless the FDIC has determined that such activities would pose no risk to the insurance fund of which it is a member and the bank is in compliance with applicable regulatory capital requirements.

Regulatory Enforcement Authority

Applicable banking laws include substantial enforcement powers available to federal banking regulators. This enforcement authority includes, among other things, the ability to assess civil money penalties, to issue cease-and-desist or removal orders and to initiate injunctive actions against banking organizations and institution-affiliated parties, as defined. In general, these enforcement actions may be initiated for violations of laws and regulations and unsafe or unsound practices. Other actions or inactions may provide the basis for enforcement action, including misleading or untimely reports filed with regulatory authorities.

Under the New York State Banking Law, the Department may issue an order to a New York-chartered banking institution to appear and explain an apparent violation of law, to discontinue unauthorized or unsafe practices and to keep prescribed books and accounts. Upon a finding by the Department that any director, trustee or officer of any banking organization has violated any law, or has continued unauthorized or unsafe practices in conducting the business of the banking organization after having been notified by the Department to discontinue such practices, such director, trustee or officer may be removed from office by the Department after notice and an opportunity to be heard. The Bank does not know of any past or current practice, condition or violation that might lead to any proceeding by the Department against the Bank or any of its directors or officers. The Department also may take possession of a banking organization under specified statutory criteria.

Prompt Corrective Action.

Section 38 of the Federal Deposit Insurance Act (FDIA) provides the federal banking regulators with broad power to take prompt corrective action to resolve the problems of undercapitalized institutions. The extent of the regulators powers depends on whether the institution in question is well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized or critically undercapitalized. A bank is deemed t (i) well capitalized if it has total risk-based capital ratio of 10.0% or more, has a Tier I risk-based capital ratio of 6.0% or more, has a Tier I leverage capital ratio of 5.0% or more and is not subject to specified requirements to meet and maintain a specific capital level for any capital measure, (ii) adequately capitalized if it has a total risk-based capital ratio of 8.0% or more, a Tier I risk-based capital ratio of 4.0% or more and a Tier I leverage capital ratio of 4.0% or more (3.0% under certain circumstances) and does not meet the definition of well capitalized, (iii) undercapitalized if it has a total risk-based capital ratio that is less than 8.0%, a Tier I risk-based capital ratio that is less than 4.0% or a Tier I leverage capital ratio that is less than 4.0% (3.0% under certain circumstances), (iv) significantly undercapitalized if it has a total risk-based capital ratio that is less than 6.0%, a Tier I risk-based capital ratio that is less than 3.0% or a Tier I leverage capital ratio that is less than 3.0%, and (v) critically undercapitalized if it has a ratio of tangible equity to total assets that is equal to or less than 2.0%. The regulations also provide that a federal banking regulator may, after notice and an opportunity for a hearing, reclassify a well capitalized institution as adequately capitalized and may require an adequately capitalized institution or an undercapitalized institution to comply with supervisory actions as if it were in the next lower category if the institution is in an unsafe or unsound condition or engaging in an unsafe or unsound practice. The federal banking regulator may not, however, reclassify a significantly undercapitalized institution as critically undercapitalized.

An institution generally must file a written capital restoration plan which meets specified requirements, as well as a performance guaranty by each company that controls the institution, with an appropriate federal banking regulator within 45 days of the date that the institution receives notice or is deemed to have notice that it is undercapitalized, significantly undercapitalized or critically undercapitalized. Immediately upon becoming undercapitalized, an institution becomes subject to statutory provisions, which, among other things, set forth various mandatory and discretionary restrictions on the operations of such an institution.

At December 31, 2008, the Company and the Bank had capital levels which qualified them as well-capitalized institutions.

FDIC Insurance

The Bank is a member of the FDIC. As insurer, the FDIC is authorized to conduct examinations of, and to require reporting by, FDIC-insured institutions. It also may prohibit any FDIC-insured institution from engaging in any activity the FDIC determines by regulation or order to pose a serious threat to the FDIC.

In late 2006, the FDIC imposed deposit insurance premium assessments for the first time in a number of years, effective beginning in 2007. Our FDIC insurance premium was $122,869 in 2008. In 2009, the FDIC has announced that institutions like our Bank will be subject to an assessment rate between seven (7) and twelve (12) basis points per annum. Additionally, the FDIC has proposed a special 20 basis point assessment, payable on September 30, 2009, with a potential additional 10 basis point special assessment at each quarter end, depending on the viability of the Bank Insurance Fund (BIF). The raising of the base assessment rates and the addition of these special assessments will significantly increase the expense to the Bank in 2009. We estimate that if our deposit levels and deposit composition remains the same, our assessment for FDIC insurance premiums in 2009 will be at least $260,000 and, if the 20 basis point special assessment is imposed, the assessment may increase to $600,000. Additional assessments, if any, would further increase our deposit insurance costs. On October 3, 2008, FDIC deposit insurance temporarily increased from $100,000 to $250,000 per depositor through December 31, 2009.

The FDIC has also recently increased insurance coverage on non-interest bearing demand accounts, Interest Only Lawyers Accounts (IOLA) and Negotiable Order of Withdrawal (NOW) accounts paying less than 50 basis points to an unlimited amount, but with the payment of an additional assessment fee. On December 5, 2008, the Bank opted in to the Temporary Account Guarantee Program, providing for the unlimited insurance coverage on non-interest bearing transaction, IOLA and NOW accounts but we opted out of the Debt Guarantee Program.

Although the increase in the amount of FDIC insurance available has no direct effect on our insurance premiums, the increase is likely to increase losses to the deposit insurance fund when banks fail. This could cause the FDIC to increase deposit insurance premiums on existing banks, or continue higher premium levels for a longer period of time, which would reduce our net income.

The FDIC may terminate the deposit insurance of any insured depository institution, including the Bank, if it determines, after a hearing, that the institution has engaged or is engaging in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, order or any condition imposed by an agreement with the FDIC. It also may suspend deposit insurance temporarily during the hearing process for the permanent termination of insurance, if the institution has no tangible capital. If insurance of accounts is terminated, the accounts at the institution at the time of the termination, less subsequent withdrawals, shall continue to be insured for a period of six months to two years, as determined by the FDIC. Management is aware of no existing circumstances that would result in termination of the Bank s deposit insurance.

Troubled Asset Relief Program and Capital Purchase Program

The United States Department of the Treasury recently announced a Capital Purchase Program (CPP) in which the Treasury will purchase preferred stock from approved institutions, with certain limitations and restrictions. These programs are all entirely voluntary. VSB Bancorp, Inc. and Victory State Bank, have strong capital (Tier 1 Capital ratio in excess of 10% and Total Risk Based Capital ratio in excess of 25%). We have reported positive and increased quarterly earnings in 2008 and we did not originate or invest in subprime mortgages nor in FNMA and FHLMC preferred stock. Upon reviewing all of the details of the Treasury programs, we did not participate in these programs.

Brokered Deposits

Under federal law and applicable regulations, (i) a well capitalized bank may solicit and accept, renew or roll over any brokered deposit without restriction, (ii) an adequately capitalized bank may not accept, renew or roll over any brokered deposit unless it has applied for and been granted a waiver of this prohibition by the FDIC and (iii) an undercapitalized bank may not (x) accept, renew or roll over any brokered deposit or (y) solicit deposits by offering an effective yield that exceeds by more than 75 basis points the prevailing effective yields on insured deposits of comparable maturity in such institution s normal market area or in the market area in which such deposits are being solicited. The term undercapitalized insured depository institution is defined to mean any insured depository institution that fails to meet the minimum regulatory capital requirement prescribed by its appropriate federal banking agency. The FDIC may, on a case-by-case basis and upon application by an adequately capitalized insured depository institution, waive the restriction on brokered deposits upon a finding that the acceptance of brokered deposits does not constitute an unsafe or unsound practice with respect to such institution. The Bank had no brokered deposits outstanding at December 31, 2008.

Community Reinvestment and Consumer Protection Laws

In connection with its lending activities, the Bank is subject to a variety of federal laws designed to protect borrowers and promote lending to various sectors of the economy and population. Included among these are the Home Mortgage Disclosure Act, Real Estate Settlement Procedures Act, Truth-in-Lending Act, Equal Credit Opportunity Act, Fair Credit Reporting Act and Community Reinvestment Act (CRA).

The CRA requires FDIC insured banks to define the assessment areas that they serve, identify the credit needs of those assessment areas and take actions that respond to the credit needs of the community. The FDIC must conduct regular CRA examinations of the Bank and assign it a CRA rating of outstanding, satisfactory, needs improvement or unsatisfactory. The Bank is also subject to provisions of the New York State Banking Law which impose similar obligations to serve the credit needs of its assessment areas. The New York Banking Department makes a biennial written assessment of a bank s compliance, and makes the assessment available to the public. Federal and New York State laws both require consideration of these ratings when reviewing a bank s application to engage in certain transactions, including mergers, asset purchases and the establishment of branch offices. A negative assessment may serve as a basis for the denial of any such application. The Bank has received Satisfactory ratings from both the New York Banking Department and the FDIC.

The Board of Governors of the Federal Reserve System has recently proposed changes to its Truth in Lending regulations and the U.S. Department of Housing and Urban Development has recently proposed changes to its Real Estate Settlement Procedures Act regulations that may have a significant effect on consumer lending, especially residential mortgage lending to consumers. Although consumer lending is not a material part of our lending program, any changes which affect the housing industry have a potential to adversely affect our customers because, as we have explained throughout this annual report, the building trades, especially related to residential construction, are an important focus of our customer base. Therefore, any regulations that make it more expensive for our customers to operate, or that restrict the ability of our customers to conduct business, could have an adverse effect on our operations.

Limitations on Dividends

The payment of dividends by the Bank is subject to various regulatory requirements. Under New York State Banking Law, a New York-chartered stock bank may declare and pay dividends out of its net profits, unless there is an impairment of capital, but approval of the Superintendent of Banks is required if the total of all dividends declared in a calendar year would exceed the total of its net profits for that year combined with its retained net profits of the preceding two years, subject to certain adjustments.

Miscellaneous

The Bank is subject to restrictions on loans to its non-bank subsidiaries, on investments in the stock or securities thereof, on the taking of such stock or securities as collateral for loans to any borrower, and on the issuance of a guarantee or letter of credit on behalf of the Bank or its non-bank subsidiaries. The Bank also is subject to restrictions on most types of transactions with the Bank or its non-bank subsidiaries, requiring that the terms of such transactions be substantially equivalent to terms of similar transactions with non-affiliated firms.

Assessments

Banking institutions are required to pay assessments to both the FDIC and the NYSBD to fund their operations. The assessments are based upon the amount of the Bank s total assets. The Bank must also pay an examination fee to the NYSBD when they conduct an examination. The Bank paid federal and state assessments and examination fees of $161,783 in 2008.

Transactions with Related Parties

The Bank s authority to engage in transactions with related parties or affiliates (i.e., any entity that controls or is under common control with an institution, including the Bank) or to make loans to certain insiders is limited by Sections 23A and 23B of the Federal Reserve Act. Section 23A limits the aggregate amount of transactions with any individual affiliate to 10% of the capital and surplus of the institution and also limits the aggregate amount of transactions with all affiliates to 20% of the institution s capital and surplus.

Loans to affiliates must be secured by collateral with a value that depends on the nature of the collateral. The purchase of low quality assets from affiliates is generally prohibited. Loans and asset purchases with affiliates, must be on terms and under circumstances, including credit standards, that are substantially the same or at least as favorable to the institution as those prevailing at the time for comparable transactions with nonaffiliated companies. In the absence of comparable transactions, such transactions may only occur under terms and circumstances, including credit standards that in good faith would be offered to or would apply to nonaffiliated companies.

The Bank s authority to extend credit to executive officers, directors and 10% shareholders, as well as entities controlled by such persons, is currently governed by Regulation O of the Federal Reserve Board. Regulation O generally requires such loans to be made on terms substantially similar to those offered to unaffiliated individuals (except for preferential loans made in accordance with broad based employee benefit plans), places limits on the amount of loans the Bank may make to such persons based, in part, on the Bank s capital position, and requires certain approval procedures to be followed.

Standards for Safety and Soundness

FDIC regulations require that Victory State Bank adopt procedures and systems designed to foster safe and sound operations in the areas of internal controls, information systems, internal and audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, asset quality, earnings and compensation, fees and benefits. Among other things, these regulations prohibit compensation and benefits and arrangements that are excessive or that could lead to a material financial loss. If Victory State Bank fails to meet any of these standards, it will be required to submit to the FDIC a plan specifying the steps that will be taken to cure the deficiency. If it fails to submit an acceptable plan or fails to implement the plan, FDIC the will require it or VSB Bancorp, Inc. to correct the deficiency and until corrected, may impose restrictions on them.

The FDIC has also adopted regulations that require Victory State Bank to adopt written loan policies and procedures that are consistent with safe and sound operation, are appropriate for the size of the Bank, and must be reviewed by the Bank s Board of Directors annually. Victory State Bank has adopted such policies and procedures, the material provisions of which are discussed above as part of the discussion of our lending operations.

Federal Reserve System

The Federal Reserve Board regulations require banks to maintain non-interest earning reserves against their transaction accounts (primarily regular checking accounts and interest-bearing checking accounts). The Federal Reserve Board regulations generally require that reserves be maintained against aggregate transaction accounts as follows: for accounts aggregating $34.6 million or less (subject to adjustment by the Federal Reserve Board) the reserve requirement is 3%; for accounts greater than $34.6 million, the reserve requirement is $1.0 million plus 10% (subject to adjustment by the Federal Reserve Board between 8% and 14%) against that portion of total transaction accounts in excess of $43.9 million. The first $9.3 million of otherwise reservable balances (subject to adjustments by the Federal Reserve Board) are exempted from the reserve requirements. The Bank is in compliance with these requirements. Because required reserves must be maintained in the form of either vault cash or a non-interest-bearing account at a Federal Reserve Bank or a pass-through account as defined by the Federal Reserve Board, the effect of this reserve requirement is to reduce our interest-earning assets.

TAXATION

Federal Taxation

General

We are subject to federal income taxation in the same general manner as other corporations with some exceptions discussed below. The following discussion of federal taxation is intended only to summarize certain pertinent federal income tax matters and is not a comprehensive description of the tax rules applicable to us. Our federal income tax returns have not been audited or closed without audit by the Internal Revenue Service.

Method of Accounting

We report our income and expenses on the accrual method of accounting and use a tax year ending December 31 for filing our consolidated federal income tax returns. The Company files consolidated tax returns with the Bank and VSB Capital Trust I.

Bad Debt Reserves

We use the experience method in computing bad debt deductions for federal tax purposes.

Minimum Tax

The Internal Revenue Code imposes an alternative minimum tax (AMT) at a rate of 20% on a base of regular taxable income plus certain tax preferences (alternative minimum taxable income or AMTI). The AMT is payable to the extent such AMT is in excess of the Company s regular tax liability. Net operating losses can offset no more than 90% of AMT. Certain payments of alternative minimum tax may be used as credits against regular tax liabilities in future years. We have not been subject to the alternative minimum tax and have no such amounts available as credits.

State and Local Taxation

New York State and New York City Taxation.

New York State Franchise Tax on corporations is imposed in an amount equal to the greater of (a) 7.5% of entire net income allocable to New York State (b) 3% of alternative entire net income allocable to New York State (c) 0.01% of the average value of assets allocable to New York State or (d) a nominal minimum tax. Entire net income is based on federal taxable income, subject to certain modifications. Alternative entire net income is equal to entire net income without certain modifications. The New York City Corporation Tax is imposed using similar alternative taxable income methods and rates.

A temporary Metropolitan Transportation Business Tax Surcharge on banking corporations doing business in the Metropolitan District has been applied since 1982. We transact a significant portion of our business within this District and thus we are subject to this surcharge. The current surcharge rate is 17% of the State franchise tax liability. New York City does not impose comparable surcharges.

For New York State and City tax purposes, the bad debt deduction may be computed using a specific formula based on our actual loss history (Experience Method).

Item 2. Properties.

At December 31, 2008, we conducted our business through five banking offices. Our main office and banking facility is at 4142 Hylan Boulevard.

Location	Description	Leased or Owned	Original Date Leased or Acquired	Date of Lease Expiration	Net Book Value of Leasehold Improvements at December 31, 2008
4142 Hylan Boulevard Staten Island, N.Y. 10308 (1)	Main Office	Leased	2005	3/25/2020	$ 1,972,655
755 Forest Avenue Staten Island, N.Y. 10310	Branch	Leased	1999	11/30/2013	$ 58,633
One Hyatt Street Staten Island, N.Y. 10301	Branch	Leased	1999	10/30/2014	$ 29,815
1762 Hylan Boulevard Staten Island, N.Y. 10305	Branch	Leased	2001	6/30/2016	$ 368,228
1766 Hylan Boulevard (2) Staten Island, N.Y. 10305	Retail Stores	Leased	2001	6/30/2016	$ 95,442
1065 Bay Street Staten Island, N.Y. 10305	Branch	Leased	2006	04/26/2021	$ 155,838
Total net book value					$ 2,680,611

(1) In February 2007, we opened our new main office at 4142 Hylan Boulevard.

(2) We leased the retail stores at 1766 Hylan Boulevard as a component of the lease for the 1762 Hylan Boulevard branch and we sublease the property to retail tenants.

Item 3. Legal Proceedings.

The Bank is a defendant in an action pending in Supreme Court, Richmond County, commenced by IndyMac Bank, F.S.B. against the Bank, LaMattina & Associates, Inc. (LAI) and various individuals and entities alleged to be officers, directors or otherwise to have relationships with LAI. LAI was a deposit customer of the Bank engaged in the business of providing real estate settlement services to lenders making residential mortgage loans. The plaintiff alleges that it was such a lender and that it had provided funds to LAI by wiring those funds to an account of LAI at the Bank to use to fund mortgage loans to be made by the plaintiff, only to have LAI not use those funds for their intended purpose. The action was commenced in August 2005. In November 2005, the plaintiff amended its complaint to add the Bank as a defendant. The plaintiff amended its complaint again and the Bank moved to dismiss the claims. In February 2007, the court dismissed two of the claims against the Bank but allowed the Plaintiff to proceed and conduct discovery with respect to two claims, one for negligence and the other for conversion. The parties are in the process of conducting discovery regarding the claims asserted in the case.

The amended complaint requests monetary damages against the Bank of $1,817,041 plus recovery of attorneys fees. The Bank intends to defend aggressively the amended claims and has referred the litigation to its insurance carrier, which has indicated that at least some of the claims asserted against the Bank are covered by insurance. The Bank has also asserted cross-claims against various former customers, principals of those customers, and other related persons on the grounds that if the Bank is held liable to the plaintiff, then the liability is the result of the misdeeds or negligence of those other parties.

IndyMac Bank, F.S.B. (Old IndyMac), was closed by the Office of Thrift Supervision (OTS) and the Federal Deposit Insurance Corporation (FDIC) was appointed as its conservator in July 2008. The OTS then created a new bank (New IndyMac) and many of the assets of Old IndyMac were transferred to New IndyMac. The Bank has been advised by opposing legal counsel that the claim in the litigation is owned by Old IndyMac, which is being liquidated by the FDIC. The Bank has been advised that the holder of the claim against the Bank intends to continue to pursue its claim against the Bank. The Bank intends to diligently defend the litigation. The litigation is in the discovery phase and depositions have not yet been held.

VSB Bancorp, Inc. is not involved in any pending legal proceedings. The Bank, from time to time, is involved in routine collection proceedings in the ordinary course of business on loans in default. Management believes that such other routine legal proceedings in the aggregate are immaterial to our financial condition or results of operations.

Item 4, Submission of Matters to a Vote of Security Holders.

None

PART II

Item 5. Market for Common Equity and Related Stockholder Matters.

Our common stock is quoted on the NASDAQ Global Market (NADAQ GM) under the symbol VSBN . We were listed on the NASDAQ Global Market effective August 4, 2008, having been formerly listed on the NASDAQ Capital Market.

The following table reflects the high and low bid price for our common stock during each calendar quarter of the last two fiscal years. Such information is derived from quotations published by Bloomberg LP. These quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission and may not represent actual transactions.

	2008			
	First Quarter	**Second Quarter**	**Third Quarter**	**Fourth Quarter**
High Bid	$ 12.25	$ 10.25	$ 13.00	$ 11.24
Low Bid	$ 10.00	$ 9.09	$ 9.09	$ 8.00

	2007			
	First Quarter	**Second Quarter**	**Third Quarter**	**Fourth Quarter**
High Bid	$ 15.20	$ 14.75	$ 13.65	$ 12.15
Low Bid	$ 14.27	$ 13.36	$ 11.76	$ 11.00

We have approximately 151 stockholders of record. We paid our first cash dividend of $0.06 per common share on January 2, 2008 to stockholders of record on November 29, 2007, and we paid quarterly dividends of $0.06 per share with respect to each calendar quarter thereafter through the end of 2008.

ISSUER PURCHASES OF EQUITY SECURITIES

Period	**(a) Total Number of Shares Purchased**	**(b) Average Price Paid Per Share**	**(c) Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs[(1)]**	**(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs**
October 1, 2008 to October 31, 2008	24,900	$ 9.68	24,900	75,100
November 1, 2008 to November 30, 2008	2,700	$ 9.75	27,600	72,400
December 1, 2008 to December 31, 2008	13,823	$ 9.15	41,423	58,577
Total	41,423	$ 9.56	41,423	58,577

(1) On September 8, 2008, we announced a stock repurchase program for the repurchase of up to 100,000 shares of our common stock. All purchases shown in the table were pursuant to such plan.

Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

General

VSB Bancorp, Inc. (referred to using terms such as we, us, or the Company) is the holding company for Victory State Bank (the Bank), a New York State chartered commercial bank. Our primary business is owning all of the issued and outstanding stock of the Bank. Victory State Bank is a New York State chartered commercial bank, founded in November 1997. The Bank is supervised by the New York State Banking Department and the Federal Deposit Insurance Corporation (FDIC). The Bank gathers deposits from individuals and businesses primarily in Staten Island and makes loans throughout that community. The Bank invests funds that are not used for lending primarily in government securities, mortgage backed securities and collateralized mortgage obligations. Customer deposits are insured, up to the applicable limit, by the FDIC. VSB Bancorp, Inc. common stock is quoted on the NASDAQ Global Market (NASDAQ GM) under the symbol VSBN .

Our results of operations are dependent primarily on net interest income, which is the difference between the income we earn on our loan and investment portfolios and our costs of funds, consisting primarily of interest paid on our deposits. Our operating expenses principally consist of employee compensation and benefits, occupancy expenses, professional fees, advertising and marketing expenses and other general and administrative expenses. Our results of operations are significantly affected by general economic and competitive conditions, particularly changes in market interest rates, government policies and actions of regulatory authorities.

Since the Bank opened for business in 1997, the Board of Directors and management have pursued a strategy of growth and expansion in order to enhance the long term value of our banking franchise. The Board of Directors and management anticipate that an increase in customer deposits, and the resulting increase in funds we would have available to fund asset growth, will generate an increase in net interest income.

We experienced an overall increase in deposits in 2008 due to factors we discuss below. We opened our new main office in 2007. We anticipate that our existing branch network will generate an increase in funds for investment in the future.

In order to support branch expansion and asset growth, we had not paid cash dividends prior to the fourth quarter of 2007. Our Board of Directors approved our first $0.06 cash dividend to stockholders of record on November 29, 2007, payable on January 2, 2008 and we paid quarterly dividends of $0.06 per share with respect to each calendar quarter thereafter through the end of 2008. We paid $443,996 of dividends out of net income of $1,931,774, for a dividend payout ratio of 23%. Thus, we retained the majority of our net income to increase our capital base to support our efforts to expand our franchise in the future.

During 2008, we faced a number of challenges, including reduction in market interest rates that pushed down our yields on assets faster than our cost of funds, due to the downward pressure of deposit rates. The real estate market continued to soften, which reduced loan originations and deposit balances from our attorney customer base. However, the decrease in the prime rate also caused a decrease in yields on our existing prime based loans and originated new loans at lower initial interest rates.

Also important in 2008 was a shift in our deposit mix as we experienced a decline in non-interest bearing demand deposits accounts. This decline resulted from a number of factors including a reduction in real estate activity, which reduced demand deposits held in connection with pending real estate transactions; and a shift in customer preferences towards interest bearing accounts as the yields on those accounts increased to the point where they became desirable alternatives.

Management intends to exert efforts to continue growing our company in the future. However, both internal and external factors could adversely affect our future growth. The recent down turn in the economy has made it more difficult for us to originate new loans that meet our underwriting standards. Not only does that cause us to invest available funds in lower-yielding securities and deposits with other banks, but it also slows the development of non-loan relationships which sometimes flow from cross-selling to loan customers.

A continuation of adverse general economic conditions could make it difficult for us to execute our growth plans. Furthermore, regulatory capital requirements could have a negative effect on our ability to grow if growth outpaces our ability to support that growth with increased capital.

Critical Accounting Policies

We are required to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the amounts of revenues and expenses during the reporting period. The allowance for loan losses, prepayment estimates on the mortgage-backed securities and Collateralized Mortgage Obligation portfolios, contingencies and fair values of financial instruments are particularly subject to change and to management s estimates. Actual results can differ from those estimates and may have an impact on our financial statements.

Asset/Liability Management

We maintain the interest rate sensitivity of our assets by investing primarily in CMO s and MBS s with short and intermediate average lives to generate cash flows and by originating and retaining primarily loans with interest rates based on the prime rate. As of December 31, 2008, prime based loans totaled $49,880,240, or 79.7% of total loans. Many of these prime based loans are subject to interest rate floors of 7.00% to 8.00%. We anticipate that we will continue to concentrate on originating prime based loans in our principal market areas. We also expect to continue to invest other available funds that we cannot invest in loans in short-term investment grade securities.

Cash Flow Sensitivity Analysis. The matching of assets and liabilities may be analyzed by examining our cash flow sensitivity gap. An asset or liability is said to be cash flow sensitive within a specific time period if it will mature or reprice within that time period. The cash flow sensitivity gap is defined as the difference between the amount of interest-earning assets maturing within a specific time period and the amount of interest-bearing liabilities maturing within that time period. A gap is considered positive when the amount of interest earning assets exceeds the amount of interest bearing liabilities. A gap is considered negative when the amount of interest bearing liabilities exceeds the amount of interest earning assets.

During a period of falling interest rates, the net income of an institution with a positive gap can be expected to be adversely affected because the yield on its interest-earning assets should reprice downward faster than the decline in its cost of funds. Conversely, during a period of rising interest rates, the net income of an institution with a positive gap position can be expected to increase as it is able to invest in higher yielding interest-earning assets at a more rapid rate than its interest-earning liabilities reprice. A positive gap may not protect an institution with a large portfolio of adjustable rate based loans or mortgage-backed securities from increases in interest rates for extended time periods if such loans or securities have annual and lifetime interest rate caps. The increase in the cost of funds in a rapidly increasing rate environment could exceed the cap on assets yields, negatively impacting net interest income. However, our prime rate based loans and our securities investments generally do not have any annual or lifetime caps.

In the current interest rate environment, we generally have been investing available funds not needed for lending in CMOs and MBSs with estimated average lives of four and one-half years or less. As a result of this strategy, and based upon the assumptions used in the following table at December 31, 2008, our total interest-bearing liabilities maturing within one year exceeded our total interest-earning assets maturing in the same period by $28,841,502, representing a one year cumulative gap ratio of negative 14.53%. In many cases, a negative gap ratio means that in a falling rate environment, the interest that we pay on deposits will reprice downward faster than the rates we earn on assets. However, for a number of important reasons, that is not our recent experience during periods of declining interest rates.

The gap analysis shown in the table measures repricing during time periods of three months, one year, or longer. However, since most of our loans have interest rates based upon the prime rate and the interest rate adjusts immediately based upon the prime rate, a reduction in the target federal funds rate, which normally presages an immediate reduction in the prime rate, will have an immediate negative effect on our earnings the next business day if the loans do not have or have not reached an interest rate floor. It will take longer for that decline in market interest rates to affect deposit costs.

The gap table does not measure the magnitude of a change in yields earned or rates paid, but only whether they are expected to change. A 1% decline in the prime rate normally causes a 1% decline in our loan yields, unless the loan is at an interest rate floor. However, a 1% decline in the prime rate would normally result in less than a one percent decline in the rate we pay on deposits because deposit rates are only a fraction of the prime rate. For example, if we offer a deposit for one-half the prime rate, then a 1% decline in the prime rate will result in a 1% decline in a loan yield, but only a 0.5% decline in the rate we offer on deposits. This effect, known as spread compression, can be especially significant at low market interest rates because the rate on deposits can not be less than zero.

The gap table does not consider the effects of customer discretion. Thus, a customer may elect to switch a deposit from one category to the other as market rates change, thus changing the cost of that deposit. Our cost of funds on a particular deposit could go up even though market rates are declining if a customer decides to move money from, for example, a low-rate NOW account to a higher-rate time deposit.

The gap table does not take into account discretion by the Bank in making deposit pricing decisions, which may cause the Bank not to reflect interest rate declines by lowering deposit rates. There are many reasons why the Bank may decide to do so. Examples of reasons include competitive pressures, irrational pricing by other institutions, and the need to maintain customer loyalty.

We closely monitor our interest rate risk as such risk relates to our operational strategies. The Victory State Bank Board of Directors has established an Asset/Liability Committee, responsible for reviewing our asset/liability policies and interest rate risk position, which generally meets quarterly and reports back to the Board on interest rate risk and trends on a quarterly basis. In light of the current interest rate environment, we are attempting to maintain a position in which our assets reprice more quickly than our liabilities. There can be no assurance, however, that we will be able to achieve that result or that we will be able to avoid further spread compression or avoid negative consequences from interest rate fluctuations. Although we have not experienced a material runoff in our core deposits, there can be no assurances that such a runoff will not occur in the future if depositors seek higher yielding investments.

Our substantial level of non-interest-bearing demand deposits also furthers our goal of maintaining a positive gap because the interest cost of those deposits will not increase as market rates increase. However an increase in market interest rates could cause our customers to shift funds from demand deposits into interest earning deposits if interest rates are high enough to justify maintaining multiple accounts. Furthermore, there have been frequent proposals in Congress to permit the payment of interest on commercial demand deposits. The adoption of such legislation could have a significant effect on our net income by forcing us to pay interest on business demand deposits to maintain parity with our competitors.

The following table sets forth the amounts of interest-earning assets and interest-bearing liabilities outstanding at December 31, 2008 which we estimate, based upon certain assumptions, will mature in each of the future time periods shown. Except as stated below, the amount of assets and liabilities shown which mature during a particular period were determined in accordance with the earlier of estimated repayment or runoff or the contractual terms of the asset or liability. There can be no assurance that deposits would reprice to peer bank s historical levels if interest rates were to increase. Certain shortcomings are inherent in the method of analysis presented in the foregoing table. For example, although certain assets and liabilities may have similar maturities, they may react in different degrees to changes in market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets may have features which restrict changes in interest rates on a short-term basis and over the life of the asset. For example, if a prime rate loan has a minimum interest rate of 7.5%, an increase in a very low prime rate might not be sufficient to increase the interest rate on the loan to more than the minimum. Further, in the event of a change in interest rates, prepayment and early withdrawal levels would likely deviate significantly from those assumed in calculating the table. Finally, the ability of many borrowers to service their prime rate loans may decrease in the event of an interest rate increase.

	At December 31, 2008				
	Three months or less	Four to twelve months	More than One year to five years	More than five years	Total
Interest-earning assets:					
Commercial loans (1)	$ 58,689,472	$ 115,806	$ 486,008	$ 81,051	$ 59,372,337
Consumer loans (1)	4,545,019	452	97,446	162,015	4,804,932
Mortgage-backed securities	4,884,270	14,652,810	99,812,207		119,349,287
Other interest-earning assets	14,909,325				14,909,325
Investment securities					
Total interest-earning assets	83,028,086	14,769,068	100,395,661	243,066	198,435,881
Less:					
Unearned (discount) and deferred fees(2)	(57,616)	(172,848)	(115,717)		(346,181)
Net interest-earning assets	82,970,470	14,596,220	100,279,944	243,066	198,089,700
Interest-bearing liabilities:					
Savings accounts	12,412,561				12,412,561
NOW accounts	17,636,154				17,636,154
Money market accounts	22,829,789				22,829,789
Certificate accounts	51,844,257	21,685,431	2,793,806		76,323,494
Subordinated debt					
Total interest-bearing liabilities	104,722,761	21,685,431	2,793,806		129,201,998
Interest sensitivity gap	$ (21,752,291)	$ (7,089,211)	$ 97,486,138	$ 243,066	$ 68,887,702
Cumulative gap	$ (21,752,291)	$ (28,841,502)	$ 68,644,636	$ 68,887,702	$ 68,887,702
Cumulative gap as a percentage of total interest-earning assets	-10.96%	-14.53%	34.59%	34.72%	34.72%
Cumulative net interest-earning assets as a percentage of total interest-bearing liabilities	79.23%	77.18%	153.13%	153.32%	153.32%

(1) For purposes of the gap analysis, mortgage and other loans are reduced for non-performing loans but are not reduced for the allowance for possible loan losses.

(2) For purposes of the gap analysis, unearned discount and deferred fees are pro-rated.

Analysis of Net Interest Income

Our profitability is primarily dependent upon net interest income. Net interest income represents the difference between interest income on interest-earning assets and the interest expense on interest-bearing liabilities. Net interest income depends primarily upon the volume of interest-earning assets and interest-bearing liabilities and the interest rates earned or paid on them.

Average Balance Sheet

The following table sets forth certain information relating to our consolidated statements of financial condition and the consolidated statements of earnings for the fiscal years ended December 31, 2008, 2007 and 2006 and reflects the average yield on assets and average cost of liabilities for the period indicated. Such yields and costs are derived by dividing income or expense by the average balance of assets or liabilities, respectively, for the periods shown. Average balances are derived from average daily balances. The average balance of loans receivable does not include loans on which we have discontinued accruing interest. The yields and costs include net fees, which are considered adjustments to yields. No tax equivalent adjustments have been made.

	Year Ended December 31, 2008			Year Ended December 31, 2007			Year Ended December 31, 2006		
	Average Balance	**Interest**	**Yield/ Cost**	**Average Balance**	**Interest**	**Yield/ Cost**	**Average Balance**	**Interest**	**Yield/ Cost**
Assets:									
Interest-earning assets:									
Loans receivable	$ 64,186,215	$ 5,078,576	7.91%	$ 61,107,477	$ 5,980,133	9.79%	$ 69,711,760	$ 6,985,200	10.02%
Other interest earning assets	14,864,864	237,490	1.60	20,652,598	994,334	4.81	18,737,570	887,663	4.74
Investment securities	119,976,379	5,699,228	4.75	112,178,675	5,303,886	4.73	114,180,350	5,201,089	4.56
Total interest-earning assets	199,027,458	11,015,294	5.53	193,938,750	12,278,353	6.33	202,629,680	13,073,952	6.45
Non-interest earning assets	11,105,146			14,624,973			14,291,015		
Total assets	$ 210,132,604			$ 208,563,723			$ 216,920,695		
Liabilities and equity:									
Interest-bearing liabilities:									
Savings accounts	$ 12,046,954	76,011	0.63	$ 11,942,515	97,900	0.82	$ 13,421,670	85,413	0.64
Time accounts	69,562,982	1,615,142	2.32	66,237,498	2,436,688	3.68	70,221,095	2,301,764	3.28
Money market accounts	21,092,188	310,714	1.47	21,366,204	439,236	2.06	19,357,106	352,956	1.82
Now accounts	17,607,727	127,066	0.72	19,258,479	131,634	0.68	21,508,418	107,973	0.50
Short Term Borrowings							19,178	1,112	5.80
Subordinated debt	3,098,634	214,685	6.91	5,155,000	356,159	6.91	5,155,000	356,159	6.91
Total interest-bearing liabilities	123,408,485	2,343,618	1.90	123,959,696	3,461,617	2.79	129,682,467	3,205,377	2.47
Checking accounts	63,545,525			63,596,060			68,870,282		
Total	186,954,010			187,555,756			198,552,749		
Other liabilities	1,308,257			1,909,693			2,529,839		
Total liabilities	188,262,267			189,465,449			201,082,588		
Equity	21,870,337			19,098,274			15,838,107		
Total liabilities and equity	$ 210,132,604			$ 208,563,723			$ 216,920,695		
Net interest income/net interest rate spread		$ 8,671,676	3.63%		$ 8,816,736	3.54%		$ 9,868,575	3.98%
Net interest earning assets/net interest margin	$ 75,618,973		4.36%	$ 69,979,054		4.55%	$ 72,947,213		4.87%
	1.61x			1.56x			1.56x		

Ratio of interest-earning assets to to interest-bearing liabilities			
Return On Average Assets:	0.92%	0.98%	1.17%
Return On Average Equity:	8.83%	10.72%	16.07%
Equity To Assets:	10.91%	10.25%	8.18%

Rate/Volume Analysis

The following table presents the extent to which changes in interest rates and changes in the volume of interest-earning assets and interest-bearing liabilities have affected our interest income and interest expense during the periods indicated. Information is provided in each category with respect to (i) changes attributable to changes in volume (changes in volume multiplied by prior rate), (ii) changes attributable to changes in rate (changes in rate multiplied by prior volume), and (iii) the net change. The changes attributable to the combined impact of volume and rate have been allocated proportionately to the changes due to volume and the changes due to rate.

	Year Ended December 31, 2008 Compared to December 31, 2007 Increase/(Decrease) In Net Interest Income			Year Ended December 31, 2007 Compared to December 31, 2006 Increase/(Decrease) In Net Interest Income			Year Ended December 31, 2006 Compared to December 31, 2005 Increase/(Decrease) In Net Interest Income		
	Due to			Due to			Due to		
	Volume	Rate	Net	Volume	Rate	Net	Volume	Rate	Net
Interest-earning assets:									
Loans receivable	$ 301,408	($ 1,202,965)	($ 901,557)	($ 862,149)	($ 142,918)	($ 1,005,067)	($ 147,482)	$ 1,304,344	$ 1,156,862
Other interest-earning assets	(278,390)	(478,454)	(756,844)	90,772	15,899	106,671	17,438	284,713	302,151
Investment securities, afs	368,831	26,511	395,342	(91,276)	194,073	102,797	(27,019)	357,473	330,454
Total	391,850	(1,654,909)	(1,263,059)	(862,653)	67,054	(795,599)	(157,062)	1,946,529	1,789,467
Interest-bearing liabilities:									
Savings accounts	856	(22,745)	(21,889)	(9,467)	21,954	12,487	(11,619)	17,959	6,340
Time accounts	122,378	(943,924)	(821,546)	(130,662)	265,586	134,924	202,996	898,202	1,101,198
Money market accounts	(5,645)	(122,877)	(128,522)	36,566	49,714	86,280	(16,260)	139,310	123,050
Now accounts	(11,225)	6,657	(4,568)	(11,250)	34,911	23,661	(12,967)	16,320	3,353
Short term borrowings				(1,112)		(1,112)	1,112		1,112
Subordinated debt	(141,474)		(141,474)						
Total	(35,110)	(1,082,889)	(1,117,999)	(115,925)	372,165	256,240	163,262	1,071,792	1,235,053
Net change in net interest income	$ 426,959	($ 572,019)	($ 145,060)	($ 746,728)	($ 305,110)	($ 1,051,839)	($ 320,324)	$ 874,737	$ 554,414

Effect of Adverse Conditions in the Residential Mortgage Market

We do not expect that adverse conditions in the residential mortgage market throughout the United States will have a direct adverse effect on our financial condition or results of operations. We are not a residential mortgage lender. At December 31, 2008, we owned $120.3 million of securities that are either collateralized by residential mortgage loans or that represent shares in pools of such loans. However, 95.0% of those securities are issued or guaranteed by FNMA, GNMA or FHLMC. The remainder of the securities portfolio are all investment grade fixed-rate securities rated AAA that are at least five years old. None of those securities have experienced ratings downgrades. We do not hold any loans in our portfolio of the type that are commonly known as subprime residential mortgage loans

However, many of our customers, both loan and deposit customers, are involved in the residential construction business in Staten Island. We believe that the turmoil in the national housing and residential mortgage markets has had an adverse effect on some of our customers. An apparent slow down in the local housing market and a noticeable reduction in the availability of residential mortgage loans seems to have had an adverse effect on our customers and reduced their business activity. We believe that this, in turn, has caused a reduction in their demand for loans from us, such as construction loans to build new homes. It also appears to have adversely affected the level of deposits they maintain. Furthermore, as the housing market has slumped, we have become more selective in our origination of construction loans, making it more difficult to deploy funds from lower yielding securities investments into higher yielding loans.

The Effect of Declining Market Interest Rates.

Market interest rates, especially short term market interest rates, declined substantially from September 2007 to April 2008 as the Federal Reserve reduced the target federal funds rate, which resulted in an immediate and equal reduction in the prime lending rate. The prime rate and the target overnight federal funds rate both declined by 325 basis points during that period, with the most dramatic decline being a 200 basis point decline in the two months from January 22, 2008 through March 18, 2008. As a result, our loan yields (usually based on the prime rate) and our overnight investment yields (based upon the target federal funds rate) declined as market interest rates declined.

The decline in loan yields and earnings on overnight investments was more rapid than the decline in our cost of funds for a number of reasons. Approximately one-third of our deposits are interest-free checking accounts and the rates on those accounts (already at zero) do not decline as market rates decline. The rates we pay on interest-bearing deposits, because of their lower starting point, cannot be reduced by as much as the basis point decline in market rates because of the need to maintain customer relationships, competitive pressures and the simple fact that if we price our time deposit rate at, hypothetically, 50% of the prime rate, and the prime rate declines 100 basis points, then the time deposit rate only declines 50 basis points. In addition, customers have the ability to exercise discretion in moving funds between different types of deposits to maximize their interest earnings.

One tool we use to manage market interest rate declines is the imposition of interest rate floors on our prime-based loans. For most of our loans, once the prime rate falls below 6% (which occurred on March 18, 2008), the interest rate remains at 7% per annum regardless of further declines in interest rates. The interest rate floors are one reason for the increase in our spread that we have recently experienced, with spread being 3.13% for the first quarter of 2008, increasing to 3.50% in the second quarter, 3.84% in the third quarter and dropping to 3.73% in the fourth quarter.

We have some flexibility in allocating our investment choices between the three categories of earning assets loans, investment securities and other investments (principally overnight investments). As interest rates declined, we elected to invest more of our available liquid assets into investment securities instead of overnight investments. This shift in the mix of our investments allowed us to reduce the effect of declining interest rates because investment securities tend to have higher yields that overnight investments. We were also able to reinvest the payments we received on existing investment securities in securities with rates comparable to the rates we were earning on the securities being repaid because many of the securities being repaid were purchased a number of years ago before market interest rates reached their recent peak towards the end of 2006.

Comparative Results for the Years Ended December 31, 2008 and December 31, 2007

General. We had net income of $1,931,744 for the year ended December 31, 2008, as compared to net income of $2,047,226 for the year ended December 31, 2007. The principal categories which make up the 2008 net income are:

Interest income of $11,015,294

Reduced by interest expense of $2,343,618

Reduced by provision for loan losses of $285,000

Increased by non-interest income of $2,400,915

Reduced by non-interest expense of $7,339,594

Reduced by $1,516,253 in income tax expense.

We discuss each of these categories individually and the reasons for the differences between the years ended December 31, 2008 and 2007 in the following paragraphs. The most significant factors that caused changes in net interest income from 2007 to 2008 were a reduction in the yield on interest-earning assets, primarily in the loan portfolio and other-interest earning assets, which reduced interest income, partially offset by the decrease in interest expense due to the drop in the cost of deposits and further partially offset by an increase in average interest-earning assets.

Interest Income. Interest income was $11,015,294 for the year ended December 31, 2008, compared to $12,278,353 for the year ended December 31, 2007, a decrease of $1,263,059, or 10.3%. The principal reasons for this decrease were a 188 basis point decrease in the yield on our loan portfolio and a 321 basis point decrease in the yield of other-interest earning assets (principally overnight investments), due principally to declines in market interest rates. The decrease was partially offset by the higher average balance of the investment security portfolio with a higher yield, as we reduced other interest earning assets and reallocated the funds to increase the average balance of investment securities. As a result, the average balance of overnight investments decreased by $5,787,734.

The average yield on our investment securities portfolio increased 2 basis points, from 4.73% to 4.75%, due to the purchase of new investment securities at slightly higher market rates than the yields on the principal paydowns we received. The yield on investment securities did not decrease as did the yields on other interest earning assets because most of the bonds and notes in our investment portfolio have either fixed interest rates or interest rates that react more slowly to changes in market interest rate conditions. The average balance of our investment portfolio increased by $7,797,704, or 7.0%, between the periods. The increase in volume and the increase in yield resulted in an overall $395,342 increase in interest income from investment securities. The investment securities portfolio represented 89.0% of average non-loan interest earning assets in the 2008 period compared to 84.5% in the 2007 period.

Interest Expense. Interest expense was $2,343,618 for 2008, compared to $3,461,617 for 2007, a decrease of $1,117,999 or 32.3%. The decrease was primarily the result of the repayment of the subordinated debt in August 2008 coupled with a decrease in the rates we paid on deposits, specifically time deposits (136 basis point decrease) and money market accounts (59 basis point decrease). Our average cost of funds, excluding the effect of interest-free demand deposits, decreased to 1.90% from 2.79% between the periods due to the decline in market interest rates.

Net Interest Income Before Provision for Loan Losses. Net interest income before the provision for loan losses was $8,671,676 for 2008, a decrease of $145,060, or 1.7%, compared to $8,816,736 of net interest income we had for 2007. The decrease was driven primarily by the decrease in the yield on average interest-earning assets coupled with the decrease in the average cost of funds. Our interest rate spread increased by 9 basis points from 3.54% at December 31, 2007 to 3.63% at December 31, 2008. We were able to increase the spread due to our ability to maintain the yield on our investment securities portfolio and the re-allocation of lower yielding overnight deposits to investment securities. Our net interest margin, which includes the effect of interest-free demand deposits and capital as funding sources, decreased to 4.36% in the year end 2008 from 4.55% in the same period of 2007, principally because interest free deposits and capital are less valuable as funding sources when they are invested at the lower yields available in 2008. The prime rate, which is the index used to adjust interest rates on many of our loans, was 3.25% at the end of 2008, as compared to 7.25% at the end of 2007. Although our prime-based loans primarily have interest rates with a margin of 100 to 150 basis points above the prime rate, many have interest rate floors so that the rates on the loans cannot decline below 7.00% to 7.50%.

Provision for Loan Losses. We took a provision for loan losses of $285,000 for the year ended December 31, 2008 compared to a credit provision for loan losses of $5,000 for the year ended December 31, 2007. The increase in the provision was the result of an increase in loan delinquencies and charge-offs. The provision for loan losses in any period depends upon the amount necessary to bring the allowance for loan losses to the level management believes is appropriate, after taking into account charge offs and recoveries. Our allowance for loan losses is based on management s evaluation of probable incurred losses on loans. Management periodically evaluates both broad categories of performing loans and problem loans individually to assess the appropriate level of the allowance.

Although management uses available information to assess the appropriateness of the allowance on a quarterly basis in consultation with outside advisors and the board of directors, changes in national or local economic conditions, the circumstances of individual borrowers, or other factors, may change, increasing the level of problem loans and requiring an increase in the level of the allowance. The allowance for loan losses represented 1.49% of total loans at December 31, 2008, but there can be no assurance that a higher level, or a higher provision for loan losses, will not be necessary in the future.

Non-interest Income. Non-interest income was $2,400,915 for the year ended December 31, 2008, compared to $2,173,392 during the same period last year, an increase of 10.5%. The $227,523, or 10.8%, increase in non-interest income was a direct result of a $326,070 increase in service charges on deposits and an increase in net rental income of $52,710, partially offset by a decrease of $151,257 in other income. Service fees on deposit accounts, principally non-sufficient funds fees, increased from 2007 to 2008 due to an increase in the number of non-sufficient fund transactions coupled with our decision to increase per item charges for both insufficient fund and bounced check fees and other deposit fees in March of 2008. The increase in net rental income was due to the occupancy of one of the Bank s subleased properties. The decrease in other income was a result of the loss of a check cashing customer and the fee income associated with that business.

Non-interest Expense. Non-interest expense was $7,339,594 for the year ended December 31, 2008, compared to $7,274,391 for the year ended December 31, 2007, an increase of 0.9%. The principal causes of the $65,203 increase were:

$116,262 increase in occupancy expenses principally due to higher utility bills;

$86,798 increase in legal expenses primarily due to increased collection costs and in 2007 we received reimbursement from our insurance company of legal fees previously expensed;

$111,466 increase in other expenses due to an increase in advertising expenses in connection with the Bank s new advertising campaign and a $40,110 recovery in 2007 of part of a reserve expensed in 2005 for a legal claim that we settled for less than the reserve in 2007; and

$286,056 decrease in salaries and benefits expense, due in part to the retirement of the former president and reduced incentive and ESOP compensation expense.

Income Tax Expense. Income tax expense was $1,516,253 for the year ended December 31, 2008, compared to income tax expense of $1,673,511 for the year ended December 31, 2007, a decrease of 9.4%. The decrease in income tax expense was due to the $272,740 decrease in income before income taxes in the 2008 and a decrease in our effective tax rate for the year ended December 31, 2008 to 44.0% from 45.0% for the year ended December 31, 2007.

Changes in Financial Condition

Total assets were $212,657,728 at December 31, 2008, an increase of $8,864,159 or, 4.4%, from December 31, 2007. The increase resulted from the investment of funds available to us as the result of an increase in deposits. The deposit increase was caused generally by our efforts to grow our franchise and specifically by the deposit increases at our branch offices. We invested these funds primarily in investment securities available for sale. The net increase in assets can be summarized as follows:

A $3,543,344 net increase in cash and cash equivalents.

A $2,474,471 net increase in investment securities available for sale and

A $3,960,909 net increase in net loans receivable.

In addition, we also experienced changes in other asset categories due to normal fluctuations in operations.

Our deposits (including escrow deposits) were $188,109,449 at December 31, 2008, an increase of $11,775,006 or 6.9%, from December 31, 2007. The increase in deposits resulted from increases of $11,584,930 in time deposits, $1,063,450 in savings accounts, $2,295,068 in money market and $705,041 in NOW, partially offset by a decrease of $3,873,483 in non-interest demand deposits.

Total stockholders equity was $23,203,767 at December 31, 2008, an increase of $2,319,962, or 11.1%, from December 31, 2007. The increase reflected (i) net income of $1,931,744 for the year ended December 31, 2008, (ii) an increase of additional paid in capital of $164,857 due to the exercise by management and directors of 23,375 options previously granted under our stock option plans, (iii) an increase of net unrealized gain on securities available for sale of $966,135 and (iv) a reduction of $169,077 in Unearned ESOP shares reflecting the gradual payment of the loan we made to fund the ESOP s purchase of our stock. These increases were partially offset by $443,996 of dividends paid, representing the four $0.06 per share quarterly, cash dividends declared in 2008.

The unrealized gain on securities available for sale is excluded from the calculation of regulatory capital. Management does not anticipate selling securities in this portfolio, but changes in market interest rates or in the demand for funds may change management s plans with respect to the securities portfolio. If there is a material increase in interest rates, the market value of the available for sale portfolio may decline. Management believes that the principal and interest payments on this portfolio, combined with the existing liquidity, will be sufficient to fund loan growth and potential deposit outflow.

For financial statement reporting purposes, we record the compensation expense related to the ESOP when shares are committed to be released from the security interest for the loan. The amount of the compensation expense is based upon the fair market value of the shares at that time, not the original purchase price. The initial sale of shares to the ESOP did not increase our capital by the amount of the purchase price because the purchase price was paid by the loan we made to the ESOP. Instead, capital increases as the shares are allocated or committed to be allocated to employee accounts (i.e., as the ESOP loan is gradually repaid), based upon the fair market value of the shares at that time. When we calculate earnings per share, only shares allocated or committed to be allocated to employee accounts are considered to be outstanding. However, all shares that the ESOP owns are legally outstanding, so they have voting rights and, if we pay dividends, dividends will be paid on all ESOP shares.

Liquidity and Capital Resources

Our primary sources of funds are increases in deposits and proceeds from the repayment of investment securities. We use these funds principally to purchase new investment securities and to fund increases in our loan portfolio.

In 2008, we had a net increase in total deposits of $11,775,006 due to increases of $11,584,930 in time deposits, $1,063,450 in savings accounts, $2,295,068 in money market and $705,041 in NOW, partially offset by a decrease of $3,873,483 in non-interest demand deposits. We also received proceeds from repayment of investment securities of $25,554,513. We used $26,157,422 of available funds to purchase new investment securities, $5,155,000 to repay our subordinated debt and we had a net loan increase of $3,960,909.

In 2007, we had a net decrease in total deposits of $10,348,707 as a result of a $4,846,529 decrease in demand deposit accounts, a $3,490,680 decrease in time deposits, a $3,004,656 decrease in NOW accounts and a $1,177,374 decrease in savings accounts, partially offset by a $2,175,714 increase in money market accounts. We received proceeds from repayment of investment securities of $36,847,421, which we used to fund the deposit outflow, net loan reduction of $4,023,211 and the purchase of $38,972,061 of investment securities.

In 2008, we experienced an increase of $3,543,344 in cash and equivalents because of the increase in deposits. Total cash and equivalents at December 31, 2008 were $21,240,223.

In 2007, we experienced a net decline of $7,666,190 in cash and equivalents because of our strategy to invest available cash in investments as opposed to lower yielding overnight deposits to the extent not needed to fund the deposit outflow. Total cash and equivalents at December 31, 2007 were $17,696,879.

At year end 2008, cash and cash equivalents represented 10% of total assets. We anticipate, based upon historical experience that these funds, combined with cash inflows we anticipate from payments on our loan and investment securities portfolios, will be sufficient to fund loan growth and unanticipated deposit outflows. As a secondary source of liquidity, at year end 2008 we had in excess of $120 million of investment securities classified available for sale. The disposition of these securities prior to maturity is an option available to us in the event, which we believe is unlikely, that our primary sources of liquidity and expected cash flows are insufficient to meet our need for funds. We do not anticipate a need for additional capital resources and do not expect to raise funds through a stock offering in the near future. As a result of our strong capital resources and available liquidity, we did not participate in the Treasury Departments TARP Capital Purchase Program. We have sufficient resources to allow us to continue to make loans as appropriate opportunities arise without having to rely on government funds to support our lending activities.

In August 2008, we unwound our trust preferred securities transaction by calling (and repaying) the $5,155,000 subordinated debenture we had on our balance sheet at June 30, 2008. We used available cash to repay the debenture and we expect that the repayment will have no material adverse effect on our liquidity. We elected to repay the debenture and end the trust preferred transaction because we believe that the future cost to us (3 month LIBOR plus 300 basis points per annum, adjusted every three months) would have exceeded the value of the additional capital that the transaction gave us for regulatory capital purposes. Victory State Bank and VSB Bancorp, Inc. were both well-capitalized for regulatory capital purposes after the debenture was repaid.

The FDIC has recently instituted the Temporary Liquidity Guarantee Program in which the FDIC will guarantee, with certain limitations, all senior unsecured debt of eligible financial institutions. We do not expect to avail ourselves of this program because we believe that our liquid assets and our ability to obtain funds through traditional channels are more than sufficient to provide the liquidity we need.

The following table sets forth our contractual obligations and commitments for future lease payments, time deposit maturities and loan commitments.

Contractual Obligations and Commitments at December 31, 2008

Contractual Obligations	**Payment due by Period**				
	Less than One Year	**One to three years**	**Four to five years**	**After five years**	**Total Amounts committed**
Minimum annual rental payments under non-cancelable operating leases	$ 399,063	$ 818,018	$ 846,968	$ 1,790,340	$ 3,854,389
Remaining contractual maturities of time deposits	73,529,688	1,141,951	1,651,855		76,323,494
Total contractual cash obligations	$ 73,928,751	$ 1,959,969	$ 2,498,823	$ 1,790,340	$ 80,177,883

Other commitments	**Amount of commitment Expiration by Period**				
	Less than One Year	**One to three years**	**Four to five years**	**After five years**	**Total Amounts committed**
Loan commitments	$ 21,583,258	$ 3,637,653	$ 499,000	$	$ 25,719,911

Impact of Inflation and Changing Prices

The consolidated financial statements and related notes presented herein have been prepared in accordance with accounting principles generally accepted in the United States, which require the measurement of financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time and due to inflation. Unlike industrial companies, nearly all of our assets and liabilities are monetary. As a result, interest rates have a greater impact on our performance than do the general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the price of goods and services.

Item 8.

The company s financial statements appear on the following pages:

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
VSB Bancorp, Inc.
Staten Island, New York

We have audited the accompanying consolidated statements of financial condition of VSB Bancorp, Inc. as of December 31, 2008 and 2007, and the related consolidated statements of earnings, stockholders equity and comprehensive income, and cash flows for the years then ended. These financial statements are the responsibility of the Company s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company s internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of VSB Bancorp, Inc. as of December 31, 2008 and 2007, and the results of its operations and its cash flows for the years then ended in conformity with U.S. generally accepted accounting principles.

/s/ Crowe Horwath LLP

Livingston, New Jersey
March 16, 2009

VSB BANCORP, INC.

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
DECEMBER 31, 2008 AND 2007

	2008	2007
ASSETS		
Cash and cash equivalents	$ 21,240,223	$ 17,696,879
Investment securities, available for sale	120,288,588	117,814,117
Loans receivable (net of allowance for loan losses of $987,876 and $927,161, respectively)	65,258,776	61,445,917
Accrued interest receivable	723,473	799,249
Premises and equipment, net	3,695,822	3,931,679
Prepaid and other assets	925,007	1,114,431
Deferred income taxes, net	525,839	991,297
Total assets	$ 212,657,728	$ 203,793,569
LIABILITIES AND STOCKHOLDERS EQUITY		
LIABILITIES:		
Deposits		
Non-interest bearing	$ 58,907,451	$ 62,780,934
Interest bearing	129,201,998	113,553,509
Total deposits	188,109,449	176,334,443
Subordinated debt		5,155,000
Accounts payable, accrued expenses and other liabilities	1,344,512	1,420,321
Total liabilities	189,453,961	182,909,764
Commitments and contigent liabilities (Note 12)		
STOCKHOLDERS EQUITY		
Common stock ($.0001 par value, 3,000,000 shares authorized, 1,923,884 issued, 1,882,461 outstanding at December 31, 2008; 1,900,509 issued and outstanding at December 31, 2007)	192	190
Additional paid-in capital	9,200,010	9,107,119
Retained earnings	14,714,143	13,226,395
Treasury stock, at cost (41,423 shares at December 31, 2008)	(395,891)	
Unearned Employee Stock Ownership Plan shares	(901,750)	(1,070,827)
Accumulated other comprehensive gains(loss), net of taxes of $488,735 and ($330,668), respectively	587,063	(379,072)
Total stockholders equity	23,203,767	20,883,805
Total liabilities and stockholders equity	$ 212,657,728	$ 203,793,569

VSB BANCORP, INC.

CONSOLIDATED STATEMENTS OF EARNINGS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

	2008	**2007**
INTEREST INCOME:		
Loans receivable	$ 5,078,576	$ 5,980,133
Investment securities	5,699,228	5,303,886
Other interest income	237,490	994,334
Total interest income	11,015,294	12,278,353
INTEREST EXPENSE:		
Deposits	2,128,933	3,105,458
Subordinated Debt	214,685	356,159
Total interest expense	2,343,618	3,461,617
Net interest income	8,671,676	8,816,736
PROVISION (CREDIT) PROVISION FOR LOAN LOSSES	285,000	(5,000)
Net interest income after provision for loan losses	8,386,676	8,821,736
NON-INTEREST INCOME:		
Deposit service fees	2,120,769	1,794,699
Other income	280,146	378,693
Total non-interest income	2,400,915	2,173,392
NON-INTEREST EXPENSES:		
Salaries and employee benefits	3,514,898	3,800,954
Occupancy and equipment	1,469,898	1,353,636
Data processing service fees	245,014	258,881
Legal fees	189,118	102,320
Professional fees	256,500	207,200
Director fees	217,450	216,150
Supplies and service	324,546	349,737
Checkbook charges	124,196	156,007
Other	997,974	829,506
Total non-interest expenses	7,339,594	7,274,391
INCOME BEFORE INCOME TAXES	3,447,997	3,720,737
PROVISION/(BENEFIT) FOR INCOME TAXES:		
Current	1,870,198	1,507,173
Deferred	(353,945)	166,338
Total income taxes	1,516,253	1,673,511
NET INCOME	$ 1,931,744	$ 2,047,226
Earnings per share:		
Basic	$ 1.04	$ 1.12
Diluted	$ 1.03	$ 1.09

Comprehensive income	$	2,897,879	$	3,048,032

See notes to consolidated financial statements.

VSB BANCORP, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

	Number of Common Shares	Common Stock	Additional Paid-in Capital	Retained Earnings	Treasury Stock, at cost	Unearned ESOP Shares	Other Comprehensive Gain / (Loss)	Total Stockholders Equity
Balance at December 31, 2006	1,891,759	$ 189	$ 8,667,665	$ 11,293,200	$	$ (1,239,905)	$ (1,379,878)	$ 17,341,271
Exercise of stock options, including tax benefit	8,750	1	77,832					77,833
Stock-based compensation			162					162
Amortization of earned portion of ESOP common stock						169,078		169,078
Amortization of cost over fair value - ESOP			(37,566)					(37,566)
Transfer from ESOP repuchase obligation			399,026					399,026
Cash dividends declared ($0.06 per share)				(114,031)				(114,031)
Comprehensive income:								
Net income				2,047,226				2,047,226
Other comprehensive income, net:								
Change in unrealized loss on securities available for sale, net of tax effects							1,000,806	1,000,806
Total comprehensive income								3,048,032
Balance at December 31, 2007	1,900,509	$ 190	$ 9,107,119	$ 13,226,395	$	$ (1,070,827)	$ (379,072)	$ 20,883,805
Exercise of stock options, including tax benefit	23,375	2	164,857					164,859
Stock-based compensation			1,278					1,278
Amortization of earned portion of ESOP common stock						169,077		169,077
Amortization of cost over fair value - ESOP			(73,244)					(73,244)
Cash dividends declared ($0.24 per share)				(443,996)				(443,996)
Purchase of treasury stock, at cost	(41,423)				(395,891)			(395,891)
Comprehensive income:								
Net income				1,931,744				1,931,744
Other comprehensive income, net:								
Change in unrealized loss on securities available for sale, net of tax effects							966,135	966,135
Total comprehensive income								2,897,879
Balance at December 31, 2008	1,882,461	$ 192	$ 9,200,010	$ 14,714,143	$ (395,891)	$ (901,750)	$ 587,063	$ 23,203,767

See notes to consolidated financial statements.

VSB BANCORP, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2008 and 2007

	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 1,931,744	$ 2,047,226
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	630,692	617,958
Accretion of discount, net amortization of premium	(222,974)	(227,323)
ESOP compensation expense	95,833	131,512
Stock-based compensation expense	1,278	162
Provision/(credit) for loan losses	285,000	(5,000)
Gain loss on the sale of other assets		(6,118)
Changes in operating assets and liabilities:		
Decrease/(increase) in prepaid and other assets	189,424	(178,762)
Decrease in accrued interest receivable	75,776	6,432
(Increase)/decrease in deferred income taxes	(353,945)	166,338
Decrease in accrued expenses, income tax payable and other liabilities	(75,809)	(885,991)
Net cash provided by operating activities	2,557,019	1,666,434
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net (increase)/decrease in loans receivable	(3,960,909)	4,023,211
Proceeds from repayments and calls of investment securities, available for sale	25,554,513	36,847,421
Purchase of investment securities, available for sale	(26,157,422)	(38,972,061)
Purchases of premises and equipment, net	(394,835)	(846,290)
Net cash (used in)/provided by investing activities	(4,958,653)	1,052,281
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase/(decrease) in deposits	11,775,006	(10,348,707)
Payment of subordinated debt	(5,155,000)	
Cash dividends paid	(443,996)	(114,031)
Exercise of stock options	164,859	77,833
Purchase of treasury stock, at cost	(395,891)	
Net cash provided by/(used in) financing activities	5,944,978	(10,384,905)
NET INCREASE/(DECREASE) IN CASH AND CASH EQUIVALENTS	3,543,344	(7,666,190)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	17,696,879	25,363,069
CASH AND CASH EQUIVALENTS, END OF YEAR	$ 21,240,223	$ 17,696,879
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	$ 2,594,736	$ 3,584,628
Income taxes	$ 1,697,259	$ 1,829,292
Transfer of construction in progress to premises and equipment from other assets	$	$ 2,142,866

See notes to consolidated financial statements.

VSB BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2008 and 2007

1. GENERAL

VSB Bancorp, Inc. (Bancorp or Company) is the holding company for Victory State Bank (Bank), a New York State chartered commercial bank. On May 30, 2003 as the result of a reorganization of the Bank into the holding company form of organization, the stockholders of the Bank became the stockholders of VSB Bancorp, Inc. As a result of the reorganization the stockholders of VSB Bancorp, Inc. received three shares of VSB Bancorp, Inc. stock for each two shares of Victory State Bank stock. Each stockholder owned the same percentage interest in VSB Bancorp immediately after the reorganization that the stockholder owned in the Bank immediately before the reorganization, subject to immaterial differences due to adjustments for cash in lieu of fractional shares. VSB Bancorp now owns 100% of the capital stock of the Bank. No stockholders of the Bank exercised dissenter s rights to receive cash instead of shares of the Company. The transaction between these entities under common control was accounted for at historical cost on an as if pooled basis . Our common stock now trades on the NASDAQ Global Market (NASDAQ GM) effective August 4, 2008, under the stock symbol VSBN .

Through the Bank, the Company is primarily engaged in the business of commercial banking, and to a lesser extent retail banking. The Bank gathers deposits from individuals and businesses primarily in Staten Island, New York and makes loans throughout that community. Therefore, the Company s exposure to credit risk is significantly affected by changes in the local Staten Island economic and real estate markets. The Bank invests funds that are not used for lending primarily in government securities, mortgage backed securities and collateralized mortgage obligations. Customer deposits are insured, up to the applicable limit, by the Federal Deposit Insurance Corporation (FDIC). The Bank is supervised by the New York State Banking Department and the FDIC.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The following is a description of the significant accounting and reporting policies followed in preparing and presenting the accompanying consolidated financial statements. These policies conform with accounting principles generally accepted in the United States of America (GAAP).

Principles of Consolidation - The consolidated financial statements of the Company include the accounts of the Company, including its subsidiary Victory State Bank. All significant inter-company accounts and transactions between the Company and Bank have been eliminated in consolidation.

Use of Estimates - The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the amounts of revenues and expenses during the reporting period. Actual results can differ from those estimates. The allowance for loan losses, prepayment estimates on the mortgage-backed securities and Collateralized Mortgage Obligation portfolios, contingencies and fair values of financial instruments are particularly subject to change.

Reclassifications Some items in the prior year financial statements were reclassified to conform to the current presentation.

Cash and Cash Equivalents Cash and cash equivalents consists of cash on hand, due from banks and interest-bearing deposits. Net cash flows are reported for customer loan and deposit transactions and interest-bearing deposits with original maturities of 90 days or less. Regulation D of the Board of Governors of the Federal Reserve System requires that Victory State Bank maintain non-interest-bearing deposits or cash on hand as reserves against its demand deposits. The amount of reserves which Victory State Bank is required to maintain depends upon its level of transaction accounts. During the fourteen day period from December 18, 2008 through December 31, 2008, Victory State Bank was required to maintain reserves, after deducting vault cash, of $2,922,000. Reserves are required to be maintained on a fourteen day basis, so, from time to time, Victory State Bank may use available cash reserves on a day to day basis, so long as the fourteen day average reserves satisfy Regulation D requirements. Victory State Bank is required to report transaction account levels to the Federal Reserve on a weekly basis.

Interest-bearing bank balances Interest-bearing bank balances mature overnight and are carried at cost.

Investment Securities, Available for Sale - Investment securities, available for sale, are to be held for an unspecified period of time and include securities that management intends to use as part of its asset/liability strategy. These securities may be sold in response to changes in interest rates, prepayments or other factors and are carried at estimated fair value. Gains or losses on the sale of such securities are determined by the specific identification method. Interest income includes amortization of purchase premium and accretion of purchase discount. Premiums and discounts are recognized in interest income using a method that approximates the level yield method without anticipating prepayments, except for mortgage-backed securities where prepayments are estimated. Unrealized holding gains or losses, net of deferred income taxes, are excluded from earnings and reported as other comprehensive income in a separate component of stockholders equity until realized. Declines in the fair value of securities below their cost that are other than temporary are reflected as realized losses. In estimating other-than-temporary losses, management considers: (1) the length of time and extent that fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, and (3) the Company s ability and intent to hold the security for a period sufficient to allow for any anticipated recovery in fair value.

The Company invests primarily in agency Collateralized Mortgage-Backed Obligations (CMOs) with estimated average lives primarily under 4.5 years and Mortgage-Backed Securities. These securities are primarily issued by the Federal National Mortgage Association (FNMA), the Government National Mortgage Association (GNMA) or the Federal Home Loan Mortgage Corporation (FHLMC) and are primarily comprised of mortgage pools guaranteed by FNMA, GNMA or FHLMC. The Company also invests in whole loan CMOs, all of which are AAA rated. These securities expose the Company to risks such as interest rate, prepayment and credit risk and thus pay a higher rate of return than comparable treasury issues.

Loans Receivable - Loans receivable, that management has the intent and ability to hold for the foreseeable future or until maturity or payoff, are stated at unpaid principal balances, adjusted for deferred net origination and commitment fees and the allowance for loan losses. Interest income on loans is credited as earned.

It is the policy of the Company to provide a valuation allowance for probable incurred losses on loans based on the Company s past loan loss experience, known and inherent risks in the portfolio, adverse situations which may affect the borrower s ability to repay, estimated value of underlying collateral and current economic conditions in the Company s lending area. The allowance is increased by provisions for loan losses charged to earnings and is reduced by charge-offs, net of recoveries. While management uses available information to estimate losses on loans, future additions to the allowance may be necessary based upon the expected growth of the loan portfolio and any changes in economic conditions beyond management s control. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank s allowance for loan losses. Such agencies may require the Bank to recognize additions to the allowance based on judgments different from those of management. Management believes, based upon all relevant and available information, that the allowance for loan losses is appropriate.

The Company has a policy that all loans 90 days past due are placed on non-accrual status. It is the Company s policy to cease the accrual of interest on loans to borrowers past due less than 90 days where a probable loss is estimated and to reverse out of income all interest that is due. The Company applies payments received on non-accrual loans to the outstanding principal balance due before applying any amount to interest, until the loan is restored to an accruing status. On a limited basis, the Company may apply a payment to interest on a non-accrual loan if there is no impairment or no estimated loss on this asset. The Company continues to accrue interest on construction loans that are 90 days past contractual maturity date if the loan is expected to be paid in full in the next 60 days and all interest is paid up to date.

Loan origination fees and certain direct loan origination costs are deferred and the net amount recognized over the contractual loan terms using the level-yield method, adjusted for periodic prepayments in certain circumstances.

The Company considers a loan to be impaired when, based on current information, it is probable that the Company will be unable to collect all principal and interest payments due according to the contractual terms of the loan agreement. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Impairment is measured on a loan by loan basis for commercial and construction loans. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan s effective interest rate or, as a practical expedient, at the loan s observable market price or the fair value of the collateral. The fair value of the collateral, as reduced by costs to sell, is utilized if a loan is collateral dependent. Large groups of smaller balance homogeneous loans, such as consumer loans and residential loans, are collectively evaluated for impairment.

Long-Lived Assets - The Company periodically evaluates the recoverability of long-lived assets, such as premises and equipment, to ensure the carrying value has not been impaired. In performing the review for recoverability, the Company would estimate the future cash flows expected to result from the use of the asset. If the sum of the expected future cash flows is less than the carrying amount an impairment will be recognized. The Company reports these assets at the lower of the carrying value or fair value.

Subordinated Debt - In August of 2003, the Company formed VSB Capital Trust I (the Trust). The Trust is a statutory business trust organized under Delaware law and the Company owns all of its common securities. The Trust issued $5.0 million of Trust Preferred Capital Securities to an independent investor and $155,000 of common securities to the Company. The Company issued a $5.16 million subordinated debenture to the Trust. The subordinated debenture was the sole asset of the Trust. On August 8, 2008, the Company repaid the subordinated debenture in full at par, received payment of $155,000 on account of its common securities of the Trust, and all the outstanding Trust Preferred Capital Securities were likewise redeemed, thereby ending the entire arrangement. The Trust is not consolidated with the Company.

Premises and Equipment - Premises, leasehold improvements, and furniture and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are accumulated by the straight-line method over the estimated useful lives of the respective assets, which range from three to fifteen years. Leasehold improvements are amortized at the lesser of their useful life or the term of the lease.

Federal Home Loan Bank (FHLB) Stock - The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment. Because this stock is viewed as a long term investment, impairment is based on ultimate recovery of par value, which is the price the Bank pays for the FHLB Stock. Both cash and stock dividends are reported as income.

Income Taxes - The Company utilizes the liability method to account for income taxes. Under this method, deferred tax assets and liabilities are determined on differences between financial reporting and the tax bases of assets and liabilities and are measured using the enacted tax rates and laws expected to be in effect when the differences are expected to reverse. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

The Company adopted FASB Interpretation 48, *Accounting for Uncertainty in Income Taxes* (FIN 48), as of January 1, 2007. A tax position is recognized as a benefit only if it is more likely than not that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the more likely than not test, no tax benefit is recorded. The adoption had no affect on the Company s financial statements.

The Company recognizes interest and/or penalties related to income tax matters in income tax expense.

Financial Instruments - In the ordinary course of business, the Company has entered into off-balance sheet financial instruments, primarily consisting of commitments to extend credit.

Basic and Diluted Net Income Per Common Share - Basic net income per share of common stock is based on 1,854,339 shares and 1,831,180 shares, the weighted average number of common shares outstanding for the years ended December 31, 2008 and 2007, respectively. Diluted net income per share of common stock is based on 1,881,782 and 1,877,605, the weighted average number of common shares and potentially dilutive common shares outstanding for the years ended December 31, 2008 and 2007, respectively. The weighted average number of potentially dilutive common shares excluded in calculating diluted net income per common share due to the anti-dilutive effect is 50,207 and 54,013 shares for the years ended December 31, 2008 and 2007, respectively. Common stock equivalents were calculated using the treasury stock method.

The reconciliation of the numerators and the denominators of the basic and diluted per share computations for the years ended December 31, are as follows:

	2008			2007		
	Net Income	**Weighted Average Shares**	**Per Share Amount**	**Net Income**	**Weighted Average Shares**	**Per Share Amount**
Basic earnings per common share						
Net income available to common stockholders	$ 1,931,744	1,854,339	$ 1.04	$ 2,047,226	1,831,180	$ 1.12
Effect of dilutive shares						
Weighted average shares, if converted		27,443			46,425	
Diluted earnings per common share						
Net income available to common stockholders	$ 1,931,744	1,881,782	$ 1.03	$ 2,047,226	1,877,605	$ 1.09

Stock Based Compensation - FAS 123, Revised, requires companies to record compensation expense for stock options provided to employees in return for employment service. The cost is measured at the fair value of the options when granted, and this cost is expensed over the employment service period, which is normally the vesting period of the options. This applies to awards granted or modified in fiscal years beginning in 2006.

Employee Stock Ownership Plan (ESOP) - The cost of shares issued to the ESOP, but not yet allocated to participants, is shown as a reduction of stockholders equity. Compensation expense is based on the market price of shares as they are committed to be released to participant accounts. Cash dividends on allocated ESOP shares reduce retained earnings; cash dividends on unearned ESOP shares reduce debt and accrued interest. As of August 4, 2008, the Company listed its common stock on the NASDAQ Global Market. We are no longer required to reclassify out of stockholders equity an amount equal to the put option of the allocated ESOP shares and we re-classed the 2006 put option allocation in the first quarter of 2007.

Stock Repurchase Program On September 8, 2008, the Company announced that its Board of Directors had authorized a Rule 10b5-1 stock repurchase program for the repurchase of up to 100,000 shares of the Company s common stock. Stock repurchases under the program will be accounted for using the cost method, in which the Company will reflect the entire cost of repurchased shares as a separate reduction of stockholders equity on its balance sheet.

Comprehensive Income - Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains and losses, net of taxes, on securities available for sale which are also recognized as separate components of equity.

Fair Value Option and Fair Value Measurement - In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*. This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This Statement establishes a fair value hierarchy about the assumptions used to measure fair value and clarifies assumptions about risk and the effect of a restriction on the sale or use of an asset. The standard is effective for fiscal years beginning after November 15, 2007. In February 2008, the FASB issued Staff Position (FSP) 157-2, *Effective Date of FASB Statement No. 157*. This FSP delays the effective date of FAS 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. The impact of adoption was not material.

Recently-Adopted Accounting Standards - *SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities-Including an amendment of FASB Statement No. 115.* SFAS 159 permits entities to choose to measure eligible items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value option has been elected are reported in earnings at each subsequent reporting date. The fair value option (i) may be applied instrument by instrument, with certain exceptions, (ii) is irrevocable (unless a new election date occurs) and (iii) is applied only to entire instruments and not to portions of instruments. SFAS 159 is effective for the Company on January 1, 2008. The Company chose not to exercise the fair value option permitted it under SFAS 159.

On November 5, 2007, the SEC issued Staff Accounting Bulletin No. 109, *Written Loan Commitments Recorded at Fair Value through Earnings* (SAB 109). Previously, SAB 105, *Application of Accounting Principles to Loan Commitments*, stated that in measuring the fair value of a derivative loan commitment, a company should not incorporate the expected net future cash flows related to the associated servicing of the loan. SAB 109 supersedes SAB 105 and indicates that the expected net future cash flows related to the associated servicing of the loan should be included in measuring fair value for all written loan commitments that are accounted for at fair value through earnings. SAB 105 also indicated that internally-developed intangible assets should not be recorded as part of the fair value of a derivative loan commitment, and SAB 109 retains that view. SAB 109 is effective for derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. The adoption of this standard was not material.

In December 2007, the SEC issued SAB No. 110, which expresses the views of the SEC regarding the use of a simplified method, as discussed in SAB No. 107, in developing an estimate of expected term of plain vanilla share options in accordance with SFAS No. 123(R), Share-Based Payment. The SEC concluded that a company could, under certain circumstances, continue to use the simplified method for share option grants after December 31, 2007. The Company does not use the simplified method for share options and therefore SAB No. 110 has no impact on the Company s consolidated financial statements.

Recently-Issued Accounting Standards - In December 2007, the FASB issued FAS No. 141 (revised 2007), Business Combinations (FAS 141(R)), which establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in an acquiree, including the recognition and measurement of goodwill acquired in a business combination. FAS No. 141(R) is effective for fiscal years beginning on or after December 15, 2008. Earlier adoption is prohibited. The adoption of this standard is not expected to have a material effect on the Corporation s results of operations or financial position.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interest in Consolidated Financial Statements, an amendment of ARB No. 51* (SFAS No. 160), which will change the accounting and reporting for minority interests, which will be recharacterized as noncontrolling interests and classified as a component of equity within the consolidated balance sheets. FAS No. 160 is effective as of the beginning of the first fiscal year beginning on or after December 15, 2008. Earlier adoption is prohibited and the Corporation does not expect the adoption of FAS No. 160 to have a significant impact on its results of operations or financial position.

In March 2008, the FASB issued SFAS No. 161, Disclosures about Derivative Instruments and Hedging Activities, an amendment of SFAS No. 133 . FAS No. 161 amends and expands the disclosure requirements of SFAS No. 133 for derivative instruments and hedging activities. FAS No. 161 requires qualitative disclosure about objectives and strategies for using derivative and hedging instruments, quantitative disclosures about fair value amounts of the instruments and gains and losses on such instruments, as well as disclosures about credit-risk features in derivative agreements. FAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. The adoption of this standard is not expected to have a material effect on the Corporation s results of operations or financial position.

3. INVESTMENT SECURITIES, AVAILABLE FOR SALE

The fair value of available for sale securities and the related gross unrealized gains and losses recognized in accumulated other comprehensive income/(loss) were as follows at December 31, 2008 and 2007:

	December 31, 2008		
	Estimated Fair Value	**Gross Unrealized Gains**	**Gross Unrealized Losses**
US Government Agency	$	$	$
FNMA MBS	6,690,594	82,351	(38,079)
FHLMC MBS	37,642	232	
GNMA MBS	1,632,790	56,026	
Whole Loan MBS	2,559,037		(61,928)
Collateralized mortgage obligations	109,368,525	1,477,051	(439,855)
	$ 120,288,588	$ 1,615,660	$ (539,862)

	December 31, 2007		
	Estimated Fair Value	Gross Unrealized Gains	Gross Unrealized Losses
US Government Agency	$	$	$
FNMA MBS	5,746,955	22,013	(37,741)
FHLMC MBS	162,752	1,239	
GNMA MBS	1,849,267		(43,682)
Whole Loan MBS	3,103,907		(31,195)
Collateralized mortgage obligations	106,951,236	512,550	(1,132,924)
	$ 117,814,117	$ 535,802	$ (1,245,542)

The tax benefits related to these net unrealized gains and losses were $488,735 and $330,668 at December 31, 2008 and 2007, respectively.

The following table shows the gross unrealized losses and estimated fair value of the Company s investments, aggregated by investment category and length of time that an individual security has been in the continuous unrealized loss position at December 31, 2008 and 2007:

December 31, 2008	Less than 12 months		More than 12 months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
US Government Agency	$	$	$	$	$	$
FHLMC MBS						
FNMA MBS	3,674,817	(34,814)	251,470	(3,265)	3,926,287	(38,079)
GNMA MBS						
Whole Loan MBS	1,451,015	(54,787)	1,108,022	(7,141)	2,559,037	(61,928)
Collateralized mortgage obligations	13,662,143	(76,957)	8,808,164	(362,898)	22,470,307	(439,855)
	$ 18,787,975	$ (166,558)	$ 10,167,656	$ (373,304)	$ 28,955,631	$ (539,862)

December 31, 2007	Less than 12 months		More than 12 months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
US Government Agency	$	$	$	$	$	$
FHLMC MBS						
FNMA MBS			3,008,560	(37,741)	3,008,560	(37,741)
GNMA MBS			1,849,267	(43,682)	1,849,267	(43,682)
Whole Loan MBS			3,103,907	(31,195)	3,103,907	(31,195)
Collateralized mortgage obligations	3,494,339	(10,274)	52,924,757	(1,122,650)	56,419,096	(1,132,924)
	$ 3,494,339	$ (10,274)	$ 60,886,491	$ (1,235,268)	$ 64,380,830	$ (1,245,542)

The Company evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. In analyzing an issuer s financial condition, the Company may consider whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, and the results of reviews of the issuer s financial condition.

At December 31, 2008, the unrealized loss on investment securities was caused by interest rate increases. We expect that these securities, at maturity, will not be settled for less than the amortized cost of the investment. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because the Company has the ability and intent to hold these securities until a market price recovery or maturity, these investments are not considered other-than-temporarily impaired. At December 31, 2008, there were thirty three debt securities with unrealized losses with aggregate depreciation of 5% or more from the Company s amortized cost basis. As the market value decline of these securities is caused by interest rate increases and management has the ability to hold these securities until maturity, or for the foreseeable future, if classified as available for sale, these securities are not deemed to be other-than-temporarily impaired.

The maturity schedule of all investment securities available for sale at amortized cost and estimated fair values for December 31, 2008 was as follows:

Securities, Available for Sale Expected Maturity	**Amortized Cost**	**Estimated Fair Value**
Less than one year	$ 37,411	$ 37,643
Due after one year through five years	4,084,755	4,108,703
Due after five years through ten years	54,005,951	54,539,994
Due after ten years	61,084,673	61,602,248
	$ 119,212,790	$ 120,288,588

Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without penalties.

Securities pledged at year end 2008 and 2007 had a carrying amount of $48,483,833 and $49,131,585, respectively and were pledged to secure public deposits and balances in excess of the deposit insurance limit on certain customer accounts.

4. LOANS RECEIVABLE, NET

Loans receivable, net at December 31, 2008 and 2007 are summarized as follows:

	2008	2007
Commercial loans (principally variable rate):		
Secured	$ 1,177,796	$ 1,171,152
Unsecured	9,558,296	10,981,044
Total commercial loans	10,736,092	12,152,196
Real estate loans:		
Commercial	39,918,879	31,607,039
One-to-four family	2,548,159	2,314,716
Total real estate loans	42,467,038	33,921,755
Construction loans (net of undisbursed funds of $5,270,500 and $7,717,362, respectively)	11,896,432	15,109,593
Consumer loans	599,293	566,356
Other loans	757,481	827,122
	1,356,774	1,393,478
Total loans receivable	66,456,336	62,577,022
Less:		
Unearned loans fees, net	(209,684)	(203,944)
Allowance for loan losses	(987,876)	(927,161)
Total	$ 65,258,776	$ 61,445,917

The activity in the allowance for loan losses, for the years ended December 31, 2008 and 2007 are summarized as follows:

	2008	2007
Beginning balance	$ 927,161	$ 1,128,824
Charge-offs	(494,788)	(263,625)
Recoveries	270,503	66,962
Provision(Credit)	285,000	(5,000)
Ending balance	$ 987,876	$ 927,161

Nonaccrual loans outstanding at December 31, 2008 and 2007 are summarized as follows:

	2008	2007
Nonaccrual loans:		
Unsecured commercial loans	$ 345,221	$ 14,970
Commercial real estate	1,453,846	459,371
Construction	480,000	480,000

Consumer loans		5,877
Total nonaccrual loans	$ 2,279,067	$ 960,218

	2008	**2007**
Interest income that would have been recorded during the year on nonaccrual loans outstanding at year-end in accordance with original terms	$ 114,464	$ 27,115

The Company s recorded investment in impaired loans at December 31 is as follows:

	2008		2007	
	Investment in Impaired Loans	**Related Allowance for loan losses**	**Investment in Impaired Loans**	**Related Allowance for loan losses**
Impaired loans				
With a related allowance for loan losses				
Commercial and financial	$ 316,775	$ 63,355	$ 50,476	$ 8,320
Commercial real estate	145,241	60,241		
Consumer loans			5,877	2,939
	$ 462,016	$ 123,596	$ 56,353	$ 11,259

The following table sets forth certain information about impaired loans at December 31:

	Investment in Impaired Loans	
	2008	**2007**
Average recorded investment	$ 53,833	$ 16,305
Interest income recognized during time period that loans were impaired, using cash-basis method of accounting	$	$

The Company s loan portfolios are primarily comprised of commercial and commercial real estate loans made to small businesses and individuals located in the Borough of Staten Island. As of December 31, 2008 and 2007, the Company had no restructured loans.

5. ACCRUED INTEREST RECEIVABLE

Accrued interest receivable at December 31, 2008 and 2007 are summarized as follows:

	2008	2007
Loans receivable	$ 469,938	$ 330,551
Investment securities, available for sale	253,535	468,698
Total	$ 723,473	$ 799,249

6. PREMISES AND EQUIPMENT

Premises and equipment at December 31, 2008 and 2007 are summarized as follows:

	2008	2007

Leasehold improvements	$ 4,238,498	$ 4,186,755
Computer equipment and software	342,290	337,430
Furniture, fixtures and equipment	1,308,825	1,100,631
Other	52,697	52,697
	5,942,310	5,677,513
Less accumulated depreciation and amortization	(2,246,488)	(1,745,834)
Total	$ 3,695,822	$ 3,931,679

Depreciation and amortization expense amounted to $630,692 and $617,958 for the years ended December 31, 2008 and 2007, respectively.

At December 31, 2008 and 2007, the Company was obligated under five non-cancelable operating leases on property used for banking purposes. Rental expense under these leases was $407,002 and $437,089 for the years ended December 31, 2008 and 2007, respectively.

The projected minimum rental payments under the terms of the leases at December 31, 2008 are summarized as follows:

Year Ending December 31,	**Amount**
2009	$ 399,063
2010	404,951
2011	413,067
2012	420,988
2013	425,980
Thereafter	1,790,340
Total	$ 3,854,389

7. PREPAID AND OTHER ASSETS

Prepaid and other assets at December 31, 2008 and 2007 are summarized as follows:

	2008	**2007**
Accounts receivable and other assets	$ 120,437	$ 28,508
Security deposit receivable	11,200	11,200
Prepaid assets	278,875	264,478
Equity securities, primarily FHLB stock	320,400	312,500
Investment in unconsolidated subsidiary		155,000
Subordinated debt related placement cost		18,763
Income tax receivable	157,978	273,972
Late charges receivable	36,117	50,010
	$ 925,007	$ 1,114,431

8. DEPOSITS

Deposits are summarized, according to their original terms, at December 31, 2008 and 2007 as follows:

	2008			2007		
	Amount	Percent	Weighted Average Stated Rate	Amount	Percent	Weighted Average Stated Rate
Checking	$ 58,598,579	31.15%	%	$ 62,525,053	35.45%	%
Variable-rate money market	22,829,789	12.14	0.71	20,534,721	11.65	1.43
Statement savings	12,412,561	6.60	0.55	11,349,111	6.44	0.82
Interest-bearing checking	17,636,154	9.38	0.30	16,931,113	9.60	0.32
	111,477,083	59.27	0.25	111,339,998	63.14	0.40
Time deposits:						
Less than six months	32,788,378	17.43	1.69	32,789,627	18.59	3.28
Six months to one year	39,017,479	20.74	2.50	27,706,849	15.71	4.12
More than one year	4,517,637	2.40	3.45	4,242,088	2.41	4.14
	76,323,494	40.57	2.21	64,738,564	36.71	3.70
Other deposits	308,872	0.16		255,881	0.15	
Total	$ 188,109,449	100.00%	0.54%	$ 176,334,443	100.00%	0.90%

The aggregate amount of jumbo certificates of deposit with a minimum denomination of $100,000 was approximately $65,526,186 and $53,753,833 at December 31, 2008 and 2007 respectively.

Scheduled maturities of time deposits at December 31, 2008 are as follows:

	Amount	Percent
Within six months	$ 67,389,210	88.29%
Six months to one year	6,140,478	8.05
One to five years	2,793,806	3.66
Total	$ 76,323,494	100.00%

9. INCOME TAXES

The Company files consolidated federal, state and local income tax returns on a calendar-year basis. For federal, state and local income tax purposes, the Company uses the specific charge-off method in computing its federal, state and local tax bad debt deduction.

The basis for the determination of state and local tax is the greater of a tax on entire net income or a tax computed on taxable assets. Federal, state and city income tax provisions were determined based on the tax computed on net income for the years ended December 31, 2008 and 2007.

The components of the income tax expense/(benefit) for the years ended December 31, 2008 and 2007 are summarized as follows:

	2008	2007
Current:		
Federal	$ 1,168,969	$ 938,424
State and local	701,229	568,749
	1,870,198	1,507,173
Deferred:		
Federal	(220,421)	103,582
State and local	(133,524)	62,756
	(353,945)	166,338
	$ 1,516,253	$ 1,673,511

The components of the deferred income tax asset, net as of December 31, 2008 and 2007 are summarized as follows:

	2008	2007
Deferred loan fees	$ 123,680	$ 115,736
Excess book allowance for loan losses	323,000	426,047
Unrealized (gain)/loss on investment securities	(488,735)	330,668
Other	567,894	118,846
Deferred tax asset, net	$ 525,839	$ 991,297

Management evaluated the weight of available evidence and concluded that it is more likely than not that the Company will realize the net deferred tax asset in future years. Factors influencing management s judgment include, among other things, changes in the levels of actual and expected future taxable income and anticipated reversals of net deductible temporary differences. There are no unrecognized tax benefits as of December 31, 2008.

The Company s effective tax rates differ from the statutory Federal tax rate for the years ended December 31, 2008 and 2007 and are as follows:

	2008		2007	
Federal income tax provision at statutory rates	$ 1,172,319	34.0%	$ 1,265,051	34.0%
State and local taxes, net of Federal income tax benefit	383,527	11.1	457,651	12.3
ESOP MTM	(34,609)	(1.0)		
Other	(4,984)	(0.1)	(49,191)	(1.3)
	$ 1,516,253	44.0%	$ 1,673,511	45.0%

10. REGULATORY MATTERS

The Bank is a New York State chartered stock form commercial bank. The Bank s deposits are insured by the Federal Deposit Insurance Corporation (FDIC). The Bank is subject to certain FDIC capital requirements. Failure to meet minimum capital requirements can initiate certain mandatory and possibly discretionary actions by the regulators that, if undertaken, could have a direct material effect on the Bank s financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet certain specific capital guidelines that involve quantitative measures of the Bank s assets, liabilities and certain off-balance sheet items calculated under regulatory accounting practices. The Bank s capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

As of the latest notification from the FDIC, the Bank was classified as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain Tier 1 Leverage, Tier 1 Risk-Based and minimum Total Risk-based ratios as set forth in the table below. There are no conditions or events since that notification that management believes have changed the Bank s category. Management believes, as of December 31, 2008, that the Bank meets all capital adequacy requirements to which it is subject.

The Bank is subject to certain restrictions on the availability of its undistributed earnings for payment of dividends to stockholders, including prior regulatory approval.

In accordance with the New York State Banking Law and the New York State Banking Board Regulations, the Bank credits 10% of quarterly net income to regulatory surplus and is required to do so until such time as shareholders equity is equal to 10% of amounts due to depositors. As of December 31, 2008, regulatory surplus equals 10% of deposits.

The following table is the Bank s actual capital amounts and ratios, as well as the minimum required levels for both capital adequacy purposes and to be considered well capitalized . No deductions were made for qualitative judgments by regulators:

	Actual		**For capital adequacy purposes**		**To be well-capitalized under prompt corrective action provisions**	
	Amount	**Ratio**	**Amount**	**Ratio**	**Amount**	**Ratio**
As of December 31, 2008:						
Tier 1 Capital (to Average Assets)	$ 22,087,000	10.45%	$ 8,516,543	4.00%	$ 10,645,678	5.00%
Tier 1 Capital (to Risk Weighted Assets)	22,087,000	24.34	3,681,128	4.00	5,521,692	6.00
Total Capital (to Risk Weighted Assets)	23,075,000	25.43	7,362,255	8.00	9,202,819	10.00

	Actual		For capital adequacy purposes		To be well-capitalized under prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2007:						
Tier 1 Capital (to Average Assets)	$ 22,821,000	11.07%	$ 8,248,120	4.00%	$ 10,310,150	5.00%
Tier 1 Capital (to Risk Weighted Assets)	22,821,000	26.19	3,484,840	4.00	5,227,260	6.00
Total Capital (to Risk Weighted Assets)	23,748,000	27.26	6,969,680	8.00	8,712,100	10.00

The Company s consolidated capital ratios as of December 31, 2008 were as follows: Tier 1 Capital to Average Assets of 10.70%; Tier 1 Capital to Risk Weighted Assets of 24.51%; and Total Capital to Risk Weighted Assets of 25.58%, which are not substantially different than the Bank s capital ratios at December 31, 2007 and therefore are not presented separately.

11. EMPLOYEE BENEFITS

The Company does not currently maintain a defined contribution benefit plan but sponsors an incentive savings plan (401(k) plan) which started March 1, 1999. All eligible employees, who have reached the age of 21, have at least one year of service and work a minimum of 1,000 hours per year will be permitted to make tax deferred contributions up to certain limits. The Bank may reduce or cease matching contributions if it is determined that the current or accumulated net earnings or undivided profits of the Bank are insufficient to pay the full contributions in a plan year. The Bank contributed $126,072 to the 401(k) plan in 2008 and $137,213 in 2007.

Stock Options

The Company has granted options pursuant to five different stock option plans. Options to buy stock are granted to directors, officers and employees under the VSB Bancorp, Inc. 2000 Incentive Plan, the 1998 Incentive Plan, the 2004 Directors Plan, the 2000 Directors Plan and the 1998 Directors Plan which, in the aggregate, provide for issue up to 243,750 options. Exercise price is the market price at the date of grant, and compensation expense will be recognized in the income statement in accordance with FAS 123, Revised. The maximum option term is ten years, and the options vesting period is up to five years.

Total compensation expense charged against income for 2008 and 2007 was $1,278 and $162.

In November 2007, 3,250 options were granted from the 2000 Incentive Plan at an exercise price of $11.75. There were no stock options granted in 2008.

The fair value of each option award is estimated on the date of grant using a closed form option valuation (Black-Scholes) model that uses the assumptions noted in the table below. Expected volatilities are based on historical volatilities of the Company s common stock. The Company uses historical data to estimate option exercise and post-vesting termination behavior. Employee and management options are tracked separately. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant.

The fair value of the options granted is estimated using the Black-Scholes option pricing model with the following weighted average assumptions used for 2007:

	2007	Exercise Rate
Dividend yield	**1.00%**	
Expected volatility	**3.38**	
Risk-free interest rate	**3.55**	
Expected life	**3 Years**	**100%**

The stock option components of the 2000 Incentive Plan, the 1998 Incentive Plan and the 2004 Directors Plan, the 2000 Directors Plan and the 1998 Directors Plan, as of December 31, 2008, and 2007, and changes during the years ended, consist of the following:

	2008		
	Shares	**Weighted Average Exercise Price**	**Aggregate Intrinsc Value**
Options outstanding at the beginning of the year	172,498	$ 10.61	
Granted			
Canceled	(3,125)	6.40	
Exercised	(23,375)	6.40	
Options outstanding at the end of the year	145,998	$ 11.23	$ (366,455)
Options exercisable at the end of the year	143,398	$ 11.35	$ (377,137)
Weighted average remaining contractual life of options outstanding at the end of the year		2.8 Years	

Nonvested Shares	**Shares**	**Weighted Average Grant Date Fair Value**
Nonvested at January 1, 2008	3,250	$ 1.18
Granted		
Vested	650	1.18
Forfeited		
Nonvested at December 31, 2008	2,600	$ 1.18

All non-exercisable options are expected to vest.

Information related to the stock option plan during each year follows:

	2008	2007
Intrinsic value of options exercised	$ 54,230	$ 46,863
Cash received from option exercise	$ 149,600	$ 56,000
Tax benefit realized from option exercise	$ 15,259	$ 21,833
Weighted average fair value of options exercised	$ 2.32	$ 1.24

As of December 31, 2007, there was $3,673 of total unrecognized compensation cost related to nonvested stock options granted under the Plan. The cost is expected to be recognized over a weighted-average period of 3 years.

Described below is the range of exercise prices for options granted under the following option plans:

Plan Description	Number of Exercisable Shares	Weighted Average Exercise Price	Weighted Average Contractual Life
1998 Director Stock Option Plan	5,000	$ 4.90	0.11
1998 Incentive Stock Option Plan	16,000	5.10	0.06
2000 Director Stock Option Plan	25,000	4.39	1.40
2000 Incentive Stock Option Plan	44,998	10.50	3.33
2004 Director Stock Option Plan	55,000	17.60	5.50
All Plans	145,998	$ 11.35	2.80

Stock Appreciation Rights

The Company issued stock appreciation rights (SARs) to an officer of the Company to advance the interests of the Company and its shareholders by providing this key officer of the Company and its affiliates, upon whose judgment, initiative and efforts were instrumental upon the formation and development of the Company and its affiliates, with an additional incentive to perform in a superior manner. Pursuant to the terms, 31,250 SARs with an exercise price of $4.00 per SAR (as adjusted for prior stock dividends), as determined by the Board of Directors, have been issued. There are no SARs available to be granted and those SARs, which terminate, or are forfeited without being exercised, can not be recycled into new grants. The term of each SAR is determined by the Committee of the Board of Directors and may not exceed ten years after the date of the grant. The SARs vest and are exercisable for the cash value between the Company s stock price less the exercise price. The SARs vest over five years, 40% two years after the grant date and 20% per year after. In 2007, 17,500 SARs were exercised. As of December 31, 2008 and 2007, there were no remaining SARs.

The Company did not grant any SARs in 2008 and 2007.

12. COMMITMENTS, CONTINGENCIES AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business in order to meet the financing needs of its customers. Such financial instruments primarily include commitments to extend credit.

A summary of these commitments and contingent liabilities, all of which are variable rate commitments, at December 31:

	2008 Amount	2007 Amount
Commitments to fund secured construction loans	$ 3,500,000	$ 7,687,362
Commitments to fund all other commercial loans	22,219,911	17,175,024
	$ 25,719,911	$ 24,862,386

Commitments to extend credit are legally binding agreements to lend to a customer. Commitments are issued following the Company s evaluation of each applicant s creditworthiness on a case-by-case basis. The Company s exposure to credit loss in the event of nonperformance by the other party to the financial instrument is represented by the contractual notional amount of those instruments.

Victory State Bank currently has a $2 million unsecured credit facility with Atlantic Central Bankers Bank which the Bank has not drawn upon.

The Bank is a defendant in a lawsuit against a former customer brought by a third party. The Bank intends to defend aggressively the claims made against it.

VSB Bancorp, Inc. is not involved in any pending legal proceedings. The Bank, from time to time, is involved in routine collection proceedings in the ordinary course of business on loans in default. Management believes that such other routine legal proceedings in the aggregate are immaterial to our financial condition or results of operations.

13. FAIR VALUE OF FINANCIAL INSTRUMENTS

The following disclosure of the estimated fair value of financial instruments is made in accordance with the requirements of SFAS No. 107, *Disclosures about Fair Value of Financial Instruments*. The estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is necessarily required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

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

Interest-bearing Bank Balances Interest-bearing bank balances mature within one year and are carried at cost which are estimated to be reasonably close to fair value.

Money Market Investments The fair value of these securities approximates their carrying value due to the relatively short time to maturity

Investment Securities, Available For Sale The estimated fair value of these securities is determined by using available market information and appropriate valuation methodologies. The estimates presented herein are not necessarily indicative of the amounts that the Company could realize in a current market exchange.

Loans Receivable - The fair value of commercial and construction loans are approximated by the carrying value as the loans are tied directly to the Prime Rate and are subject to change on a daily basis. The fair value of the remainder of the portfolio is determined by discounting the future cash flows of the loans using the appropriate discount rate.

Other Financial Assets - The fair value of these assets, principally accrued interest receivable, approximates their carrying value due to their short maturity.

Non-Interest Bearing and Interest Bearing Deposits - The fair value disclosed for non-interest bearing deposits is equal to the amount payable on demand at the reporting date. The fair value of interest bearing deposits is based upon the current rates for instruments of the same remaining maturity. Interest bearing deposits with a maturity of greater than one year are estimated using a discounted cash flow approach that applies interest rates currently being offered.

Subordinated Debt The fair value of subordinated debt is based upon the current rates for such instruments of the same remaining maturity.

Other Liabilities - The estimated fair value of other liabilities, which primarily include accrued interest payable, approximates their carrying amount.

Off-Balance Sheet Items - The estimated fair value of off-balance sheet items, including adjustable rate loan commitments, unused lines of credit and letters of credit are not material and are not included in the fair value table.

The estimated fair values of the Company s financial instruments at December 31, 2008 and 2007 were as follows:

	2008		2007	
	Carrying Amount	**Fair Value**	**Carrying Amount**	**Fair Value**
Financial Assets:				
Cash and cash equivalents	$ 21,240,223	$ 21,240,223	$ 17,696,879	$ 17,696,879
Investment securities, available for sale	120,288,588	120,288,588	117,814,117	117,814,117
Loans receivable	65,258,776	63,767,118	61,445,917	64,711,536
Other financial assets	723,473	723,473	799,249	799,249
Total Financial Assets	$ 207,511,060	$ 206,019,402	$ 197,756,162	$ 201,021,781
Financial Liabilities:				
Non-interest bearing deposits	$ 58,907,451	$ 58,907,451	$ 62,780,934	$ 62,780,934
Interest bearing deposits	129,201,998	129,096,378	113,553,509	109,224,316
Subordinated debt			5,155,000	5,247,510
Other liabilities	162,731	162,731	362,991	362,991
Total Financial Liabilities	$ 188,272,180	$ 188,166,560	$ 181,852,434	$ 177,615,751

Statement 157 establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity s own assumptions about the assumptions that market participants would use in pricing and asset or liability.

The fair value of securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or matrix pricing, which is a mathematical technique widely used to in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities relationship to other benchmark quoted securities (Level 2 inputs).

Assets and Liabilities Measured on a Recurring Basis

Assets and liabilities measured at fair value on a recurring basis are summarized below:

		Fair Value Measurements at December 31, 2008 Using		
	December 31, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Available for sale securities	$ 120,288,588	$	$ 120,288,588	$

Assets and Liabilities Measured on a Non-Recurring Basis

Assets and liabilities measured at fair value on a non-recurring basis are summarized below:

		Fair Value Measurements at December 31, 2008 Using		
	December 31, 2008	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Impaired loans	$ 85,000			$ 85,000

Impaired loans are reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 3 inputs based on internally customized discounting criteria.

As of December 31, 2008, we had one impaired loans that was collateral dependent. Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of $85,000, with a valuation allowance of $60,241, resulting in an additional provision for loan losses of $40,000 for the period.

Certain financial assets and financial liabilities are measured at fair value on a nonrecurring basis, that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). Financial assets and financial liabilities measured at fair value on a non-recurring basis were not significant at December 31, 2008.

14. INTEREST RATE RISK (UNAUDITED)

The Company s principal business of originating loans, issuing term certificates of deposit and other interest-bearing deposit accounts and investing in short-term investment securities inherently includes elements of interest rate risk and requires careful application of interest rate management techniques to manage such risks.

Because the Company has a varied array of investment, loan and deposit products, which differ as to maturity, repricing terms and interest rate spreads relative to various rate indices, different interest rate risk management strategies are utilized.

The Company funds its assets primarily with deposits. A substantial portion of these, mature or reprice within one year of their origination or last repricing date.

In view of the short maturity profile of the Company s funding sources, the Company invests in loans and investments which have a maturity or repricing date designed to match the Company s funding maturities and serve as a natural hedge of the related interest rate risk.

Net interest income will fluctuate based on changes in the general level of interest rates, changes in the levels of interest sensitive assets and liabilities, and changes in the relationships between different interest rate indices. In addition, net interest income can also be affected by timing of repricing dates and repayments and changes in estimated prepayments.

15. RELATED PARTIES

The Bank at times has had loans, and other financial transactions, with its executive officers and directors. At December 31, 2008, the aggregate amount of loans outstanding to directors was $159,664. There were no loans granted to executive officers.

The change in aggregate amount of loans outstanding to directors as of December 31, 2008 and 2007 are as follows:

	2008	**2007**
Beginning balance	$ 192,219	$ 174,754
Originations	84,514	333,505
Payments	(117,069)	(316,040)
Ending balance	$ 159,664	$ 192,219

The interest income that was paid on these loans was $12,189 and $19,679 for 2008 and 2007, respectively.

Certain officers and directors own, in the aggregate, 33.4% and 33.2% of the common shares outstanding at December 31, 2008 and 2007, respectively.

16. CONDENSED FINANCIAL STATEMENTS OF THE PARENT COMPANY ONLY

VSB BANCORP, INC.

STATEMENTS OF FINANCIAL CONDITION
DECEMBER 31, 2008 and 2007

		2008		2007
ASSETS				
Cash and cash equivalents	$	542	$	
Money market		496,371		3,505,410
Investment in subsidiaries		22,673,688		22,596,729
Deferred taxes		31,293		
Other assets		20,332		43,570
Total assets	$	23,222,226	$	26,145,709
LIABILITIES AND STOCKHOLDERS EQUITY				
LIABILITIES:				
Subordinated debt	$		$	5,155,000
Accounts payable, accrued expenses and other liabilities		18,459		106,904
Total liabilities		18,459		5,261,904
COMMITMENTS AND CONTINGENT LIABILITIES				
STOCKHOLDERS EQUITY				
Common stock ($.0001 par value, 3,000,000 shares authorized, 1,923,884 issued and 1,882,461 outstanding at December 31, 2008; 1,900,509 issued and outstanding at December 31, 2007)		192		190
Additional paid-in capital		9,200,010		9,107,119
Retained earnings		14,714,143		13,226,395
Treasury stock, at cost (41,423 shares at December 31, 2008)		(395,891)		
Unearned Employee Stock Ownership Plan shares		(901,750)		(1,070,827)
Accumulated other comprehensive gain/(loss), net of taxes of $488,735 and ($330,668), respectively		587,063		(379,072)
Total stockholders equity		23,203,767		20,883,805
Total liabilities and stockholders equity	$	23,222,226	$	26,145,709

VSB BANCORP, INC.

STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

	2008	**2007**
INTEREST INCOME:		
Loans recievable	$ 42,815	$ 49,578
Other interest income	70,656	32,942
Total interest income	113,471	82,520
INTEREST EXPENSE:		
Subordinated debt	214,685	356,159
Total interest expense	214,685	356,159
Net interest loss	(101,214)	(273,639)
NON-INTEREST INCOME:		
Dividend income	2,768,723	2,800,000
Other	6,455	10,709
	2,775,178	2,810,709
NON-INTEREST EXPENSES:		
Legal fees	56,000	19,000
Other	86,722	90,942
Total non-interest expenses	142,722	109,942
INCOME BEFORE INCOME TAXES	2,531,242	2,427,128
PROVISION/(BENEFIT) FROM INCOME TAXES:		
Current	(104,725)	(227,029)
Deferred	(72,768)	30,272
Total income taxes	(177,493)	(196,757)
EQUITY IN UNDISTRIBUTED EARNINGS, NET OF TAXES	(776,991)	(576,659)
NET INCOME	$ 1,931,744	$ 2,047,226

VSB BANCORP, INC.

STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2008 AND 2007

	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$ 1,931,744	$ 2,047,226
Adjustments to reconcile net income to net cash used in operating activities:		
Changes in operating assets and liabilities:		
ESOP compensation expense	(71,966)	(37,404)
Undistributed income of subsidiaries	776,991	576,659
Decrease in other assets	23,238	5,269
(Increase)/decrease in deferred income taxes	(31,293)	15,178
Decrease in accounts payable, accrued expenses, and other liabilities	(131,260)	(22,443)
Net cash provided by operating activities	2,497,454	2,584,485
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net decrease in loan receivable	169,077	169,078
Net decrease/(increase) in money market deposit	3,009,039	(2,717,365)
Net cash provided by/(used in) investing activities	3,178,116	(2,548,287)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Exercise stock option	164,859	77,833
Payment of subordinated debt	(5,155,000)	
Return of VSB Capital Trust - common stock	155,000	
Purchase of treasury stock, at cost	(395,891)	
Payment of dividends	(443,996)	(114,031)
Net cash used in financing activities	(5,675,028)	(36,198)
NET INCREASE IN CASH AND CASH EQUIVALENTS	542	
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR		
CASH AND CASH EQUIVALENTS, END OF YEAR	$ 542	$
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	$ 259,088	$ 345,450
Income taxes	$	$

17. EMPLOYEE STOCK OWNERSHIP PLAN

Employees participate in an Employee Stock Ownership Plan (ESOP). VSB Bancorp, Inc. ESOP Trust was formed on May 1, 2004. The ESOP borrowed from the Company to purchase 92,900 shares of stock at $18.20 per share. The Company makes discretionary contributions to the ESOP, as well as paying dividends on unallocated shares to the ESOP, and the ESOP uses funds it receives to repay the loan. When loan payments are made, ESOP shares are allocated to participants based on relative compensation and expense is recorded. Dividends on allocated shares increase participant accounts.

Shares allocated to each participant, to the extent vested, are distributed to the participant upon termination of employment. As required by federal law, a participant may require the Company to repurchase shares so distributed unless the stock is traded on an established market.

The contribution to the ESOP was $169,078 for each of the years ended December 31, 2008 and 2007. ESOP expense was $97,112 and $131,674, for the years ended December 31, 2008 and 2007, respectively.

Shares held by the ESOP at December 31, 2008 and 2007 were as follows:

	2008	2007
Shares allocated to participants	47,151	37,602
Shares released to participants	(3,885)	(564)
Unearned shares	45,749	55,298
Total ESOP Shares	89,015	92,336
Fair value of unearned shares	$ 398,931	$ 616,573

18. SUBORDINATED DEBENTURES

In August of 2003, the Company formed VSB Capital Trust I (the Trust). The Trust is a statutory business trust organized under Delaware law and the Company owns all of its common securities. The Trust issued $5.0 million of Trust Preferred Capital Securities to an independent investor and $155,000 of common securities to the Company. The Company issued a $5.16 million subordinated debenture to the Trust. The subordinated debenture is the sole asset of the Trust. The subordinated debenture and the Trust Preferred Capital Securities pay interest and dividends, respectively, on a quarterly basis, at a rate of 6.909%, for the first five years. They mature thirty years after the issuance of the securities and are non-callable for five years. After the first five years, the Trust Preferred Securities may be called by the Company at any quarterly interest payment date at par and the rate of interest that fluctuates quarterly based upon 300 basis points over the 90 day LIBOR rate. On August 8, 2008, the Company repaid the subordinated debenture in full at par, received payment of $155,000 on account of its common securities of the Trust, and all the outstanding Trust Preferred Capital Securities were likewise redeemed, thereby ending the entire arrangement.

The Company reports as liabilities the subordinated debentures issued by the Company and held by the Trust.

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Item 9. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure

Not applicable.

Item 9a (T) Controls and Procedures

Disclosure Controls and Procedures

Our principal executive and principal financial officer evaluated our disclosure controls and procedures (as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended (the Exchange Act)), as of the end of the period covered by this Annual Report, as required by paragraph (b) of Rule 13a-15 of the Exchange Act. Based on such evaluation, our principal executive and principal financial officer concluded that, as of the end of the period covered by this Annual Report, our disclosure controls and procedures are effective.

Management s Annual Report on Internal Control Over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934. Our internal control over financial reporting is designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles in the United States.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies or procedures may deteriorate.

Management assessed the effectiveness of our internal control over financial reporting as of December 31, 2008. In making this assessment, management used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control-Integrated Framework* as amplified by the *Guidance for Smaller Public Companies.* The five principal components of the Framework that management analyzed in connection with its assessment were our Control Environment, Risk Assessment, Control Activities, Information and Communication, and Monitoring. Based on that assessment, management believes that we maintained effective internal control over financial reporting as of December 31, 2008.

This annual report does not include an attestation report of the company s registered public accounting firm regarding internal control over financial reporting. Management s report was not subject to attestation by the company s registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the company to provide only management s report in this annual report.

Item 9B. Other Information.

Not applicable.

PART III

Item 10. Directors, Executive Officers, Promoters and Control Persons; Compliance with Section 16(a) of the Exchange Act

Incorporated by reference to pages 4 and 5 of the Proxy Statement under the caption General Information Regarding Nominees and Our Other Directors; page 13 of the Proxy Statement under the caption Section 16a Beneficial Ownership Reporting Compliance; and pages 5 and 6 of the Proxy Statement under the caption Audit Committee.

The Company has a Code of Ethics that applies to all officers and employees. The Code of Ethics is posted on our web site www.victorystatebank.com and can be found under the Investor Relations tab.

Item 11. Executive Compensation

The information required by this Item is incorporated by reference to pages 8 through 11 of the Proxy Statement under the caption Compensation through and including the sub-caption Directors Compensation.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters

The information required by this Item is incorporated by reference to page 11 through page 12 of the Proxy Statement under the caption Security Ownership of Management and Certain Beneficial Owners.

Item 13. Certain Relationships and Related Transactions, and Director Independence

The information required by this Item is incorporated by reference to pages 12 through 13 of the Proxy Statement under the caption Transactions with Directors and Officers and Their Related Interests.

Item 14. Principal Accounting Fees and Services.

The information required by this Item is incorporated by reference to pages 13 through 14 of the Proxy Statement under the caption Audit and Other Fees.

Item 15. Exhibits, Financial Statement Schedules

(a) Financial Statements

(b) Exhibits

Exhibit No.	**Title of Exhibit**
3.1	Restated Certificate of Incorporation of VSB Bancorp, Inc.*
3.2	Bylaws of VSB Bancorp, Inc.*
10.1	Employment Agreement between Merton Corn and Victory State Bank*
10.2	Victory State Bank 2000 Incentive Stock Option Plan*
10.3	Victory State Bank 2000 Directors Stock Option Plan*
10.4	Victory State Bank 1998 Incentive Stock Option Plan*
10.5	Victory State Bank 1998 Directors Stock Option Plan*
10.6	VSB Bancorp, Inc. Restated 2000 Incentive Stock Option Plan*
10.7	VSB Bancorp, Inc. Restated 2000 Directors Stock Option Plan*
10.8	VSB Bancorp, Inc. Restated 1998 Incentive Stock Option Plan*
10.9	VSB Bancorp, Inc. Restated 1998 Directors Stock Option Plan*
10.10	VSB Bancorp, Inc. 2004 Directors Stock Option Plan**
10.11	Employment Agreement among Raffaele M. Branca, VSB Bancorp, Inc. and Victory State Bank***
21.	Subsidiaries of the Registrant
23.	Consent of Independent Registered Public Accounting Firm
31.1	Rule 13A-14(a)/15D-14(a) Certification of Chief Executive Officer
31.2	Rule 13A-14(a)/15D-14(a) Certification of Principal Accounting Officer
32.1	Certification by CEO pursuant to 18 U.S.C. 1350
32.2	Certification by Principal Accounting Officer pursuant to 18 U.S.C. 1350

* - previously filed as an exhibit on Form 10-KSB (File No. 0-05237) as filed with the Securities and Exchange Commission on March 26, 2008.

** - previously filed as an exhibit included in the Issuer s proxy statement for its 2004 Annual Meeting of Stockholders on Form 14A.

*** - previously filed as exhibit on Form 8-K (File No. 0-50237) as filed with the Securities and Exchange Commission on November 16, 2007.

SIGNATURES

Pursuant to the requirements of Section 12 of the Securities Exchange Act of 1934, the registrant has duly caused this registration statement to be signed on its behalf by the undersigned, thereunto duly authorized.

	VSB Bancorp, Inc. (Registrant)
Date: March 24, 2009	By: /s/ Raffaele M. Branca
	Raffaele M. Branca, President & CEO, Principal Executive Officer and Principal Financial Officer
Date: March 24, 2009	/s/ Ronald Giampaolo
	Ronald Giampaolo Vice President, Controller and Principal Accounting Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant in the capacities indicated below.

/s/ Raffaele M. Branca	March 24, 2009
Raffaele M. Branca, President and Chief Executive Officer and Director	Date
/s/ Joseph J. LiBassi	March 24, 2009
Joseph J, LiBassi, Chairman of the Board	Date
/s/ Joan Nerlino Caddell	March 24, 2009
Joan Nerlino Caddell, Director	Date
/s/ Robert S. Cutrona, Sr.	March 24, 2009
Robert S. Cutrona, Sr., Director	Date
/s/ Chaim Farkas	March 24, 2009
Chaim Farkas, Director	Date
/s/ Alfred C. Johnsen	March 24, 2009
Alfred C. Johnsen, Director	Date
/s/ Carlos Perez	March 24, 2009
Carlos Perez, Director	Date
/s/ Bruno Savo	March 24, 2009
Bruno Savo, Director	Date