VSB BANCORP INC
Form 10-K
March 15, 2011

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, 2010

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 o.

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, 2010 was $15,186,204.

Number of shares of the registrant's common stock outstanding as of March 10, 2011: 1,825,009 shares.

Documents incorporated by reference:

Portions of the registrant's definitive proxy statement filed on or about March 28, 2011 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 identify "forward-looking statements." A 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 the public's perception of financial institutions in general and banks in particular;
- 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. We 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 10.8% through July 1, 2009. 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 2009, when the 45 to 64 year age group increased to 27.1% of the total population. The largest age group continued to be the 20 to 44 age group, at 34.6% of total population in 2009, 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 27 counties had an estimated net migration into the county during the period from the end of the 2000 census through July 1, 2009, 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 stabilized in the past year and may increase in the future as financial service firms and public sector employers 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 estimated 180,104 housing units at June 30, 2009, an increase of 9.9% 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 few years creates problems faced by Staten Island, its residents and its businesses. According to Zillow.com, a real estate information service, the estimated median home value has increased 3.1% in the past year. Although there was an increase in the past year, the overall home values are still substantially lower than in 2007. 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 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, was, and may still be, in a recession. 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. Some of our customers have been adversely affected by the economic downturn, and if the recession continues, or the recovery is slow, 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, which totaled 7.2% of total loans at December 31, 2010. 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, during periods of changing market interest rates, the interest rates we pay on deposits adjust more slowly than the interest rates we earn on loans because our loan portfolio consists primarily 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. Thus, the rates on those accounts, as well as the rates we pay on certificates of deposit, tend to adjust more slowly. As a result, the declines in market interest rates that occurred through the end of 2008 initially had an adverse effect on our net income because the yields we earn on our loans declined more rapidly than our cost of funds. However, many of our prime-based loans had minimum interest rates, or floors, below which the interest rate does not decline despite further decreases in the prime rate. As our loans reached their interest rate floors, our loan yields stabilized while our deposit costs continued to decline. This had a positive effect on our net interest income. When market interest rates begin increasing, which we expect will occur at some point in the future, we anticipate an initial adverse effect on our net income. We anticipate that this will occur because our deposit rates should begin to rise while loan yields remain relatively steady until the prime rate increases sufficiently that our loans begin to reprice above their interest rate floors. Once our loan rates exceed the interest rate floors, increases in market interest rates should increase our net interest income because our cost of deposits should 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.

The limited trading market for our common stock may make it difficult for stockholders to sell their stock for full value. Our common stock is listed on the NASDAQ Global Market, which listing was effective on August 4, 2008. We continue to trade under the symbol "VSBN." We listed 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 February 28, 2011, there were trades reported on only 77 out of 253 trading days, or less than one out of every three trading days. Our average daily trading volume during that period was 591 shares for all trading days and 1,942 shares per day for the 77 days on which trades occurred. During the twelve months ended February 28, 2011, 11.4% of all reported trading volume represented stock repurchases by us pursuant to our announced stock repurchase programs. We currently have approximately 149 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 or our reputation. In the past three years, 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 regular insurance premium was $345,226 in 2010 compared to $268,015 in 2009 (excluding the $101,950 special assessment described below), an increase of 28.8%. The FDIC also imposed a special assessment in 2009 on all FDIC-insured banks equal to 5 basis points on total assets minus Tier 1 capital. Our special assessment in 2009 amounted to $101,950. As required by The Dodd –Frank Wall Street Reform and Consumer Protection Law (the "Dodd-Frank" Act), the FDIC has recently revised its deposit insurance premium assessment rates. Our Bank, even though we are in the lowest regulatory risk category, will be subject to an assessment rate between five (5) and nine (9) basis points per annum. In general, the rates are applied to our bank's total assets less tangible capital, in contrast to the former rule which applied the assessment rate to our level of deposits.

Despite the deposit insurance premium change and the special assessment, the fund created to pay the cost of resolving failed banks currently has a negative balance. The Dodd-Frank Act requires that the FDIC must increase the ratio of the FDIC insurance fund to estimated total insured deposits to 1.35% by September 30, 2020. The FDIC believes that most banks will pay a lower total assessment under the new system than under the former system, and it appears likely that will apply to Victory State Bank. However, if bank failures in the future exceed FDIC estimates, or other estimates that the FDIC makes turn out to be incorrect, and the losses to the insurance fund increase, the FDIC could be forced to increase insurance premiums. Such an increase would increase our non-interest expense.

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 have a substantial, regular and every-day effect on our business. 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. 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.

The substantial decline in the national housing market and the advent of the increase in bank failures over the past few years has spawned many statutes and regulations affecting Banks, including the 2,000+ pages of the Dodd-Frank Act and the hundreds of regulations adopted or to be adopted to implement its provisions. There are constantly new proposals to further change the laws that affect our business. Notably, the Dodd-Frank Act creates a Consumer Financial Protection Bureau that will have broad authority to restrict our flexibility in dealing with consumer transactions and our ability to charge fees for bank services. The final implementation of the Dodd-Frank Act through regulatory enactments and the actions of the Consumer Financial Protection Bureau could have a significant negative effect on our income and our expenses in a manner and a level that we cannot predict.

There have recently been changes at both the state and the federal level in the laws and regulations applicable to 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.

Delays in foreclosure proceedings may adversely affect our ability to realize upon the value of collateral. The length of time it takes to prosecute a foreclosure action and be able to sell real estate collateral in New York has substantially lengthened. It is not unusual for it to take more than a full year from the date a foreclosure action is commenced until the property is sold even in uncontested cases, and some uncontested cases can take as long as two years. This problem, if it continues or gets worse, could have a substantial adverse effect on the value of the Bank’s collateral for loans in default. Especially in the case of construction loans, where property value deterioration during a lengthy foreclosure is more likely, the inability to realize upon collateral increases the loss to the Bank in the event of a default.

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. Furthermore, in 2010, federal law was changed to allow any bank, regardless of where it is headquartered, to open a branch throughout most of the United States, and now Staten Island is open to unrestricted branching. This could increase competition.

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. Unsecured commercial loans include loans with personal guaranties or personal obligations in all cases, and, in some cases, may also include loans with illiquid personal property collateral. At December 31, 2010, we had total unsecured commercial loans outstanding of $12,924,378, or 15.8% of total loans, and commercial real estate loans of $58,204,596, or 71.1% of total loans. There were $5,874,500 of construction loans secured by real estate, $5,387,500 of which were construction loans to businesses for the construction of either commercial property or residential property for sale, representing 6.6% of total loans. Other loans in our portfolio principally included commercial loans secured by assets other than real estate totaling $1,393,532 or 1.7% of total loans at December 31, 2010; residential mortgage loans of $2,460,114, or 3.0% of total loans and consumer non-mortgage loans of $533,860 or 0.7% 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, 2010, approximately $61,645,509, or 75.4%, 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. None of these loans are loans to or in foreign countries.

	At December 31, 2010		2009		2008		2007		2006	
	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total	Amount	% of Total
Commercial loans:										
Commercial secured	$1,393,532	1.7 %	$1,138,308	1.4 %	$1,177,796	1.8 %	$1,171,152	1.9 %	$1,231,880	1.8 %
Commercial unsecured	12,924,378	15.8	10,966,874	13.9	9,558,296	14.4	10,981,044	17.5	10,882,002	16.3
Total commercial loans	14,317,910	17.5	12,105,182	15.3	10,736,092	16.2	12,152,196	19.4	12,113,882	18.1
Real Estate loans:										
Commercial	58,204,596	71.1	48,767,729	61.7	39,918,879	60.1	31,607,039	50.6	33,215,627	49.9
Residential	2,460,114	3.0	2,914,956	3.7	2,548,159	3.8	2,314,716	3.7	165,801	0.2
Total real estate loans	60,664,710	74.1	51,682,685	65.4	42,467,038	63.9	33,921,755	54.3	33,381,428	50.1
Construction loans:										
Commercial	5,387,500	6.6	10,964,000	13.9	10,996,432	16.5	13,585,698	21.7	17,552,797	26.4

Owner occupied one-to-four family	487,000	0.6	2,294,000	2.9	900,000	1.4	1,523,895	2.4	1,825,000	2.7
Total construction loans	5,874,500	7.2	13,258,000	16.8	11,896,432	17.9	15,109,593	24.1	19,377,797	29.1
Other loans:										
Consumer loans	533,860	0.7	532,498	0.7	599,293	0.9	566,356	0.9	826,528	1.2
Other loans	386,750	0.5	1,455,224	1.8	757,481	1.1	827,122	1.3	974,278	1.5
Total other loans	920,610	1.2	1,987,722	2.5	1,356,774	2.0	1,393,478	2.2	1,800,806	2.7
Total loans	81,777,730	100.0 %	79,033,589	100.0 %	66,456,336	100.0 %	62,577,022	100.0%	66,673,913	100.0%
Less:										
Unearned discounts, net and deferred loan fees, net	239,506		199,433		209,684		203,944		263,236	
Allowance for loan losses	1,277,220		1,063,454		987,876		927,161		1,128,824	
Loans, net	$80,261,004		$77,770,702		$65,258,776		$61,445,917		$65,281,853	

The following table sets forth our loan originations and principal repayments for the periods indicated. We did not purchase or sell any loans in 2010, 2009 or 2008.

	Year Ended December 31, 2010	Year Ended December 31, 2009	Year Ended December 31, 2008
Commercial Loans (gross):			
At beginning of period	$ 12,105,182	$ 10,736,092	$ 12,152,196
Commercial loans originated:			
Secured	1,484,940	1,178,006	1,841,943
Unsecured	34,313,999	30,778,779	30,451,244
Total commercial loans	35,798,939	31,956,785	32,293,187
Principal repayments	(33,586,211)	(30,587,695)	(33,709,291)
At end of period	$ 14,317,910	$ 12,105,182	$ 10,736,092
Real Estate loans:			
At beginning of period	$ 51,682,685	$ 42,467,038	$ 33,921,755
Real estate loans originated:			
Commercial	21,034,000	16,934,000	12,217,500
Residential	—	535,000	4,180,000
Total real estate loans	21,034,000	17,469,000	16,397,500
Principal repayments	(12,051,975)	(8,253,353)	(7,852,217)
At end of period	$ 60,664,710	$ 51,682,685	$ 42,467,038
Construction loans			
At beginning of period	$ 13,258,000	$ 11,896,432	$ 15,109,593
Construction loans originated	4,460,000	5,938,000	8,422,000
Principal repayments	(11,843,500)	(4,576,432)	(11,635,161)
At end of period	$ 5,874,500	$ 13,258,000	$ 11,896,432
Other loans (gross):			
At beginning of period	$ 1,987,722	$ 1,356,774	$ 1,393,478
Other loans originated	479,555	798,536	769,067
Principal repayments	(1,546,667)	(167,588)	(805,771)
At end of period	$ 920,610	$ 1,987,722	$ 1,356,774

Loan Maturity. The following table shows the contractual maturity of our loans at December 31, 2010. 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 and minimum interest rate floors.

	At December 31, 2010					
	Commercial Unsecured	Commercial Secured	Construction	Real Estate	Other Loans	Total
Amounts due:						
Within one year	$ 8,452,240	$ 1,042,114	$ 3,454,500	$ 10,672,348	$ 433,298	$ 24,054,500
After one year:						
One to five years	4,332,005	351,418	2,420,000	8,429,312	487,312	16,020,047
After five years	140,133	—	—	41,563,050	—	41,703,183
Total amount due	12,924,378	1,393,532	5,874,500	60,664,710	920,610	81,777,730

Less:												
Unearned fees		—		342		40,585		198,579		—		239,506
Allowance for loan losses		520,953		13,486		52,138		660,536		30,107		1,277,220
Loans, net	$	12,403,425	$	1,379,704	$	5,781,777	$	59,805,595	$	890,503	$	80,261,004

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The following table sets forth at December 31, 2010, the dollar amount of all loans, due after December 31, 2011, and whether such loans have fixed or variable interest rates.

	Due After December 31, 2011		
	Fixed	Variable	Total
Commercial Business Loans:			
Unsecured	$104,080	$4,368,058	$4,472,138
Secured	152,520	198,898	351,418
Real Estate			
Commercial	6,897,071	51,307,525	58,204,596
Residential	2,460,114	—	2,460,114
Construction	—	2,420,000	2,420,000
Other loans	487,312	—	487,312
Total loans	$10,101,097	$58,294,481	$68,395,578

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 businesses 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, 2010, commercial business loans totaled $14,317,910 or 17.5% 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. A majority 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.

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 buildings 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, but we have recently increased our guidelines to include 20 year fully amortizing loans. 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, 2010, our commercial real estate loans totaled $60,664,710, or 74.1% 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 and commercial use 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. 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, 2010, our construction loans totaled $5,874,500 or 7.2% of total loans. This represents a reduction of our construction loan portfolio over the past three years as economic conditions in the construction industry caused 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. In addition, in the event of a default, buildings under construction may deteriorate rapidly and it may be more difficult to realize upon the value of the building compared to an existing building that is ready for occupancy or already rented to third party tenants.

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 the 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, 2010, we had twenty three (23) loans, in the aggregate amount of $4,739,884, designated as special mention. We had twenty one (21) loans, in the aggregate amount of $7,937,828, classified as substandard, nineteen of which, in the aggregate amount of $7,900,122, are secured by real estate. At December 31, 2009, special mention loans totaled $11,191,987 and substandard loans totaled $4,098,640. The Bank actively monitors all special mention loans to seek to avoid deterioration in the quality of the loan. The Bank is actively collecting the substandard loans and expects to collect substantially all the amounts due. We had no loans classified as doubtful or loss at December 31, 2010.

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 at the dates indicated:

	At December 31, 2010						
	60-89 Days				90 Days or more		
	Number		Principal		Number		Principal
Commercial real estate	2	$	277,960		12	$	4,064,281
Commercial unsecured	2		42,708		2		37,706
Real Estate - Residential	—		—		3		2,276,306
Total	4	$	320,668		17	$	6,378,293
Delinquent loans to total loans			0.39	%			7.80 %

	At December 31, 2009			
	60-89 Days		90 Days or more	
	Number	Principal	Number	Principal
Commercial real estate	9	$3,848,990	7	$1,176,114

Commercial construction	—	—		2	480,000	
Commercial unsecured	4	61,907		1	41,037	
Real Estate - Residential	3	2,299,322		—	—	
Total	16	$6,210,219		10	$1,697,151	
Delinquent loans to total loans		7.86	%		2.15	%

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	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 %

Loans 90 days or more past due represent non-accrual loans and loans that are contractually past due maturity but are still accruing interest. Loans past due 90 or more and still on accrual were $0 for 2010, 2009 and 2008, $2,025,000 for 2007 and $585,000 for 2006.

Non-performing Assets. The following table sets forth information about our non-performing assets at December 31, 2010, 2009 and 2008.

	At December 31, 2010	At December 31, 2009	At December 31, 2008
Non-performing assets:			
Commercial loans:			
Unsecured	$ 37,706	$ 41,037	$ 345,221
Commercial real estate	4,064,281	1,176,114	1,453,846
Residential real estate	2,276,306	—	—
Construction	—	480,000	480,000
Total non-performing assets	$ 6,378,293	$ 1,697,151	$ 2,279,067

Non-performing loans to total loans	7.80	%	2.15	%	3.43	%
Non-performing loans to total assets	2.71	%	0.72	%	1.07	%
Non-performing assets to total assets	2.71	%	0.72	%	1.07	%

The gross interest income that would have been recorded in 2010 if the non-accrual loans had been current in accordance with their original terms was $469,484. The amount of interest income on those loans that was included in net income for 2010 was $344,630.

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, 2010			
	Substandard		Doubtful	
	Number	Amount	Number	Amount
Classification of assets:				
Commercial Loans:				
Unsecured	2	$37,706	—	$—
Commercial Real Estate	16	5,623,816	—	—
Residential Real Estate	3	2,276,306	—	—
Total loans	21	$7,937,828	—	—

No assets were classified as Loss at year end 2010 or 2009.

Non-Performing Loans

Management closely monitors non-performing loans and other assets with potential problems on a regular basis. We had seventeen non-performing loans, totaling $6,378,293 at December 31, 2010, compared to ten non-performing loans, totaling $1,697,151, at December 31, 2009. We believe that the increase was the result of the effect of adverse economic conditions on some of our borrowers. The following is information about the seven largest non-performing loans, totaling $5,517,790, or 86.5% of our non-performing loans, in outstanding principal balance at December 31, 2010. Management believes it has taken appropriate steps with a view towards maximizing recovery and minimizing loss, if any, on these loans.

$2,403,245 in two loans to a retail business, which are fully secured by commercial real estate collateral. We have entered into a modified repayment arrangement with the borrower and we have obtained confessions of judgment. We have collected a large portion of their arrears and the borrower has agreed to pay all remaining arrears over the upcoming year. The borrower is current in payments under the modified payment terms. We maintain the personal guaranties of the principals on these loans.

$2,200,000 in two residential mortgage loans that are fully secured. We have entered into modified repayment arrangements with the borrowers and we have obtained confessions of judgment. We have collected a large portion of their arrears and the borrowers have agreed to pay all remaining arrears over the upcoming year. The borrowers are current in payments under the modified payments terms.

$371,818 in a loan to a local business in which we are a participant in the loan with another bank. We are not the lead lender. The loan is in arrears and the lead lender has commenced a foreclosure action. The loan is secured by a first mortgage on a commercial building, a security interest in the business, and the personal guaranties of the principals.

$270,787 in a net loan to a local business, which is secured by a first mortgage on commercial real estate collateral. We have entered into modified repayment arrangements with the borrowers and we have obtained confessions of judgment. We maintain a security interest in the business as well as the personal guaranty of the principal. The borrower is current under the modified payments terms.

$271,940 in a net loan to a local business, which is secured by a first mortgage on two parcels of commercial real estate. The loan has been sent to our attorneys for collection. We also have a security interest in the business as well as the personal guaranty of the principal.

From time to time, as in the case of the first two loan relationships described above, the Bank will enter into agreements with borrowers to modify the terms of their loans when we believe that a modification will maximize our recovery. In most cases, we do not agree to reduce the rate of interest or forgive the repayment of principal when we agree to loan modification, and we did not do so in any of the modifications described above. Instead, we seek to modify terms on an interim basis to allow the borrower to reduce payments for a short duration and thus give the borrower an opportunity to get back on its feet.

If loans with modifications are on non-accrual status when they are modified, we do not immediately restore them to accruing status. For those loans, as well as other loans on non-accrual status when the borrower makes payments, we initially record payments received either as a reduction of principal or as interest received on a cash basis. The choice between those alternatives depends upon the magnitude of the concessions, if any, we have given to the borrower, the nature of the collateral and the related loan to value ratio, and other factors affecting the likelihood that we will continue to receive regular payments. After a period of consistent on-time performance, the loan may be restored to accruing status. The length of on-time performance required to restore a loan to accruing status varies from a minimum of six months on loans with minor modifications or less-severe weaknesses to as long as a year or more on loans for which we have granted more significant concessions to the borrower or which otherwise have more significant weaknesses.

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. The fixed percentages are based upon historical loss experience in each category, the state of the economy, special risks in that particular category, and other factors that management deems relevant. 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.

One important data point in evaluating the appropriateness of the allowance as it relates to problem real estate loans is the value of the real estate collateral. A loan is considered a problem loan when we believe it is probable that we will be unable to collect all amounts due according to the contractual terms of the loan agreement. Those loans generally include loans past due at least 90 days and loans otherwise classified as Substandard or Doubtful as described above. For problem real estate loans over $100,000, we obtain a new appraisal of the real estate at least annually. For smaller loans, we take the original appraisal and adjust the valuation based upon changing conditions, if any. We then adjust the value for costs of sale and carrying costs to measure the weakness in the loan as part of our overall evaluation of the appropriateness of our allowance for loan losses.

In order to assist in determining the appropriate 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, 2010, our allowance for loan losses was $1,277,220 or 1.56% 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.

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

	For the Year Ended December 31,				
	2010	2009	2008	2007	2006
Allowance for Loan Losses:					
Balance at beginning of period	$ 1,063,454	$ 987,876	$ 927,161	$ 1,128,824	$ 1,153,298
Charge-offs:					
Real estate loans:					
Commercial	—	(110,241)	—	—	—
Commercial loans:					
Unsecured	(15,765)	(412,112)	(483,326)	(254,986)	(62,181)
Consumer loan	(4,863)	(18,606)	(7,959)	—	(17,511)
Other loans	(2,084)	(15,679)	(3,503)	(8,639)	(28,111)
Total charge-offs	(22,712)	(556,638)	(494,788)	(263,625)	(107,803)
Recoveries	96,478	72,216	270,503	66,962	148,329
Net (charge-offs) / recoveries	73,766	(484,422)	(224,285)	(196,663)	40,526
Provision charged to income	140,000	560,000	285,000	(5,000)	(65,000)
Balance at end of period	$ 1,277,220	$ 1,063,454	$ 987,876	$ 927,161	$ 1,128,824
Ratio of net charge-offs / (recoveries) during the period to average loans outstanding during the period	-0.09 %	0.68 %	0.35 %	0.32 %	-0.06 %
Ratio of allowance for loan losses to total loans at the end of period	1.56 %	1.35 %	1.49 %	1.48 %	1.69 %
Ratio of allowance for loan losses to non-performing loans at the end of the period	20.02 %	62.66 %	43.35 %	96.56 %	538.61 %
Ratio of allowance for loan losses to non-performing assets at the end of the period	20.02 %	62.66 %	43.35 %	96.56 %	538.61 %

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

	At December 31, 2010			At December 31, 2009			At December 31, 2008			At December 31, 2007			At Dece 20
	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
Allowance:													
Commercial loans:													
Unsecured	$520,953	15.8	%	$460,474	13.9	%	$372,803	14.4	%	$330,355	17.5	%	$337,054
Secured	13,486	1.7		8,124	1.4		7,451	1.8		19,877	1.9		10,859
Commercial real estate	653,362	71.1		418,215	61.7		449,525	60.1		345,407	50.6		518,620
Residential real estate	7,174	3.0		40,302	3.7		25,686	3.8		15,887	3.7		12,501
Construction loans	52,138	7.2		71,968	16.8		100,737	17.9		166,437	24.1		198,901
Other loans	30,107	1.2		64,371	2.5		31,674	2.0		49,198	2.2		50,889
Total allowances	$1,277,220	100.0	%	$1,063,454	100.0	%	$987,876	100.0	%	$927,161	100.0	%	$1,128,824

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 MBSs 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, 2010, we had investment securities with a cost basis of $118,655,349 and a fair value of $121,307,907. All investment securities at December 31, 2010, were either CMOs or MBSs. The entire investment portfolio at December 31, 2010 was classified as available for sale and is accounted on a fair value basis with changes in fair value included as other comprehensive income.

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. The excess of fair value over amortized cost at year end 2010 is the result of the effect of recent low market interest rates on the value of previously-purchased investment securities. If market interest rates were to increase, we anticipate that this excess would decrease and, under certain circumstances depending upon the timing of securities purchases and the rate of increase in interest rates, amortized cost may exceed fair value.

	At December 31,					
	2010		2009		2008	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Investments securities, available for sale						
FNMA	$ 3,428,696	$ 3,571,217	$ 4,855,213	$ 5,040,820	$ 6,646,320	$ 6,690,593
FHLMC	—	—	—	—	37,411	37,643
GNMA	4,092,912	4,081,112	1,265,428	1,321,240	1,576,764	1,632,790
Whole Loan MBS	1,212,246	1,235,501	1,860,603	1,856,893	2,620,965	2,559,037
	109,921,495	112,420,077	102,933,529	105,693,451	108,331,330	109,368,525

Collateralized mortgage obligations						
	$ 118,655,349	$ 121,307,907	$ 110,914,773	$ 113,912,404	$ 119,212,790	$ 120,288,588

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The table below sets forth certain information regarding the amortized cost, weighted average yields and stated maturities of our investment securities at December 31, 2010 and 2009.

	At December 31, 2010								
	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:									
FNMA	$ 576,009	4.22 %	$ 477,176	5.17 %	$ 1,302,618	4.71 %	$ 1,072,893	2.69 %	$ 3,428,696
FHLMC	—	—	—	—	—	—	—	—	—
GNMA	—	—	—	—	1,023,986	4.47	3,068,926	1.46	4,092,912
Whole Loan MBS	—	—	—	—	1,212,246	4.84	—	—	1,212,246
Collateralized Mortgage Obligations	—	—	953,858	5.69	24,826,571	4.61	84,141,066	3.28	109,921,495
Total	$ 576,009	4.22 %	$ 1,431,034	5.52 %	$ 28,365,421	4.62 %	$ 88,282,885	3.21 %	$ 118,655,349

	At December 31, 2009								
	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:									
FNMA	$ —	—%	$ 1,390,603	4.49 %	$ 1,682,752	4.42 %	$ 1,781,857	3.95 %	$ 4,855,212
FHLMC	—	—	—	—	—	—	—	—	—
GNMA	—	—	—	—	1,265,428	4.38	—	—	1,265,428
Whole Loan MBS	—	—	—	—	1,860,603	4.64	—	—	1,860,603
Collateralized Mortgage Obligations	—	—	1,941,530	4.82	37,530,714	4.43	63,461,286	4.32	102,933,530
Total	—	—%	$ 3,332,133	4.68 %	$ 42,339,497	4.44 %	$ 65,243,143	4.31 %	$ 110,914,773

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 a quarterly or 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, 2010, these types of low cost deposit accounts amounted to $116,484,532, or 55.2% of total deposits.

The following table presents deposit activity for the periods indicated.

	Year Ended December 31, 2010	Year Ended December 31, 2009	Year Ended December 31, 2008
Beginning balance	$ 210,986,086	$ 188,109,449	$ 176,334,443
Net increase/(decrease) before interest credited	(4,600,492)	21,511,428	9,646,073
Interest credited on deposits	1,021,063	1,365,209	2,128,933
Ending balance	$ 207,406,657	$ 210,986,086	$ 188,109,449

The following table provides information regarding the remaining term to maturity of our time deposits over $100,000 at December 31, 2010:

Maturity Period	Amount
Three months or less	$ 34,689,845
Over three through six months	14,833,103
Over six through 12 months	2,174,782
Over 12 months	910,059
Total	$ 52,607,789

The following table presents by various rate categories, the amount and the periods to maturity of the certificate accounts outstanding at December 31, 2010.

	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:						
0.00% to 0.99%	$ 38,209,021	$ 770,867	$ 148,918	$ —	$ 2,212,222	$ 41,341,028
1.00% to 1.99%	15,664,184	3,034,746	710,535	469,163	36,000	19,914,628
2.00% to 2.99%	137,683	—	108,608	—	1,361,132	1,607,423
3.00% to 3.99%	—	—	—	404,000	—	404,000
4.00% to 4.99%	208,825	21,902	147,156	—	—	377,883
	$ 54,219,713	$ 3,827,515	$ 1,115,217	$ 873,163	$ 3,609,354	$ 63,644,962

Borrowings

We do not routinely utilize borrowings as a source of funds. At December 31, 2010 and 2009, we had no outstanding borrowings.

Personnel

As of December 31, 2010, we had 45 full-time employees and 18 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, 2010, the ratio of Tier 1 capital to total assets was 10.13%, the ratio of Tier 1 capital to risk-weighted assets was 25.20%, and the ratio of qualifying total capital to risk-weighted assets was 26.45%.

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 Dodd-Frank Wall Street Reform and Consumer Protection Law

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Law was adopted. It has been described as the greatest legislative change in the supervision of financial institutions since the 1930s. Its effect on Victory State Bank and VSB Bancorp, Inc. cannot now be judged with certainty because the law requires over 200 regulatory rulemakings and over 50 agency studies. However, we believe that the following areas, among others, will be or may be significant to our future operations:

1. The law exempts smaller reporting companies filing with the Securities and Exchange Commission, such as our company, from the internal controls attestation rules of Section 404(b) of the Sarbanes-Oxley Act. Thus far, we have incurred expenses to prepare for compliance but we have not been governed by Section 404(b) due to temporary SEC extensions of the compliance deadline. The permanent exemption means that we will not be required to incur the expense of actual compliance as long as we continue to qualify as a smaller reporting company.

2. Securities brokers may not vote shares held in “street name” unless they receive instructions from their customers on the election of directors, executive compensation or any other significant matter, as determined by the SEC. This may increase our costs of holding annual stockholder meetings if it becomes necessary for us to retain the services of a proxy solicitor to increase shareholder participation in our meetings or to obtain approval of matters that the Board presents to stockholders.

3. At least every three years, we will be required to submit to our stockholders, for a non-binding vote, our executive compensation. This requirement may increase the cost of holding some stockholder meetings. The law also requires that the SEC implement other requirements for enhanced compensation disclosures. The SEC adopted a temporary exemption for smaller reporting companies, such as our company, until annual meetings occurring on or after January 21, 2013.

4. The law includes a number of changes to expand FDIC insurance coverage, as well as changes to the premiums banks must pay for insurance coverage, and the requirements applicable to the reserve ratio (the ratio of the deposit insurance fund to the amount of insured deposits). One important change is that, in the future, deposit insurance premiums we pay will be based upon total assets minus tangible capital, rather than based upon deposits. Since we do not use material borrowings to provide funds for asset growth, and we do not have material intangible assets that are excluded from capital such as goodwill, we anticipate that our share of the total deposit premiums to be collected may decrease as the result of this change. However, other factors, such as required replenishment of the current reserve fund, which has a negative reserve ratio and which must be increased to 1.35% of total insured deposits in the next ten years, as well as future failures of banks that may further deplete the fund, may result in an increase in our future deposit insurance premium. The FDIC must provide an offset for smaller banks negating the adverse effect of requiring a reserve ratio in excess of 1.15%, but reaching even the 1.15% ratio may require additional burdens on smaller banks. The FDIC approved final regulations implementing these changes on February 25, 2011, effective April 1, 2011. According to the FDIC, the substantial majority of banks will see reduced deposit insurance premiums as a result of the new rules. We believe that will be the case for us as long as all other relevant factors remain unchanged.

5. The law increases the amount of each customer’s deposits that are subject to FDIC insurance. The general limit has been permanently increased from $100,000 to $250,000. In addition, non-interest bearing transaction accounts will be fully insured, without limit, from December 31, 2010 to January 1, 2013.

6. The law repeals the prohibition on paying interest on demand deposit accounts, effective in July 2011. Interest-free demand deposits represent a substantial portion of our deposit base. Once the prohibition on

paying interest on such deposits becomes effective, competitive pressures may require that we offer interest checking accounts to businesses in order to retain deposits. That could have a direct adverse effect on our cost of funds. Although current market interest rates are very low, and such deposits are unlikely to carry high rates of interest, an increase in market interest rates could result in significant additional costs in order to maintain the level of such deposits.

7. The law makes interstate branching by banks much easier than in the past. We have no plans to branch outside New York State, but the law facilitates out of state banks branching into our market area, thus increasing competition.

8. The law creates a new federal agency – the Consumer Financial Protection Bureau– which will have substantial authority to regulate consumer financial transactions. Our loans are primarily made to businesses rather than individual consumers, so the bureau will not have a direct effect on many of our loan transactions. However, the bureau also has authority to regulate other non-loan consumer transactions, such as deposits and electronic banking transactions. The implementation of new consumer regulations may increase our operating costs in a manner we cannot predict until regulations are adopted.

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;

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(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 subordi–nated 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%. Furthermore, anecdotal evidence indicates that in recent regulatory examinations and in informal discussions with regulators the FDIC has been urging banks to maintain even higher levels of capital during the current period of economic difficulty.

At December 31, 2010, 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, 2010						
Tier 1 Capital (to Average Assets)	$ 24,062,000	9.96 %	$ 9,664,133	4.00 %	$ 12,080,167	5.00 %
Tier 1 Capital (to Risk Weighted Assets)	24,062,000	24.63 %	3,907,400	4.00 %	5,861,100	6.00 %
Total Capital (to Risk Weighted Assets)	25,284,000	25.88 %	7,814,800	8.00 %	9,768,500	10.00 %

There have been a number of recent proposals and suggestions by regulators, politicians and commentators that the capital ratio standards should be increased. Our current capital ratios are more than sufficient to satisfy any reasonably anticipated increase. However, an increase in the amount of capital that the Bank must maintain in order to support a given level of assets would reduce the amount of leverage that our capital could support. This might adversely affect our ability to increase our level of interest-earning assets.

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 invest–ments 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 to be (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 undercapital–ized” 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, 2010, 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 the past three years, 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 may further decline, and the FDIC would be required 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 regular insurance premium was $345,226 in 2010 compared to $268,015 in 2009 (excluding the $101,950 special assessment described below), an increase of 28.8%. The FDIC also imposed a special assessment in 2009 on all FDIC-insured banks equal to 5 basis points on total assets minus Tier 1 capital. Our special assessment in 2009 amounted to $101,950. As required by The Dodd –Frank Wall Street Reform and Consumer Protection Law (the “Dodd-Frank” Act), the FDIC has recently revised its deposit insurance premium assessment rates. Our Bank, even though we are in the lowest regulatory risk category, will be subject to an assessment rate between five (5) and nine (9) basis points per annum. In general, the rates are applied to our bank’s total assets less tangible capital, in contrast to the former rule which applied the assessment rate to our level of deposits.

Despite the deposit insurance premium change and the special assessment, the fund created to pay the cost of resolving failed banks currently has a negative balance. The Dodd-Frank Act requires that the FDIC must increase the ratio of the FDIC insurance fund to estimated total insured deposits to 1.35% by September 30, 2020. The FDIC believes that most banks will pay a lower total assessment under the new system than under the former system, and it appears likely that will apply to Victory State Bank. However, if bank failures in the future exceed FDIC estimates, or other estimates that the FDIC makes turn out to be incorrect, and the losses to the insurance fund increase, the FDIC could be forced to increase insurance premiums. Such an increase would increase our non-interest expense.

As a result of the Dodd-Frank Act, non-interest bearing demand deposits, together with certain attorney trust account deposits commonly known in New York as IOLA accounts, will have the benefit of unlimited federal deposit insurance until December 31, 2012. Since the Dodd-Frank Act also authorized banks to pay interest on commercial demand deposits beginning in June 2011, commercial depositors will have to choose between earning interest on their demand deposits or having the benefit of unlimited deposit insurance coverage. In addition, the increase in the general FDIC insurance limit from $100,000 to $250,000 was made permanent.

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

In late 2008, the United States Department of the Treasury implemented a Capital Purchase Program (“CPP”) under the Troubled Asset Relief Program (“TARP”) pursuant to which the Treasury purchased preferred stock from approved institutions, with certain limitations and restrictions. The TARP CPP was entirely voluntary. VSB Bancorp, Inc. and Victory State Bank had, at the time of announcement, and still have, strong capital (Tier 1 Capital ratio in excess of 9% and Total Risk Based Capital ratio in excess of 20%). 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’s TARP CPP, we elected not to participate in it. We have continued to make loans to creditworthy customers throughout 2010 as we increased the size of our loan portfolio, so our decision to refuse the federal government’s TARP CPP money did not have an adverse effect on our ability to make loans.

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, 2010.

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”).

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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,” “satisfac–tory,” “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 Dodd-Frank Act created a new federal Consumer Financial Protection Bureau (“Bureau”) with broad authority to regulate and enforce consumer protection laws. The Bureau will assume those responsibilities on July 21, 2011. The Bureau has the authority to participate in regulatory examinations and to adopt regulations under numerous existing federal consumer protection statutes. The Bureau may also decide that a particular consumer financial product or service, or the manner in which it is offered, is an unfair, deceptive, or abusive act or practice. If the Bureau so decides, it has the authority to outlaw such act or practice. Since the Bureau is just in its formative stages and has not yet exercised any of its authority to regulate, examine or enforce consumer laws, it is impossible to predict its effect on our company.

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 $385,829 in 2010, including $227,294 that was previously prepaid in 2009.

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 $48.1 million or less (subject to adjustment by the Federal Reserve Board) the reserve requirement is 3%; for accounts greater than $48.1 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 $48.1 million. The first $10.7 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. The Federal Reserve now permits the payment of interest on reserve deposits so such deposits are now classified as interest-earning assets. However, due to the extremely low target federal funds rate in 2010 as established by the Federal Reserve, the amount of interest we earned on reserve deposits was negligible. The effect of this reserve requirement is to reduce the amount of our interest-earning assets that are available to invest in higher yielding assets, such as loans. However, due to the high level of overnight investments that we elected to maintain during 2010, the reserve deposit requirement and the low rate available on those deposits in 2010 did not cause us to forgo material income.

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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 comprehen–sive 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.

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) 7.1% 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 conforms to the federal deduction.

Item 2. Properties.

At December 31, 2010, 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 (2)		Net Book Value of Leasehold Improvements at December 31, 2010
4142 Hylan Boulevard Staten Island, N.Y. 10308	Main Office	Leased	2005	3/25/2020	$	1,676,329
755 Forest Avenue Staten Island, N.Y. 10310	Branch	Leased	1999	11/30/2013	$	35,300
One Hyatt Street Staten Island, N.Y. 10301	Branch	Leased	1999	10/30/2014	$	11,140
1762 Hylan Boulevard Staten Island, N.Y. 10305	Branch	Leased	2001	6/30/2016	$	188,781
1766 Hylan Boulevard (1) Staten Island, N.Y. 10305	Retail Stores	Leased	2001	6/30/2016	$	38,746
1065 Bay Street Staten Island, N.Y. 10305	Branch	Leased	2006	04/26/2021	$	116,156
Total net book value					$	2,066,452

(1) 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.

(2) We maintain multiple lease extension options that we may elect, in our sole discretion, which will extend the maturity of these leases.

Item 3. Legal Proceedings.

The legal action pending in Supreme Court, Richmond County, commenced by IndyMac Bank, F.S.B. against the Bank, LaMattina & Associates, Inc. and others which was described in the report on Form 10-K for the company for the year ended December 31, 2009, has been settled for a negligible $35,000 payment by the Bank to Indymac, which payment was fully covered by our insurance. The settlement was approximately only 2% of the amount that Indymac demanded. The Bank settled the case to avoid the wasted time and effort necessary to prepare for a trial. The settlement agreement provides that it is not an admission that the Bank did anything wrong. The Bank believes that the negligible settlement amount is a vindication of the Bank's position that its actions with respect to the entire matter were entirely proper.

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".

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.

	2010 First Quarter	Second Quarter	Third Quarter	Fourth Quarter
High Bid	$ 12.12	$ 12.00	$ 12.75	$ 11.75
Low Bid	$ 9.01	$ 10.50	$ 9.76	$ 11.00

	2009 First Quarter	Second Quarter	Third Quarter	Fourth Quarter
High Bid	$ 8.90	$ 12.98	$ 12.50	$ 11.90
Low Bid	$ 7.65	$ 8.08	$ 10.21	$ 10.92

We have approximately 149 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 2010.

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) (2)	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
October 1, 2010 to October 31, 2010	9,015	$ 11.69	9,015	6,176
November 1, 2010 to November 30, 2010	None	None	None	6,176
December 1, 2010 to December 31, 2010	6,176	$ 11.50	6,176	None
Total	15,191	$ 11.61	15,191	None

(1) On April 21, 2009, we announced a second 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.

(2) As of December 31, 2010, the Company had repurchased a total of 200,000 shares of its common stock under these stock repurchase programs and is now completed.

The following table sets forth information regarding our equity compensation plan information, and includes options issued to directors and officers and remaining options or restricted stock issuable to officers and directors.

Equity Compensation Plan Information

Plan category	Number of securities to be issued upon exercise of outstanding options, warrants and rights (a)	Weighted-average exercise price of outstanding options, warrants and rights (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)	
Equity compensation plans approved by security holders	124,423	$ 14.28	37,177	(1)
Equity compensation plans not approved by security holders	None	N/A	None	
Total	124,423	$ 14.28	37,177	(1)

(1) Includes 14,500 shares of restricted stock available to be awarded under the Company's 2010 Retention and Recognition 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 the general strength of the local economy, 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 decrease in deposits in 2010 due to factors we discuss below. 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 2009. We paid $423,679 of dividends out of net income of $1,822,277, for a dividend payout ratio of 23% in 2009 and we paid $429,935 of dividends out of net income of $1,880,629, for a dividend payout ratio of 23% in 2010. 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 2010, we faced a number of challenges, including low market interest rates that pushed down our yields on assets. Our cost of funds, due to the downward pressure of deposit rates, declined but not as fast as our yield on assets. The real estate market continued to soften, which reduced deposit balances and loan originations from real estate attorneys who form a segment of our customer base. We incurred additional provisions for loan loss due to the increased level of delinquencies. Due to the weak economic and real estate market, other financial institutions failed, which caused our FDIC assessments to increase significantly during 2009 and 2010 to help capitalize the Deposit Insurance Fund.

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 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. Additionally, an increase in market rates may have a negative impact on our net interest income. 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 CMOs and MBSs with short and intermediate average lives to generate cash flows and by originating and retaining primarily loans with interest rates that adjust based on the prime rate. As of December 31, 2010, prime based loans totaled $61,645,509, or 75.4% 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. In a low interest rate environment, such as the one that we are experiencing, once the yields on assets reach their interest rate floors, the yields do not further decline even if the index used to determine the interest rate continues to decline. When market interest rates then increase, the assets that have floors will not reprice upwards until the index rises sufficiently to cause the interest rates to exceed their floors. This delay in the upward adjustment of the interest rate may negatively affect net interest income. Our prime rate based loans and our securities investments generally do not have any annual or lifetime maximum interest rates, or caps. Caps can adversely affect net interest income if market interest rates rise substantially.

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 five years or less and we invested the increase in funds resulting from our growth in deposits in overnight liquid investments to the extent not needed to fund an increase in loans. As a result of this strategy, and based upon the assumptions used in the following table at December 31, 2010, our total interest-bearing assets maturing within one year exceeded our total interest-bearing liabilities maturing in the same period by $8,211,414, representing a one year cumulative positive gap ratio of 3.74%. In many cases, a positive gap ratio means that in an increasing rate environment, the interest that we earn on assets will reprice upward faster than the rates we pay on deposits. However, for a number of important reasons, that may not be the results we will experience if market interest rates begin to rise.

- As explained above, an increase in the target federal funds rate, which normally presages an immediate increase in the prime rate, will not have an immediate positive effect on most of our adjustable rate loans because they have interest rate floors that must be surpassed before yields on those assets begin to increase. However, the increase in the prime rate is likely to put prompt upward pressure on the rates we pay to depositors, at least in the case of certificates of deposit.
- The gap table does not consider the effects of customer discretion. When market interest rates are very low, the difference between the rates paid on different deposit types is relatively small, and customers may elect to keep funds in very liquid deposits with the lowest interest rates because those deposits provide the greatest flexibility when market rates increase. Those customers may elect to switch a deposit to a higher cost category, such as from NOW accounts to a time deposit, if the increase in market rates makes the difference in rates between those two deposit types more meaningful. Our cost of a specific customer's deposit could go up faster than market rates are rising if the customer decides to do so.
- The gap table does not take into account discretion by the Bank in making deposit pricing decisions. Other external factors, such as changes in competition or the decision by a local competitor to aggressively seek local deposits by offering premium rates on deposits, may cause the Bank to increase deposit rates more rapidly to match competitors.

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, effective July 2011, banks will be permitted to pay interest on commercial demand deposits. This 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, 2010 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. The table reflects only whether a yield or cost is expected to adjust without measuring whether the magnitude of the adjustment is the same for different types of assets or liabilities. 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 7.0%, 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 may deviate significantly, in a manner we cannot predict, 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 interest rate increases.

	At December 31, 2010 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)	$ 66,433,529	$ 423,078	$ 1,102,799	$ 5,848,613	$ 73,808,019
Consumer loans (1)	390,357	569,739	516,539	114,782	1,591,417
Mortgage-backed securities	12,347,217	37,041,651	68,309,362	—	117,698,230
Other interest-earning assets	26,489,709	—	—	—	26,489,709
Total interest-earning assets	105,660,812	38,034,468	69,928,700	5,963,395	219,587,375
Less:					
Unearned (discount) and deferred fees (2)	40,531	121,593	555,490	—	717,614
Net interest-earning assets	105,701,343	38,156,061	70,484,190	5,963,395	220,304,989
Interest-bearing liabilities:					
Savings accounts	14,938,440	—	—	—	14,938,440
NOW accounts	35,138,867	—	—	—	35,138,867
Money market accounts	27,521,455	—	—	—	27,521,455
Certificate accounts	37,923,844	20,123,384	5,597,734	—	63,644,962
Total interest-bearing liabilities	115,522,606	20,123,384	5,597,734	—	141,243,724
Interest sensitivity gap	$ (9,821,263)	$ 18,032,677	$ 64,886,456	$ 5,963,395	$ 79,061,265
Cumulative gap	$ (9,821,263)	$ 8,211,414	$ 73,097,870	$ 79,061,265	$ 79,061,265
Cumulative gap as a percentage of total interest-earning assets	–4.47 %	3.74 %	33.29 %	36.00 %	36.00 %
Cumulative net interest-earning assets as a percentage of total interest-bearing liabilities	91.50 %	106.05 %	151.75 %	155.98 %	155.98 %

(1) For purposes of the gap analysis, mortgage and other loans are reduced by non-performing loans but are not reduced by 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, 2010, 2009 and 2008 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, 2010			Year Ended December 31, 2009			Year Ended December 31, 2008		
	Average Balance	Interest1	Yield/ Cost	Average Balance	Interest1	Yield/ Cost	Average Balance	Interest1	Y C
Assets:									
Interest-earning assets:									
Loans receivable	$78,995,376	$5,800,691	7.34 %	$71,655,679	$5,465,368	7.63 %	$64,186,215	$5,078,576	7.
Other interest earning assets	39,091,176	61,124	0.16	27,440,096	33,050	0.12	14,864,864	237,490	1.
Investment securities	114,319,832	4,401,547	3.85	118,475,481	5,149,770	4.35	119,976,379	5,699,228	4.
Total interest-earning assets	232,406,384	10,263,362	4.42	217,571,256	10,648,188	4.89	199,027,458	11,015,294	5.
Non-interest earning assets	8,380,147			8,472,431			11,105,146		
Total assets	$240,786,531			$226,043,687			$210,132,604		
Liabilities and equity:									
Interest-bearing liabilities:									
Savings accounts	$15,262,470	47,445	0.31	$13,733,980	50,145	0.37	$12,046,954	76,011	0.
Time accounts	65,196,898	572,292	0.88	66,249,743	925,793	1.40	69,562,982	1,615,142	2.
Money market accounts	27,820,065	240,461	0.86	25,387,152	246,866	0.97	21,092,188	310,714	1.
Now accounts	35,273,971	160,865	0.46	29,304,494	142,405	0.49	17,607,727	127,066	0.
Subordinated debt	—	—	—	—	—	—	3,098,634	214,685	6.
Total interest-bearing liabilities	143,553,404	1,021,063	0.71	134,675,369	1,365,209	1.01	123,408,485	2,343,618	1.
Checking accounts	68,686,944			64,757,449			63,123,757		
Escrow Deposits	437,880			484,013			421,768		

Total	212,678,228				199,916,831				186,954,010		
Other liabilities	2,169,130				1,740,429				1,308,257		
Total liabilities	214,847,358				201,657,260				188,262,267		
Equity	25,939,173				24,386,427				21,870,337		
Total liabilities and equity	$240,786,531				$226,043,687				$210,132,604		
Net interest income/net interest rate spread		$9,242,299	3.71	%		$9,282,979	3.88	%		$8,671,676	3.
Net interest earning assets/net interest margin	$88,852,980		3.98	%	$82,895,887		4.27	%	$75,618,973		4.
Ratio of interest-earning assets to to interest-bearing liabilities	1.62	x			1.62	x			1.61	x	
Return On Average Assets:			0.78	%			0.81	%			0.
Return On Average Equity:			7.25	%			7.47	%			8.
Equity To Assets:			11.07	%			10.33	%			10
Dividend Payout Ratio			22.86	%			23.25	%			22

1 - Interest on loans includes $25,261in 2010, $164,708 in 2009 and $218,882 in 2008 representing interest received during the year on non-accrual loans that is attributable to prior years. Those amounts were excluded in calculating the average loan yield for the year in which they were received but were not added to the prior period interest in calculating the yield in the prior period.

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, 2010 Compared to December 31, 2009 Increase/(Decrease) In Net Interest Income			Year Ended December 31, 2009 Compared to December 31, 2008 Increase/(Decrease) In Net Interest Income			Year Ended December 31, 2 Compared to December 31, 2007 Increase/(Decrease) In Net Interest Income		
	Due to			Due to			Due to		
	Volume	Rate	Net	Volume	Rate	Net	Volume	Rate	N
Interest-earning assets:									
Loans receivable	$560,019	$(224,696)	$335,323	$590,835	$(204,043)	$386,792	$301,408	$(1,202,965)	$(901
Other interest-earning assets	13,981	14,093	28,074	201,204	(405,644)	(204,440)	(278,390)	(478,454)	(756
Investment securities, afs	(180,771)	(567,452)	(748,223)	(71,293)	(478,165)	(549,458)	368,831	26,511	395
Total	393,229	(778,055)	(384,826)	720,746	(1,087,852)	(367,106)	391,850	(1,654,909)	(1,2
Interest-bearing liabilities:									
Savings accounts	5,655	(8,355)	(2,700)	10,628	(36,494)	(25,866)	856	(22,745)	(21,
Time accounts	(14,740)	(338,761)	(353,501)	(76,867)	(612,482)	(689,349)	122,378	(943,924)	(821
Money market accounts	23,599	(30,004)	(6,405)	63,136	(126,984)	(63,848)	(5,645)	(122,877)	(128
Now accounts	29,250	(10,790)	18,460	84,217	(68,878)	15,339	(11,225)	6,657	(4,5
Subordinated debt	—	—	—	(214,685)	—	(214,685)	(141,474)	—	(141
Total	43,765	(387,911)	(344,146)	(133,571)	(844,838)	(978,409)	(35,110)	(1,082,889)	(1,1
Net change in net interest income	$349,464	$(390,144)	$(40,680)	$854,317	$(243,014)	$611,303	$426,959	$(572,019)	$(145

Effect of Adverse Conditions in the Residential Mortgage Market

We do not expect that the continued 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, 2010, we owned $121.3 million of securities that are either collateralized by residential mortgage loans or that represent shares in pools of such loans. However, 98.6% 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 Rising Market Interest Rates that Many Commentators Are Predicting.

Market interest rates, especially short term market interest rates, declined substantially from September 2007 to December 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 500 basis points during that period. 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.

As market interest rates began their rapid decline, the decline in our loan yields and earnings on investments securities was initially slower than the decline in our cost of funds for a number of reasons. Interest rate floors on our loans with interest tied to the prime rate had the effect of moderating the decline in our yield on those loans, while our investment portfolio consisted primarily of debt securities with fixed rates, so our average yield on that portfolio was affected only gradually, as we reinvested the proceeds of principal payments on those securities.

However, most of our loans are now at their interest rate floors and a substantial portion of our investment securities portfolio that had been purchased at higher yields before interest rates began to decline has now been repaid and reinvested at lower yields. Both of these factors have the effect of slowing the increase in our asset yields as market rates rise above their current historic lows. Specifically, the yields on most of our loans with interest rate floors will not begin to increase until the prime rate exceeds 6%, which is 2.75% above the current prime rate. Furthermore, most of our securities investments will have constant yields despite increases in market rates until we receive principal payments on those securities and we reinvest them at higher yields then available to us.

The cost of deposits initially declined more rapidly than our asset yields as interest rates declined. If market interest rate trend upward, the rates we pay on interest-bearing deposits, because of their lower starting point, can increase more in step with the basis point increases in market rates because of the need to maintain customer relationships, competitive pressures, and other factors.

As a result, although our loans are technically considered to be interest rate sensitive because they are tied to the prime rate, their sensitivity to market interest rate increases may lag behind our deposits, depending upon how fast interest rates increase. This could have an adverse effect on net interest income as interest rates increase. In addition, customers may exercise discretion in moving funds between different types of deposits to maximize their interest earnings when interest rates rise and they perceive a greater advantage in managing the movement of funds between accounts with different interest rates.

One tool we use to manage market interest rate increases is to increase overnight investments, as these investments are highly correlated with the change in market interest rates. Additionally, approximately one-third of our deposits are interest-free checking accounts and the rates on those accounts (already at zero) do not rise as market rates increases.

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 than overnight investments. We reinvested the payments we received on existing investment securities in securities with rates that were lower than 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, 2010 and December 31, 2009

Our results of operations depend primarily on net interest income, which is the difference between the income we earn on our loan and investment portfolios and our cost of funds, consisting primarily of interest we pay on customer 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.

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General. We had net income of $1,880,629 for the year ended December 31, 2010, compared to net income of $1,822,277 for the comparable period in 2009. The principal categories which make up the 2010 net income are:

Interest income of $10,263,362
Reduced by interest expense of $1,021,063
Reduced by a provision for loan losses of $140,000
Increased by non-interest income of $2,485,923
Reduced by non-interest expense of $8,121,458
Reduced by income tax expense of $1,586,135

We discuss each of these categories individually and the reasons for the differences between the years ended December 31, 2010 and 2009 in the following paragraphs.

Interest Income. Interest income was $10,263,362 for the year ended December 31, 2010, compared to $10,648,188 for the year ended December 31, 2009, a decrease of $384,826, or 3.6%. There were two principal reasons for the decline. First, a $4.2 million decrease in average balance in investment securities between the periods, coupled with a decline in market interest rates, were the principal causes of a $748,233 decline in interest income on investment securities. Second, an increase in the average balance of other interest-earning assets shifted our asset mix for non-loan assets toward our lowest interest-earning asset category due to our decision to become more liquid to provide increased flexibility in the event of an interest rate increase. On the positive side, interest income on loans increased by $335,323 as the average balance of loans increased between the periods due to our efforts to increase our loan portfolio but this was partially offset by the decrease in the average yield between the periods.

The average balance of loans, our highest-yielding asset category, increased by $7,339,697 from the year ended December 31, 2009 to the year ended December 31, 2010 due to management's efforts to increase our loan portfolio. The positive effect of the increase in average balance was partially offset by a 29 basis point drop in our average loan yield due to the continued low market interest rate conditions and a lower level of recovery of non-accrual interest income, $164,708 for the year ended 2009, compared to $25,261 for the same period in 2010. The interest rate floors on our loans have helped to stabilize interest income from the loan portfolio, but these floors will have the effect of limiting increases in our income until the prime rate rises above 6%.

We experienced a 50 basis point decrease in the average yield on our investment securities portfolio, from 4.35% to 3.85%, due to the purchase of new investment securities at lower market rates than the yields on the principal paydowns we received. The average balance of our investment portfolio decreased by $4,155,649 or 3.51%, between the periods. The investment securities portfolio represented 74.5% of average non-loan interest earning assets in the 2010 period compared to 81.2% in the 2009 period as we deliberately limited our investment of available funds in investment securities due to the low yields available to us in the year ended December 31, 2010 and our desire to avoid locking in those low yields for long periods.

We had an increase in average balance of other interest earning assets of $11,651,080 from the year ended December 31, 2009 to the year ended December 31, 2010 and the average yield on other interest earning assets (principally overnight investments) increased 4 basis points from 0.12% for the year ended December 31, 2009 to 0.16% for the year ended December 31, 2010. This increase in average balance occurred because we chose to invest the excess proceeds from our deposit growth into overnight investments and Federal Reserve term deposits as a tool to increase our liquidity in a volatile market and to help establish a buffer for when market interest rates begin to rise.

Interest Expense. Interest expense was $1,021,063 for the year ended December 31, 2010, compared to $1,365,209 for the year ended December 31, 2009, a decrease of $344,146 or 25.2%. The decrease was primarily the result of a reduction in the rates we paid on deposits, principally reflecting a 52 basis point decrease in the cost of time deposits between the periods, due to continuing low market interest rates. As a result, our average cost of funds, excluding the effect of interest-free demand deposits, decreased to 0.71% from 1.01% between the periods.

Net Interest Income Before Provision for Loan Losses. Net interest income before the provision for loan losses was $9,242,299 for the year ended December 31, 2010, a decrease of $40,680, or 0.44%, over the $9,282,979 in the comparable 2009 period. The decrease was primarily due to the decline in the average yield on interest earning assets of 47 basis points, from the year ended December 31, 2009 to the year ended December 31, 2010, which was partially offset by the reduction in our cost of funds of 30 basis points from the same period. Our interest rate spread decreased 17 basis points to 3.71% for the year ended December 31, 2010 from 3.88% in the same period of 2009. The spread declined because our yields on our new investment securities were lower than the principal paydowns in 2010 and overnight investments were a larger percentage of the earning asset mix in 2010. This was partially offset by the increase in interest income from loans due to the increased average balance in 2010.

Our net interest margin decreased to 3.98% for the year ended December 31, 2010 from 4.27% in the same period of 2009. The interest rate margin decreased when we invested the proceeds from payments on investment securities at lower rates because of the decline in market interest rates and also because other interest earning assets (principally overnight investments) were a larger percentage of the asset mix. The margin is higher than the spread because it takes into account the effect of interest free demand deposits and capital. However, the average margin declined more rapidly than the spread because we shifted more marginal, excess funds not needed to fund loans into overnight investments rather than purchasing investment securities to position ourselves to better address an increase in market interest rates that many experts are predicting will occur in the foreseeable future.

Provision for Loan Losses. We took a provision for loan losses of $140,000 for the year ended December 31, 2010 compared to a provision for loan losses of $560,000 for the year ended December 31, 2009. The $420,000 decrease in the provision was due to our evaluation of our loan portfolio, higher recoveries of previously charged-off loans and substantially lower level of charge-offs in the 2010 period. Charge-offs totaled $22,712 for the year ended December 31, 2010 as compared to $556,638 in the same period in 2009, while we had recoveries of $96,478 for the year ended 2010 compared to recoveries of $72,216 for the year ended 2009. We are aggressively collecting charged-off loans in an effort to recover the amounts charged off whenever we believe that collection efforts are likely to be fruitful. Although we experienced an increase in non-performing loans from $1,697,151 at December 31, 2009 to $6,378,293 at December 31, 2010, most of those loans are secured by real estate. We individually evaluated the non-performing mortgage loans based primarily upon updated appraisals and we determined that the level of our allowance was appropriate to address inherent losses. Overall, our allowance for loan losses increased from $1,063,454, or 1.35% of total loans at December 31, 2009 to $1,277,220, or 1.56% of total loans, at December 31, 2010.

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 the risks inherent in our loan portfolio and the general economy. 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 1.56% of total loans at December 31, 2010 compared to 1.35% at December 31, 2009. 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 $2,485,923 for the year ended December 31, 2010, compared to $2,418,857 during the same period last year. The $67,066, or 2.7%, increase in non-interest income was a direct result of normal fluctuations in retail banking transactions and the fees derived from them, such as insufficient funds fees, in 2010.

Non-interest Expense. Non-interest expense was $8,121,458 for the year ended December 31, 2010, compared to $7,829,796 for the year ended December 31, 2009, an increase of $291,662 or 3.7%. The principal shifts in the individual categories were:

- a $293,350 increase in salaries and benefits as a result of new hires, higher related benefit costs, including the costs of the recently adopted stock plans, and increased salary and benefits due to normal raises;
- a $49,095 increase in legal expense primarily due to increased collection costs; and
- a $55,250 decrease in professional fees due to the exemption in complying with SOX 404(b).

In addition to these changes, we also experienced changes in the various other non-interest expenses categories due to normal fluctuations in operations.

Income Tax Expense. Income tax expense was $1,586,135 for the year ended December 31, 2010, compared to income tax expense of $1,489,763 for the same period ended 2009. The increase in income tax expense was due to the $96,372 increase in income before income taxes in the 2010 period. Our effective tax rate for the year ended December 31, 2010 was 45.8% and for the year ended December 31, 2009 was 45.0%.

Changes in Financial Condition

Total assets were $235,253,699 at December 31, 2010, a decrease of $1,746,173 or, 0.7%, from December 31, 2009. The slight decline in total assets was the results of a moderate deposit outflow which management believes may have been the result of the normal ebb and flow of customer deposits coupled with extreme weather in New York during the last week of the year which may have increased customers' need for funds while decreasing both business and personal deposits. The principal changes resulting in the net decrease in assets can be summarized as follows:

- a $7,395,503 net increase in investment securities available for sale;
- a $2,490,302 net increase in net loans receivable, partially offset by
- a $10,951,932 net decrease in cash and cash equivalents.

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

Our deposits (including escrow deposits) were $207,406,657 at December 31, 2010, a decrease of $3,579,429 or 1.70%, from December 31, 2009. The decrease in deposits resulted from decreases of $3,965,223 in non-interest demand deposits, $1,066,683 in money market accounts, $1,024,165 in time deposits, $96,799 in escrow deposits and $63,496 in savings accounts, partially offset by an increase of $2,636,937 in NOW accounts.

Total stockholders' equity was $26,044,856 at December 31, 2010, an increase of $1,560,907 or 6.38%, from December 31, 2009. The increase reflected: (i) a $1,450,694 increase in retained earnings due to net income of $1,880,629 for the year ended December 31, 2010 partially offset by $429,935 of dividends paid in 2010; (ii) a decrease in the net unrealized gain on securities available for sale of $187,202; (iii) a $292,211 increase due to the exercise by officers and directors of options to purchase 44,375 shares of common stock; and (iv) a reduction of $169,078 in Unearned ESOP shares reflecting the gradual payment of the loan we made to fund the ESOP's purchase of our stock. We implemented a stockholder-approved restricted stock award plan in 2010, which resulted in a $395,586 decrease in additional paid in capital and a corresponding reduction in Treasury shares, with no net change in stockholders' equity. Additionally, there was a $199,134 increase in Treasury shares representing the cost of 17,057 shares of common stock we repurchased in the second, third and fourth quarter of 2010 under our Company's previously announced stock repurchase plans.

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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.

Liquidity and Capital Resources

Our primary sources of funds are increases in deposits, proceeds from the repayment of investment securities, and the repayment of loans. We use these funds to purchase new investment securities and to fund new and renewing loans in our loan portfolio. Remaining funds are invested in short-term liquid assets such as overnight federal funds loans and bank deposits.

In 2010, we had a net decrease in total deposits of $3,579,429 due to decreases of $3,965,223 in non-interest demand deposits, $1,066,683 in money market accounts, $1,024,165 in time deposits, $96,799 in escrow deposits and $63,496 in savings accounts, partially offset by an increase of $2,636,937 in NOW accounts. These are all what are commonly known as “retail” deposits that we obtain through the efforts of our branch network rather than “wholesale” deposits that some banks obtain from deposit brokers. We also received proceeds from repayment of investment securities of $38,643,601. We used $46,528,587 of available funds to purchase new investment securities and we had a net loan increase of $2,520,342. These changes resulted in an overall decrease in cash and cash equivalents of $10,951,932. Total cash and equivalents at December 31, 2010 were $28,764,987.

In contrast, in 2009, we had a net increase in total deposits of $22,876,637 due to increases of $14,865,776 in NOW accounts, $11,781,326 in non-interest demand deposits, $5,294,526 in money market accounts and $2,589,375 in savings accounts, partially offset by a decrease of $11,654,366 in time deposits. We also received proceeds from repayment of investment securities of $37,675,927. We used $29,480,949 of available funds to purchase new investment securities and we had a net loan increase of $12,953,701. These changes resulted in an overall increase in cash and cash equivalents of $18,476,696. Total cash and equivalents at December 31, 2009 were $39,716,919.

At December 31, 2010, cash and cash equivalents represented 12.2% 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 noted above, the federal legal prohibition on paying interest on demand deposit accounts has been repealed effective July 2011. Depending upon competitive pressures, we may need to implement interest-paying business checking in order to maintain demand deposits at historical levels or to increase such deposits.

As a secondary source of liquidity, at December 31, 2010 we had $121 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. Additionally, we have the ability to borrow funds at the Federal Home Loan Bank of New York and the Federal Reserve Bank of New York using securities in our investment portfolio as collateral if the need arises. Based upon our assets size and the amount of our securities portfolio that qualifies as eligible collateral, we had more than $80.3 million of unused borrowing capability from the FHLBNY at December 31, 2010. Victory State Bank also has a $2 million unsecured credit facility with Atlantic Central Bankers Bank, which the Bank has not drawn upon. 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 apply for or 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.

Victory State Bank satisfied all capital ratio requirements of the Federal Deposit Insurance Corporation at December 31, 2010, with a Tier I Leverage Capital ratio of 9.96%, a Tier I Capital to Risk-Weighted Assets ratio of 24.63%, and a Total Capital to Risk-Weighted Assets ratio of 25.88%.

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, 2010

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	$ 413,067	$ 846,968	$ 750,021	$ 1,040,319	$ 3,050,375
Remaining contractual maturities of time deposits	58,047,229	2,475,934	3,121,800	—	63,644,963
Total contractual cash obligations	$ 58,460,296	$ 3,322,902	$ 3,871,821	$ 1,040,319	$ 66,695,338

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	$ 24,508,597	$ 3,151,054	$ —	$ —	$ 27,659,651

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, 2010 and 2009, 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, 2010 and 2009, 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 14, 2011

VSB BANCORP, INC.

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
DECEMBER 31, 2010 AND 2009

	2010	2009
ASSETS		
Cash and cash equivalents	$28,764,987	$39,716,919
Investment securities, available for sale	121,307,907	113,912,404
Loans receivable (net of allowance for loan losses of $1,277,220 and $1,063,454, respectively)	80,261,004	77,770,702
Accrued interest receivable	673,967	722,228
Premises and equipment, net	2,732,229	3,204,063
Prepaid and other assets	1,513,605	1,673,556
Total assets	$235,253,699	$236,999,872
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES:		
Deposits		
Non-interest bearing	$66,626,755	$70,688,777
Interest bearing	140,779,902	140,297,309
Total deposits	207,406,657	210,986,086
Accounts payable, accrued expenses and other liabilities	1,802,186	1,529,837
Total liabilities	209,208,843	212,515,923
Commitments and contigent liabilities (Note 12)	—	—
STOCKHOLDERS' EQUITY		
Common stock ($.0001 par value, 3,000,000 shares authorized, 1,989,509 issued, 1,825,009 outstanding at December 31, 2010; 1,945,134 issued, 1,762,191 outstanding at December 31, 2009)	199	195
Additional paid-in capital	9,249,600	9,317,719
Retained earnings	17,563,435	16,112,741
Treasury stock, at cost (164,500 shares at December 31, 2010 and 182,943 shares at December 31, 2009)	(1,643,797)	(1,840,249)
Unearned Employee Stock Ownership Plan shares	(563,594)	(732,672)
Accumulated other comprehensive gains, net of taxes of $1,213,545 and $1,371,416, respectively	1,439,013	1,626,215
Total stockholders' equity	26,044,856	24,483,949
Total liabilities and stockholders' equity	$235,253,699	$236,999,872

See notes to consolidated financial statements.

VSB BANCORP, INC.
CONSOLIDATED STATEMENTS OF EARNINGS FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

	2010	2009
INTEREST INCOME:		
Loans receivable	$5,800,691	$5,465,368
Investment securities	4,401,547	5,149,770
Other interest income	61,124	33,050
Total interest income	10,263,362	10,648,188
INTEREST EXPENSE:		
Deposits	1,021,063	1,365,209
Total interest expense	1,021,063	1,365,209
Net interest income	9,242,299	9,282,979
PROVISION FOR LOAN LOSSES	140,000	560,000
Net interest income after provision for loan losses	9,102,299	8,722,979
NON-INTEREST INCOME:		
Deposit service fees	2,190,397	2,137,676
Other income	295,526	281,181
Total non-interest income	2,485,923	2,418,857
NON-INTEREST EXPENSES:		
Salaries and employee benefits	3,968,499	3,675,149
Occupancy and equipment	1,445,538	1,482,300
Data processing service fees	264,423	279,152
Legal fees	274,267	225,172
Professional fees	252,850	308,100
Director fees	239,600	218,225
FDIC and NYSBD assessments	399,000	392,000
Supplies and service	351,699	351,015
Checkbook charges	126,814	147,048
Other	798,768	751,635
Total non-interest expenses	8,121,458	7,829,796
INCOME BEFORE INCOME TAXES	3,466,764	3,312,040
PROVISION/(BENEFIT) FOR INCOME TAXES:		
Current	1,670,259	1,373,021
Deferred	(84,124)	116,742
Total income taxes	1,586,135	1,489,763
NET INCOME	$1,880,629	$1,822,277
Earnings per share:		
Basic	$1.06	$1.02
Diluted	$1.06	$1.01
Comprehensive income	$1,693,427	$2,861,429

See notes to consolidated financial statements.

VSB BANCORP, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY AND COMPREHENSIVE INCOME FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

	Number of Common Shares	Common Stock	Additional Paid-in Capital	Retained Earnings	Treasury Stock, at cost	Unearned ESOP Shares	Other Comprehensive Gain	Total Stockholders' Equity
Balance at December 31, 2008	1,882,461	$ 192	$ 9,200,010	$ 14,714,143	$ (395,891)	$ (901,750)	$ 587,063	$ 23,203,767
Exercise of stock options, including tax benefit	21,250	3	118,624					118,627
Stock-based compensation			1,278					1,278
Amortization of earned portion of ESOP common stock						169,078		169,078
Amortization of cost over fair value - ESOP			(2,193)					(2,193)
Cash dividends declared ($0.24 per share)				(423,679)				(423,679)
Purchase of treasury stock, at cost	(141,520)				(1,444,358)			(1,444,358)
Comprehensive income:								
Net income				1,822,277				1,822,277
Other comprehensive income, net:								
Change in unrealized gain on securities available for sale, net of tax effects	—	—	—	—	—	—	1,039,152	1,039,152
Total comprehensive income								2,861,429
Balance at December 31,	1,762,191	$ 195	$ 9,317,719	$ 16,112,741	$ (1,840,249)	$ (732,672)	$ 1,626,215	$ 24,483,949

2009

Exercise of stock options, including tax benefit	44,375	4	292,207					292,211
Stock-based compensation			70,811					70,811
Amortization of earned portion of ESOP common stock						169,078		169,078
Amortization of cost over fair value - ESOP			(35,551)					(35,551)
Cash dividends declared ($0.24 per share)				(429,935)				(429,935)
Purchase of treasury stock, at cost	(17,057)				(199,134)			(199,134)
Contribution to RRP Trust from treasury shares	35,500		(395,586)		395,586			—
Comprehensive income:								
Net income				1,880,629				1,880,629
Other comprehensive income, net:								
Change in unrealized gain on securities available for sale, net of tax effects	—	—	—	—	—	—	(187,202)	(187,202)
Total comprehensive income								1,693,427
Balance at December 31, 2010	1,825,009	$ 199	$ 9,249,600	$ 17,563,435	$ (1,643,797)	$ (563,594)	$ 1,439,013	$ 26,044,856

See notes to consolidated financial statements.

VSB BANCORP, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2010 and 2009

	2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$1,880,629	$1,822,277
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	598,384	665,422
Amortization of premium/(accretion of income), net	34,449	(15,186)
ESOP compensation expense	102,065	94,370
Stock-based compensation expense	70,811	1,278
Provision for loan losses	140,000	560,000
Changes in operating assets and liabilities:		
Decrease/(increase) in prepaid and other assets	159,951	(748,549)
Decrease in accrued interest receivable	48,261	1,245
(Increase)/decrease in deferred income taxes	(84,124)	116,742
Increase/(decrease) in accrued expenses, income tax payable and other liabilities	545,807	(215,744)
Net cash provided by operating activities	3,496,233	2,281,855
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net change in loans receivable	(2,520,342)	(12,953,701)
Proceeds from repayments and calls of investment securities, available for sale	38,643,601	37,675,927
Purchase of investment securities, available for sale	(46,528,587)	(29,480,949)
Purchases of premises and equipment, net	(126,550)	(173,663)
Net used in investing activities	(10,531,878)	(4,932,386)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in deposits	(3,579,429)	22,876,637
Cash dividends paid	(429,935)	(423,679)
Exercise of stock options	292,211	118,627
Purchase of treasury stock, at cost	(199,134)	(1,444,358)
Net cash (used in)/provided by financing activities	(3,916,287)	21,127,227
NET (DECREASE)/INCREASE IN CASH AND CASH EQUIVALENTS	(10,951,932)	18,476,696
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	39,716,919	21,240,223
CASH AND CASH EQUIVALENTS, END OF YEAR	$28,764,987	$39,716,919
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	$1,051,191	$1,486,955
Income taxes	$1,630,317	$1,303,405

See notes to consolidated financial statements.

VSB BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2010 and 2009

1. 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 chartered commercial bank. 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. We trade under the 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. Interest-bearing deposits with original maturities of 90 days or less are included in this category. Customer loan and deposit transactions are reported on a net cash basis. Regulation D of the Board of Governors of the Federal Reserve System requires that Victory State Bank maintain 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 30, 2010 through January 12, 2011, Victory State Bank was required to maintain reserves, after deducting vault cash, of $4,548,000. 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. For debt securities with other than temporary impairment (OTTI) that management does not intend to sell or expect to be required to sell, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis.

The Company invests primarily in agency Collateralized Mortgage-Backed Obligations ("CMOs") with estimated average lives primarily under 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. Loans with modified terms that the Company would not normally consider, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired. 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.

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. As such, 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 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 - The Company has stock compensation awards with non-forfeitable dividend rights which are considered participating securities. As such, earnings per share is computed using the two-class method. Basic earnings per common share is computed by dividing net income allocated to common stock by the weighted average number of common shares outstanding during the period which excludes the participating securities. Diluted earnings per common share includes the dilutive effect of additional potential common shares from stock-based compensation plans, but excludes awards considered participating securities. Earnings and dividends per share are restated for all stock splits and stock dividends through the date of issuance of the financial statements.

Basic net income per share of common stock is based on 1,757,210 shares and 1,791,756 shares, the weighted average number of common shares outstanding for the years ended December 31, 2010 and 2009, respectively. Diluted net income per share of common stock is based on 1,757,377 and 1,809,538, the weighted average number of common shares outstanding plus potentially dilutive common shares for the years ended December 31, 2010 and 2009, 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 34,727 and 45,831 shares for the years ended December 31, 2010 and 2009, 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:

Reconciliation of EPS

	Year ended December 31, 2010	Year ended December 31, 2009
Basic		
Distributed earnings allocated to common stock	$ 421,730	$ 437,346
Undistributed earnings allocated to common sock	1,435,162	1,384,931
Net earnings allocated to common stock	$ 1,856,892	$ 1,822,277
Weighted common shares outstanding including participating securities	1,781,025	1,791,756
Less: Participating securities	(23,815)	—
Weighted average shares	1,757,210	1,791,756
Basic EPS	$ 1.06	$ 1.02
Diluted		
Net earnings allocated to common stock	$ 1,856,892	$ 1,822,277
Weighted average shares for basic	1,757,210	1,791,756
Dilutive effects of:		
Stock Options	167	17,782
Unvested shares not considered particpating securties	—	—
	1,757,377	1,809,538
Diluted EPS	$ 1.06	$ 1.01

Net earnings allocated to common stock for the period is distributed earnings during the period, such as dividends on common shares outstanding, plus a proportional amount of retained income for the period based on restricted shares granted but unvested compared to the total common shares outstanding.

Stock Based Compensation - The Company records 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.

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.

Stock Repurchase Programs - 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. On April 21, 2009, the Company announced that its Board of Directors had authorized a second Rule 10b5-1 stock repurchase program for the repurchase of up to an additional 100,000 shares of the Company's common stock. At December 31, 2010, the Company had repurchased a total of 200,000 shares of its common stock under these stock repurchase programs and is now completed. Stock repurchases under the program have been 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.

Retention and Recognition Plan - At the April 27, 2010 Annual Meeting, the stockholders of VSB Bancorp, Inc. approved the adoption of the 2010 Retention and Recognition Plan (the "RRP"). The RRP authorizes the award of up to 50,000 shares of its common stock to directors, officers and employees. In conjunction with the approval the RRP, stockholders approved the award of 4,000 shares of stock to each of its eight directors who had at least five years of service. The director awards will vest over five years, with 20% vesting annually for each of the first five years after the award is made, subject to acceleration and forfeiture. On June 8, 2010, an additional 3,500 shares of stock were awarded to the President and CEO of the Company, which will vest over a 65 month period, with 20% vesting annually for each of the first five years starting in November 2011, subject to acceleration and forfeiture. The recipient of an award will not be required to make any payment to receive the award or the stock covered by the award. As of December 31, 2010, 35,500 shares of the RRP have been awarded. The Company recognizes compensation expense for the shares awarded under the RRP gradually as the shares vest, based upon the market price of the shares on the date of the award.

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.

Recently-Adopted Accounting Standards - In June 2009, the FASB amended previous guidance relating to transfers of financial assets and eliminated the concept of a qualifying special purpose entity. This guidance must be applied as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period and for interim and annual reporting periods thereafter. This guidance must be applied to transfers occurring on or after the effective date. Additionally, on and after the effective date, the concept of a qualifying special-purpose entity is no longer relevant for accounting purposes. Therefore, formerly qualifying special-purpose entities should be evaluated for consolidation by reporting entities on and after the effective date in accordance with the applicable consolidation guidance. The disclosure provisions were also amended and apply to transfers that occurred both before and after the effective date of this guidance. The adoption of this standard did not have a material effect on the Company's results of operations or financial position.

In June 2009, the FASB amended guidance for consolidation of variable interest entity guidance by replacing the quantitative-based risks and rewards calculation for determining which enterprise, if any, has a controlling financial interest in a variable interest entity with an approach focused on identifying which enterprise has the power to direct the activities of a variable interest entity that most significantly impact the entity's economic performance and (1) the obligation to absorb losses of the entity or (2) the right to receive benefits from the entity. Additional disclosures about an enterprise's involvement in variable interest entities are also required. This guidance is effective as of the beginning of each reporting entity's first annual reporting period that begins after November 15, 2009, for interim periods within that first annual reporting period, and for interim and annual reporting periods thereafter. Early adoption is prohibited. The adoption of this standard did not have a material effect on the Company's results of operations or financial position.

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In June 2009, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 166 "Accounting for Transfers of Financial Assets – an amendment of FASB Statement No. 140", which was reissued in December 2009 as Accounting Standards Update ("ASU") 2009-16 and is now part of FASB Accounting Standards Codification ("ASC") 860 "Transfers and Servicing." The objective of this Statement is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about: (1) a transfer of financial assets; (2) the effects of a transfer on its financial position, financial performance, and cash flows; and (3) a transferor's continuing involvement, if any, in transferred financial assets. This guidance was effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2009. The recognition and measurement provisions of this statement need to be applied to transfers that occur on or after the effective date. The adoption of this guidance on January 1, 2010 has not impacted the Corporation's consolidated financial statements.

In January 2010, the FASB issued guidance to improve disclosure requirements related to fair value measurements and disclosures. The guidance requires that a reporting entity should disclose separately the amounts of significant transfers in and out of Level 1 and Level 2 fair value measurements and describe the reasons for the transfers and that activity in Level 3 should be presented on a gross basis rather than one net number for information about purchases, issuances, and settlements. The guidance also requires that a reporting entity should provide fair value measurement disclosures for each class of assets and liabilities and about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring fair value measurements. This guidance is effective for interim and annual reporting periods beginning after December 31, 2009 except for the roll forward of activity in Level 3 which is effective for interim and annual reporting periods beginning after December 31, 2010. Adopting this pronouncement did not have a material effect on the results of operations or financial condition of the Company.

In July 2010, the FASB issued an Accounting Standards Update ("ASU"), "Receivables: Disclosure about the Credit Quality of Financing Receivables and the Allowance for Credit Losses." The objective of this ASU is for an entity to provide disclosures that facilitate financial statement users' evaluation of the nature of credit risk inherent in the entity's portfolio of financing receivables, how that risk is analyzed and assessed in arriving at the allowance for credit losses, and the changes and reasons for those changes in the allowance for credit losses. An entity should provide disclosures on a disaggregated basis on two defined levels: (1) portfolio segment; and (2) class of financing receivable. The ASU makes changes to existing disclosure requirements and includes additional disclosure requirements about financing receivables, including credit quality indicators of financing receivables at the end of the reporting period by class of financing receivables, the aging of past due financing receivables at the end of the reporting period by class of financing receivables, and the nature and extent of troubled debt restructurings ("TDRs") that occurred during the period by class of financing receivables and their effect on the allowance for credit losses. The Company's adoption on December 31, 2010 except for those parts pertaining to TDRs, being disclosure-related only, had no impact on its results of operations. At its January 4, 2011, meeting, the FASB affirmed its decision to temporarily defer the effective date for TDRs. The new effective date is to be concurrent with the effective date for the proposed ASU, "Receivables (Topic 310): Clarifications to Accounting for Troubled Debt Restructurings by Creditors." The FASB directed its staff to draft a final ASU to change the effective date of the TDRs disclosures for public companies for a vote by the board. The deferral will become effective upon issuance of the final ASU.

3. INVESTMENT SECURITIES, AVAILABLE FOR SALE

The following table summarizes the amortized cost and fair value of the available-for-sale investment securities portfolio at December 31, 2010 and December 31, 2009 and the corresponding amounts of unrealized gains and losses therein:

	December 31, 2010 Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
FNMA MBS - Residential	$3,428,696	$142,521	$—	$3,571,217
GNMA MBS - Residential	4,092,912	65,164	(76,964)	4,081,112
Whole Loan MBS - Residential	1,212,246	23,255	—	1,235,501
Collateralized mortgage obligations	109,921,495	2,906,359	(407,777)	112,420,077
	$118,655,349	$3,137,299	$(484,741)	$121,307,907

	December 31, 2009 Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
FNMA MBS - Residential	$4,855,213	$185,607	$—	$5,040,820
GNMA MBS - Residential	1,265,428	55,812	—	1,321,240
Whole Loan MBS - Residential	1,860,603	15,135	(18,845)	1,856,893
Collateralized mortgage obligations	102,933,529	3,085,224	(325,302)	105,693,451
	$110,914,773	$3,341,778	$(344,147)	$113,912,404

There were no sales of investment securities for the years ended December 31, 2010 and 2009.

The amortized cost and fair value of the investment securities portfolio are shown by expected maturity. Expected maturities may differ from contractual maturities, especially for collateralized mortgage obligations, if borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

	December 31, 2010 Amortized Cost	Fair Value
Less than one year	$ 576,009	$ 579,799
Due after one year through five years	1,431,034	1,456,140
Due after five years through ten years	28,365,421	29,772,512
Due after ten years	88,282,885	89,499,456
	$ 118,655,349	$ 121,307,907

The following table summarizes the investment securities with unrealized losses at December 31, 2010 and December 31, 2009 by aggregated major security type and length of time in a continuous unrealized loss position:

December 31, 2010	Less than 12 months		More than 12 months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
FNMA MBS	$ —	$ —	$ —	$ —	$ —	$ —
GNMA MBS	2,991,961	(76,964)	—	—	2,991,961	(76,964)
Whole Loan MBS	—	—	—	—	—	—
Collateralized mortgage obligations	20,223,509	(407,777)	—	—	20,223,509	(407,777)
	$ 23,215,470	$ (484,741)	$ —	$ —	$ 23,215,470	$ (484,741)

December 31, 2009	Less than 12 months		More than 12 months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
FNMA MBS	$ —	$ —	$ —	$ —	$ —	$ —
GNMA MBS	—	—	—	—	—	—
Whole Loan MBS	—	—	433,666	(18,845)	433,666	(18,845)
Collateralized mortgage obligations	10,036,242	(280,961)	1,750,950	(44,341)	11,787,192	(325,302)
	$ 10,036,242	$ (280,961)	$ 2,184,616	$ (63,186)	$ 12,220,858	$ (344,147)

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, 2010, 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 does not intend to sell the securities and it is not more likely than not the Company will be required to sell the securities before recovery of the amortized cost basis less any current-period loss, these investments are not considered other-than-temporarily impaired. At December 31, 2010, there were no debt securities with unrealized losses with aggregate depreciation of 5% or more from the Company’s amortized cost basis.

Securities pledged had a fair value of $66,089,701 and $54,199,477 at December 31, 2010 and December 31, 2009, 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, 2010 and 2009 are summarized as follows:

	2010	2009
Commercial loans (principally variable rate):		
Secured	$1,393,532	$1,138,308
Unsecured	12,924,378	10,966,874
Total commercial loans	14,317,910	12,105,182
Real estate loans:		
Commercial	58,204,596	48,767,729
Residential	2,460,114	2,914,956
Total real estate loans	60,664,710	51,682,685
Construction loans (net of undisbursed funds of $2,672,000 and $3,168,000, respectively)	5,874,500	13,258,000
Consumer loans	533,860	532,498
Other loans	386,750	1,455,224
	920,610	1,987,722
Total loans receivable	81,777,730	79,033,589
Less:		
Unearned loans fees, net	(239,506)	(199,433)
Allowance for loan losses	(1,277,220)	(1,063,454)
Total	$80,261,004	$77,770,702

Nonaccrual loans outstanding at December 31, 2010 and 2009 are summarized as follows:

	2010	2009
Nonaccrual loans:		
Unsecured commercial loans	$37,706	$41,037
Commercial real estate	4,064,281	1,176,114
Residential real estate	2,276,306	—
Construction	—	480,000
Total nonaccrual loans	$6,378,293	$1,697,151

	2010	2009
Interest income that would have been recorded during the year on nonaccrual loans outstanding at year-end in accordance with original terms	$469,484	$108,719

At December 31, 2010 and 2009, there were no loans 90 days past due and still accruing interest.

The following table presents the aging of the loan balances in past due loans as of December 31, 2010 by class of loans:

	Total	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days Past Due	Total Past Due	Loans Not Past Due
Commercial loans:						
Unsecured	$ 12,924,378	$ 46,562	$ 42,708	$ 37,706	$ 126,976	$ 12,797,402
Secured	1,393,532	—	—	—	—	1,393,532
Real Estate loans						
Commercial	58,204,596	3,103,589	277,960	4,064,281	7,445,830	50,758,766
Residential	2,460,114	—	—	2,276,306	2,276,306	183,808
Construction loans	5,874,500	795,000	—	—	795,000	5,079,500
Consumer loans	533,860	11,277	—	—	11,277	522,583
Other loans	386,750	2,279	—	—	2,279	384,471
Total loans	$ 81,777,730	$ 3,958,707	$ 320,668	$ 6,378,293	$ 10,657,668	$ 71,120,062

Nonaccrual loans include smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

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. Commercial real estate loans and construction loans are generally fully secured by real estate collateral. Commercial loans are generally secured by accounts receivable, inventory and equipment. We seek to minimize the risk of loss through our underwriting standards. As of December 31, 2010, the Company had six restructured loans in the amount of $2,825,494 and as of December 31, 2009, the Company had one restructured loan in the amount of $41,037.

The Company has allocated specific reserves of $7,367 to a customer whose loan terms have been modified in troubled debt restructurings as of December 31, 2010. The Company has not allocated specific reserves to customers whose loan terms have been modified in troubled debt restructurings as of December 31, 2009. The Company has not committed to lend additional amounts to customers with outstanding loans that are classified as troubled debt restructurings.

Individually impaired loans were as follows:

	2010	2009
Year-end loans with no allocated allowance for loan losses:		
Construction	$—	$480,000
Commercial real estate	39,377	820,469
Year-end loans with allocated allowance for loan losses:		
Commercial and financial	36,837	41,037
Commercial real estate	3,448,695	—
	$3,524,909	$1,341,506
Amount of the allowance for loan losses allocated:		
Commercial and financial	$7,367	$8,207

Commercial real estate	83,459	—
	$90,826	$8,207

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

	2010	2009
Average of individually impaired loans during year	$813,419	$1,371,850
Interest income recognized during time period that loans were impaired, using cash-basis method of accounting	$—	$—

Credit Quality Indicators:

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debts such as: current financial information, historical payment experience, credit documentation, public information and current economic trends, among other factors. The Company analyzes loans individually by classifying the loans as to credit risk. This analysis is performed on a quarterly basis. The Company uses the following definitions for risk ratings:

Special Mention. Loans classified as special mention have a potential weakness that deserves management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position as some future date.

Substandard. Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful. Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristics that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and vales, highly questionable and improbable.

The following table sets forth at December 31, 2010, the aggregate carrying value of our assets classified as Special Mention, Substandard and Doubtful according to asset type:

	At December 31, 2010		
	Special Mention	Substandard	Doubtful
Classification of assets:			
Commercial Loans:			
Unsecured	$ 459,160	$ 37,706	$ —
Commercial Real Estate	4,250,511	5,623,816	—
Residential Real Estate	—	2,276,306	—
Consumer	18,117	—	—
Other	12,096	—	—
Total loans	$ 4,739,884	$ 7,937,828	$ —

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The activity in the allowance for loan losses, for the years ended December 31, 2010 and 2009 are summarized as follows:

	2010	2009
Beginning balance	$ 1,063,454	$ 987,876
Charge-offs	(22,713)	(556,639)
Recoveries	96,479	72,217
Provision	140,000	560,000
Ending balance	$ 1,277,220	$ 1,063,454

The following table presents the balance in the allowance for loan losses and the recorded balance in loans by portfolio segment and based on impairment method as of December 31, 2010:

	Commercial Unsecured	Commercial Secured	Construction	Commerical Real Estate	Residential Real Estate	Other Loans	Total
Allowance for loan losses:							
Ending allowance balance attributable to loans							
Individually evaluated for impairment	$ 7,541	$ —	$ —	$ 132,511	$ 1,717	$ —	$ 141,769
Collectively evaluated for impairment	513,412	13,486	52,138	520,851	5,457	30,107	1,135,451
Total ending allowance balance	$ 520,953	$ 13,486	$ 52,138	$ 653,362	$ 7,174	$ 30,107	$ 1,277,220
Loans:							
Individually evaluated for impairment	$ 37,706	$ —	$ —	$ 5,623,816	$ 2,276,306	$ —	$ 7,937,828
Collectively evaluated for impairment	12,886,672	1,393,532	5,874,500	52,580,780	183,808	920,610	73,839,902
Total ending loans balance	$ 12,924,378	$ 1,393,532	$ 5,874,500	$ 58,204,596	$ 2,460,114	$ 920,610	$ 81,777,730

5. ACCRUED INTEREST RECEIVABLE

Accrued interest receivable at December 31, 2010 and 2009 are summarized as follows:

	2010	2009
Due from banks	$ 1,871	$ —
Loans receivable	292,916	313,203
Investment securities, available for sale	379,180	409,025
Total	$ 673,967	$ 722,228

6. PREMISES AND EQUIPMENT

Premises and equipment at December 31, 2010 and 2009 are summarized as follows:

	2010	2009
Leasehold improvements	$ 3,775,068	$ 3,823,772
Computer equipment and software	329,739	376,178
Furniture, fixtures and equipment	1,120,591	1,092,349
Other	52,697	52,697
	5,278,095	5,344,996
Less accumulated depreciation and amortization	(2,545,866)	(2,140,933)
Total	$ 2,732,229	$ 3,204,063

Depreciation and amortization expense amounted to $598,384 and $665,422 for the years ended December 31, 2010 and 2009, respectively.

At December 31, 2010 and 2009, 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 $407,002 for the years ended December 31, 2010 and 2009, respectively.

The projected minimum rental payments under the terms of the leases at December 31, 2010 are summarized as follows:

Year Ending December 31,		Amount
2011	$	413,067
2012		420,988
2013		425,980
2014		384,187
2015		365,834
Thereafter		1,040,319
Total	$	3,050,375

7. PREPAID AND OTHER ASSETS

Prepaid and other assets at December 31, 2010 and 2009 are summarized as follows:

		2010		2009
Accounts receivable and other assets	$	47,675	$	61,286
Security deposit receivable		11,200		11,200
Prepaid assets		956,252		1,189,203
Equity securities, primarily FHLB stock		347,700		345,400
Income tax receivable		103,493		9,422
Late charges receivable		47,285		57,045
	$	1,513,605	$	1,673,556

8. DEPOSITS

Deposits are summarized, according to their original terms, at December 31, 2010 and 2009 as follows:

	2010			2009		
	Amount	Percent	Weighted Average Stated Rate	Amount	Percent	Weighted Average Stated Rate
Checking	$ 66,407,225	32.02 %	— %	$ 70,372,448	33.36 %	— %
Variable-rate money market	27,057,632	13.05	0.59	28,124,315	13.33	0.68
Statement savings	14,938,440	7.20	0.30	15,001,936	7.11	0.34
Interest-bearing checking	35,138,867	16.94	0.19	32,501,930	15.40	0.23
	143,542,164	69.21	0.19	146,000,629	69.20	0.22
Time deposits:						
Less than six months	15,557,955	7.50	0.59	17,999,752	8.53	0.91
Six months to one year	41,842,379	20.17	1.14	41,590,066	19.71	1.49
More than one year	6,244,629	3.01	2.23	5,079,310	2.41	1.84
	63,644,963	30.68	1.11	64,669,128	30.65	1.36
Other deposits	219,530	0.11	—	316,329	0.15	—
Total	$ 207,406,657	100.00 %	0.47 %	$ 210,986,086	100.00 %	0.57 %

The aggregate amount of jumbo time deposit with a minimum denomination of $100,000 was approximately $52,607,789 and $54,127,546 at December 31, 2010 and 2009 respectively.

Scheduled maturities of time deposits at December 31, 2010 are as follows:

	Amount	Percent
Within six months	$ 54,219,713	85.19 %
Six months to one year	3,827,516	6.01
Over one year to two years	1,115,217	1.75
Over two years to three years	873,163	1.37
Over three years to four years	1,397,132	2.20
Over four years to five years	2,212,222	3.48
Total	$ 63,644,963	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, 2010 and 2009.

The components of the income tax expense/(benefit) for the years ended December 31, 2010 and 2009 are summarized as follows:

	2010	2009
Current:		
Federal	$ 1,048,801	$ 877,307
State and local	621,458	495,715
	1,670,259	1,373,022
Deferred:		
Federal	(52,386)	72,698
State and local	(31,738)	44,044
	(84,124)	116,742
	$ 1,586,135	$ 1,489,764

The components of the deferred income tax asset/(liability), net as of December 31, 2010 and 2009 are summarized as follows:

	2010	2009
Deferred tax assets:		
Deferred loan fees	$ 108,432	$ 89,991
Excess book allowance for loan losses	393,403	328,927
Other	480,121	478,914
	981,956	897,832
Deferred tax liabilities:		
Unrealized gain on investment securities	(1,213,545)	(1,371,416)
Net deferred tax liability:	$ (231,589)	$ (473,584)

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, 2010.

The Company is subject to United States federal income tax, New York State income tax and New York City income tax.

The Company is no longer subject to examination by taxing authorities for years before 2007 unless specifically directed by the taxing authorities during an audit.

The Company’s effective tax rates differ from the statutory Federal tax rate for the years ended December 31, 2010 and 2009 and are as follows:

	2010		2009	
Federal income tax provision at statutory rates	$ 1,178,700	34.0 %	$ 1,126,094	34.0 %
State and local taxes, net of Federal income tax benefit	407,345	11.8	356,240	11.0
Other	90	0.0	7,429	0.0
	$ 1,586,135	45.8 %	$ 1,489,763	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, 2010, 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, 2010, 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 Amount	Ratio	For capital adequacy purposes Amount	Ratio	To be well-capitalized under prompt corrective action provisions Amount	Ratio
As of December 31, 2010:						
Tier 1 Capital (to Average Assets)	$ 24,062,000	9.96 %	$ 9,664,133	4.00 %	$ 12,080,167	5.00 %
Tier 1 Capital (to Risk Weighted Assets)	24,062,000	24.63	3,907,400	4.00	5,861,100	6.00
Total Capital (to Risk Weighted Assets)	25,284,000	25.88	7,814,800	8.00	9,768,500	10.00

	Actual Amount	Ratio	For capital adequacy purposes Amount	Ratio	To be well-capitalized under prompt corrective action provisions Amount	Ratio
As of December 31, 2009:						
Tier 1 Capital (to Average Assets)	$ 22,468,000	9.51 %	$ 9,454,548	4.00 %	$ 11,818,185	5.00 %
Tier 1 Capital (to Risk Weighted Assets)	22,468,000	21.94	4,095,720	4.00	6,143,580	6.00
Total Capital (to Risk Weighted Assets)	23,531,000	22.98	8,191,440	8.00	10,239,300	10.00

The Company is subject to comparable capital ratio requirements of the Board of Governors of the Federal Reserve system. The Company's consolidated capital ratios as of December 31, 2010 were as follows: Tier 1 Capital to Average Assets of 10.13%; Tier 1 Capital to Risk Weighted Assets of 25.20%; and Total Capital to Risk Weighted Assets of 26.45%, which are not substantially different than the Bank's capital ratios at December 31, 2010 and therefore are not presented separately.

11. EMPLOYEE BENEFITS

The Company 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 $133,205 to the 401(k) plan in 2010 and

$128,852 in 2009.

Stock Options

The Company has granted options pursuant to six different stock option plans. Options to buy stock are granted to directors, officers and employees under the VSB Bancorp, Inc. 2010 Incentive Plan, the 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 293,750 options. Exercise price is the market price at the date of grant, and compensation expense will be recognized in the income statement over the vesting period. The maximum option term is ten years, and the options vesting period is up to five years.

Total compensation expense for the stock option plans charged against income for 2010 and 2009 was $11,487 and $1,278.

In January 2010, 5,977 options were granted from the 2000 Incentive Plan at an exercise price of $11.10. In April 2010, 12,000 options were granted from the 2004 Director's Plan at an exercise price of $12.09. Also, in April 2010, the 2010 Incentive Stock Option Plan was approved for issue up to 50,000 options. In June 2010, 34,073 options were granted from the 2010 Incentive Plan.

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 2010:

	2010		Exercise Rate	
Dividend yield	2.08	%		
Expected volatility	7.76			
Risk-free interest rate	2.96			
Expected life	8.27 Years		100	%

The stock option components of the 2000 Incentive Plan, the 1998 Incentive Plan, the 2010 Incentive Plan and the 2004 Directors' Plan, the 2000 Directors' Plan and the1998 Directors' Plan, as of December 31, 2010, and changes during the year ended, consist of the following:

	Shares	2010 Weighted Average Exercise Price	Aggregate Intrinsic Value
Options outstanding at the beginning of the year	116,748	$12.16	
Granted	52,050	11.56	
Exercised	(44,375)	4.77	
Options outstanding at the end of the year	124,423	$14.28	$(347,140)
Options exercisable at the end of the year	72,373	$16.87	$(389,367)
Weighted average remaining contractual life of options outstanding at the end of the year		5.5 Years	

Nonvested Options	Shares	Weighted Average Grant Date Fair Value
Nonvested at January 1, 2010	1,950	$ 1.18
Granted	52,050	1.25
Vested	1,950	1.18
Forfeited	—	
Nonvested at December 31, 2010	52,050	$ 1.25

All non-vested options are expected to vest.

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

	2010	2009
Intrinsic value of options exercised	$ 311,956	$ 145,350
Cash received from option exercise	$ 211,531	$ 106,625
Tax benefit realized from option exercise	$ 80,680	$ 12,002
Weighted average fair value of options exercised	$ 7.03	$ 6.84

Described below is the range of exercise prices for options granted and outstanding under the following option plans at December 31, 2010:

Plan Description	Number of Exercisable Shares	Weighted Average Exercise Price	Weighted Average Contractual Life
1998 Director Stock Option Plan	—	$ —	—
1998 Incentive Stock Option Plan	3,250	11.75	6.92
2000 Director Stock Option Plan	—	—	—
2000 Incentive Stock Option Plan	26,350	14.58	4.36
2004 Director Stock Option Plan	60,750	16.51	4.19
2010 Incentive Stock Option Plan	34,073	11.45	9.17
All Plans	124,423	$ 14.28	5.48

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:

	2010 Amount	2009 Amount
Commitments to fund secured construction loans	$2,672,000	$3,168,000
Commitments to fund all other commercial loans	24,987,651	20,794,679
	$27,659,651	$23,962,679

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.

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.

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13. FAIR VALUE

The following disclosure of the estimated fair value of financial instruments is made in accordance with the requirements of FASB ASC 820, "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.

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

The carrying amounts and estimated fair values of financial instruments, at December 31, 2010 and December 31, 2009 are as follows:

	December 31, 2010		December 31, 2009	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets:				
Cash and cash equivalents	$28,764,987	$28,764,987	$39,716,919	$39,716,919
Investment securities, available for sale	121,307,907	121,307,907	113,912,404	113,912,404
Loans receivable	80,261,004	81,526,941	77,770,702	78,515,058
Other financial assets	673,967	673,967	722,228	722,228

Total Financial Assets	$231,007,865	$232,273,802	$232,122,253	$232,866,609
Financial Liabilities:				
Non-interest bearing deposits	$66,626,755	$66,626,755	$70,688,777	$70,688,777
Interest bearing deposits	140,779,902	140,634,427	140,297,309	140,258,492
Other liabilities	19,039	19,039	45,695	45,695
Total Financial Liabilities	$207,425,696	$207,280,221	$211,031,781	$210,992,964

ASC 825 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 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).

	Fair Value Measurements at December 31, 2010 Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
FNMA MBS - Residential	$ 3,571,217	$ —	$ 3,571,217	$ —
GNMA MBS - Residential	4,081,112	—	4,081,112	—
Whole Loan MBS-Residential	1,235,501	—	1,235,501	—
Collateralized mortgage obligations	112,420,077	—	112,420,077	—
Total Available for sale Securities	$ 121,307,907	$ —	$ 121,307,907	$ —

	Fair Value Measurements at December 31, 2009 Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
FNMA MBS - Residential	$ 5,040,820	$ —	$ 5,040,820	$ —
GNMA MBS - Residential	1,321,240	—	1,321,240	—
Whole Loan MBS-Residential	1,856,893	—	1,856,893	—
Collateralized mortgage obligations	105,693,451	—	105,693,451	—
Total Available for sale Securities	$ 113,912,404	$ —	$ 113,912,404	$ —

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).

Assets and Liabilities Measured on a Non-Recurring Basis

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

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 and updated appraisals when received.

	Fair Value Measurements at December 31, 2010 Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Impaired loans	$643,758	—	—	$ 643,758

	Fair Value Measurements at December 31, 2009 Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Impaired loans	$43,505	—	—	$ 43,505

As of December 31, 2010, we had two impaired loans with specific reserves that were collateral dependent. Collateral dependent impaired loans, which are measured for impairment using the fair value of the collateral, had a carrying amount of $727,217, with a valuation allowance of $83,459.

As of December 31, 2009, we had one impaired loan with a specific reserve that was collateral dependent. Collateral dependent impaired loans, which are measured for impairment using the fair value of the collateral, had a carrying amount of $43,505.

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, 2010, the aggregate amount of loans outstanding to directors was $11,995. There were no loans granted to executive officers.

The change in aggregate amount of loans outstanding to directors as of December 31, 2010 and 2009 are as follows:

	2010	2009
Beginning balance	$ 91,010	$ 159,664
Originations	50	81,187
Payments	(79,065)	(149,841)
Ending balance	$ 11,995	$ 91,010

The interest income that was paid on these loans was $3,348 and $9,500 for 2010 and 2009, respectively.

Executive officers and directors own, in the aggregate, 27.9% and 27.7% of the common shares outstanding at December 31, 2010 and 2009, respectively.

16. CONDENSED FINANCIAL STATEMENTS OF THE PARENT COMPANY ONLY

VSB BANCORP, INC.

STATEMENTS OF FINANCIAL CONDITION
DECEMBER 31, 2010 and 2009

	2010	2009
ASSETS		
Cash and cash equivalents	$9	$-
Money market	463,823	297,496
Investment in subsidiaries	25,500,560	24,093,862
Deferred taxes	54,896	30,922
Other assets	39,093	78,007
Total assets	$26,058,381	$24,500,287
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES:		
Accounts payable, accrued expenses and other liabilities	$13,525	$16,338
Total liabilities	13,525	16,338
COMMITMENTS AND CONTINGENT LIABILITIES		
STOCKHOLDERS' EQUITY		
Common stock ($.0001 par value, 3,000,000 shares authorized, 1,989,509 issued and 1,825,009 outstanding at December 31, 2010; 1,945,134 issued and 1,762,191 outstanding at December 31, 2009)	199	195
Additional paid-in capital	9,249,600	9,317,719
Retained earnings	17,563,435	16,112,741
Treasury stock, at cost (164,500 shares at December 31, 2010 and 182,943 shares at December 31, 2009)	(1,643,797)	(1,840,249)
Unearned Employee Stock Ownership Plan shares	(563,594)	(732,672)
Accumulated other comprehensive gain, net of taxes of $1,213,545 and $1,371,416, respectively	1,439,013	1,626,215
Total stockholders' equity	26,044,856	24,483,949
Total liabilities and stockholders' equity	$26,058,381	$24,500,287

VSB BANCORP, INC.

STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

	2010	2009
INTEREST INCOME:		
Loans recievable	$29,288	$36,051
Other interest income	3,472	4,710
Total interest income	32,760	40,761
INTEREST EXPENSE:		
Subordinated debt	—	—
Total interest expense	—	—
Net interest income	32,760	40,761
NON-INTEREST INCOME:		
Dividend income	400,000	1,500,000
Other	—	—
	400,000	1,500,000
NON-INTEREST EXPENSES:		
Salaries and benefits	70,811	—
Legal fees	57,500	38,000
Other	84,005	74,763
Total non-interest expenses	212,316	112,763
INCOME BEFORE INCOME TAXES	220,444	1,427,998
PROVISION/(BENEFIT) FROM INCOME TAXES:		
Current	(71,600)	(49,678)
Deferred	(23,974)	371
Total income taxes	(95,574)	(49,307)
EQUITY IN UNDISTRIBUTED EARNINGS, NET OF TAXES	1,564,611	344,972
NET INCOME	$1,880,629	$1,822,277

VSB BANCORP, INC.

STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2010 AND 2009

	2010	2009
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	$1,880,629	$1,822,277
Adjustments to reconcile net income to net cash used in operating activities:		
Changes in operating assets and liabilities:		
ESOP compensation expense	(67,013)	(73,431)
Stock-based compensation expense	70,811	—
Undistributed (loss) income of subsidiaries	(1,564,611)	(344,972)
Decrease/ (increase) in other assets	38,914	(57,675)
(Increase)/decrease in deferred income taxes	(23,974)	371
(Decrease)/increase in accounts payable, accrued expenses, and other liabilities	(640)	34,345
Net cash provided by operating activities	334,116	1,380,915
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net decrease in loan receivable	169,078	169,078
Net decrease/(increase) in money market deposit	(166,327)	198,875
Net cash provided by investing activities	2,751	367,953
CASH FLOWS FROM FINANCING ACTIVITIES:		
Exercise stock option	292,211	118,627
Purchase of treasury stock, at cost	(199,134)	(1,444,358)
Payment of dividends	(429,935)	(423,679)
Net cash used in financing activities	(336,858)	(1,749,410)
NET INCREASE/(DECREASE) IN CASH AND CASH EQUIVALENTS	9	(542)
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	—	542
CASH AND CASH EQUIVALENTS, END OF YEAR	$9	$—
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	$—	$—
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, 2010 and 2009. ESOP expense was $102,065 and $95,647 for the years ended December 31, 2010 and 2009, respectively.

Shares held by the ESOP at December 31, 2010 and 2009 were as follows:

	2010	2009
Shares allocated to participants	65,336	56,396
Shares released to participants	(6,688)	(5,070)
Unearned shares	27,564	36,504
Total ESOP Shares	86,212	87,830
Fair value of unearned shares	$316,710	$432,937

18. RETENTION AND RECOGNITION PLAN

At the April 27, 2010 Annual Meeting, the stockholders of VSB Bancorp, Inc. approved the adoption of the 2010 Retention and Recognition Plan (the “RRP”). The RRP authorizes the award of up to 50,000 shares of its common stock to directors, officers and employees. In conjunction with the approval the RRP, stockholders approved the award of 4,000 shares of stock to each of its eight directors who had at least five years of service. The director awards will vest over five years, with 20% vesting annually for each of the first five years after the award is made, subject to acceleration and forfeiture. On June 8, 2010, an additional 3,500 shares of stock were awarded to the President and CEO of the Company, which will vest over a 65 month period, with 20% vesting annually for each of the first five years starting in November 2011, subject to acceleration and forfeiture. The recipient of an award will not be required to make any payment to receive the award or the stock covered by the award. As of December 31, 2010, 35,500 shares of the RRP have been awarded. The Company recognizes compensation expense for the shares awarded under the RRP gradually as the shares vest, based upon the market price of the shares on the date of the award. For the year ended December 31, 2010, the Company recognized $59,324 of compensation expense related to the shares awarded. The income tax benefit resulting from this expense was $23,730. As of December 31, 2010, there was approximately $336,262 of unrecognized compensation costs related to the shares awarded. These costs are expected to be recognized over the next 4.25 years.

A summary of the status of the Company’s nonvested plan shares as of December 31, 2010 is as follows:

For the Year Ended December 31, 2010:

	Shares	Weighted Average Grant Date Share Value
Non vested at beginning of period	—	$ —
Granted	35,500	11.46
Vested	—	—
Non vested at end of period	35,500	$ 11.46

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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, 2010. 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, 2010.

This annual report does not include an audit 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 the 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 through 6 of the Proxy Statement under the caption “General Information Regarding Nominees and Our Other Directors;” page 16 of the Proxy Statement under the caption “Section 16a Beneficial Ownership Reporting Compliance;” and pages 7 and 8 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 10 through 14 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 pages 14 through 15 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 15 through 16 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 page 22 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	Amended Bylaws of VSB Bancorp, Inc.****
10.1	VSB Bancorp, Inc. Restated 2000 Incentive Stock Option Plan*
10.2	VSB Bancorp, Inc. Restated 2000 Directors Stock Option Plan*
10.3	VSB Bancorp, Inc. Restated 1998 Incentive Stock Option Plan*
10.4	VSB Bancorp, Inc. Restated 1998 Directors Stock Option Plan*
10.5	VSB Bancorp, Inc. 2004 Directors Stock Option Plan**
10.6	VSB Bancorp, Inc. 2010 Retention and Recognition Plan *****
10.7	VSB Bancorp, Inc. 2010 Incentive Stock Option Plan *****
10.8	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 on March 24, 2004, SEC Accession Number 0001019056-04-000401, Film Number 04685677.
*** - previously filed as an exhibit on Form 8-K (File No. 0-50237) as filed with the Securities and Exchange Commission on June 24, 2010.
**** - previously filed as an exhibit on Form 8-K (File No. 0-50237) as filed with the Securities and Exchange Commission on January 18, 2011.
***** - previously filed as an exhibit included in the Issuer’s proxy statement for its 2010 Annual Meeting of Stockholders on Form 14A on March 26, 2010, SEC Accession Number 0001019056-10-000360, Film Number 10706769.

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 14, 2011	By:	/s/Raffaele M. Branca Raffaele M. Branca, President & CEO, Principal Executive Officer and Principal Financial Officer
Date: March 14, 2011		/s/ Jonathan B. Lipschitz Jonathan B. Lipschitz 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 Raffaele M. Branca, President and Chief Executive Officer and Director	March 14, 2011 Date
/s/ Joseph J. LiBassi Joseph J, LiBassi, Chairman of the Board	March 14, 2011 Date
/s/ Joan Nerlino Caddell Joan Nerlino Caddell, Director	March 14, 2011 Date
/s/ Robert S. Cutrona, Sr. Robert S. Cutrona, Sr., Director	March 14, 2011 Date
/s/ Chaim Farkas Chaim Farkas, Director	March 14, 2011 Date
/s/ Alfred C. Johnsen Alfred C. Johnsen, Director	March 14, 2011 Date
/s/ Robert P. Moore Robert P. Moore, Director	March 14, 2011 Date
/s/ Carlos Perez Carlos Perez, Director	March 14, 2011 Date
/s/ Bruno Savo Bruno Savo, Director	March 14, 2011 Date

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