VSB BANCORP INC
Form 10-Q
November 12, 2013

UNITED STATES

SECURITY AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20849

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
FOR THE QUARTER ENDED **SEPTEMBER 30, 2013**

o TRANSITION REPORT PURSUANT TO SECTION 13 OF THE EXCHANGE ACT FOR THE TRANSITION PERIOD

COMMISSION FILE NUMBER 001-33250

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

Registrant'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 Exchange Act during the past 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 whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, a non-accelerated filer or a smaller reporting company. See 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

Par Value: $0.0001 Class of Common Stock

The Registrant had 1,782,309 common shares outstanding as of November 8, 2013.

CROSS REFERENCE INDEX

2

Forward-Looking Statements

When used in this periodic report, 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 a intended to 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;

increases in inflation;

technology changes requiring additional capital investment;

breaches of security or other criminal acts affecting our operations;

changes in laws and regulations affecting the financial service industry;

changes in accounting rules;

changes in the public’s perception of financial institutions in general and banks in particular;

changes in borrowers’ attitudes towards their moral and legal obligations to repay their debts;

the health and soundness of other financial institutions;

changes in the securities or real estate markets;

weather, geologic or climatic conditions;

changes in government monetary or fiscal policy or other government political changes;

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 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.

3

VSB Bancorp, Inc.
Consolidated Statements of Financial Condition
(unaudited)

	September 30, 2013	December 31, 2012
Assets:		
Cash and due from banks	$63,257,198	$77,728,426
Investment securities, available for sale	56,912,504	106,825,570
Investment securities, held to maturity (fair value 2013 - $99,128,515)	99,958,474	—
Loans receivable	76,520,302	81,971,571
Allowance for loan loss	(1,260,454)	(1,753,521)
Loans receivable, net	75,259,848	80,218,050
Bank premises and equipment, net	2,050,521	2,097,356
Accrued interest receivable	551,728	617,833
Other assets	1,926,974	2,217,136
Total assets	$299,917,247	$269,704,371
Liabilities and stockholders' equity:		
Liabilities:		
Deposits:		
Demand and checking	$97,497,389	$81,881,173
NOW	35,502,753	33,394,785
Money market	41,565,442	33,023,373
Savings	22,591,370	20,871,593
Time	73,828,624	71,452,704
Total deposits	270,985,578	240,623,628
Escrow deposits	104,885	77,578
Accounts payable and accrued expenses	1,291,551	1,249,194
Total liabilities	272,382,014	241,950,400
Stockholders' equity:		
Common stock ($.0001 par value, 10,000,000 shares authorized, 1,989,509 issued, 1,785,309 outstanding at September 30, 2013 and at December 31, 2012)	199	199
Additional paid in capital	9,321,312	9,257,167
Retained earnings	19,790,109	19,336,280
Treasury stock, at cost (204,200 shares at September 30, 2013 and at December 31, 2012)	(2,068,898)	(2,068,898)
Unearned Employee Stock Ownership Plan shares	(98,629)	(225,438)
Accumulated other comprehensive income, net of taxes of $498,519 and $1,226,742, respectively	591,140	1,454,661
Total stockholders' equity	27,535,233	27,753,971
Total liabilities and stockholders' equity	$299,917,247	$269,704,371

See notes to consolidated financial statements.

VSB Bancorp, Inc.
Consolidated Statements of Operations
(unaudited)

	Three months ended Sept. 30, 2013	Three months ended Sept. 30, 2012	Nine months ended Sept. 30, 2013	Nine months ended Sept. 30, 2012
Interest and dividend income:				
Loans receivable	$ 1,312,109	$ 1,484,891	$ 4,137,806	$ 4,489,089
Investment securities	817,651	736,733	2,093,702	2,319,168
Other interest earning assets	39,722	30,259	123,781	78,331
Total interest income	2,169,482	2,251,883	6,355,289	6,886,588
Interest expense:				
NOW	15,110	19,414	47,303	62,972
Money market	57,048	59,187	157,163	174,058
Savings	20,030	16,493	57,963	35,693
Time	113,503	105,518	359,326	335,370
Total interest expense	205,691	200,612	621,755	608,093
Net interest income	1,963,791	2,051,271	5,733,534	6,278,495
Provision for loan loss	45,000	40,000	180,000	280,000
Net interest income after provision for loan loss	1,918,791	2,011,271	5,553,534	5,998,495
Non-interest income:				
Loan fees	13,399	12,471	37,132	32,063
Service charges on deposits	630,611	524,766	1,651,242	1,626,041
Net rental income	17,667	18,327	52,903	42,605
Other income	52,690	52,264	224,629	156,075
Total non-interest income	714,367	607,828	1,965,906	1,856,784
Non-interest expenses:				
Salaries and benefits	947,829	934,410	2,898,913	2,861,845
Occupancy expenses	340,003	367,248	994,348	1,095,729
Legal expense	85,477	59,292	198,637	209,276
Professional fees	105,975	84,819	276,947	253,880
Computer expense	70,724	66,463	223,547	183,131
Directors’ fees	53,375	60,775	177,625	205,900
FDIC and NYSBD assessments	60,500	57,000	175,500	178,500
Other expenses	340,253	330,204	1,146,787	1,003,474
Total non-interest expenses	2,004,136	1,960,211	6,092,304	5,991,735
Income before income taxes	629,022	658,888	1,427,136	1,863,544
Provision/(benefit) for income taxes:				
Current	323,092	329,410	424,715	1,058,329
Deferred	(35,308)	(27,982)	228,243	(205,730)

Total provision for income taxes	287,784	301,428	652,958	852,599
Net income	$ 341,238	$ 357,460	$ 774,178	$ 1,010,945
Earnings per share:				
Basic	$ 0.19	$ 0.20	$ 0.44	$ 0.57
Diluted	$ 0.19	$ 0.20	$ 0.44	$ 0.57
Comprehensive income/(loss)	$ 294,391	$ 547,112	$ (89,343)	$ 1,028,966

See notes to consolidated financial statements.

5

VSB Bancorp, Inc.
Consolidated Statements of Comprehensive Income/(Loss)
(unaudited)

	Three months ended Sept. 30, 2013	Three months ended Sept. 30, 2012	Nine months ended Sept. 30, 2013	Nine months ended Sept. 30, 2012
Net Income	$ 341,238	$ 357,460	$ 774,178	$ 1,010,945
Other comprehensive income:				
Unrealized gains on securities, AFS:				
Change in unrealized gain on securities, AFS	(59,153)	349,589	(2,089,216)	33,219
Unrealized gains on securities transferred from AFS to HTM	—	—	533,811	—
Accretion on unrealized gains on HTM securities	(27,201)	—	(36,338)	—
Tax effects	(39,507)	159,937	(728,222)	15,198
Net of tax	(46,847)	189,652	(863,521)	18,021
Comprehensive income/(loss)	$ 294,391	$ 547,112	$ (89,343)	$ 1,028,966

See notes to consolidated financial statements.

VSB Bancorp, Inc.
Consolidated Statements of Changes in Stockholders' Equity
Year Ended December 31, 2012 and For Each of the Quarters in the Nine Month Period Ended September 30, 2013
(unaudited)

	Number of Common Shares Outstanding	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock, at cost	Unearned ESOP Shares	Other Comprehensive Gain/(Loss)	Total Stockhold Equity
Balance at January 1, 2012	1,797,809	$199	$9,304,789	$18,574,651	$(1,935,596)	$(394,516)	$1,552,733	$27,102,2
Stock-based compensation			101,672					101,672
Amortization of earned portion of ESOP common stock						169,078		169,078
Amortization of cost over fair value - ESOP			(48,119)					(48,119
Cash dividends declared ($0.24 per share)				(426,571)				(426,57

Purchase of treasury stock, at cost	(22,000)				(234,477)			(234,47
Contribution to RRP Trust from treasury shares	9,500		(101,175)		101,175			—
Net income				1,188,200				1,188,20
Other comprehensive income	—	—	—	—	—	—	(98,072)	(98,072
Balance at December 31, 2012	1,785,309	$199	$9,257,167	$19,336,280	$(2,068,898)	$(225,438)	$1,454,661	$27,753,9
Stock-based compensation			36,185					36,185
Amortization of earned portion of ESOP common stock						42,270		42,270
Amortization of cost over fair value - ESOP			(21,552)					(21,552
Cash dividends declared ($0.06 per share)				(106,783)				(106,783
Net income				209,871				209,871
Other comprehensive income	—	—	—	—	—	—	(184,611)	(184,611
Balance at March 31, 2013	1,785,309	$199	$9,271,800	$19,439,368	$(2,068,898)	$(183,168)	$1,270,050	$27,729,3

6

VSB Bancorp, Inc.
Consolidated Statements of Changes in Stockholders' Equity
Year Ended December 31, 2012 and For Each of the Quarters in the Nine Month Period Ended September 30, 2013
(unaudited)

	Number of Common Shares Outstanding	Common Stock	Additional Paid-In Capital	Retained Earnings	Treasury Stock, at cost	Unearned ESOP Shares	Other Comprehensive Gain/(Loss)	Total Stockholders' Equity
Balance at March 31, 2013	1,785,309	$199	$9,271,800	$19,439,368	$(2,068,898)	$(183,168)	$1,270,050	$27,729,351
Stock-based compensation			59,415					59,415
Amortization of earned portion of ESOP common stock						42,269		42,269
Amortization of cost over fair value - ESOP			(21,150)					(21,150)
Cash dividends declared ($0.06 per share)				(106,783)				(106,783)
Net income				223,069				223,069
Other comprehensive income	—	—	—	—	—	—	(632,063)	(632,063)
Balance at June 30, 2013	1,785,309	$199	$9,310,065	$19,555,654	$(2,068,898)	$(140,899)	$637,987	$27,294,108
Stock-based compensation			32,544					32,544
Amortization of earned portion of ESOP common stock						42,270		42,270
Amortization of cost over fair value - ESOP			(21,297)					(21,297)
Cash dividends declared								

($0.06 per share)				(106,783)				(106,783)
Net income				341,238				341,238
Other comprehensive income	—	—	—	—	—	—	(46,847)	(46,847)
Balance at September 30, 2013	1,785,309	$199	$9,321,312	$19,790,109	$(2,068,898)	$(98,629)	$591,140	$27,535,233

See notes to consolidated financial statements.

7

VSB Bancorp, Inc.

Consolidated Statements of Cash Flows

(unaudited)

	Three months ended Sept. 30, 2013	Three months ended Sept. 30, 2012	Nine months ended Sept. 30, 2013	Nine months ended Sept. 30, 2012
CASH FLOWS FROM OPERATING ACTIVITIES:				
Net income	$ 341,238	$ 357,460	$ 774,178	$ 1,010,945
Adjustments to reconcile net income to net cash provided by operating activities				
Depreciation and amortization	117,395	145,384	370,733	442,378
Accretion of income, net of amortization of premium	52,807	60,649	256,250	292,498
ESOP compensation expense	20,973	22,012	62,810	65,661
Stock-based compensation expense	32,544	23,447	128,144	70,338
Provision for loan losses	45,000	40,000	180,000	280,000
(Gain)/loss on sale of other real estate	—	—	(9,611)	—
Write-down of other real estate owned	—	—	59,792	—
Decrease in prepaid and other assets	194,256	121,195	588,646	335,239
(Increase)/decrease in accrued interest receivable	(3,750)	2,554	66,105	26,928
(Increase)decrease in deferred income taxes	(35,308)	(27,982)	228,243	(205,730)
(Decrease)/increase in accrued expenses and other liabilities	(11,460)	(72,790)	42,357	(342,557)
Net cash provided by operating activities	753,695	671,929	2,747,647	1,975,700
CASH FLOWS FROM INVESTING ACTIVITIES:				
Net change in loan receivable	280,068	4,045,312	4,637,604	(36,363)
Available-for-sale securities:				
Proceeds from repayment and calls of investment securities	3,519,874	9,050,698	20,505,835	27,734,440
Purchases of investment securities	(13,286,448)	(3,941,875)	(46,942,854)	(31,841,957)
Held-to-maturity securities:				
Proceeds from repayment and calls of investment securities	3,565,344	—	3,571,244	—
Purchases of investment securities	(21,789,638)	—	(29,087,028)	—
Proceeds from sale of other real estate	202,000	—	492,686	—
Purchases of premises and equipment	(116,471)	(167,840)	(465,270)	(293,493)
Net cash (used in)/provided by investing activities	(27,625,271)	8,986,295	(47,287,783)	(4,437,373)
CASH FLOWS FROM FINANCING ACTIVITIES:				
Net increase in deposits	2,364,841	7,225,994	30,389,257	17,731,942
Purchase of treasury stock, at cost	—	(128,409)	—	(234,477)

Cash dividends paid	(106,783)	(106,283)	(320,349)	(320,289)
Net cash provided by financing activities	2,258,058	6,991,302	30,068,908	17,177,176
NET (DECREASE)/INCREASE IN CASH AND CASH EQUIVALENTS	(24,613,518)	16,649,526	(14,471,228)	14,715,503
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	87,870,716	46,173,650	77,728,426	48,107,673
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 63,257,198	$ 62,823,176	$ 63,257,198	$ 62,823,176
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:				
Cash paid during the period for:				
Interest	$ 204,120	$ 197,554	$ 618,567	$ 612,222
Taxes	$ 175,000	$ 321,000	$ 330,849	$ 886,610
SUPPLEMENTAL NONCASH DISCLOSURE:				
Transfer from loans to real estate owned	$ —	$ —	$ 200,000	$ 81,075
Transfer from AFS to HTM investment securities	$ —	$ —	$ 74,540,643	$ —

See notes to consolidated financial statements.

8

VSB BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE THREE AND NINE MONTHS ENDED SEPTEMBER 30, 2013 AND 2012 (UNAUDITED)

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 Department of Financial Services (“NYDFS”) 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 consist 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 September 19, 2013 through October 2, 2013, Victory State Bank was required to maintain reserves, after deducting vault cash, of $5,574,000. 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 7 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, collateralized loan obligations ("CLO") and asset backed securities, all of which are AAA rated at the time of purchase, as well as corporate bonds, which are rated A or better at the time of purchase. 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.

Investment Securities, Held To Maturity – Investment securities, held to maturity are carried at amortized cost when management has the positive intent and ability to hold them to maturity. The Company invests in agency Collateralized Mortgage-Backed Obligations ("CMOs") with average lives primarily under 7 years and balloon Mortgage-Backed Securities with a final maturity of ten years or less. 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.

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 but has not been paid. 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 these assets. 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. The fair value of the collateral is estimated by obtaining a new appraisal, if the loan amount exceeds $100,000, or by adjusting the most recent appraisal to reflect the current market if the loan is less than $100,000 or a more recent appraisal has yet to be received. 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 homogeneous 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.

11

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 1,756,670 shares and 1,740,777 shares, the weighted average number of common shares outstanding for the three months ended September 30, 2013 and 2012, respectively. Diluted net income per share of common stock is based on 1,756,670 and 1,740,777, the weighted average number of common shares outstanding plus potentially dilutive common shares for the three months ended September 30, 2013 and 2012, 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 48,452 and 48,267 shares for the three months ended September 30, 2013 and 2012, respectively. Common stock equivalents were calculated using the treasury stock method.

Basic net income per share of common stock is based on 1,750,777 shares and 1,744,379 shares, the weighted average number of common shares outstanding for the nine months ended September 30, 2013 and 2012, respectively. Diluted net income per share of common stock is based on 1,750,777 and 1,744,379, the weighted average number of common shares outstanding plus potentially dilutive common shares for the nine months ended September 30, 2013 and 2012, 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 48,615 and 47,293 shares for the nine months ended September 30, 2013 and 2012, 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 three and nine months ended September 30, are as follows:

Reconciliation of EPS

	Three months ended Sept. 30, 2013	Three months ended Sept. 30, 2012
Basic		
Distributed earnings allocated to common stock	$ 105,400	$ 104,447
Undistributed earnings allocated to common sock	231,655	248,552
Net earnings allocated to common stock	$ 337,055	$ 352,999
Weighted common shares outstanding including participating securities	1,778,470	1,762,777
Less: Participating securities	(21,800)	(22,000)
Weighted average shares	1,756,670	1,740,777
Basic EPS	$ 0.19	$ 0.20
Diluted		
Net earnings allocated to common stock	$ 337,055	$ 352,999
Weighted average shares for basic	1,756,670	1,740,777
Dilutive effects of:		
Stock Options	—	—
Unvested shares not considered participating securities	—	—
	1,756,670	1,740,777
Diluted EPS	$ 0.19	$ 0.20

Reconciliation of EPS

	Nine months ended Sept. 30, 2013	Nine months ended Sept. 30, 2012
Basic		
Distributed earnings allocated to common stock	$ 315,140	$ 313,988
Undistributed earnings allocated to common sock	447,834	682,823
Net earnings allocated to common stock	$ 762,974	$ 996,811
Weighted common shares outstanding including participating securities	1,776,486	1,769,112
Less: Participating securities	(25,709)	(24,733)
Weighted average shares	1,750,777	1,744,379
Basic EPS	$ 0.44	$ 0.57
Diluted		
Net earnings allocated to common stock	$ 762,974	$ 996,811
Weighted average shares for basic	1,750,777	1,744,379
Dilutive effects of:		
Stock Options	—	—
Unvested shares not considered participating securities	—	—
	1,750,777	1,744,379

Diluted EPS	$ 0.44	$ 0.57

13

Net earnings allocated to common stock for the period are 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. The Company has repurchased a total of 200,000 shares of its common stock under these stock repurchase programs, which were completed by the end of 2010. On September 14, 2011, the Company announced that its Board of Directors had authorized a third Rule 10b5-1 stock repurchase program for the repurchase of up to an additional 100,000 shares of the Company's common stock. At September 30, 2013, the Company had repurchased a total of 49,200 shares of its common stock under this third stock repurchase program. Stock repurchases under the programs 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 April 27, 2011, 6,400 shares or 20% of the 32,000 shares of stock awarded to its eight directors who had at least five years of service had vested. On April 27, 2012, an additional 6,400 shares or 20% of the 32,000 shares of stock awarded to its eight directors who had at least five years of service had vested. On April 29, 2013, an additional 6,400 shares or 20% of the 32,000 shares of stock awarded to its eight directors who had at least five years of service had vested. On May 1, 2013, an additional 1,600 shares vested due to the retirement of a director. 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. On November 16, 2011, 700 shares or 20% of the 3,500 shares of stock awarded to the President and CEO of the Company had vested. On November 16, 2012, an additional 700 shares or 20% of the 3,500 shares of stock awarded to the President and CEO of the Company had vested. On November 13, 2012, an additional 2,500 shares of stock were awarded to the President and CEO of the

Company on an equal two year vesting beginning November 13, 2013. Also, on November 13, 2012, an additional 1,000 shares were awarded to seven non-employee directors on an equal two year vesting beginning November 13, 2013. The recipient of an award will not be required to make any payment to receive the award or the stock covered by the award. 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.

14

A summary of the status of the Company's non-vested plan shares as of September 30, 2013 is as follows:

For the Nine Months Ended September 30, 2013:

	Shares	Weighted Average Grant Date Share Value
Non vested at beginning of period	30,800	$ 11.25
Granted	—	
Vested	9,000	$ —
Non vested at end of period	21,800	$ 11.25

Comprehensive Income – Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains and losses, net of taxes, on our securities' portfolios which are also recognized as separate components of equity.

Recently-Adopted Accounting Standards – In February 2013, the FASB issued an Accounting Standards Update ("ASU") to finalize the reporting requirements for reclassifications of amounts out of accumulated other comprehensive income ("AOCI"). Items reclassified out of AOCI to net income in their entirety must have the effect of the reclassification disclosed according to the respective income statement line item. This information must be provided either on the face of the financial statements by income statement line item, or in a footnote. For public companies, the amendments in the update became effective for interim and annual periods beginning on or after December 15, 2012. As of September 30, 2013, the Company's adoption of this ASU had no impact on its results of operations.

3. INVESTMENT SECURITIES

The following table summarizes the amortized cost and fair value of securities available-for-sale and securities held-to-maturity at September 30, 2013 and December 31, 2012 and the corresponding amounts of unrealized gains and losses herein:

	September 30, 2013			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Available-for-Sale				
FNMA MBS - Residential	$ 1,259,522	$ 63,600	$ —	$ 1,323,122
Whole Loan MBS - Residential	138,646	3,007	—	141,653
Collateralized mortgage obligations	37,851,998	505,153	(239,821)	38,117,330
Collateralized loan obligations	5,000,000	35,000	—	5,035,000
Corporate bonds	9,570,797	—	(264,988)	9,305,809

Other debt securities	2,949,526	40,064	—	2,989,590
Total Available-for-Sale	$56,770,489	$646,824	$(504,809)	$56,912,504

	September 30, 2013			
	Amortized Cost	Gross Unrecognized Gains	Gross Unrecognized Losses	Fair Value
Held-to-Maturity				
FNMA MBS - Residential	$58,103,774	$ 132,485	$ (475,584)	$57,760,675
GNMA MBS - Residential	3,953,859	—	(24,307)	3,929,552
Collateralized mortgage obligations	37,900,841	8,341	(470,894)	37,438,288
Total Held-to-Maturity	$99,958,474	$ 140,826	$ (970,785)	$99,128,515

	December 31, 2012			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Available-for-sale				
FNMA MBS - Residential	$34,168,335	$ 869,590	$ (32,664)	$35,005,261
GNMA MBS - Residential	5,074,518	155,906	—	5,230,424
Whole Loan MBS - Residential	473,273	16,852	—	490,125
Collateralized mortgage obligations	60,483,873	1,597,293	(96)	62,081,070
Collateralized loan obligations	1,000,000	—	—	1,000,000
Other debt securities	2,944,168	74,522	—	3,018,690
Total Available-for-Sale	$104,144,167	$ 2,714,163	$ (32,760)	$106,825,570

There were no sales of investment securities for the nine months ended September 30, 2013 and 2012.

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.

	September 30, 2013	
Available-for-Sale	Amortized Cost	Fair Value
Less than one year	$—	$—
Due after one year through five years	8,264,158	8,308,027
Due after five years through ten years	13,053,295	12,850,939
Due after ten years	35,453,036	35,753,538
Available-for-Sale	$ 56,770,489	$ 56,912,504

	September 30, 2013	
Held-to-Maturity	Amortized Cost	Fair Value
Less than one year	$—	$—
Due after one year through five years	29,465,277	29,237,950
Due after five years through ten years	29,722,179	29,596,276
Due after ten years	40,771,018	40,294,289
Held-to-Maturity	$ 99,958,474	$ 99,128,515

The following table summarizes the investment securities with unrealized losses at September 30, 2013 and December 31, 2012 by aggregated major security type and length of time in a continuous unrealized loss position:

September 30, 2013	Less than 12 months		More than 12 months		Total	
Available-for-Sale	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
FNMA MBS	$—	$—	$ —	$ —	$—	$—
GNMA MBS	—	—	—	—	—	—
Whole Loan MBS	—	—	—	—	—	—
Collateralized mortgage obligations	15,981,110	(239,821)	—	—	15,981,110	(239,821)
Collateralized loan obligations	—	—	—	—	—	—
Corporate bonds	9,305,809	(264,988)	—	—	9,305,809	(264,988)
Other debt securities	—	—	—	—	—	—
Available-for-Sale	$25,286,919	$(504,809)	$ —	$ —	$25,286,919	$(504,809)

September 30, 2013	Less than 12 months		More than 12 months		Total	
Held-to-Maturity	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
FNMA MBS	$43,703,786	$(475,584)	$ —	$ —	$43,703,786	$(475,584)
GNMA MBS	3,929,552	(24,307)	—	—	3,929,552	(24,307)
Collateralized mortgage obligations	30,454,114	(470,894)	—	—	30,454,114	(470,894)
Held-to-Maturity	$78,087,452	$(970,785)	$ —	$ —	$78,087,452	$(970,785)

December 31, 2012	Less than 12 months		More than 12 months		Total	
Available-for-Sale	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss

FNMA MBS	$4,499,561	$(32,664)	$—	$—	$4,499,561	$(32,664)
GNMA MBS	—	—	—	—	—	—
Whole Loan MBS	—	—	—	—	—	—
Collateralized mortgage obligations	101,543	(96)	—	—	101,543	(96)
Collateralized loan obligations	—	—	—	—	—	—
Other debt securities	—	—	—	—	—	—
Available-for-Sale	$4,601,104	$(32,760)	$—	$—	$4,601,104	$(32,760)

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 September 30, 2013, the unrealized loss on investment securities was caused by a rise in intermediate and long term market interest rates generally. We expect that these securities, at maturity, will be settled for at least 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 that 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 September 30, 2013, 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 $62,090,144 and $66,043,504 at September 30, 2013 and December 31, 2012, respectively and were pledged to secure public deposits and balances in excess of the deposit insurance limit on certain customer accounts.

During the second quarter of 2013, $74,540,643 of securities was transferred from the available for sale portfolio to the held to maturity portfolio. These securities were transferred at fair value with the unrealized gain/loss remaining in accumulated other comprehensive income to be accreted or amortized through other comprehensive income over the remaining life of the securities.

4. FAIR VALUE MEASUREMENTS

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 and Held To Maturity – 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.

Federal Home Loan Bank Stock – It is not practical to determine the fair value of FHLB stock due to restrictions placed on its transferability.

Loans Receivable – The fair value of commercial and construction loans is approximated by the carrying value as the loans are tied directly to the Prime Rate and are subject to change on a daily basis, subject to the applicable interest rate floors. 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 September 30, 2013 and December 31, 2012 are as follows:

	Fair Value Measurements at September 30, 2013 Using				
	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total
Financial Assets:					
Cash and cash equivalents	$63,257,198	$ 6,495,284	$56,761,914	$—	$63,257,198
Investment securities, available for sale	56,912,504	—	51,877,504	5,035,000	56,912,504
Investment securities, held to maturity	99,958,474	—	99,128,515	—	99,128,515
Loans receivable	75,259,848	—	—	76,117,619	76,117,619
Accrued interest receivable	551,728	—	305,953	245,775	551,728
Total Financial Assets	$295,939,752	$ 6,495,284	$208,073,886	$81,398,394	$295,967,564
Financial Liabilities:					
Deposits	$271,090,463	$ 97,497,389	$173,425,360	$—	$270,922,749
Accrued interest payable	17,108	—	17,108	—	17,108
Total Financial Liabilities	$271,107,571	$ 97,497,389	$173,442,468	$—	$270,939,857

	Fair Value Measurements at December 31, 2012 Using				
		Quoted Prices in Active Markets for	Significant Other Observable	Significant Unobservable	

	Carrying Value	Identical Assets (Level 1)	Inputs (Level 2)	Inputs (Level 3)	Total
Financial Assets:					
Cash and cash equivalents	$77,728,426	$ 3,723,131	$74,005,295	$—	$77,728,426
Investment securities, available for sale	106,825,570	—	105,825,570	1,000,000	106,825,570
Loans receivable	80,218,050	—	—	80,432,242	80,432,242
Accrued interest receivable	617,833	—	262,577	355,256	617,833
Total Financial Assets	$265,389,879	$ 3,723,131	$180,093,442	$81,787,498	$265,604,071
Financial Liabilities:					
Deposits	$240,701,206	$ 81,881,173	$158,706,059	$—	$240,587,232
Accrued interest payable	13,920	—	13,920	—	13,920
Total Financial Liabilities	$240,715,126	$ 81,881,173	$158,719,979	$—	$240,601,152

19

ASC 820 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 and held to maturity is determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or using 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). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3).

	Fair Value Measurements at September 30, 2013 Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Available for sale:				
FNMA MBS - Residential	$ 1,323,122	$ —	$ 1,323,122	$ —
Whole Loan MBS-Residential	141,653	—	141,653	—
Collateralized mortgage obligations	38,117,330	—	38,117,330	—
Collateralized loan obligations	5,035,000	—	—	5,035,000
Corporate bonds	9,305,809	—	9,305,809	—
Other debt securities	2,989,590	—	2,989,590	—
Total Available for sale Securities	$ 56,912,504	$ —	$ 51,877,504	$ 5,035,000

20

	Fair Value Measurements at December 31, 2012 Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Available for sale:				
FNMA MBS - Residential	$ 35,005,261	$ —	$ 35,005,261	$ —
GNMA MBS - Residential	5,230,424	—	5,230,424	—
Whole Loan MBS-Residential	490,125	—	490,125	—
Collateralized mortgage obligations	62,081,070	—	62,081,070	—
Collateralized loan obligations	1,000,000	—	—	1,000,000
Other debt securities	3,018,690	—	3,018,690	—
Total Available for sale Securities	$ 106,825,570	$ —	$ 105,825,570	$ 1,000,000

The table below presents a reconciliation of all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the nine months ended September 30, 2013:

	Collateralized Loan Obligations
	2013
Balance of recurring Level 3 assets at January 1:	$ 1,000,000
Total gains or losses for the period:	—
Included in earnings	—
Included in other comprehensive income	35,000
Purchases	4,000,000
Sales	—
Issuances	—
Settlements	
Transfers into Level 3	—
Transfers out of Level 3	—
Balance of recurring Level 3 assets at September 30:	$ 5,035,000

21

The following table presents quantitative information about recurring Level 3 fair value measurement at September 30, 2013:

	Fair Value	Valuation Techniques	Unobservable Inputs	Range
Collateralized loan obligations	$5,035,000	Discounted cash flow	Collateral default rate	0%-2%
			Recovery probability	70%-100%

There were no transfers between levels from December 31, 2012 to September 30, 2013.

Assets Measured on a Non-Recurring

Certain financial assets 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 measured at a fair value on a non-recurring basis are summarized below:

Impaired Loans: The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Real Estate Owned: Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals which are updated no less frequently than annually. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. There were no write downs for real estate owned for the three and nine months ended September 30, 2013 and 2012.

	Fair Value Measurements at September 30, 2013 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				
Commercial Real Estate	$ 1,039,204	—	—	$ 1,039,204
Other real estate owned	—	—	—	—

22

	Fair Value Measurements at December 31, 2012 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				
Commercial Real Estate	$ 934,034	—	—	$ 934,034
Other real estate owned	342,867	—	—	342,867

As of September 30, 2013, we had three 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 $1,373,021, with a valuation allowance of $ 333,817 at that date. The valuation allowance decreased $504,714 from December 31, 2012 to September 30, 2013. The unpaid principal balance on impaired loans at September 30, 2013 was $1,426,671.

As of December 31, 2012, we had four 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 $1,772,565, with a valuation allowance of $838,531 at that date. The unpaid principal balance on impaired loans at December 31, 2012 was $1,792,790.

The following table presents quantitative information about level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at September 30, 2013.

	Fair Value	Valuation Techniques	Unobservable Inputs	Range
Impaired loans - Commercial real estate	$521,844	Third Party Appraisal	Discount adjustment for differences in various costs.	0.01%
	64,579	Third Party Appraisal	Adjustments for differences between comparable sales.	2% - 4%
	452,781	Third Party Appraisal	Adjustments for differences in net operating income expectations	4% - 13%
			Capitalization Rate	5.75%
		Third Party Appraisal	Adjustments for differences between comparable sales.	2% - 6%

23

5. LOANS RECEIVABLE, NET

Loans receivable, net at September 30, 2013 and December 31, 2012 are summarized as follows:

	September 30, 2013	December 31, 2012
Commercial loans (principally variable rate):		
Secured	$ 1,785,392	$ 2,050,728
Unsecured	15,155,159	16,502,920
Total commercial loans	16,940,551	18,553,648
Real estate loans:		
Commercial	52,674,057	56,698,844
Residential	2,460,097	2,498,603
Total real estate loans	55,134,154	59,197,447
Construction loans (net of undisbursed funds of $1,571,000 and $2,854,500, respectively)	3,254,000	3,112,477
Consumer loans	722,281	565,573
Other loans	668,214	768,790
	1,390,495	1,334,363
Total loans receivable	76,719,200	82,197,935
Less:		
Unearned loans fees, net	(198,898)	(226,364)
Allowance for loan losses	(1,260,454)	(1,753,521)
Total	$ 75,259,848	$ 80,218,050

Nonaccrual loans outstanding at September 30, 2013 and December 31, 2012 are summarized as follows:

	September 30, 2013	December 31, 2012
Nonaccrual loans:		
Commercial real estate	$ 4,334,938	$ 5,923,090
Commercial secured	88,021	—
Commercial unsecured	245,913	—
Construction	467,500	467,500

Total nonaccrual loans	$ 5,136,372	$ 6,390,590

	September 30, 2013	December 31, 2012
Interest income that would have been recorded during the period on nonaccrual loans outstanding in accordance with original terms	$ 329,804	$ 478,556

24

At September 30, 2013 and at December 31, 2012, there were no loans 90 days past due and still accruing interest.

The following table presents the aging of the past due loan balances as of September 30, 2013 and December 31, 2012 by class of loans:

September 30, 2013	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	$15,155,159	$216,553	$—	$ 245,913	$462,466	$14,692,693
Secured	1,785,392	—	—	88,021	—	1,785,392
Real Estate loans						
Commercial	52,674,057	141,816	—	4,334,938	4,476,754	48,197,303
Residential	2,460,097	100,051	—	—	100,051	2,360,046
Construction loans	3,254,000	—	300,000	467,500	767,500	2,486,500
Consumer loans	722,281	—	—	—	—	722,281
Other loans	668,214	504	—	—	504	667,710
Total loans	$76,719,200	$458,924	$300,000	$ 5,136,372	$5,807,275	$70,911,925

December 31, 2012	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	$16,502,920	$4,599	$—	$ —	$4,599	$16,498,321
Secured	2,050,728	—	91,649	—	91,649	1,959,079
Real Estate loans						
Commercial	56,698,844	1,946,281	150,000	5,923,090	8,019,371	48,679,473
Residential	2,498,603	—	—	—	—	2,498,603
Construction loans	3,112,477	—	—	467,500	467,500	2,644,977
Consumer loans	565,573	—	2,903	—	2,903	562,670
Other loans	768,790	—	—	—	—	768,790
Total loans	$82,197,935	$1,950,880	$244,552	$ 6,390,590	$8,586,022	$73,611,913

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

Loans individually evaluated for impairment were as follows:

	September 30, 2013	December 31, 2012
Loans with no allocated allowance for loan losses:		
Commercial real estate	$ 2,753,935	$ 3,924,469
Commercial secured	88,021	—
Construction	467,500	467,500
Loans with allocated allowance for loan losses:		
Commercial real estate	1,373,021	1,772,565
Commercial unsecured	245,913	—
	$ 4,928,390	$ 6,164,534

25

Amount of the allowance for loan losses allocated:		
Commercial real estate	$333,817	$838,531
Commercial unsecured	49,182	—
	$382,999	$838,531

The following table sets forth certain information about impaired loans with a measured impairment for the three and nine months ended September 30, 2013 and 2012:

	Three Months Ended September 30, 2013	Three Months Ended September 30, 2012
Average of individually impaired loans during period:		
Commercial real estate	$ 4,582,437	$ 5,873,758
Construction	467,500	—
Commercial secured	88,716	—
Commercial unsecured	261,247	—
	$ 5,399,900	$ 5,873,758
Interest income recognized during time period that loans were impaired, either using accrual or cash-basis method of accounting	$ 9,589	$ 304

	Nine Months Ended September 30, 2013	Nine Months Ended September 30, 2012
Average of individually impaired loans during period:		
Commercial real estate	$ 4,655,481	$ 6,605,848
Construction	467,500	132,500
Commercial secured	59,651	—
Residential real estate	—	488,889
Commercial unsecured	155,041	—
	$ 5,337,673	$ 7,227,237
Interest income recognized during time period that loans were impaired, either using accrual or cash-basis method of accounting	$ 62,269	$ 304

Troubled Debt Restructurings:

The Company has allocated $105,062 and $63,329 of specific reserves to customers whose loan terms have been modified in troubled debt restructurings (“TDRs”) as of September 30, 2013 and December 31, 2012, respectively. The Company has not committed to lend any additional amounts to customers with outstanding loans that are classified as TDRs.

The outstanding principal balance of trouble debt restructurings at September 30, 2013 was $5,431,492 and at December 31, 2012 was $5,826,633. None of the loans currently classified as TDRs have defaulted during the third quarter of 2013 and 2012. These TDRs are all current and are paying under the modified arrangements.

26

There was one loan that was modified during the nine months ended September 30, 2013 that did not meet the definition of a TDR. Modification of loans that do not meet the definition of a TDR involve either a modification of the terms of a loan to borrowers who were not experiencing financial difficulties or a delay in a payment that was considered to be insignificant.

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification.

The following table presents loans by class modified as troubled debt restructurings that occurred during the three and nine months ending September 30, 2013:

	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Troubled Debt Restructurings:			
Commercial real estate	8	$ 245,913	$ 245,913

The troubled debt restructurings described above required an additional allowance of $41,733 during the nine months ended September 30, 2013.

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 categorized 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 values, highly questionable and improbable.

The following table sets forth at September 30, 2013 and December 31, 2012, the aggregate carrying value of our assets categorized as Special Mention, Substandard and Doubtful according to asset type:

	At September 30, 2013				
	Special Mention	Substandard	Doubtful	Not Classified	Total
Commercial Loans:					
Secured	$—	$88,021	$ —	$1,697,371	$1,785,392
Unsecured	269,243	245,913	—	14,640,003	15,155,159
Commercial Real Estate	6,487,429	5,976,365	—	40,210,263	52,674,057
Residential Real Estate	—	2,140,047	—	320,050	2,460,097
Construction	300,000	467,500	—	2,486,500	3,254,000
Consumer	—	—	—	722,281	722,281
Other	2,889	—	—	665,325	668,214
Total loans	$7,059,561	$8,917,846	$ —	$60,741,793	$76,719,200
Real estate owned	—	—	—	—	—
Total assets	$7,059,561	$8,917,846	$ —	$60,741,793	$76,719,200

	At December 31, 2012				
	Special Mention	Substandard	Doubtful	Not Classified	Total
Commercial Loans:					
Secured	$91,649	$—	$ —	$1,959,079	$2,050,728
Unsecured	63,032	—	—	16,439,888	16,502,920
Commercial Real Estate	5,820,246	6,570,971	—	44,307,627	56,698,844
Residential Real Estate	—	2,174,455	—	324,148	2,498,603
Construction	—	467,500	—	2,644,977	3,112,477
Consumer	—	—	—	565,573	565,573
Other	3,746	—	—	765,044	768,790
Total loans	$5,978,673	$9,212,926	$ —	$67,006,336	$82,197,935
Real estate owned	—	342,867	—	—	342,867
Total assets	$5,978,673	$9,555,793	$ —	$67,006,336	$82,540,802

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 September 30, 2013 and December 31, 2012:

September 30, 2013

	Commercial Unsecured	Commercial Secured	Construction	Commercial Real Estate	Residential Real Estate	Other Loans	Total

Allowance for loan losses:							
Ending allowance balance attributable to loans							
Individually evaluated for impairment	$49,183	$—	$—	$372,103	$—	$—	$421,286
Collectively evaluated for impairment	390,365	12,659	18,378	372,776	5,457	39,533	839,168
Total ending allowance balance	$439,548	$12,659	$18,378	$744,879	$5,457	$39,533	$1,260,454
Loans:							
Individually evaluated for impairment	$245,913	$88,021	$467,500	$5,976,365	$2,140,047	$—	$8,917,846
Collectively evaluated for impairment	14,909,246	1,697,371	2,786,500	46,697,692	320,050	1,390,495	67,801,354
Total ending loans balance	$15,155,159	$1,785,392	$3,254,000	$52,674,057	$2,460,097	$1,390,495	$76,719,200

28

December 31, 2012

	Commercial Unsecured	Commercial Secured	Construction	Commercial Real Estate	Residential Real Estate	Other Loans	Total
Allowance for loan losses:							
Ending allowance balance attributable to loans							
Individually evaluated for impairment	$—	$—	$—	$853,108	$—	$—	$853,108
Collectively evaluated for impairment	425,495	18,790	16,282	394,091	4,528	41,227	900,413
Total ending allowance balance	$425,495	$18,790	$16,282	$1,247,199	$4,528	$41,227	$1,753,521
Loans:							
Individually evaluated for impairment	$—	$—	$467,500	$6,570,971	$2,174,455	$—	$9,212,926
Collectively evaluated for impairment	16,502,920	2,050,728	2,644,977	50,127,873	324,148	1,334,363	72,985,009
Total ending loans balance	$16,502,920	$2,050,728	$3,112,477	$56,698,844	$2,498,603	$1,334,363	$82,197,935

The following table presents the activity in the allowance for loan losses by portfolio segment for the three months and nine months ended September 30, 2013 and 2012.

Three months ended September 30, 2013

	Commercial Unsecured	Commercial Secured	Construction	Commercial Real Estate	Residential Real Estate	Other Loans	Total
Allowance for loan losses:							
Beginning balance	$ 453,305	$ 30,194	$ 18,517	$ 710,884	$ 4,485	$34,202	$1,251,587
Provision for loan losses	(19,082)	(17,535)	(139)	28,995	(2,420)	55,181	45,000
Loans charged-off	—	—	—	—	—	(50,000)	(50,000)
Recoveries	5,325	—	—	5,000	3,392	150	13,867
Total ending allowance balance	$ 439,548	$ 12,659	$ 18,378	$ 744,879	$ 5,457	$39,533	$1,260,454

Three months ended September 30, 2012

	Commercial Unsecured	Commercial Secured	Construction	Commercial Real Estate	Residential Real Estate	Other Loans	Total
Allowance for loan losses:							
Beginning balance	$ 547,621	$ 13,678	$ 37,186	$ 930,883	$ 2,190	$ 50,839	$ 1,582,397
Provision for loan losses	(29,818)	(2,235)	(16,491)	86,237	999	1,308	40,000
Loans charged-off	—	—	—	—	—	(10,917)	(10,917)
Recoveries	10,779	—	—	42,750	—	1,907	55,436
Total ending allowance balance	$ 528,582	$ 11,443	$ 20,695	$ 1,059,870	$ 3,189	$ 43,137	$ 1,666,916

Nine months ended
September 30, 2013

	Commercial Unsecured	Commercial Secured	Construction	Commercial Real Estate	Residential Real Estate	Other Loans	Total
Allowance for loan losses:							
Beginning balance	$ 425,495	$ 18,790	$ 16,282	$ 1,247,199	$ 4,528	$ 41,227	$ 1,753,521
Provision for loan losses	(27,038)	(6,131)	2,096	173,081	(8,914)	46,906	180,000
Loans charged-off	—	—	—	(680,401)	—	(50,000)	(730,401)
Recoveries	41,091	—	—	5,000	9,843	1,400	57,334
Total ending allowance balance	$ 439,548	$ 12,659	$ 18,378	$ 744,879	$ 5,457	$ 39,533	$ 1,260,454

Nine months ended
September 30, 2012

	Commercial Unsecured	Commercial Secured	Construction	Commercial Real Estate	Residential Real Estate	Other Loans	Total
Allowance for loan losses:							
Beginning balance	$ 474,686	$ 12,356	$ 34,184	$ 780,820	$ 672	$ 40,302	$ 1,343,020
Provision for loan losses	54,906	(913)	(13,489)	252,975	(25,124)	11,645	280,000
Loans charged-off	(100,757)	—	—	(16,675)	—	(10,917)	(128,349)
Recoveries	99,747	—	—	42,750	27,641	2,107	172,245
Total ending allowance balance	$ 528,582	$ 11,443	$ 20,695	$ 1,059,870	$ 3,189	$ 43,137	$ 1,666,916

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

Financial Condition at September 30, 2013

Total assets were $299,917,247 at September 30, 2013, an increase of $30,212,876, or 11.2%, from December 31, 2012. The increase resulted from the investment of funds available to us as the result of retained earnings and an increase in deposits. The deposit increase was caused generally by our efforts to grow our franchise and specifically by the deposit increases at our branch offices. We invested these funds primarily in the purchase of new investment securities. The principal changes resulting in the net increase in assets can be summarized as follows:

a $50,045,408 net increase in investment securities, partially offset by

a $14,471,228 net decrease in cash and cash equivalents and

a $ 4,958,202 net decrease in loans receivable, net.

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 $271,090,463 at September 30, 2013, an increase of $30,389,257 or 12.6%, from December 31, 2012 as a result of our active solicitation of retail deposits to increase funds for investment. The aggregate increase in deposits resulted from increases of $15,616,216 in non-interest demand deposits, $8,542,069 in money market accounts, $2,375,920 in time deposits, $2,107,968 in NOW accounts, $1,719,777 in savings accounts and $27,307 in escrow deposits.

Total stockholders' equity was $27,535,233 at September 30, 2013, a decrease of $218,738, or 0.79%, from December 31, 2012. The decrease reflected: (i) a $453,829 increase in retained earnings due to net income of $774,178 for the nine months ended September 30, 2013, partially offset by $320,349 of dividends paid in 2013; (ii) a reduction of $126,809 in Unearned ESOP shares reflecting the gradual payment of the loan we made to fund the ESOP's purchase of our stock and (iii) a decrease in the net unrealized gain on securities of $863,521.

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

The Current Economic Turmoil

The economy in the United States, including the economy in Staten Island, has recently come out of a recession, but the recovery has been slow and uneven. The extent and speed of the recovery is far from clear and the effects of low inflation, moderate job growth, and the Federal Reserve's decision to taper their purchase of mortgage-backed securities have created uncertainty not only on the pace of economic growth but on its sustainability. Some analysts continue to predict a darker road ahead. Substantial stress remains on many financial institutions and financial products due to the artificially maintained low interest rate environment, which directly places negative pressure on interest rate margins. We draw a substantial portion of our customer base from local businesses, especially those in the building trades and related industries, and we believe that there continue to be significant weaknesses in the business economy in our market area. Our customers have been adversely affected by the economic downturn and Superstorm Sandy. If adverse conditions in the local economy continue, 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. By September 30, 2013, the percentage had declined to 4.2%. However, developers and builders provide not only a source of loans, but they also provide us with deposits and other business. The weakness in the economy and the uncertain pace of the recovery has had an adverse effect on some of our customers and potential customers, making it more difficult for us to find satisfactory loan opportunities. This compelled us to invest in lower yielding securities instead of higher-yielding loans. This has and may continue to reduce our net income.

Possible Adverse Effects on Our Net Income Due to Fluctuations in Market Rates

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

In general, the interest rates we pay on deposits adjust more slowly than the interest rates we earn on loans because 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 have 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. For most of our prime-rate based loans, this will not occur until the prime rate increases above 6%. 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 have a substantial amount of investment securities with fixed rates of interest, most of which are mortgage-backed securities with an estimated average life of not more than 7 years. We receive regular cash flows from the repayment of our securities portfolios. These repayments had averaged in excess of $8 million per quarter for over two years but declined to $7 million in the third quarter of 2013. As securities purchased in past years gradually repaid and were replaced with purchases of new investment securities, our cash flows from those securities did and will decline in the immediate future because prepayments tend to be lower on recently-issued securities. We also have a significant level of overnight and short term investments, The availability overnight funds and securities repayments should allow us to invest at higher yields as market rates increase, thus blunting the effect of the delay in repricing our loans with interest rate floors.

Transfer of Some Available For Sale Securities to Held to Maturity

During the second quarter of 2013, Senior Management and the Board decided to transfer some securities that we pledge to secure borrowings and deposits (GNMA MBS, GNMA CMOs, and FNMA balloon MBS with final maturities of ten years or less) from available for sale portfolio to the held to maturity portfolio to align those securities with the Bank’s ability and intent to hold until maturity. As the securities are backed by GNMA, FNMA or FHLMC, we will recover the recorded investment and thus realize no gains or losses when the issuer pays the amount promised through maturity. Each transfer was done at fair value and any unrealized gain or loss is being amortized or accreted as the security pays down.

Delays in Foreclosure Proceedings

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 two years from the date a foreclosure action is commenced until the property is sold even in uncontested cases, and some uncontested cases can take longer. This problem, if it continues or gets worse, could have a substantial adverse effect on the value of our collateral for loans in default. The inability to realize upon collateral promptly, increases our loss in the event of a default due to the property value deterioration during a lengthy foreclosure.

Effects of Superstorm Sandy

Superstorm Sandy has had a devastating effect on the homes and businesses of New York City, especially Staten Island. We opened four of five locations (all located in Richmond County) the day after the Hurricane and they are in full operation. We re-opened the fifth location in February 2013 and all retail banking services are fully operational. While Superstorm Sandy did not have a significant effect on our operations, we incurred expenses of approximately $300,000 to remediate and reconstruct one of our branches that suffered sewer backup, water and wind driven rain damage. We have received insurance proceeds of $275,333 to help defray those costs. In the aftermath of Sandy, we had waived deposit service charges and late fees to those affected customers.

After Superstorm Sandy, we immediately embarked an outreach program to determine the extent that our borrowers were affected by Superstorm Sandy. We contacted 58 customers that we identified as being located in areas affected by the Superstorm who sustained some of, or a combination of, the following issues: substantial water and sewage damage to the business' physical plant, machinery and equipment; extended power loss causing business interruptions; displaced tenants due to the flood and sewage backup; employees unable to report to work due to the loss/damage of their personal homes or cars and the loss of mass transit. We individually assessed their condition and access to resources. The majority of our customers were able to restart their business with little assistance from us.

As we are primarily a commercial lender, we did not have residential loans that were negatively affected. We received 12 requests for either one or two month payment deferrals on commercial loans, which we granted. All twelve resumed their payments.

We operate primarily in Richmond County (Staten Island) and that is where we had the highest impact. We had one loan in Kings County that was affected but has since been current on payments. We had sufficient liquidity and resources to handle the effects of Superstorm Sandy. Our operations center was up and running the day Superstorm Sandy left the region and had full access to all of our resources.

We have assessed the short term impact of Superstorm Sandy, including the effects on the allowance for loan losses and the loan portfolio, but the sustainability and the viability of some businesses may take longer to evaluate. We will address any of the associated issues as they arise.

Results of Operations for the Three Months Ended September 30, 2013 and September 30, 2012

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.

General. We had net income of $341,238 for the three months ended September 30, 2013, compared to net income of $357,460 for the comparable period in 2012. The principal categories which make up the 2013 net income are:

Interest income of $2,169,482

Reduced by interest expense of $205,691

Reduced by a provision for loan losses of $45,000

Increased by non-interest income of $714,367

Reduced by non-interest expense of $2,004,136

Reduced by income tax expense of $287,784

We discuss each of these categories individually and the reasons for the differences between the three months ended September 30, 2013 and 2012 in the following paragraphs.

Interest Income. Interest income was $2,169,482 for the three months ended September 30, 2013, compared to $2,251,883 for the three months ended September 30, 2012, a decrease of $82,401 or 3.7%. The main reason for the decline was a $7,764,984 decrease in the average loan balance and a 14 basis point decrease in the yield on loans, between the periods, which combined to cause a $172,782 decline in interest income on loans.

Interest income on loans decreased by $172,782 as a result of a decrease of $7.8 million in the average balance of loans and a 14 basis point decrease in the average yield, from the three months ended September 30, 2012 to the three months ended September 30, 2013. There was a $225,582 decrease in our average non-performing loans, from $6.1 million in the three months ended September 30, 2012 to $5.9 million in the same period ended 2013. During the period in which interest is not being paid, non-performing loans continue to be included in the calculation of average loan yield, but with an effective yield of zero. We estimate that if all non-performing loans were performing according to their contractual terms during the three months ended September 30, 2013, our average loan yield would have been approximately 41 basis points higher. In contrast, we estimate that the comparable effect in 2012 period would have been approximately a 55 basis point increase in average loan yield. Substantially all of the non-accrual loans are secured by mortgages on real estate.

Interest rate floors on most of 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 had an increase of $80,918, or 11.0%, in income on investment securities when comparing the third quarter of 2012 to the third quarter of 2013. We experienced a 35 basis point decrease in the average yield on our investment securities portfolios, from 2.55% to 2.20%, due to the purchase of new investment securities at lower market rates than the rates we had been earning on the investment securities previously purchased that were gradually being repaid. The combined average balance of our investment portfolios increased by $32.4 million, or 28.2%, between the periods, as market conditions gave us opportunities to purchase investment securities at more favorable yields with terms similar to those we had purchased in the past. This increase in average balance was the reason for the overall increase in interest income on securities. The investment securities portfolios represented 68.9% of average non-loan interest earning assets in the 2013 period compared to 68.1% in the 2012 period.

Interest income from other interest earning assets (principally overnight investments) increased by $9,463 due to an increase in the yield of 2 basis point from 0.22% for the three months ended September 30, 2012 to 0.24% for the same period ended September 30, 2013. In addition, the average balance of our other interest earning assets increased by $12.6 million between the periods because we elected to invest most of the available funds in overnight investments rather than tie them up in longer term investment securities which were available only at relatively low yields.

Interest Expense. Interest expense was $205,691 for the three months ended September 30, 2013, compared to $200,612 for the three months ended September 30, 2012, an increase of $5,079 or 2.5%. The principal reason for the increase was an increase in the average balance of interest-bearing deposits as we sought to increase our total deposits, partially offset by a decline in average cost of funds as we were able to reprice some deposits downward as market interest rates remained low. The components of this increase included a $7,985 increase in interest on time deposits due to a $10.3 million increase in the average balance between the periods, even as the average cost declined by 5 basis point, and a $3,537 increase in the cost of savings accounts due to 3 basis point increase in the average cost and the $2.5 million increase in the average balance between the periods. The increase in interest expense was partially offset by an $2,139 decrease in the cost of money market accounts, as the average cost declined by 16 basis points, while the average balance increased by $7.5 million and a $4,304 decrease in the cost of NOW accounts, as the average cost declined by 6 basis points, while the average balance increased by $1.5 million. We decided to reprice money market and NOW accounts downward due to a continuation of low market interest rates. As a result, our average cost of funds, excluding the effect of interest-free demand deposits, decreased to 0.47% from 0.53% between the periods.

Net Interest Income Before Provision for Loan Losses. Net interest income before the provision for loan losses was $1,963,791 for the three months ended September 30, 2013, compared to $2,051,271 for the three months ended September 30, 2012, a decrease of $87,480, or 4.3%. The decrease was because the reduction in our interest income was greater than the reduction in our cost of funds when comparing the three months ended September 30, 2013 to the same period ended 2012. The average yield on interest earning assets declined by 55 basis points, while the average cost of funds declined by 6 basis points. The reduction in the yield on assets was principally due to the 35 basis points drop in the yield on investment securities and the 14 basis points drop in the yield on loans, partially offset by an increase of 2 basis points in the low yielding overnight investments. In addition, loans, our highest yielding asset category, declined from 33.1% of earning assets in the 2012 quarter to 26.2% in the 2013 quarter, which also contributed to the decline in average yield. Overall, our interest rate spread declined 49 basis points, from 2.97% to 2.48% between the periods. Correspondingly, our net interest margin decreased to 2.67% for the three months ended September 30, 2013 from 3.18% in the same period of 2012. The margin is higher than the spread because it takes into account the effect of interest free demand deposits and capital. We are working to reverse the trend of declining spread by seeking to increase our loan portfolio and by taking advantage of opportunities to purchase investment securities at favorable yields that presented themselves during the third quarter of 2013.

The spread and margin both decreased because of the combined effect of the decline in earnings we were able to obtain on our investments securities and the larger average balances of our lowest yielding category, other interest earning assets. These declines could not be offset by corresponding declines in the cost of deposits because the rates we paid on deposits were already low due to low markets rates so that we could not reduce them as much as the decline in the earnings on investment securities. In addition, we continued to incur interest expense on deposits that funded the non-performing loans that did not earn interest and on other interest earning assets, our lowest yielding asset class.

Provision for Loan Losses. 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. We took a provision for loan losses of $45,000 for the three months ended September 30, 2013 compared to a provision for loan losses of $40,000 for the same period in 2012. The $5,000 increase in the provision was a result of a higher level of charge-offs despite a lower level of non-performing loans and total loans.

We experienced a decrease of $953,866 in non-performing loans from $6,090,239 at September 30, 2012 to $5,136,373 at September 30, 2013. Most of those loans are secured by real estate. We individually evaluated the non-performing mortgage loans based primarily upon updated appraisals as part of our analysis of the appropriate level of our allowance for loan and lease losses. We charged-off $50,000 of loans for the three months ended September 30, 2013 as compared to charge-offs of $10,917 for the same period in 2012. We also had recoveries (which are added back to the allowance for loan losses) of $13,867 for the three months ended September 30, 2013 as compared to $55,436 in the same period of 2012.

After considering other matters that increased or decreased the allowance, we determined that the level of our allowance at September 30, 2013 was appropriate to address inherent losses. Overall, our allowance for loan losses decreased from $1,666,916 or 2.03% of total loans, at September 30, 2012 to $1,260,454 or 1.64% of total loans, at September 30, 2013. 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 $714,367 for the three months ended September 30, 2013, compared to $607,828 during the same period last year. The $106,539, or 17.5%, increase in non-interest income was a direct result of an increase of $105,845 in service charges on deposits primarily due to a recent increase in the per item insufficient fund fee we charge. Service charges on deposits consist mainly of insufficient fund fees, which are inherently volatile, and are based upon the number of items being presented for payment against insufficient funds.

Non-interest Expense. Non-interest expense was $2,004,136 for the three months ended September 30, 2013, compared to $1,960,211 for the three months ended September 30, 2012, an increase of $43,925 or 2.2%. The principal shifts in the individual categories were:

a $26,185 increase in legal expense due to general corporate needs in 2013 and a recovery of legal expense on a past due loan in the third quarter of 2012 which legal fees had been previously expensed;

a $21,156 increase in professional fees due to the engagement of a consulting firm;

a $13,419 increase in salaries and benefits due to termination expenses;

a $10,049 increase in other non-interest expenses due to a $4,255 increase in the costs of operating our ATM, a $2,571 increase in regulatory filing costs and increases other normal operating expenses;

a $4,261 increase in computer expense due to a recent rise in software contract expense, partially offset by;

a $27,245 decrease in occupancy expense due to reduced fixed asset costs; and

a $7,400 decrease in directors fees due to fewer meetings in 2013.

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 $287,784 for the three months ended September 30, 2013, compared to income tax expense of $301,428 for the same period ended 2012. The decrease in income tax expense was due to the $29,866 decrease in income before income taxes in the 2013 period. Our effective tax rate for the three months ended September 30, 2013 and 2012 was 45.8%.

Results of Operations for the Nine Months Ended September 30, 2013 and September 30, 2012

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.

General. We had net income of $774,178 for the nine months ended September 30, 2013, compared to net income of $1,010,945 for the comparable period in 2012. The principal categories which make up the 2013 net income are:

Interest income of $6,355,289

Reduced by interest expense of $621,755

Reduced by a provision for loan losses of $180,000

Increased by non-interest income of $1,965,906

Reduced by non-interest expense of $6,092,304

Reduced by income tax expense of $652,958

We discuss each of these categories individually and the reasons for the differences between the nine months ended September 30, 2013 and 2012 in the following paragraphs.

Interest Income. Interest income was $6,355,289 for the nine months ended September 30, 2013, compared to $6,886,588 for the nine months ended September 30, 2012, a decrease of $531,299 or 7.7%. The main reason for the decline was a $5,346,704 decrease in the average loan balance and a 9 basis point decrease in the yield on loans between the periods, which combined to cause a $351,283 decline in interest income on loans. There was also an increase of $225,466 in investment securities.

Interest income on loans decreased by $351,283 as a result of a decrease of $5.3 million in the average balance of loans and a 9 basis point decrease in the average yield, from the nine months ended September 30, 2012 to the nine months ended September 30, 2013. There was a $1,926,874 decrease in our average non-performing loans, from $7.7 million in the nine months ended September 30, 2012 to $5.8 million in the same period ended 2013. During the period in which interest is not being paid, non-performing loans continue to be included in the calculation of average loan yield, but with an effective yield of zero. We estimate that if all non-performing loans were performing according to their contractual terms during the nine months ended September 30, 2013, our average loan yield would have been approximately 37 basis points higher. In contrast, we estimate that the comparable effect in 2012 period would have been approximately a 34 basis point increase in average loan yield. Substantially all of the non-accrual loans are secured by mortgages on real estate.

Interest rate floors on most of 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 56 basis point decrease in the average yield on our investment securities portfolios, from 2.71% to 2.15%, due to the purchase of new investment securities at lower market rates than the rates we had been earning on the investment securities previously purchased that were gradually being repaid. The aggregate average balance of our investment portfolios increased by $15.8 million, or 13.9%, between the periods. The investment securities portfolios represented 64.6% of average non-loan interest earning assets in the 2013 period compared to 70.4% in the 2012 period.

Interest income from other interest earning assets (principally overnight investments) increased by $45,450 due to an increase in the yield of 1 basis point from 0.22% for the nine months ended September 30, 2012 to 0.23% for the same period ended September 30, 2013. In addition, the average balance of our other interest earning assets increased by $23.1 million between the periods because we elected to invest most of the available funds in overnight investments rather than tie them up in longer term investment securities which were available only at relatively low yields.

Interest Expense. Interest expense was $621,755 for the nine months ended September 30, 2013, compared to $608,093 for the nine months ended September 30, 2012, an increase of $13,662 or 2.3%. The principal reason for the increase was an increase in the average balance of interest-bearing deposits as we sought to increase our total deposits, partially offset by a decline in average cost of funds as we were able to reprice some deposits downward as market interest rates remained low. The increase was the result of a $23,956 increase in interest on time deposits due to a $9.8 million increase in the average balance between the periods, a $22,270 increase in the cost of savings accounts due to 8 basis point increase in the average cost and the $4.1 million increase in the average balance between the periods. The increase in interest expense was partially offset by an $16,895 decrease in the cost of money market accounts, as the average cost declined by 16 basis points and an $15,669 decrease in the cost of NOW accounts, as the average cost declined by 8 basis points, due to our decision to reprice those deposits downward during the continuation of low market interest rates. As a result, our average cost of funds, excluding the effect of interest-free demand deposits, decreased to 0.50% from 0.55% between the periods.

Net Interest Income Before Provision for Loan Losses. Net interest income before the provision for loan losses was $5,733,534 for the nine months ended September 30, 2013, compared to $6,278,495 for the nine months ended September 30, 2012, a decrease of $544,961, or 8.7%. The decrease was because the reduction in our interest income was greater than the reduction in our cost of funds when comparing the nine months ended September 30, 2013 to the same period ended 2012. The average yield on interest earning assets declined by 70 basis points, while the average cost of funds declined by 5 basis points. The reduction in the yield on assets was principally due to the 56 basis points drop in the yield on investment securities and the 9 basis points decrease in the yield on loans, partially offset by the increase in low yielding overnight investments as a percentage of total interest-earning assets. Overall, our interest rate spread declined 65 basis points, from 3.17% to 2.52% between the periods. Correspondingly, our net interest margin decreased to 2.73% for the nine months ended September 30, 2013 from 3.39% in the same period of 2012. The margin is higher than the spread because it takes into account the effect of interest free demand deposits and capital.

The spread and margin both decreased because of the combined effect of the decline in earnings we were able to obtain on our investments securities and the larger average balances of our lowest yielding category, other interest earning assets. These declines could not be offset by corresponding declines in the cost of deposits because the rates we paid on deposits were already low due to low markets rates so that we could not reduce them as much as the decline in the earnings on investment securities. In addition, we continued to incur interest expense on deposits that funded the non-performing loans that did not earn interest and on other interest earning assets, our lowest yielding asset class.

Provision for Loan Losses. 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. We took a provision for loan losses of $180,000 for the nine months ended September 30, 2013 compared to a provision for loan losses of $280,000 for the same period in 2012. The $100,000 decrease in the provision was a result of a lower level of non-performing loans and total loans, despite a higher level of charge-offs.

We experienced a decrease of $953,866 in non-performing loans from $6,090,239 at September 30, 2012 to $5,136,373 at September 30, 2013. Most of those loans are secured by real estate. We individually evaluated the non-performing mortgage loans based primarily upon updated appraisals as part of our analysis of the appropriate level of our allowance for loan and lease losses. We charged-off $730,401 of loans for the nine months ended September 30, 2013 as compared to charge-offs of $128,349 for the same period in 2012. We also had recoveries (which are added back to the allowance for loan losses) of $57,334 for the nine months ended September 30, 2013 as compared to $172,245 in the same period of 2012.

After considering other matters that increased or decreased the allowance, we determined that the level of our allowance at September 30, 2013 was appropriate to address inherent losses. Overall, our allowance for loan losses decreased from $1,666,916 or 2.03% of total loans, at September 30, 2012 to $1,260,454 or 1.64% of total loans, at September 30, 2013. 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 $1,965,906 for the nine months ended September 30, 2013, compared to $1,856,784 during the same period last year. The $109,122, or 5.9%, increase in non-interest income was a direct result of a $68,554 increase in other income, primarily due a reimbursement of $36,394 in expenses received from insurance proceeds as a result of Superstorm Sandy and a $17,571 gain on the sale of a fixed asset and an increase of $25,201 in service charges on deposits primarily due to a recent increase in the per-item insufficient fund fee assessed against deposit accounts. Service charges on deposits consist mainly of insufficient fund fees, which are inherently volatile, and are based upon the number of items being presented for payment against insufficient funds.

Non-interest Expense. Non-interest expense was $6,092,304 for the nine months ended September 30, 2013, compared to $5,991,735 for the nine months ended September 30, 2012, an increase of $100,569 or 1.7%. The principal shifts in the individual categories were:

a $143,313 increase in other non-interest expenses due to a $66,477 increase in the cost of holding real estate acquired in foreclosure, principally writedowns of REO assets, and foreclosure costs; a $21,379 increase in the costs of operating our ATM’s; a $14,675 increases in marketing costs due to a new ad campaign, a $8,539 increase in forgery costs and increase in other normal operating expenses;

a $40,416 increase in computer expense due to a recent rise in software acquisition and maintenance expenses

a $37,068 increase in salaries and benefits due to severance payments and the acceleration of stock benefits upon retirement;

a $23,067 increase in professional fees due to the engagement of a consulting firm to assist in identifying alternate revenue sources, partially offset by;

a $101,381 decrease in occupancy expense due to a reimbursement by our insurance carrier on monies expensed in the remediation and rebuilding of our Dongan Hills branch, which sustained damage during Superstorm Sandy, and reduced fixed asset costs;

a $28,275 decrease in director fees due to fewer meetings; and

a $10,639 decrease in legal expense, due to a recovery of legal expense on two past due loans, on which $15,992 in legal fees had been previously expensed.

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 $652,958 for the nine months ended September 30, 2013, compared to income tax expense of $852,599 for the same period ended 2012. The decrease in income tax expense was due to the $436,408 decrease in income before income taxes in the 2013 period. Our effective tax rate for the nine months ended September 30, 2013 and 2012 was 45.8%.

VSB Bancorp, Inc.
Consolidated Average Balance Sheets
(unaudited)

	Three Months Ended September 30, 2013 Average Balance	Interest	Yield/ Cost	Three Months Ended September 30, 2012 Average Balance	Interest	Yield/ Cost	Nine Months Ended September 30, 2013 Average Balance	Interest
Assets:								
Interest-earning assets:								
Loans receivable	$75,859,572	$1,312,109	6.79%	$83,624,556	$1,484,891	6.93%	$78,262,384	$4,137,80
Investment securities, afs & htm	147,493,695	817,651	2.20	115,085,676	736,733	2.55	129,974,164	2,093,70
Other interest-earning assets	66,517,357	39,722	0.24	53,928,685	30,259	0.22	71,086,253	123,781
Total interest-earning assets	289,870,624	2,169,482	2.95	252,638,917	2,251,883	3.50	279,322,801	6,355,28
Non-interest earning assets	7,791,484			6,322,086			7,349,027	
Total assets	$297,662,108			$258,961,003			$286,671,828	
Liabilities and equity:								
Interest-bearing liabilities:								
Savings accounts	$22,998,714	20,030	0.35	$20,524,056	16,493	0.32	$22,671,048	57,963
Time accounts	74,867,612	113,503	0.60	64,522,535	105,518	0.65	74,728,385	359,326
Money market accounts	39,813,966	57,048	0.57	32,315,022	59,187	0.73	35,673,688	157,163
Now accounts	35,170,903	15,110	0.17	33,625,213	19,414	0.23	34,271,100	47,303
Total interest-bearing liabilities	172,851,195	205,691	0.47	150,986,826	200,612	0.53	167,344,221	621,755
Checking accounts	96,186,019			78,777,306			90,497,422	
Escrow deposits	110,760			330,984			214,946	
Total deposits	269,147,974			230,095,116			258,056,589	
Other liabilities	1,031,206			1,250,885			912,860	
Total liabilities	270,179,180			231,346,001			258,969,449	

Equity	27,482,928			27,615,002			27,702,379		
Total liabilities and equity	$297,662,108			$258,961,003			$286,671,828		
Net interest income/net interest rate spread		$1,963,791	2.48%		$2,051,271	2.97%		$5,733,53	
Net interest earning assets/net interest margin	$117,019,429		2.67%	$101,652,091		3.18%	$111,978,580		
Ratio of interest-earning assets to interest-bearing liabilities	1.68 x			1.67 x			1.67 x		
Return on Average Assets (1)	0.44 %			0.53 %			0.35 %		
Return on Average Equity (1)	4.81 %			4.92 %			3.63 %		
Tangible Equity to Total Assets	9.18 %			10.66 %			9.18 %		

(1) Ratios have been annualized.

39

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.

During the nine months ended September 30, 2013, we had a net increase in total deposits of $30,389,257 due to increases of $15,616,216 in non-interest demand deposits, $8,542,069 in money market accounts, $2,375,920 in time deposits, $2,107,968 in NOW accounts, $1,719,777 in savings accounts and $27,307 in escrow deposits. 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 $24,077,079. We used $76,029,882 of available funds to purchase new investment securities and we had a net loan decrease of $4,637,604. These changes resulted in an overall decrease in cash and cash equivalents of $14,471,228. Total cash and cash equivalents at September 30, 2013 were $63,257,198.

In contrast, during the nine months ended September 30, 2012, we had a net increase in total deposits of $17,731,942 due to increases of $7,026,530 in non-interest demand deposits, $5,727,857 in money market accounts, $3,575,103 in savings accounts, $3,290,674 in NOW accounts, and $141,775 in escrow deposits partially offset by a decrease of $2,029,997 in time deposits. These are all what are commonly known as “retail” deposits rather than “wholesale” deposits. We also received proceeds from repayment of investment securities of $27,734,440. We used $31,841,957 of available funds to purchase new investment securities and we had a net loan increase of $36,363. These changes resulted in an overall increase in cash and cash equivalents of $14,715,503. Total cash and cash equivalents at September 30, 2012 were $62,823,176.

At September 30, 2013, cash and cash equivalents represented 21.1% of total assets. Our cash and cash equivalents increased due to a recent influx of new deposits, which we have deployed into investment securities, which will enable us to generate higher interest income. We maintain a higher level of cash and cash equivalents to help buffer the adverse effects of potential, future rising interest rates but we anticipate that we will be purchasing more investment securities and seeking loan participations to reduce the current level of cash and cash equivalents. 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. 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 September 30, 2013 we had $56.9 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 all the securities in our investment portfolios as collateral if the need arises.

Based upon our asset size and the amount of our securities portfolios that qualifies as eligible collateral, we had more than $122.1 million of unused borrowing capability from the FHLBNY at September 30, 2013. 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. 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 September 30, 2013, with a Tier I Leverage Capital ratio of 8.86%, a Tier I Capital to Risk-Weighted Assets ratio of 25.17%, and a Total Capital to Risk-Weighted Assets ratio of 26.37%.

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 September 30, 2013

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	$436,010	$793,382	$508,330	$410,019	$2,147,741
Remaining contractual maturities of time deposits	64,891,609	3,156,500	5,780,515	—	73,828,624
Total contractual cash obligations	$65,327,619	$3,949,882	$6,288,845	$410,019	$75,976,365

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	$15,515,624	$1,612,000	$—	$—	$17,127,624

Non-Performing Loans

Management closely monitors non-performing loans and other assets with potential problems on a regular basis. We had twenty four non-performing loans, totaling $5,136,373 at September 30, 2013, compared to nineteen non-performing loans, totaling $6,390,590 at December 31, 2012. Non-performing loans totaled 6.70% of total loans at September 30, 2013 compared to 7.77% of total loans at December 31, 2012. We have always followed a hands-on approach to dealing with our past due borrowers that we believe is sufficiently aggressive to maximize recovery.

As noted in the discussion below regarding specific loans, many of our non-performing loans are secured by real estate, and thus we expect substantial if not complete recovery of the loan amount. However, it is inevitable that we will experience some charge-offs of non-performing loans. All of the loans discussed individually below were evaluated separately for impairment under ASC 310 and we have included a component of our allowance for loan and lease losses representing our measurement of the impairment on those loans. However, the process by which we estimate the potential loss on those loans is necessarily imprecise and subject to changing future events, facts that may be unknown to us, and other uncertainties. Thus, although we believe that our allowance for loan losses is appropriate to address the weaknesses in those loans, we may be required to increase our provision for loan losses in the future if actual impairment exceeds our expectations.

The following is information about the seven largest non-performing loans and the associated relationships, totaling $3,796,752, or 73.9% of our non-performing loans, by outstanding principal balance at September 30, 2013. Management believes it has taken appropriate steps with a view towards maximizing recovery and minimizing loss, if any, on these loans.

$1,224,198 in two commercial real estate loans. The loans, made to two individuals, are secured by a first mortgage and second mortgage on two pieces of real estate in Staten Island. The borrowers are actively pursuing the sale of these properties. We commenced a foreclosure proceeding and we have obtained a money judgment on one of the loans that is a lien on their personal residence.

41

$826,054 in a commercial real estate loan. The loan is secured by a first mortgage on the property in Staten Island. The loan is guaranteed personally by the principals of the borrower. The borrower signed a forbearance agreement during the fourth quarter of 2012 which includes a modified payment arrangement. We received a $145,000 upfront payment and the borrower agreed to make monthly payments. We agreed to hold the previously commenced foreclosure proceedings in abeyance as long as there is performance under the forbearance agreement. The borrower has defaulted on the payments according to the forbearance agreement and we have resumed the foreclosure action.

$780,000 in a commercial real estate loan, which is secured by a first mortgage on property in Queens. We have commenced a foreclosure action and we are at the stage of getting final court approval of the referee's report on the amount due so we can hold the foreclosure sale of the property. A guarantor of the loan filed a bankruptcy petition, which temporarily delayed the foreclosure action. We had another second mortgage loan to the same and related borrowers and guarantors. The first mortgagor foreclosed and we charged-off that loan. We have a money judgment on that loan for $764,226.65, including principal, interest and costs, and have been aggressively pursuing collection but collection proceedings against the principal individual guarantor remains stayed due to the same bankruptcy.

$499,000 in a commercial real estate loan on property in Staten Island that is leased to a restaurant. The loan is secured by a first mortgage on the property and a second mortgage on other commercial real estate collateral. The loan is guaranteed personally by the principals of the borrower and we have a security interest in the business. We have commenced foreclosure proceedings and we have obtained a foreclosure judgment.

$467,500 in two construction loans. The loans are secured by a first and second mortgage on property in Staten Island. The loans are guaranteed personally by the principals of the borrower. The borrower signed a forbearance agreement in October, 2012 and has received a certificate of occupancy on the property. The borrowers executed a second forbearance agreement in April 2013 and payments are current.

From time to time, 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 the 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. We prefer to develop repayment plans for our borrowers that provide them with cash flow relief while requiring that they ultimately pay all amounts that they owe. However, we are not averse to commencing legal action to foreclose on mortgages or obtain personal judgments against obligors when we perceive that as the appropriate strategy. Unfortunately, in recent years, many courts have taken a very pro-borrower stance in foreclosure actions, which has resulted in delays in our ability to realize upon real estate collateral.

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.

Once a loan is categorized as a non-accrual loan, the loan may be restored to accruing status after a period of consistent on-time performance. 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.

Critical Accounting Policies and Judgments

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.

Item 3 – Controls and Procedures

Evaluation of Disclosure Controls and Procedures: As of September 30, 2013, we undertook an evaluation of our disclosure controls and procedures under the supervision and with the participation of Raffaele M. Branca, President and CEO and Jonathan B. Lipschitz, Vice President and Controller. Disclosure controls are the systems and procedures we use that are designed to ensure that information we are required to disclose in the reports we file or submit under the Securities Exchange Act of 1934 (such as annual reports on Form 10-K and quarterly periodic reports on Form 10-Q) is recorded, processed, summarized and reported, in a manner which will allow senior management to make timely decisions on the public disclosure of that information. Mr. Branca and Mr. Lipschitz concluded that our current disclosure controls and procedures are effective in ensuring that such information is (i) collected and communicated to senior management in a timely manner, and (ii) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Since our last evaluation of our disclosure controls, we have not made any significant changes in, or taken corrective actions regarding, either our internal controls or other factors that could significantly affect those controls.

We intend to continually review and evaluate the design and effectiveness of our disclosure controls and procedures and to correct any deficiencies that we may discover. Our goal is to ensure that senior management has timely access to all material financial and non-financial information concerning our business so that they can evaluate that information and make determinations as to the nature and timing of disclosure of that information. While we believe the present design of our disclosure controls and procedures is effective to achieve this goal, future events may cause us to modify our disclosure controls and procedures.

Part II

Item 1 – Legal Proceedings

VSB Bancorp, Inc. is not involved in any pending legal proceedings. Victory State 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.

Signature Page

In accordance with the requirements of the Exchange Act, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

	VSB Bancorp, Inc.
Date: November 12, 2013	/s/ Raffaele M. Branca Raffaele M. Branca President, CEO and Principal Executive Officer
Date: November 12, 2013	/s/ Jonathan B. Lipschitz Jonathan B. Lipschitz Vice President, Controller and Principal Accounting Officer

EXHIBIT INDEX

Exhibit Number	Description of Exhibit
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.
101.INS	XBRL Instance Document (furnished herewith)
101.SCH	XBRL Taxonomy Extension Schema Document (furnished herewith)
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document (furnished herewith)
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document (furnished herewith)
101.LAB	XBRL Taxonomy Extension Label Linkbase Document (furnished herewith)
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document (furnished herewith)

Item 6 - Exhibits

Exhibit Number	Description of Exhibit
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.
101.INS	XBRL Instance Document (furnished herewith)
101.SCH	XBRL Taxonomy Extension Schema Document (furnished herewith)
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document (furnished herewith)
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document (furnished herewith)
101.LAB	XBRL Taxonomy Extension Label Linkbase Document (furnished herewith)
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document (furnished herewith)