UNITY BANCORP INC /NJ/
Form 10-Q
August 10, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

(X) QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED June 30, 2012

OR

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

Commission file number 1-12431

Unity Bancorp, Inc.

(Exact Name of Registrant as Specified in Its Charter)

New Jersey	22-3282551
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)

64 Old Highway 22, Clinton, NJ	08809
(Address of Principal Executive Offices)	(Zip Code)

Registrant’s Telephone Number, Including Area Code (908) 730-7630

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

Yes x No o

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

Large accelerated filer o Accelerated filer o Nonaccelerated filer o Smaller reporting company x

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

Yes o No x

The number of shares outstanding of each of the registrant’s classes of common equity stock, as of August 1, 2012 common stock, no par value: 7,460,572 shares outstanding

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PART I CONSOLIDATED FINANCIAL INFORMATION

ITEM 1 Consolidated Financial Statements (Unaudited)

Unity Bancorp, Inc.

Consolidated Balance Sheets

(Unaudited)

(In thousands)	June 30, 2012	December 31, 2011	June 30, 2011
ASSETS			
Cash and due from banks	$ 18,600	$ 17,688	$ 12,915
Federal funds sold and interest-bearing deposits	19,235	64,886	33,367
Cash and cash equivalents	37,835	82,574	46,282
Securities:			
Securities available for sale	97,965	88,765	101,872
Securities held to maturity (fair value of $18,301, $19,879 and $13,855, respectively)	16,881	18,771	13,316
Total securities	114,846	107,536	115,188
Loans:			
SBA loans held for sale	6,087	7,668	13,753
SBA loans held to maturity	60,382	64,175	71,429
SBA 504 loans	45,247	55,108	55,810
Commercial loans	310,331	283,104	287,785
Residential mortgage loans	136,514	134,090	134,782
Consumer loans	46,340	48,447	51,546
Total loans	604,901	592,592	615,105
Allowance for loan losses	(16,284)	(16,348)	(16,018)
Net loans	588,617	576,244	599,087
Premises and equipment, net	12,146	11,350	10,650
Bank owned life insurance ("BOLI")	9,253	9,107	8,959
Deferred tax assets	6,977	6,878	6,756
Federal Home Loan Bank stock	3,989	4,088	4,088
Accrued interest receivable	3,415	3,703	3,692
Other real estate owned ("OREO")	2,355	3,032	2,722
Prepaid FDIC Insurance	2,230	2,545	2,720
Goodwill and other intangibles	1,522	1,530	1,537
Other assets	1,926	2,259	4,482
Total assets	$ 785,111	$ 810,846	$ 806,163

LIABILITIES AND SHAREHOLDERS' EQUITY
Liabilities:

Deposits:			
Noninterest-bearing demand deposits	$ 107,497	$ 101,193	$ 94,547
Interest-bearing demand deposits	101,420	104,749	93,730
Savings deposits	273,395	278,603	285,651
Time deposits, under $100,000	83,138	102,809	106,880
Time deposits, $100,000 and over	50,993	56,617	60,359
Total deposits	616,443	643,971	641,167
Borrowed funds	75,000	75,000	75,000
Subordinated debentures	15,465	15,465	15,465
Accrued interest payable	470	523	570
Accrued expenses and other liabilities	2,832	2,329	1,754
Total liabilities	710,210	737,288	733,956
Commitments and contingencies	-	-	-
Shareholders' equity:			
Cumulative perpetual preferred stock	19,824	19,545	19,278
Common stock	53,917	53,746	53,590
Retained earnings (deficit)	231	(854)	(1,757)
Accumulated other comprehensive income	929	1,121	1,096
Total shareholders' equity	74,901	73,558	72,207
Total liabilities and shareholders' equity	$ 785,111	$ 810,846	$ 806,163
Preferred shares	21	21	21
Issued common shares	7,461	7,459	7,412
Outstanding common shares	7,461	7,459	7,412

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

Unity Bancorp, Inc.

Consolidated Statements of Income

(Unaudited)

(In thousands, except per share amounts)	For the three months ended June 30, 2012	2011	For the six months ended June 30, 2012	2011
INTEREST INCOME				
Federal funds sold and interest-bearing deposits	$ 11	$ 9	$ 43	$ 20
Federal Home Loan Bank stock	44	35	95	101
Securities:				
Available for sale	690	891	1,410	1,754
Held to maturity	163	180	336	468
Total securities	853	1,071	1,746	2,222
Loans:				
SBA loans	846	1,191	1,770	2,427
SBA 504 loans	691	834	1,451	1,789
Commercial loans	4,216	4,581	8,397	8,887
Residential mortgage loans	1,582	1,846	3,237	3,677
Consumer loans	529	629	1,089	1,315
Total loans	7,864	9,081	15,944	18,095
Total interest income	8,772	10,196	17,828	20,438
INTEREST EXPENSE				
Interest-bearing demand deposits	123	143	259	283
Savings deposits	287	584	641	1,165
Time deposits	689	1,045	1,603	2,140
Borrowed funds and subordinated debentures	816	953	1,662	1,904
Total interest expense	1,915	2,725	4,165	5,492
Net interest income	6,857	7,471	13,663	14,946
Provision for loan losses	1,000	1,750	2,200	4,250
Net interest income after provision for loan losses	5,857	5,721	11,463	10,696
NONINTEREST INCOME				
Branch fee income	362	337	748	680
Service and loan fee income	287	384	588	627
Gain on sale of SBA loans held for sale, net	223	399	381	510
Gain on sale of mortgage loans, net	453	87	864	256
BOLI income	73	74	146	147
Net security gains (losses)	283	(39)	507	87
Other income	160	205	322	395
Total noninterest income	1,841	1,447	3,556	2,702
NONINTEREST EXPENSE				
Compensation and benefits	3,133	2,880	6,315	5,937
Occupancy	740	827	1,348	1,546
Processing and communications	553	537	1,087	1,044
Furniture and equipment	355	410	717	794

Professional services	211	192	402	394
Loan collection costs	91	201	271	425
OREO expenses	237	223	362	445
Deposit insurance	168	282	339	601
Advertising	302	205	448	323
Other expenses	414	490	872	897
Total noninterest expense	6,204	6,247	12,161	12,406
Income before provision for income taxes	1,494	921	2,858	992
Provision for income taxes	518	277	977	129
Net income	976	644	1,881	863
Preferred stock dividends and discount accretion	401	395	797	778
Income available to common shareholders	$ 575	$ 249	$ 1,084	$ 85
Net income per common share - Basic	$ 0.08	$ 0.03	$ 0.15	$ 0.01
Net income per common share - Diluted	$ 0.07	$ 0.03	$ 0.14	$ 0.01
Weighted average common shares outstanding - Basic	7,462	7,271	7,461	7,245
Weighted average common shares outstanding - Diluted	7,784	7,710	7,788	7,688

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

Unity Bancorp, Inc.

Consolidated Statements of Comprehensive Income

(Unaudited)

(In thousands)	For the three months ended June 30, 2012	2011	For the six months ended June 30, 2012	2011
Net income	$ 976	$ 644	$ 1,881	$ 863
Other comprehensive income (loss), net of tax:				
Unrealized gains (losses) on securities:				
Unrealized holding gains arising during period	299	643	119	918
Less: Reclassification adjustment for gains included in net income	188	20	337	103
Total unrealized gains (losses) on securities	111	623	(218)	815
Unrealized gains on cash flow hedge derivatives:				
Unrealized holding gains arising during period	-	74	26	158
Total other comprehensive income (loss)	111	697	(192)	973
Total comprehensive income	$ 1,087	$ 1,341	$ 1,689	$ 1,836

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

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Unity Bancorp, Inc.

Consolidated Statements of Changes in Shareholders' Equity

For the six months ended June 30, 2012 and 2011

(Unaudited)

(In thousands)	Preferred stock	Common stock Shares	Common stock Amount	Retained earnings (deficit)	Accumulated other comprehensive income	Total shareholders' equity
Balance, December 31, 2011	$ 19,545	7,459	$ 53,746	$ (854)	$ 1,121	$ 73,558
Net income				1,881		1,881
Unrealized holding losses on securities and cash flow hedge derivatives					(192)	(192)
Accretion of discount on preferred stock	279			(279)		-
Dividends on preferred stock (5% annually)				(517)		(517)
Common stock issued and related tax effects (1)		2	171			171
Balance, June 30, 2012	$ 19,824	7,461	$ 53,917	$ 231	$ 929	$ 74,901

(In thousands)	Preferred stock	Common stock Shares	Common stock Amount	Accumulated deficit	Treasury stock	Accumulated other comprehensive income	Total shareholders' equity
Balance, December 31, 2010	$ 19,019	7,211	$ 55,884	$ (772)	$ (4,169)	$ 123	$ 70,085
Net income				863			863
Unrealized holding gains on securities and cash flow hedge derivatives						973	973
Accretion of discount on preferred stock	259			(259)			-
Dividends on preferred stock (5% annually)				(521)			(521)
Retire Treasury stock			(3,101)	(1,068)	4,169		-
Common stock issued and related tax effects (1)		201	807				807
Balance, June 30, 2011	$ 19,278	7,412	$ 53,590	$ (1,757)	$ -	$ 1,096	$ 72,207

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

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

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Unity Bancorp, Inc.

Consolidated Statements of Cash Flows

(Unaudited)

(In thousands)	For the six months ended June 30, 2012		2011	
OPERATING ACTIVITIES:				
Net income	$	1,881	$	863
Adjustments to reconcile net income to net cash provided by operating activities:				
Provision for loan losses		2,200		4,250
Net amortization of purchase premiums and discounts on securities		458		265
Depreciation and amortization		622		721
Deferred income tax expense		28		147
Net security gains		(507)		(87)
Stock compensation expense		157		77
Loss (gain) on sale of OREO		168		(51)
Gain on sale of mortgage loans held for sale, net		(864)		(256)
Gain on sale of SBA loans held for sale, net		(381)		(510)
Origination of mortgage loans held for sale		(41,509)		(15,692)
Origination of SBA loans held for sale		(2,637)		(9,347)
Proceeds from sale of mortgage loans held for sale, net		42,373		15,948
Proceeds from sale of SBA loans held for sale, net		4,599		6,501
Loss on sale or disposal of premises and equipment		20		199
Net change in other assets and liabilities		1,770		(1,243)
Net cash provided by operating activities		8,378		1,785
INVESTING ACTIVITIES				
Purchases of securities available for sale		(32,802)		(22,685)
		1,818		5,606

Maturities and principal payments on securities held to maturity				
Maturities and principal payments on securities available for sale		16,723		18,868
Proceeds from sales of securities held to maturity		-		2,168
Proceeds from sales of securities available for sale		6,638		10,273
Proceeds from redemption of Federal Home Loan Bank stock		99		118
Proceeds from sale of OREO		2,046		306
Net decrease (increase) in loans		(18,285)		99
Proceeds from sale or disposal of premises and equipment		11		-
Purchases of premises and equipment		(1,338)		(488)
Net cash provided by (used in) investing activities		(25,090)		14,265
FINANCING ACTIVITIES				
Net decrease in deposits		(27,528)		(13,621)
Proceeds from exercise of stock options		17		443
Dividends on preferred stock		(516)		(516)
Net cash used in financing activities		(28,027)		(13,694)
Increase (decrease) in cash and cash equivalents		(44,739)		2,356
Cash and cash equivalents, beginning of period		82,574		43,926
Cash and cash equivalents, end of period	$	37,835	$	46,282
SUPPLEMENTAL DISCLOSURES				
Cash:				
Interest paid	$	4,218	$	5,478
Income taxes paid		739		345
Noncash investing activities:				
Transfer of loans to OREO		2,027		1,385

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

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Unity Bancorp, Inc.

Notes to the Consolidated Financial Statements (Unaudited)

June 30, 2012

NOTE 1. Significant Accounting Policies

The accompanying Consolidated Financial Statements include the accounts of Unity Bancorp, Inc. (the "Parent Company") and its wholly-owned subsidiary, Unity Bank (the "Bank" or when consolidated with the Parent Company, the "Company"), and reflect all adjustments and disclosures which are generally routine and recurring in nature, and in the opinion of management, necessary for a fair presentation of interim results. Unity Investment Services, Inc., a wholly-owned subsidiary of the Bank, is used to hold part of the Bank's investment portfolio. All significant intercompany balances and transactions have been eliminated in consolidation. Certain reclassifications have been made to prior period amounts to conform to the current year presentation, with no impact on current earnings. The financial information has been prepared in accordance with U.S. generally accepted accounting principles and has not been audited. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities and revenues and expenses during the reporting periods. Actual results could differ from those estimates. The Company has evaluated subsequent events for potential recognition and/or disclosure through the date the consolidated financial statements included in this Quarterly Report on Form 10-Q were issued.

Estimates that are particularly susceptible to significant changes relate to the determination of the allowance for loan losses, the valuation of deferred income tax assets and the fair value of financial instruments. Management believes that the allowance for loan losses is adequate. While management uses available information to recognize losses on loans, future additions to the allowance for loan losses may be necessary based on changes in economic conditions. The interim unaudited consolidated financial statements included herein have been prepared in accordance with instructions for Form 10-Q and the rules and regulations of the Securities and Exchange Commission ("SEC"). The results of operations for the six months ended June 30, 2012 are not necessarily indicative of the results which may be expected for the entire year. As used in this Form 10-Q, "we" and "us" and "our" refer to Unity Bancorp, Inc., and its consolidated subsidiary, Unity Bank, depending on the context. Certain information and financial disclosures required by generally accepted accounting principles have been condensed or omitted from interim reporting pursuant to SEC rules. Interim financial statements should be read in conjunction with the Company's consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

Stock Transactions

The Company has incentive and nonqualified option plans, which allow for the grant of options to officers, employees and members of the Board of Directors. In addition, restricted stock is issued under the stock bonus program to reward employees and directors and to retain them by distributing stock over a period of time.

Stock Option Plans

Grants under the Company's incentive and nonqualified option plans generally vest over 3 years and must be exercised within 10 years of the date of grant. The exercise price of each option is the market price on the date of grant. As of June 30, 2012, 1,720,529 shares have been reserved for issuance upon the exercise of options, 628,807 option grants are outstanding, and 961,398 option grants have been exercised, forfeited or expired, leaving 130,324 shares available for grant.

No options were granted during the six months ended June 30, 2012, compared to 67,000 options during the six months ended June 30, 2011. The fair value of the options granted in 2011 was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	For the six months ended June 30,	
	2012	2011
Number of options granted	-	67,000
Weighted average exercise price	$ -	$ 6.66
Weighted average fair value of options	$ -	$ 3.20
Expected life (years)	-	4.62
Expected volatility	- %	57.69 %
Risk-free interest rate	- %	1.28 %
Dividend yield	- %	- %

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

Financial Accounting Standards Board Accounting Standards Codification ("FASB ASC") Topic 718, "Compensation - Stock Compensation," requires an entity to recognize the fair value of equity awards as compensation expense over the period during which an employee is required to provide service in exchange for such an award (vesting period). Compensation expense related to stock options and the related income tax benefit for the three and six months ended June 30, 2012 and 2011 is detailed in the following table:

	For the three months ended June 30,		For the six months ended June 30,	
	2012	2011	2012	2011
Compensation expense	$ 35,249	$ 26,383	$ 75,464	$ 45,778
Income tax benefit	14,079	9,230	28,397	16,853

As of June 30, 2012, unrecognized compensation costs related to nonvested share-based compensation arrangements granted under the Company's stock option plans totaled approximately $262 thousand. That cost is expected to be recognized over a weighted average period of 2.1 years.

Transactions under the Company's stock option plans for the six months ended June 30, 2012 are summarized in the following table:

	Shares	Weighted average exercise price	Weighted average remaining contractual life (in years)	Aggregate intrinsic value
Outstanding at December 31, 2011	642,647	$ 6.80	5.3	$ 517,867
Options granted	-	-		
Options exercised	(3,841)	4.44		
Options forfeited	(9,666)	6.16		
Options expired	(333)	3.98		
Outstanding at June 30, 2012	628,807	$ 6.82	4.6	$ 402,547
Exercisable at June 30, 2012	516,225	$ 6.97	3.7	$ 369,720

The following table summarizes information about stock options outstanding at June 30, 2012:

	Options outstanding			Options exercisable	
Range of exercise prices	Options outstanding	Weighted average remaining contractual life (in years)	Weighted average exercise price	Options exercisable	Weighted average exercise price
$ 0.00 - 4.00	122,083	6.8	$ 3.87	105,832	$ 3.86
4.01 - 8.00	328,466	5.0	6.05	232,135	5.85
8.01 - 12.00	121,617	1.7	9.22	121,617	9.22
12.01 - 16.00	56,641	4.2	12.54	56,641	12.54

Total	628,807	4.6	$ 6.82	516,225	$ 6.97

The following table presents information about options exercised during the three and six months ended June 30, 2012 and 2011:

	For the three months ended June 30,		For the six months ended June 30,	
	2012	2011	2012	2011
Number of options exercised	-	191,895	3,841	232,367
Total intrinsic value of options exercised	$ -	$ 669,799	$ 6,055	$ 751,146
Cash received from options exercised	-	440,541	17,046	442,905
Tax deduction realized from options exercised	-	262,223	513	294,713

Upon exercise, the Company issues shares from its authorized but unissued common stock to satisfy the options.

Restricted Stock Awards

Restricted stock awards granted to date vest over a period of 4 years and are recognized as compensation to the recipient over the vesting period. The awards are recorded at fair market value at the time of grant and amortized into salary expense on a straight line basis over the vesting period. As of June 30, 2012, 221,551 shares of restricted stock were reserved for issuance, of which 47,162 shares are available for grant.

Restricted stock awards granted during the six months ended June 30, 2012 and 2011 were as follows:

	For the six months ended June 30,	
	2012	2011
Number of shares granted	-	22,500
Average grant date fair value	$ -	$ 6.66

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Compensation expense related to the restricted stock for the three and six months ended June 30, 2012 and 2011 is detailed in the following table:

	For the three months ended June 30,		For the six months ended June 30,	
	2012	2011	2012	2011
Compensation expense	$ 37,754	$ 15,214	$ 81,112	$ 31,418

As of June 30, 2012, there was approximately $422 thousand of unrecognized compensation cost related to nonvested restricted stock awards granted under the Company's stock incentive plans. That cost is expected to be recognized over a weighted average period of 3.0 years.

The following table summarizes nonvested restricted stock activity for the six months ended June 30, 2012:

	Shares	Average grant date fair value
Nonvested restricted stock at December 31, 2011	93,684	$ 6.06
Granted	-	-
Vested	(7,859)	6.93
Forfeited	(2,000)	6.25
Nonvested restricted stock at June 30, 2012	83,825	$ 5.97

Income Taxes

The Company follows FASB ASC Topic 740, "Income Taxes," which prescribes a threshold for the financial statement recognition of income taxes and provides criteria for the measurement of tax positions taken or expected to be taken in a tax return. ASC 740 also includes guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition of income taxes. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using the enacted tax rates applicable to taxable income for the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Valuation reserves are established against certain deferred tax assets when it is more likely than not that the deferred tax assets will not be realized. Increases or decreases in the valuation reserve are charged or credited to the income tax provision.

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

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

Derivative Instruments and Hedging Activities

The Company may use derivative instruments, such as interest rate swaps, to manage interest rate risk. The Company recognizes all derivative instruments at fair value as either assets or liabilities in other assets or other liabilities. The accounting for changes in the fair value of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as an accounting hedge, the gain or loss is recognized in trading noninterest income. The Company had no derivative instruments at June 30, 2012, and all of the Company's derivative instruments qualified as hedging instruments at December 31, 2011.

For those derivative instruments that are designated and qualify as hedging instruments, the Company must designate the hedging instrument, based on the exposure being hedged, as a fair value hedge, a cash flow hedge or a hedge of a net investment in a foreign operation. The Company does not have any fair value hedges or hedges of foreign operations.

The Company formally documents the relationship between the hedging instruments and hedged item, as well as the risk management objective and strategy before undertaking a hedge. To qualify for hedge accounting, the derivatives and hedged items must be designated as a hedge. For hedging relationships in which effectiveness is measured, the Company formally assesses both at inception and on an ongoing basis, if the derivatives are highly effective in offsetting changes in fair values or cash flows of the hedged item. If it is determined that the derivative instrument is not highly effective as a hedge, hedge accounting is discontinued.

For derivatives that are designated as cash flow hedges, the effective portion of the gain or loss on derivatives is reported as a component of other comprehensive income or loss and subsequently reclassified in interest income in the same period during which the hedged transaction affects earnings. As a result, the change in fair value of any ineffective portion of the hedging derivative is recognized immediately in earnings.

The Company will discontinue hedge accounting when it is determined that the derivative is no longer qualifying as an effective hedge; the derivative expires or is sold, terminated or exercised; or the derivative is de-designated as a fair value or cash flow hedge or it is no longer probable that the forecasted transaction will occur by the end of the originally specified time period. If the Company determines that the derivative no longer qualifies as a cash flow or fair value hedge and therefore hedge accounting is discontinued, the derivative will continue to be recorded on the balance sheet at its fair value with changes in fair value included in current earnings.

Loans Held to Maturity and Loans Held for Sale

Loans held to maturity are stated at the unpaid principal balance, net of unearned discounts and net of deferred loan origination fees and costs. Loan origination fees, net of direct loan origination costs, are deferred and are recognized over the estimated life of the related loans as an adjustment to the loan yield utilizing the level yield method.

Interest is credited to operations primarily based upon the principal amount outstanding. When management believes there is sufficient doubt as to the ultimate ability to collect interest on a loan, interest accruals are discontinued and all past due interest, previously recognized as income, is reversed and charged against current period earnings. Payments received on nonaccrual loans are applied as principal. Loans are returned to an accrual status when the ability to collect is reasonably assured and when the loan is brought current as to principal and interest.

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

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

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

The Company evaluates its loans for impairment. A loan is considered impaired when, based on current information and events; it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. The Company has defined impaired loans to be all troubled debt restructurings and nonperforming loans. Impairment is evaluated in total for smaller-balance loans of a similar nature (consumer and residential mortgage loans), and on an individual basis for other loans. Troubled debt restructurings ("TDRs") occur when a creditor, for economic or legal reasons related to a debtor's financial condition, grants a concession to the debtor that it would not otherwise consider. These concessions typically include reductions in interest rate, extending the maturity of a loan, or a combination of both. Interest income on accruing TDRs is credited to operations primarily based upon the principal amount outstanding, as stated in the paragraphs above. Impairment of a loan is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate. Impairment can also be measured based on a loan's observable market price or the fair value of collateral, net of estimated costs to sell, if the loan is collateral dependent. If the measure of the impaired loan is less than the recorded investment in the loan, the Company establishes a valuation allowance, or adjusts existing valuation allowances, with a corresponding charge or credit to the provision for loan losses.

Loans held for sale are SBA loans and are reflected at the lower of aggregate cost or market value. The net amount of loan origination fees on loans sold is included in the carrying value and in the gain or loss on the sale.

The Company originates loans to customers under an SBA program that historically has provided for SBA guarantees of up to 90 percent of each loan. The Company generally sells the guaranteed portion of its SBA loans to a third party and retains the servicing, holding the nonguaranteed portion in its portfolio. When sales of SBA loans do occur, the premium received on the sale and the present value of future cash flows of the servicing assets are recognized in income.

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

For additional information see the section titled "Loan Portfolio" under Item 2. Management's Discussion and Analysis.

Allowance for Loan Losses and Unfunded Loan Commitments

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

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

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

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

For additional information, see the sections titled "Asset Quality" and "Allowance for Loan Losses and Unfunded Loan Commitments" under Item 2. Management's Discussion and Analysis.

Other-Than-Temporary Impairment

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

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

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

NOTE 2. Litigation

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

NOTE 3. Net Income per Share

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

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

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

(In thousands, except per share amounts)	For the three months ended June 30, 2012	2011	For the six months ended June 30, 2012	2011
Net income	$ 976	$ 644	$ 1,881	$ 863
Less: Preferred stock dividends and discount accretion	401	395	797	778
Income available to common shareholders	$ 575	$ 249	$ 1,084	$ 85
Weighted average common shares outstanding - Basic	7,462	7,271	7,461	7,245
Plus: Potential dilutive common stock equivalents	322	439	327	443
Weighted average common shares outstanding - Diluted	7,784	7,710	7,788	7,688
Net income per common share - Basic	$ 0.08	$ 0.03	$ 0.15	$ 0.01
Net income per common share - Diluted	0.07	0.03	0.14	0.01
Stock options and common stock excluded from the income per share calculation as their effect would have been anti-dilutive	505	346	504	345

The "potential dilutive common stock equivalents" and the "stock options and common stock excluded from the income per share calculation as their effect would have been anti-dilutive" shown in the table above include the impact of 764,778 common stock warrants issued to the U.S. Department of Treasury under the Capital Purchase Program in December 2008, as applicable. These warrants were dilutive for the three and six months ended June 30, 2012 and 2011.

NOTE 4. Income Taxes

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

For the quarter ended June 30, 2012, the Company reported income tax expense of $518 thousand for an effective tax rate of 34.7 percent, compared to an income tax expense of $277 thousand and effective tax rate of 30.1 percent for the prior year's quarter. For the six months ended June 30, 2012, the Company reported income tax expense of $977 thousand for an effective tax rate of 34.2 percent, compared to an income tax expense of $129 thousand and effective tax rate of 13.0 percent for the six months ended June 30, 2011. The provision for income taxes for the six months ended June 30, 2011 included the reversal of $150 thousand of a valuation reserve for deferred taxes related to the net operating loss carry-forward deferred tax asset. Excluding this valuation adjustment, our effective tax rate would have been 28.1 percent.

The Company did not recognize or accrue any interest or penalties related to income taxes during the six months ended June 30, 2012 or 2011. The Company does not have an accrual for uncertain tax positions as of June 30, 2012 or December 31, 2011, as deductions taken and benefits accrued are based on widely understood administrative practices and procedures and are based on clear and unambiguous tax law. Tax returns for all years 2008 and thereafter are subject to future examination by tax authorities.

NOTE 5. Other Comprehensive Income (Loss)

The following table shows the changes in other comprehensive income (loss) for the three months ended June 30, 2012 and 2011:

	For the three months ended June 30,					
	2012			2011		
(In thousands)	Pre-tax	Tax	After-tax	Pre-tax	Tax	After-tax
Net unrealized gains on securities:						
Balance, beginning of period			$ 818			$ 615
Unrealized holding gains arising during period	$ 469	$ 170	299	$ 1,065	$ 422	643
Less: Reclassification adjustment for gains included in net income	283	95	188	30	10	20
Net unrealized gains on securities arising during the period	186	75	111	1,035	412	623
Balance, end of period			929			1,238
Net unrealized gains (losses) on cash flow hedges:						
Balance, beginning of period			$ -			$ (216)
Unrealized holding gain on cash flow hedges arising during the period	$ -	$ -	-	$ 124	$ 50	74
Balance, end of period			-			(142)
Total accumulated other comprehensive income			$ 929			$ 1,096

The following table shows the changes in other comprehensive income (loss) for the six months ended June 30, 2012 and 2011:

	For the six months ended June 30,					
	2012			2011		
(In thousands)	Pre-tax	Tax	After-tax	Pre-tax	Tax	After-tax
Net unrealized gains (losses) on securities:						
Balance, beginning of period			$ 1,147			$ 423
Unrealized holding gains arising during period	$ 145	$ 26	119	$ 1,511	$ 593	918
Less: Reclassification adjustment for gains included in net income	507	170	337	155	52	103
Net unrealized gains (losses) on securities arising during the period	(362)	(144)	(218)	1,356	541	815
Balance, end of period			929			1,238
Net unrealized gains (losses) on cash flow hedges:						
Balance, beginning of period			$ (26)			$ (300)
Unrealized holding gain on cash flow hedges arising during the period	$ 43	$ 17	26	$ 263	$ 105	158
Balance, end of period			-			(142)
Total accumulated other comprehensive income			$ 929			$ 1,096

NOTE 6. Fair Value

Fair Value Measurement

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

Level 1 Inputs

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

Level 2 Inputs

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

Level 3 Inputs

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

Fair Value on a Recurring Basis

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

Securities Available for Sale

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

As of June 30, 2012, the fair value of the Company's AFS securities portfolio was $98.0 million. Approximately 55 percent of the portfolio was made up of residential mortgage-backed securities, which had a fair value of $53.7 million at June 30, 2012. Approximately $52.2 million of the residential mortgage-backed securities are guaranteed by the Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA") or the Federal Home Loan Mortgage Corporation ("FHLMC"). The underlying loans for these securities are residential mortgages that are geographically dispersed throughout the United States. All AFS securities were classified as Level 2 assets at June 30, 2012. The valuation of AFS securities using Level 2 inputs was primarily determined using the market approach, which uses quoted prices for similar assets or liabilities in active markets and all other relevant information. It includes model pricing, defined as valuing securities based upon their relationship with other benchmark securities.

Interest Rate Swap Agreements

Based on the complex nature of interest rate swap agreements, the markets these instruments trade in are not as efficient and are less liquid than that of Level 1 markets. These markets do, however, have comparable, observable inputs in which an alternative pricing source values these assets or liabilities in order to arrive at a fair value. The fair values of any interest swaps are measured based on the difference between the yield on the existing swaps and the yield on current swaps in the market (i.e. The Yield Book); consequently, they are classified as Level 2 instruments.

There were no changes in the inputs or methodologies used to determine fair value during the period ended June 30, 2012, as compared to the periods ended December 31, 2011 and June 30, 2011. The tables below present the balances of assets and liabilities measured at fair value on a recurring basis as of June 30, 2012 and December 31, 2011.

	June 30, 2012			
(In thousands)	Level 1	Level 2	Level 3	Total
Financial assets:				
Securities available for sale:				
U.S. Government sponsored entities	$ -	$ 2,289	$ -	$ 2,289
State and political subdivisions	-	14,385	-	14,385
Residential mortgage-backed securities	-	53,732	-	53,732
Commercial mortgage-backed securities	-	6,997	-	6,997
Corporate and other securities	-	20,562	-	20,562
Total securities available for sale	$ -	$ 97,965	$ -	$ 97,965

	December 31, 2011			
(In thousands)	Level 1	Level 2	Level 3	Total
Financial assets:				
Securities available for sale:				
U.S. Government sponsored entities	$ -	$ 5,376	$ -	$ 5,376
State and political subdivisions	-	17,878	-	17,878
Residential mortgage-backed securities	-	57,924	-	57,924
Commercial mortgage-backed securities	-	210	-	210
Corporate and other securities	-	7,377	-	7,377
Total securities available for sale	$ -	$ 88,765	$ -	$ 88,765
Financial liabilities:				
Interest rate swap agreements	$	$ 43	$	$ 43

Fair Value on a Nonrecurring Basis

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

Other Real Estate Owned ("OREO")

The fair value was determined using appraisals, which may be discounted based on management’s review and changes in market conditions (Level 3 Inputs). All appraisals must be performed in accordance with the Uniform Standards of Professional Appraisal Practice ("USPAP"). Appraisals are certified to the Company and performed by appraisers on the Company’s approved list of appraisers. Evaluations are completed by a person independent of Company management. The content of the appraisal depends on the complexity of the property. Appraisals are completed on a “retail value” and an “as is value”.

The Company requires current real estate appraisals on all loans that become OREO or in-substance foreclosure, loans that are classified substandard, doubtful or loss, or loans that are over $100,000 and nonperforming. Prior to each balance sheet date, the Company values impaired collateral-dependent loans and OREO based upon a third party appraisal, broker's price opinion, drive by appraisal, automated valuation model, updated market evaluation, or a combination of these methods. The amount is discounted for the decline in market real estate values (for original appraisals), for any known damage or repair costs, and for selling and closing costs. The amount of the discount is dependent upon the method used to determine the original value. The original appraisal is generally used when a loan is first determined to be impaired. When applying the discount, the Company takes into consideration when the appraisal was performed, the collateral’s location, the type of collateral, any known damage to the property and the type of business. Subsequent to entering impaired status and the Company determining that there is a collateral shortfall, the Company will generally, depending on the type of collateral, order a third party appraisal, broker's price opinion, automated valuation model or updated market evaluation. Subsequent to receiving the third party results, the Company will discount the value 6-10% for selling and closing costs.

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

Impaired Collateral-Dependent Loans

The fair value of impaired collateral-dependent loans is derived in accordance with FASB ASC Topic 310, “Receivables.” Fair value is determined based on the loan’s observable market price or the fair value of the collateral. The valuation allowance for impaired loans is included in the allowance for loan losses in the consolidated balance sheets. At June 30, 2012, the valuation allowance for impaired loans was $3.7 million, a decrease of $179 thousand from $3.9 million at March 31, 2012 and $747 thousand from $4.4 million at December 31, 2011.

The following tables present the assets and liabilities carried on the balance sheet by caption and by level within the hierarchy (as described above) as of June 30, 2012 and June 30, 2011 and the fair value gains (losses) recognized during the three and six months ended June 30, 2012 and 2011:

	Fair value at June 30, 2012				Gains (losses) from fair value changes for the three months ended June 30, 2012	Gains (losses) from fair value changes for the six months ended June 30, 2012
(In thousands)	Level 1	Level 2	Level 3	Total		
Financial assets:						
OREO	$ -	$ -	$ 1,416	$ 1,416	$ (524)	$ (880)
Impaired collateral-dependent loans	-	-	11,581	11,581	179	747

	Fair value at June 30, 2011				Losses from fair value changes for the three months ended June 30, 2011	Losses from fair value changes for the six months ended June 30, 2011
(In thousands)	Level 1	Level 2	Level 3	Total		
Financial assets:						
OREO	$ -	$ -	$ 2,364	$ 2,364	$ (405)	$ (754)
Impaired collateral-dependent loans	-	-	13,086	13,086	(1,120)	(1,440)

Fair Value of Financial Instruments

FASB ASC Topic 825, "Financial Instruments," requires the disclosure of the estimated fair value of certain financial instruments, including those financial instruments for which the Company did not elect the fair value option. These estimated fair values as of June 30, 2012 and December 31, 2011 have been determined using available market information and appropriate valuation methodologies. Considerable judgment is required to interpret market data to develop estimates of fair value. The estimates presented are not necessarily indicative of amounts the Company could realize in a current market exchange. The use of alternative market assumptions and estimation methodologies could have had a material effect on these estimates of fair value. The methodology for estimating the fair value of financial assets and liabilities that are measured on a recurring or nonrecurring basis are discussed above. The following methods and assumptions were used to estimate the fair value of other financial instruments for which it is practicable to estimate that value:

Cash and Cash Equivalents

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

Securities Held to Maturity

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

SBA loans held for sale

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

Loans

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

Federal Home Loan Bank Stock

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

SBA Servicing Assets

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

Deposit Liabilities

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

Borrowed Funds & Subordinated Debentures

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

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Standby Letters of Credit

At June 30, 2012, the Bank had standby letters of credit outstanding of $1.3 million, as compared to $1.8 million at December 31, 2011. The fair value of these commitments is nominal.

The table below presents the carrying amount and estimated fair values of the Company's financial instruments not previously presented as of June 30, 2012 and December 31, 2011:

		June 30, 2012		December 31, 2011	
(In thousands)	Fair value level	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
Financial assets:					
Cash and cash equivalents	Level 1	$ 37,835	$ 37,835	$ 82,574	$ 82,574
Securities held to maturity	Level 2	16,881	18,301	18,771	19,879
SBA loans held for sale	Level 2	6,087	6,518	7,668	8,192
Loans, net of allowance for loan losses	Level 2	582,530	582,973	568,576	572,165
Federal Home Loan Bank stock	Level 2	3,989	3,989	4,088	4,088
SBA servicing assets	Level 3	424	424	418	418

Accrued interest receivable	Level 2	3,415	3,415	3,703	3,703
Financial liabilities:					
Deposits	Level 2	616,443	618,868	643,971	647,281
Borrowed funds and subordinated debentures	Level 2	90,465	100,915	90,465	102,533
Accrued interest payable	Level 2	470	470	523	523

Note 7. Securities

This table provides the major components of securities available for sale ("AFS") and held to maturity ("HTM") at amortized cost and estimated fair value at June 30, 2012 and December 31, 2011:

	June 30, 2012				December 31, 2011			
(In thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value	Amortized cost	Gross unrealized gains	Gross unrealized losses	Estimated fair value
Securities available for sale:								
U.S. Government sponsored entities	$ 2,193	$ 96	$ -	$ 2,289	$ 5,274	$ 102	$ -	$ 5,376
State and political subdivisions	13,867	526	(8)	14,385	17,031	856	(9)	17,878
Residential mortgage-backed securities	52,454	1,476	(198)	53,732	56,546	1,655	(277)	57,924
Commercial mortgage-backed securities	7,034	8	(45)	6,997	208	2	-	210
Corporate and other securities	20,872	192	(502)	20,562	7,799	5	(427)	7,377
Total securities available for sale	$ 96,420	$ 2,298	$ (753)	$ 97,965	$ 86,858	$ 2,620	$ (713)	$ 88,765
Securities held to maturity:								
State and political subdivisions	$ 2,989	$ 311	$ -	$ 3,300	$ 2,992	$ 192	$ -	$ 3,184
Residential mortgage-backed securities	11,208	379	(13)	11,574	13,083	329	(31)	13,381
Commercial mortgage-backed securities	2,684	743	-	3,427	2,696	618	-	3,314
Total securities held to maturity	$ 16,881	$ 1,433	$ (13)	$ 18,301	$ 18,771	$ 1,139	$ (31)	$ 19,879

This table provides the remaining contractual maturities and yields of securities within the investment portfolios. The carrying value of securities at June 30, 2012 is primarily distributed by contractual maturity. Mortgage-backed securities and other securities, which may have principal prepayment provisions, are distributed based on contractual maturity. Expected maturities will differ materially from contractual maturities as a result of early prepayments and calls. The total weighted average yield excludes equity securities.

(In thousands)	Within one year Amount	Within one year Yield	After one through five years Amount	After one through five years Yield	After five through ten years Amount	After five through ten years Yield	After ten years Amount	After ten years Yield	Total carrying value Amount	Total carrying value Yield
Available for sale at fair value:										
U.S. Government sponsored entities	$ -	- %	$ 1,353	1.73 %	$ 8	0.97 %	$ 928	3.66 %	$ 2,289	2.51 %
State and political subdivisions	-	-	148	6.50	9,100	2.97	5,136	2.44	14,385	3.18
Residential mortgage-backed securities	48	3.85	159	3.49	1,248	4.48	52,277	2.98	53,732	3.01
Commercial mortgage-backed securities	-	-	-	-	-	-	6,997	1.95	6,997	1.95
Corporate and other securities	-	-	3,300	2.58	3,968	3.81	13,294	2.24	20,562	2.60
Total securities available for sale	$ 48	3.85 %	$ 4,960	2.49 %	$ 14,324	3.33 %	$ 78,632	2.77 %	$ 97,965	2.86 %
Held to maturity at cost:										
State and political subdivisions	$ -	- %	$ -	- %	$ -	- %	$ 2,989	4.59 %	$ 2,989	4.59 %
Residential mortgage-backed securities	-	-	821	4.64	1,160	4.95	9,227	2.95	11,208	3.28
Commercial mortgage-backed securities	-	-	-	-	-	-	2,684	5.40	2,684	5.40
Total securities held to maturity	$ -	- %	$ 821	4.64 %	$ 1,160	4.95 %	$ 14,900	3.72 %	$ 16,881	3.85 %

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The fair value of securities with unrealized losses by length of time that the individual securities have been in a continuous unrealized loss position at June 30, 2012 and December 31, 2011 are as follows:

	June 30, 2012						
		Less than 12 months		12 months and greater		Total	
(In thousands)	Total number in a loss position	Estimated fair value	Unrealized loss	Estimated fair value	Unrealized loss	Estimated fair value	Unrealized loss
Securities available for sale:							
State and political subdivisions	3	$ 1,057	$ (8)	$ -	$ -	$ 1,057	$ (8)
Residential mortgage-backed securities	8	5,747	(59)	1,220	(139)	6,967	(198)
Commercial mortgage-backed securities	7	4,312	(45)	-	-	4,312	(45)
Corporate and other securities	9	9,578	(182)	1,219	(320)	10,797	(502)
Total temporarily impaired investments	27	$ 20,694	$ (294)	$ 2,439	$ (459)	$ 23,133	$ (753)
Securities held to maturity:							
Residential mortgage-backed securities	1	$ -	$ -	$ 345	$ (13)	$ 345	$ (13)
Total temporarily impaired investments	1	$ -	$ -	$ 345	$ (13)	$ 345	$ (13)

	December 31, 2011						
		Less than 12 months		12 months and greater		Total	
(In thousands)	Total number in a loss position	Estimated fair value	Unrealized loss	Estimated fair value	Unrealized loss	Estimated fair value	Unrealized loss
Securities available for sale:							
State and political subdivisions	2	$ 424	$ (9)	$ -	$ -	$ 424	$ (9)
Residential mortgage-backed securities	6	4,512	(80)	871	(197)	5,383	(277)
Corporate and other securities	8	5,038	(173)	1,334	(254)	6,372	(427)
Total temporarily impaired investments	16	$ 9,974	$ (262)	$ 2,205	$ (451)	$ 12,179	$ (713)
Securities held to maturity:							
Residential mortgage-backed securities	3	$ 2,545	$ (4)	$ 542	$ (27)	$ 3,087	$ (31)
Total temporarily impaired investments	3	$ 2,545	$ (4)	$ 542	$ (27)	$ 3,087	$ (31)

Unrealized Losses

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

State and political subdivision securities: The unrealized losses on investments in this type of security were caused by the increase in interest rate spreads. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the par value of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be at maturity, the Company did not consider these investments to be other-than temporarily impaired as of June 30, 2012 or December 31, 2011.

Residential and commercial mortgage-backed securities: The unrealized losses on investments in mortgage-backed securities were caused by increases in interest rate spreads or faster prepayment speeds. The majority of contractual cash flows of these securities are guaranteed by Fannie Mae, Ginnie Mae and the Federal Home Loan Mortgage Corporation. It is expected that the securities would not be settled at a price significantly less than the par value of the investment. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be at maturity, the Company did not consider these investments to be other-than-temporarily impaired as of June 30, 2012 or December 31, 2011.

Corporate and other securities: Included in this category are corporate debt securities, stock of other financial institutions, Community Reinvestment Act (“CRA”) investments, asset-backed securities, and trust preferred securities. The unrealized losses on corporate debt securities were due to widening credit spreads and the unrealized losses on stock of other financial institutions and CRA investments were caused by decreases in the market prices of the shares. The Company evaluated the prospects of the issuers and forecasted a recovery period; therefore it did not consider these investments to be other-than-temporarily impaired as of June 30, 2012 or December 31, 2011. The unrealized losses on asset-backed securities were caused by increases in interest rate spreads. The majority of contractual cash flows of these securities are guaranteed by Sallie Mae as part of the Federal Family Education Loan ("FFEL") Program. It is expected that the securities would not be settled at a price significantly less than the par value of the investment. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be at maturity, the Company did not consider these investments to be other-than-temporarily impaired as of June 30, 2012 or December 31, 2011. The unrealized losses on trust preferred securities were caused by an inactive trading market and changes in market credit spreads. At June 30, 2012 and December 31, 2011, this category consisted of one single-issuer trust preferred security. The contractual terms do not allow the security to be settled at a price less than the par value. Because the Company does not intend to sell the security and it is not more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis, which may be at maturity, the Company did not consider this security to be other-than-temporarily impaired as of June 30, 2012 or December 31, 2011.

Realized Gains and Losses

Gross realized gains (losses) on securities for the three and six months ended June 30, 2012 and 2011 are detailed in the table below:

(In thousands)	For the three months ended June 30, 2012	2011	For the six months ended June 30, 2012	2011
Securities available for sale:				
Realized gains	$ 283	$ 41	$ 511	$ 168
Realized losses	-	(12)	(4)	(13)
Total securities available for sale	283	29	507	155
Securities held to maturity:				
Realized gains	-	-	-	-
Realized losses	-	(68)	-	(68)
Total securities held to maturity	-	(68)	-	(68)
Net gains (losses) on sales of securities	$ 283	$ (39)	$ 507	$ 87

The net realized gains (losses) are included in noninterest income in the Consolidated Statements of Income as net security gains (losses). For the three and six months ended June 30, 2012, there were gross realized gains of $283 thousand and $511 thousand, respectively. There were no realized losses during the second quarter of 2012 and gross realized losses of $4 thousand in the first quarter. The net realized gains during 2012 were a result of the following:

- The Company sold approximately $6.1 million in book value of available for sale mortgage-backed and municipal securities, resulting in pre-tax gains of approximately $511 thousand, partially offset by

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· Losses of $4 thousand on the partial call of $64 thousand in book value of one available for sale municipal security.

For the three and six months ended June 30, 2011, there were gross realized gains of $41 thousand and $168 thousand, respectively, and gross realized losses of $80 thousand and $81 thousand, respectively. The net gains during the six months ended June 30, 2011 were primarily attributed to:

- The Company selling approximately $9.1 million in book value of mortgage-backed securities, resulting in pretax gains of approximately $168 thousand, partially offset by
- Losses of $13 thousand on the sale of approximately $1.0 million in book value of five available for sale mortgage-backed securities and losses of $68 thousand on the sale of approximately $2.1 million in book value of three held to maturity private label mortgage backed securities. Although designated as held to maturity, these securities were sold due to the deterioration in the underlying credit, as evidenced by downgrades in their credit ratings.

Pledged Securities

Securities with a carrying value of $63.2 million and $81.1 million at June 30, 2012 and December 31, 2011, respectively, were pledged to secure Government deposits, secure other borrowings and for other purposes required or permitted by law. Included in these figures was $12.4 million and $27.7 million pledged against Government deposits at June 30, 2012 and December 31, 2011, respectively.

Note 8. Loans

The following table sets forth the classification of loans by class, including unearned fees, deferred costs and excluding the allowance for loan losses as of June 30, 2012 and December 31, 2011:

(In thousands)	June 30, 2012	December 31, 2011
SBA loans	$ 66,469	$ 71,843
SBA 504 loans	45,247	55,108
Commercial loans		
Commercial other	28,134	26,542
Commercial real estate	271,542	246,824
Commercial real estate construction	10,655	9,738
Residential mortgage loans		
Residential mortgages	128,652	123,843
Residential construction	-	2,205
Purchased residential mortgages	7,862	8,042

Consumer loans		
Home equity	45,097	46,935
Consumer other	1,243	1,512
Total loans	$ 604,901	$ 592,592

Loans are made to individuals as well as commercial entities. Specific loan terms vary as to interest rate, repayment, and collateral requirements based on the type of loan requested and the credit worthiness of the prospective borrower. Credit risk, excluding SBA loans, tends to be geographically concentrated in that a majority of the loan customers are located in the markets serviced by the Bank. As a preferred SBA lender, a portion of the SBA portfolio is to borrowers outside the Company's lending area. However, during late 2008, the Company withdrew from SBA lending outside of its primary trade area, but continues to offer SBA loan products as an additional credit product within its primary trade area. A description of the Company's different loan segments follows:

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

SBA 504 Loans: The SBA 504 program consists of real estate backed commercial mortgages where the Company has the first mortgage and the SBA has the second mortgage on the property. SBA 504 loans are made based primarily on the historical and projected cash flow of the business and secondarily on the underlying collateral provided. Generally, the Company has a 50 percent loan to value ratio on SBA 504 program loans at origination. Loan performance may be adversely affected by factors impacting the general economy or conditions specific to the real estate market such as geographic location and/or property type.

Commercial Loans: Commercial credit is extended primarily to middle market and small business customers. Commercial loans are generally made in the Company's market place for the purpose of providing working capital, financing the purchase of equipment, inventory or commercial real estate and for other business purposes. Loans will generally be guaranteed in full or for a meaningful amount by the businesses' major owners. Commercial loans are made based primarily on the historical and projected cash flow of the business and secondarily on the underlying collateral provided. Loan performance may be adversely affected by factors impacting the general economy or conditions specific to the real estate market such as geographic location and/or property type.

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

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

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

Credit Ratings:

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

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

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

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

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

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

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

The tables below detail the Company's loan portfolio by class according to their credit quality indicators discussed in the paragraphs above as of June 30, 2012:

	June 30, 2012 SBA, SBA 504 & Commercial loans - Internal risk ratings			
(In thousands)	Pass	Special mention	Substandard	Total
SBA loans	$ 49,412	$ 9,419	$ 7,638	$ 66,469
SBA 504 loans	33,214	4,076	7,957	45,247
Commercial loans				
Commercial other	21,229	2,167	4,738	28,134
Commercial real estate	216,243	43,031	12,268	271,542
Commercial real estate construction	9,775	880	-	10,655
Total commercial loans	247,247	46,078	17,006	310,331
Total SBA, SBA 504 and commercial loans	$ 329,873	$ 59,573	$ 32,601	$ 422,047

	Residential mortgage & Consumer loans - Performing/Nonperforming		
(In thousands)	Performing	Nonperforming	Total
Residential mortgage loans			
Residential mortgages	$ 127,168	$ 1,484	$ 128,652
Purchased residential mortgages	4,693	3,169	7,862
Total residential mortgage loans	131,861	4,653	136,514
Consumer loans			
Home equity	44,786	311	45,097
Consumer other	1,232	11	1,243
Total consumer loans	$ 46,018	$ 322	$ 46,340
Total loans			$ 604,901

The tables below detail the Company's loan portfolio by class according to their credit quality indicators discussed in the paragraphs above as of December 31, 2011:

	December 31, 2011 SBA, SBA 504 & Commercial loans - Internal risk ratings			
(In thousands)	Pass	Special mention	Substandard	Total
SBA loans	$ 49,568	$ 8,900	$ 13,375	$ 71,843
SBA 504 loans	39,566	5,543	9,999	55,108
Commercial loans				
Commercial other	20,921	1,160	4,461	26,542

Commercial real estate	187,680	49,231	9,913	246,824
Commercial real estate construction	8,255	883	600	9,738
Total commercial loans	216,856	51,274	14,974	283,104
Total SBA, SBA 504 and commercial loans	$ 305,990	$ 65,717	$ 38,348	$ 410,055

	Residential mortgage & Consumer loans - Performing/Nonperforming		
(In thousands)	Performing	Nonperforming	Total
Residential mortgage loans			
Residential mortgages	$ 122,012	$ 1,831	$ 123,843
Residential construction	36	2,169	2,205
Purchased residential mortgages	6,005	2,037	8,042
Total residential mortgage loans	128,053	6,037	134,090
Consumer loans			
Home equity	46,676	259	46,935
Consumer other	1,503	9	1,512
Total consumer loans	$ 48,179	$ 268	$ 48,447
Total loans			$ 592,592

Nonperforming and Past Due Loans:

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

The risk of loss is difficult to quantify and is subject to fluctuations in collateral values, general economic conditions and other factors. The current state of the economy and the downturn in the real estate market has resulted in increased loan delinquencies and defaults. In some cases, these factors have also resulted in significant impairment to the value of loan collateral. The Company values its collateral through the use of appraisals, broker price opinions, and knowledge of its local market. In response to the credit risk in its portfolio, the Company has increased staffing in its credit monitoring department and increased efforts in the collection and analysis of borrowers' financial statements and tax returns.

The following tables set forth an aging analysis of past due and nonaccrual loans as of June 30, 2012 and December 31, 2011:

	June 30, 2012						
(In thousands)	30-59 days past due	60-89 days past due	90+ days and still accruing	Nonaccrual (1)	Total past due	Current	Total loans
SBA loans	$ 506	$ 169	$ 241	$ 3,345	$ 4,262	$ 62,207	$ 66,469
SBA 504 loans	2,201	-	-	1,775	3,975	41,272	45,247
Commercial loans							
Commercial other	55	-	2	1,100	1,157	26,977	28,134
Commercial real estate	1,538	172	286	8,636	10,631	260,911	271,542
Commercial real estate construction	-	-	-	-	-	10,655	10,655
Residential mortgage loans							
Residential mortgages	1,665	228	1,881	1,484	5,258	123,394	128,652
Purchased residential mortgages	142	621	34	3,169	3,965	3,897	7,862
Consumer loans							
Home equity	761	106	-	311	1,178	43,919	45,097
Consumer other	2	-	-	11	13	1,230	1,243
Total loans	$ 6,870	$ 1,296	$ 2,443	$ 19,831	$ 30,441	$ 574,460	$ 604,901

(1) At June 30, 2012, nonaccrual loans included $871 thousand of troubled debt restructurings ("TDRs") and $526 thousand of loans guaranteed by the SBA. The remaining $20.5 million of TDRs are in accrual status because they are performing in accordance with their restructured terms.

(In thousands)	December 31, 2011 30-59 days past due	60-89 days past due	90+ days and still accruing	Nonaccrual (1)	Total past due	Current	Total loans
SBA loans	$ 879	$ 225	$ 247	$ 5,858	$ 7,208	$ 64,635	$ 71,843
SBA 504 loans	2,006	-	-	2,086	4,092	51,016	55,108
Commercial loans							
Commercial other	1,158	-	192	815	2,165	24,377	26,542
Commercial real estate	2,493	3,119	949	7,104	13,666	233,158	246,824
Commercial real estate construction	-	-	-	600	600	9,138	9,738
Residential mortgage loans							
Residential mortgages	3,519	1,310	-	1,831	6,660	117,183	123,843
Residential construction	-	-	36	2,169	2,205	0	2,205
Purchased residential mortgages	149	-	-	2,037	2,187	5,855	8,042
Consumer loans							
Home equity	338	199	988	259	1,784	45,151	46,935
Consumer other	1	3	-	9	14	1,498	1,512
Total loans	$ 10,545	$ 4,856	$ 2,411	$ 22,769	$ 40,581	$ 552,011	$ 592,592

(1) At December 31, 2011, nonaccrual loans included $3.6 million of TDRs and $939 thousand of loans guaranteed by the SBA. The remaining $17.4 million of TDRs are in accrual status because they are performing in accordance with their restructured terms.

Impaired Loans:

The Company has defined impaired loans to be all nonperforming loans and troubled debt restructurings. Management considers a loan impaired when, based on current information and events, it is determined that the company will not be able to collect all amounts due according to the loan contract. Impairment is evaluated in total for smaller-balance loans of a similar nature, (consumer and residential mortgage loans), and on an individual basis for other loans.

The following tables provide detail on the Company's impaired loans with the associated allowance amount, if applicable, as of June 30, 2012 and December 31, 2011:

	June 30, 2012		
(In thousands)	Outstanding principal balance	Specific reserves	Net exposure (balance less specific reserves)
With no related allowance:			
SBA loans (1)	$ 1,573	$ -	$ 1,573
SBA 504 loans	4,668	-	4,668
Commercial loans			
Commercial other	4,261	-	4,261
Commercial real estate	6,513	-	6,513
Total commercial loans	10,774	-	10,774
Total impaired loans with no related allowance	17,015	-	17,015
With an allowance:			
SBA loans (1)	2,184	847	1,337
SBA 504 loans	1,443	132	1,311
Commercial loans			
Commercial other	62	62	-
Commercial real estate	14,167	2,661	11,506
Total commercial loans	14,229	2,723	11,506
Total impaired loans with a related allowance	17,856	3,702	14,154
Total individually evaluated impaired loans:			
SBA loans (1)	3,757	847	2,910
SBA 504 loans	6,111	132	5,979
Commercial loans			
Commercial other	4,323	62	4,261
Commercial real estate	20,680	2,661	18,019
Total commercial loans	25,003	2,723	22,280
Total individually evaluated impaired loans	34,871	3,702	31,169

Homogeneous collectively evaluated impaired loans:			
Residential mortgage loans			
Residential mortgages	1,484	-	1,484
Purchased residential mortgages	3,169	-	3,169
Total residential mortgage loans	4,653	-	4,653
Consumer loans			
Home equity	311	-	311
Consumer other	11	-	11
Total consumer loans	322	-	322
Total homogeneous collectively evaluated impaired loans	4,975	-	4,975
Total impaired loans	$ 39,846	$ 3,702	$ 36,144

(1) Balances are reduced by amount guaranteed by the Small Business Administration of $526 thousand at June 30, 2012.

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	December 31, 2011		
(In thousands)	Outstanding principal balance	Specific reserves	Net exposure (balance less specific reserves)
With no related allowance:			
SBA loans (1)	$ 1,553	$ -	$ 1,553
SBA 504 loans	5,331	-	5,331
Commercial loans			
Commercial other	1,725	-	1,725
Commercial real estate	6,197	-	6,197
Total commercial loans	7,922	-	7,922
Total impaired loans with no related allowance	14,806	-	14,806
With an allowance:			
SBA loans (1)	4,763	1,694	3,069
SBA 504 loans	1,127	1	1,126
Commercial loans			
Commercial other	75	75	-
Commercial real estate	11,589	2,530	9,059
Commercial real estate construction	600	149	451
Total commercial loans	12,264	2,754	9,510
Total impaired loans with a related allowance	18,154	4,449	13,705
Total individually evaluated impaired loans:			
SBA loans (1)	6,316	1,694	4,622
SBA 504 loans	6,458	1	6,457
Commercial loans			
Commercial other	1,800	75	1,725
Commercial real estate	17,786	2,530	15,256
Commercial real estate construction	600	149	451
Total commercial loans	20,186	2,754	17,432
Total individually evaluated impaired loans	32,960	4,449	28,511
Homogeneous collectively evaluated impaired loans:			
Residential mortgage loans			
Residential mortgages	1,831	-	1,831
Residential construction	2,169	-	2,169
Purchased residential mortgages	2,037	-	2,037
Total residential mortgage loans	6,037	-	6,037
Consumer loans			
Home equity	259	-	259
Consumer other	9	-	9
Total consumer loans	268	-	268
Total homogeneous collectively evaluated impaired loans	6,305	-	6,305

Total impaired loans	$ 39,265	$ 4,449	$ 34,816

(1) Balances are reduced by amount guaranteed by the SBA of $939 thousand at December 31, 2011.

The following tables present the average recorded investments in impaired loans and the related amount of interest recognized during the time period in which the loans were impaired for the three and six months ended June 30, 2012 and 2011. The average balances are calculated based on the month-end balances of impaired loans. When the ultimate collectability of the total principal of an impaired loan is in doubt and the loan is on nonaccrual status, all payments are applied to principal under the cost recovery method, therefore no interest income is recognized. Any interest income recognized on a cash basis during the three and six months ended June 30, 2012 and 2011 was immaterial. The interest recognized on impaired loans noted below represents accruing troubled debt restructurings only.

	For the three months ended June 30,			
	2012		2011	
(In thousands)	Average recorded investment	Interest income recognized on impaired loans	Average recorded investment	Interest income recognized on impaired loans
SBA loans (1)	$ 4,150	$ 36	$ 6,343	$ 44
SBA 504 loans	6,443	69	9,131	92
Commercial loans				
Commercial other	4,344	47	1,457	8
Commercial real estate	19,853	169	15,520	99
Commercial real estate construction	-	-	789	-
Residential mortgage loans				
Residential mortgages	1,959	-	2,079	-
Residential construction	1,446	-	-	-
Purchased residential mortgages	2,362	-	2,101	-
Consumer loans				
Home equity	328	-	348	-
Consumer other	10	-	3	-
Total	$ 40,895	$ 321	$ 37,771	$ 243

(1) Balances are reduced by the average amount guaranteed by the Small Business Administration of $529 thousand and $2.6 million for the three months ended June 30, 2012 and 2011, respectively.

	For the six months ended June 30,			
	2012		2011	
(In thousands)	Average recorded investment	Interest income recognized on impaired loans	Average recorded investment	Interest income recognized on impaired loans
SBA loans (1)	$ 4,952	$ 85	$ 6,563	$ 101

SBA 504 loans	6,453	140	9,693	232
Commercial loans				
Commercial other	3,556	69	983	9
Commercial real estate	19,107	299	13,125	158
Commercial real estate construction	267	-	920	-
Residential mortgage loans				
Residential mortgages	1,804	-	2,148	-
Residential construction	1,808	-	-	-
Purchased residential mortgages	2,184	-	2,122	-
Consumer loans				
Home equity	306	-	288	-
Consumer other	10	-	2	-
Total	$ 40,447	$ 593	$ 35,844	$ 500

(1) Balances are reduced by the average amount guaranteed by the Small Business Administration of $584 thousand and $2.8 million for the six months ended June 30, 2012 and 2011, respectively.

Troubled Debt Restructurings:

The Company's loan portfolio also includes certain loans that have been modified in a troubled debt restructuring (“TDR”). TDRs occur when a creditor, for economic or legal reasons related to a debtor’s financial condition, grants a concession to the debtor that it would not otherwise consider, unless it results in a delay in payment that is insignificant. These concessions typically include reductions in interest rate, extending the maturity of a loan, or a combination of both. When the Company modifies a loan, management evaluates for any possible impairment using either the discounted cash flows method, where the value of the modified loan is based on the present value of expected cash flows, discounted at the contractual interest rate of the original loan agreement, or by using the fair value of the collateral less selling costs. If management determines that the value of the modified loan is less than the recorded investment in the loan, impairment is recognized by segment or class of loan, as applicable, through an allowance estimate or charge-off to the allowance. This process is used, regardless of loan type, and for loans modified as TDRs that subsequently default on their modified terms. Effective September 30, 2011, the Company adopted the amendments in Accounting Standards Update ("ASU") No. 2011-02, Receivables (Topic 310): A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring, and did not identify any additional TDRs as a result of this adoption.

TDRs of $21.4 million are included in the impaired loan numbers listed above, of which $871 thousand are in nonaccrual status. The remaining TDRs are in accrual status since they continue to perform in accordance with their restructured terms. There are no commitments to lend additional funds on these loans.

There were no loans modified during the three months ended June 30, 2012 that were deemed to be TDRs. In addition, there were no loans modified as TDRs within the previous 12 months where a concession was made and the loan subsequently defaulted at some point during the three months ended June 30, 2012. In this case, subsequent default is defined as being transferred to nonaccrual status.

The following table details loans modified during the six months ended June 30, 2012, including the number of modifications, the recorded investment at the time of the modification and the year-to-date impact to interest income as a result of the modification. There were no loans modified as TDRs within the previous 12 months where a concession was made and the loan subsequently defaulted at some point during the six months ended June 30, 2012. In this case, subsequent default is defined as being transferred to nonaccrual status.

	For the six months ended June 30, 2012		
(In thousands, except number of contracts)	Number of contracts	Recorded investment at time of modification	Impact of interest rate change on income
Commercial loans			
Commercial other	3	$ 1,291	$ -
Commercial real estate	3	1,856	-
Total	6	$ 3,147	$ -

During the six months ended June 30, 2012, TDRs consisted of interest only periods; there was no principal forgiveness. The following table shows the types of modifications done during the six months ended June 30, 2012, with the respective loan balances as of June 30, 2012:

	June 30, 2012		
(In thousands)	Commercial other	Commercial real estate	Total
Type of modification:			
Interest only	$ 1,289	$ 1,856	$ 3,145
Total	$ 1,289	$ 1,856	$ 3,145

Note 9. Allowance for Loan Losses & Unfunded Loan Commitments

Allowance for Loan Losses:

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

The standardized methodology used to assess the adequacy of the allowance includes the allocation of specific and general reserves. The same standard methodology is used, regardless of loan type. Specific reserves are made to individual impaired loans and troubled debt restructurings (see Note 1 for additional information on this term). The general reserve is set based upon a representative average historical net charge-off rate adjusted for the following environmental factors: delinquency and impairment trends, charge-off and recovery trends, restructured loans, volume and loan term trends, risk and underwriting policy trends, staffing and experience changes, national and local economic trends, industry conditions and credit concentration changes. Beginning in the third quarter of 2009, when calculating the five-year historical net charge-off rate, the Company weights the past three years more heavily due to the higher amount of charge-offs experienced during those years. All of the environmental factors are ranked and assigned a basis points value based on the following scale: low, low moderate, moderate, high moderate and high risk. Each environmental factor is evaluated separately for each class of loans and risk weighted based on its individual characteristics.

· For SBA 7(a), SBA 504 and commercial loans, the estimate of loss based on pools of loans with similar characteristics is made

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through the use of a standardized loan grading system that is applied on an individual loan level and updated on a continuous basis. The loan grading system incorporates reviews of the financial performance of the borrower, including cash flow, debt-service coverage ratio, earnings power, debt level and equity position, in conjunction with an assessment of the borrower's industry and future prospects. It also incorporates analysis of the type of collateral and the relative loan to value ratio.

· For residential mortgage and consumer loans, the estimate of loss is based on pools of loans with similar characteristics. Factors such as credit score, delinquency status and type of collateral are evaluated. Factors are updated frequently to capture the recent behavioral characteristics of the subject portfolios, as well as any changes in loss mitigation or credit origination strategies, and adjustments to the reserve factors are made as needed.

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

The allocated allowance is the total of identified specific and general reserves by loan category. The allocation is not necessarily indicative of the categories in which future losses may occur. The total allowance is available to absorb losses from any segment of the portfolio.

The following tables detail the activity in the allowance for loan losses by portfolio segment for the three months ended June 30, 2012 and 2011.

	For the three months ended June 30, 2012						
(In thousands)	SBA	SBA 504	Commercial	Residential	Consumer	Unallocated	Total
Beginning balance	$ 3,639	$ 1,285	$ 8,361	$ 1,770	$ 527	$ 757	$ 16,339
Charge-offs	(213)	(100)	(540)	(494)	(25)	-	(1,372)
Recoveries	249	15	53	-	-	-	317
Net charge-offs	36	(85)	(487)	(494)	(25)	-	(1,055)
Provision for loan losses charged to expense	(474)	131	882	560	20	(119)	1,000
Ending balance	$ 3,201	$ 1,331	$ 8,756	$ 1,836	$ 522	$ 638	$ 16,284

	For the three months ended June 30, 2011						
(In thousands)	SBA	SBA 504	Commercial	Residential	Consumer	Unallocated	Total
Beginning balance	$ 4,254	$ 1,622	$ 6,785	$ 1,799	$ 527	$ 288	$ 15,275
Charge-offs	(592)	(125)	(521)	-	(131)	-	(1,369)
Recoveries	71	77	214	-	-	-	362

Net charge-offs	(521)	(48)	(307)	-	(131)	-	(1,007)
Provision for loan losses charged to expense	564	(164)	1,191	(37)	173	23	1,750
Ending balance	$ 4,297	$ 1,410	$ 7,669	$ 1,762	$ 569	$ 311	$ 16,018

The following tables detail the activity in the allowance for loan losses by portfolio segment for the six months ended June 30, 2012 and 2011:

	For the six months ended June 30, 2012						
(In thousands)	SBA	SBA 504	Commercial	Residential	Consumer	Unallocated	Total
Beginning balance	$ 4,088	$ 1,423	$ 8,129	$ 1,703	$ 536	$ 469	$ 16,348
Charge-offs	(828)	(327)	(886)	(607)	(25)	-	(2,673)
Recoveries	302	43	64	-	-	-	409
Net charge-offs	(526)	(284)	(822)	(607)	(25)	-	(2,264)
Provision for loan losses charged to expense	(361)	192	1,449	740	11	169	2,200
Ending balance	$ 3,201	$ 1,331	$ 8,756	$ 1,836	$ 522	$ 638	$ 16,284

	For the six months ended June 30, 2011						
(In thousands)	SBA	SBA 504	Commercial	Residential	Consumer	Unallocated	Total
Beginning balance	$ 4,198	$ 1,551	$ 6,011	$ 1,679	$ 586	$ 339	$ 14,364
Charge-offs	(1,303)	(425)	(1,069)	(142)	(131)	-	(3,070)
Recoveries	79	77	312	4	2	-	474
Net charge-offs	(1,224)	(348)	(757)	(138)	(129)	-	(2,596)
Provision for loan losses charged to expense	1,323	207	2,415	221	112	(28)	4,250
Ending balance	$ 4,297	$ 1,410	$ 7,669	$ 1,762	$ 569	$ 311	$ 16,018

The following tables present loans and their related allowance for loan losses, by portfolio segment, as of June 30, 2012 and December 31, 2011:

	June 30, 2012						
(In thousands)	SBA	SBA 504	Commercial	Residential	Consumer	Unallocated	Total
Allowance for loan losses ending balance:							
Individually evaluated for impairment	$ 847	$ 132	$ 2,723	$ -	$ -	$ -	$ 3,702
Collectively evaluated for impairment	2,354	1,199	6,033	1,836	522	638	12,582
Total	$ 3,201	$ 1,331	$ 8,756	$ 1,836	$ 522	$ 638	$ 16,284
Loan ending balances:							
Individually evaluated for impairment	$ 3,757	$ 6,111	$ 25,003	$ -	$ -	$ -	$ 34,871
Collectively evaluated for impairment	62,712	39,136	285,328	136,514	46,340	-	570,030
Total	$ 66,469	$ 45,247	$ 310,331	$ 136,514	$ 46,340	$ -	$ 604,901

	December 31, 2011						
(In thousands)	SBA	SBA 504	Commercial	Residential	Consumer	Unallocated	Total
Allowance for loan losses ending balance:							
Individually evaluated for impairment	$ 1,694	$ 1	$ 2,754	$ -	$ -	$ -	$ 4,449
Collectively evaluated for impairment	2,394	1,422	5,375	1,703	536	469	11,899
Total	$ 4,088	$ 1,423	$ 8,129	$ 1,703	$ 536	$ 469	$ 16,348
Loan ending balances:							
Individually evaluated for impairment	$ 6,316	$ 6,458	$ 20,186	$ -	$ -	$ -	$ 32,960
Collectively evaluated for impairment	65,527	48,650	262,918	134,090	48,447	-	559,632
Total	$ 71,843	$ 55,108	$ 283,104	$ 134,090	$ 48,447	$ -	$ 592,592

Changes in Methodology:

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

Unfunded Loan Commitments:

In addition to the allowance for loan losses, the Company maintains an allowance for unfunded loan commitments that is maintained at a level that management believes is adequate to absorb estimated probable losses. Adjustments to the allowance are made through other expense and applied to the allowance which is maintained in other liabilities. At June 30, 2012, a $69 thousand commitment reserve was reported on the balance sheet as an "other liability", compared to a $79 thousand commitment reserve at December 31, 2011.

Note 10. New Accounting Pronouncements

ASU No. 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. In December 2011, the FASB issued ASU No. 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. This ASU will require companies to disclose gross and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting arrangement. The scope will include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements, and securities borrowing and securities lending arrangements. The amendments are effective for interim and annual periods beginning on or after January 1, 2012. The amendment is not expected to impact the Company's financial condition, results of operations or cash flows.

ASU No. 2011-08, Intangibles - Goodwill and Other (Topic 350): Testing Goodwill for Impairment. In September 2011, the FAS issued ASU No. 2011-08, Intangibles - Goodwill and Other (Topic 350): Testing Goodwill for Impairment. This ASU allows companies to use a qualitative approach to test goodwill for impairment. An entity is permitted to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test described in Topic 350. The more likely than not threshold is defined as having a likelihood of more than 50 percent. The amendments are effective for interim and annual goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The amendment is not expected to impact the Company's financial condition, results of operations or cash flows.

ASU No. 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. In May 2011, the FASB issued ASU No. 2011-04, with the intent of converging U.S. GAAP and International Financial Reporting Standards ("IFRS") requirements for measurement of and disclosures about fair value. Key provisions of the amendment include: a prohibition on grouping financial instruments for purposes of determining fair value, except when an entity manages market and credit risks on the basis of the entity's net exposure to the group; an extension of the prohibition against the use of a blockage factor to all fair value measurements (that prohibition currently applies only to financial instruments with quoted prices in active markets); and a requirement that for recurring Level 3 fair value measurements, entities disclose quantitative information about unobservable inputs, a description of the valuation process used and qualitative details about the sensitivity of the measurements. In addition, for items not carried at fair value but for which fair value is disclosed, entities are required to disclose the level within the fair value hierarchy that applies to the fair value measurement disclosed. The Company adopted this amendment effective March 31, 2012 with no impact to the Company's fair value measurements, financial condition, results of operations or cash flows.

ASU No. 2011-03, Transfers and Servicing (Topic 860): Reconsideration of Effective Control for Repurchase Agreements. In April 2011, the FASB issued ASU No. 2011-03, which amends the sale accounting requirement concerning a transferor's ability to repurchase transferred financial assets even in the event of default by the transferee, which typically is facilitated in a repurchase agreement by the presence of a collateral maintenance provision. Specifically, the level of cash collateral received by a transferor is no longer relevant in determining whether a repurchase agreement constitutes a sale. As a result of this amendment, more repurchase agreements are treated as secured financings rather than sales. The Company adopted this amendment effective March 31, 2012, however, since all repurchase agreements entered into by the Company are deemed secured financing transactions, this amendment did not impact the Company's financial condition, results of operations or cash flows.

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

The following discussion and analysis of financial condition and results of operations should be read in conjunction with the 2011 consolidated audited financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2011. When necessary, reclassifications have been made to prior period data throughout the following discussion and analysis for purposes of comparability. This Quarterly Report on Form 10-Q contains certain "forward looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, which may be identified by the use of such words as "believe", "expect", "anticipate", "should", "planned", "estimated" "potential". Examples of forward looking statements include, but are not limited to, estimates with respect to the financial condition, results of operations and business of Unity Bancorp, Inc. that are subject to various factors which could cause actual results to differ materially from these estimates. These factors include, in addition to those items contained in the Company's Annual Report on Form 10-K under Item IA-Risk Factors, as updated by our subsequent Quarterly Reports on Form 10-Q, the following: changes in general, economic, and market conditions, legislative and regulatory conditions, or the development of an interest rate environment that adversely affects Unity Bancorp, Inc.'s interest-rate spread or other income anticipated from operations and investments.

Overview

Unity Bancorp, Inc. (the “Parent Company”) is incorporated in New Jersey and is registered as a bank holding company under the Bank Holding Company Act of 1956, as amended. Its wholly-owned subsidiary, Unity Bank (the “Bank” or, when consolidated with the Parent Company, the “Company”) was granted a charter by the New Jersey Department of Banking and Insurance and commenced operations on September 13, 1991. The Bank provides a full range of commercial and retail banking services through 15 branch offices located in Hunterdon, Somerset, Middlesex, Union and Warren counties in New Jersey, and Northampton County in Pennsylvania. These services include the acceptance of demand, savings, and time deposits and the extension of consumer, real estate, Small Business Administration and other commercial credits. Unity Investment Services, Inc., a wholly-owned subsidiary of the Bank, is used to hold part of the Bank’s investment portfolio.

Unity (NJ) Statutory Trust II is a statutory business trust and wholly owned subsidiary of Unity Bancorp, Inc. On July 24, 2006, the Trust issued $10.0 million of trust preferred securities to investors. Unity (NJ) Statutory Trust III is a statutory business trust and wholly owned subsidiary of Unity Bancorp, Inc. On December 19, 2006, the Trust issued $5.0 million of trust preferred securities to investors. These floating rate securities are treated as subordinated debentures on the Company’s financial statements. However, they qualify as Tier I Capital for regulatory capital compliance purposes, subject to certain limitations. The Company does not consolidate the accounts and related activity of any of its business trust subsidiaries.

Earnings Summary

Net income available to common shareholders totaled $575 thousand, or $0.07 per diluted share, for the quarter ended June 30, 2012, compared to $249 thousand, or $0.03 per diluted share for the same period a year ago. For the six months ended June 30, 2012, net income available to common shareholders totaled $1.1 million or $0.14 per diluted share compared to $85 thousand, or $0.01 per diluted share for the same period a year ago.

Net income available to common shareholders for the prior year’s periods was adversely impacted by the Company’s decision during the second quarter of 2011 to close two of its underperforming branches. As a result of this decision, $215 thousand in residual lease and fixed asset disposal expenses were realized in the second quarter of 2011. Excluding these expenses, net income available to common shareholders for the three month period ending June 30, 2011, would have been $399 thousand or $0.05 per diluted share. For the six month period, net income available to common shareholders would have been $236 thousand or $0.03 per diluted share.

Highlights for the quarterly and year-to-date periods include:

· Continued reductions in loan loss provisions due to improvement in asset quality.
· Significant increases in residential mortgage originations resulting in increases in gains on sale of mortgage loans.
· Significant commercial loan growth.
· Planned reduction in SBA loans outstanding from our National Program.
· Continued growth in noninterest-bearing demand deposits to 17.4 percent of total deposits.
· Continued reduction in higher costing time deposits. Time deposits now represent 22 percent of total deposits.
· Further improvement in our equity to assets ratio.

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

	For the three months ended June 30,		For the six months ended June 30,	
	2012	2011	2012	2011
Net income per common share - Basic (1)	$ 0.08	$ 0.03	$ 0.15	$ 0.01
Net income per common share - Diluted (1)	$ 0.07	$ 0.03	$ 0.14	0.01
Return on average assets	0.49 %	0.32 %	0.47 %	0.21 %
Return on average equity (2)	4.25 %	1.95 %	4.03 %	0.34 %
Efficiency ratio	73.72 %	69.74 %	72.76 %	70.64 %

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

Net Interest Income

The primary source of income for the Company is net interest income, the difference between the interest earned on earning assets such as investments and loans, and the interest paid on deposits and borrowings. Factors that impact the Company’s net interest income include the interest rate environment, the volume and mix of interest-earning assets and interest-bearing liabilities, and the competitive nature of the Company’s marketplace.

Our net interest income continues to be impacted by the sustained low interest rate environment, which the Federal Open Market Committee ("FOMC") forecasts will continue through 2014, due to continued weak economic conditions. This rate environment has resulted in a tighter net interest margin as our earning assets continue to re-price at lower rates. Partially offsetting these declines are lower funding costs; however the reduction in yield on earning assets is anticipated to exceed the benefits of further declines in the cost of funds.

During the three months ended June 30, 2012, tax-equivalent interest income decreased $1.4 million or 13.8 percent to $8.8 million when compared to the same period in the prior year. This decrease was driven by the lower average yield on earning assets and a shift in the mix of earning assets as average loans decreased:

× Of the $1.4 million decrease in interest income on a tax-equivalent basis, $1.3 million was attributed to reduced yields on average interest-earning assets and $138 thousand was attributable to the decrease in volume of average interest-earning assets.

× The average volume of interest-earning assets decreased $22 million to $755.1 million for the second quarter of 2012 compared to $777.1 million for the same period in 2011. This was due primarily to a $15.1 million decrease in average loans and a $9.7 million decrease in Federal funds sold and interest-bearing deposits, partially offset by a $2.9 million increase in average investment securities.

× The yield on interest-earning assets decreased 58 basis points to 4.70 percent for the three months ended June 30, 2012 when compared to the same period in 2011, due to continued re-pricing in a lower overall interest rate environment. Yields on most earning assets, particularly those with variable rates, fell due to these lower market rates.

Total interest expense was $1.9 million for the three months ended June 30, 2012, a decrease of $810 thousand or 29.7 percent compared to the same period in 2011. This decrease was driven by the lower overall interest rate environment combined with the shift in deposit mix away from higher priced products and a decrease in the average volume of interest-bearing liabilities:

× Of the $810 thousand decrease in interest expense, $618 thousand was attributed to a decrease in the rates paid on interest-bearing liabilities and $192 thousand was due to the decrease in the volume of average interest-bearing liabilities.

× Interest-bearing liabilities averaged $610.4 million for the second quarter of 2012, a decrease of $39.4 million or 6.1 percent, compared to the prior year's quarter. The decrease in interest-bearing liabilities was a result of a decrease in average time deposits and average savings deposits, partially offset by an increase in interest-bearing demand deposits.

- The average cost of interest-bearing liabilities decreased 42 basis points to 1.25 percent, primarily due to the repricing of deposits in a lower interest rate environment. The cost of interest-bearing deposits decreased 42 basis points to 0.85 percent for the first quarter of 2012 and the cost of borrowed funds and subordinated debentures decreased 60 basis points to 3.57 percent.
- The lower cost of funding was also attributed to a shift in the mix of deposits from higher cost time deposits to lower cost products as part of management's strategy to restructure the deposit portfolio.

During the quarter ended June 30, 2012, tax-equivalent net interest income amounted to $6.9 million, a decrease of $609 thousand or 8.1 percent when compared to the same period in 2011. Net interest margin decreased 20 basis points to 3.68 percent for the quarter ended June 30, 2012, compared to 3.88 percent for the same period in 2011. The net interest spread was 3.45 percent for the second quarter of 2012, a 16 basis point decrease from 3.61 for the same period in 2011.

During the six months ended June 30, 2012, tax-equivalent interest income was $18.0 million, a decrease of $2.6 million or 12.6 percent when compared to the same period in 2011.

- Of the $2.6 million decrease in interest income on a tax-equivalent basis, $2.1 million was attributed to reduced yields on average interest-earning assets and $524 thousand was attributable to the decrease in volume of average interest-earning assets.
- The average volume of interest-earning assets decreased $11.3 million to $766.2 million for the six months ended June 30, 2012, compared to $777.6 million for the same period in 2011. This was due primarily to a $21.5 million decrease in average loans, partially offset by a $10.9 million increase in federal funds sold and interest-bearing deposits.
- The yield on interest-earning assets decreased 60 basis points to 4.71 percent for the six months ended June 30, 2012 when compared to the same period in 2011, due to continued re-pricing in a lower overall interest rate environment. Yields on most earning assets, particularly those with variable rates, fell due to these lower market rates.

Total interest expense was $4.2 million for the six months ended June 30, 2012, a decrease of $1.3 million or 24.2 percent compared to the same period in 2011. This decrease was driven by the lower overall interest rate environment combined with the shift in deposit mix away from higher priced products and a decrease in the average volume of interest-bearing liabilities:

- Of the $1.3 million decrease in interest expense, $1.0 million was due to a decrease in the rates paid on interest-bearing liabilities and $300 thousand was attributed to the decrease in the volume of average interest-bearing liabilities.
- Interest-bearing liabilities averaged $625.0 million for the six months ended June 30, 2012, a decrease of $29.1 million or 4.4 percent, compared to the same period in 2011. The decrease in interest-bearing liabilities was a result of a decrease in average time deposits and savings deposits, partially offset by an increase in interest-bearing deposits.
- The average cost of interest-bearing liabilities decreased 36 basis points to 1.33 percent, primarily due to the re-pricing of deposits in a lower interest rate environment. The cost of interest-bearing deposits decreased 34 basis points to 0.94 percent for the six months ended June 30, 2012 and the cost of borrowed funds and subordinated

debentures decreased 56 basis points to 3.63 percent.

× The lower cost of funding was also attributed to a shift in the mix of deposits from higher cost time deposits to lower cost savings deposits and interest-bearing demand deposits.

During the six months ended June 30, 2012, tax-equivalent net interest income amounted to $13.8 million, a decrease of $1.3 million or 8.4 percent, compared to the same period in 2011. Net interest margin decreased 28 basis points to 3.62 percent for the six months ended June 30, 2012, compared to 3.90 percent for the same period in 2011. The net interest spread was 3.38 percent for the six months ended June 30, 2011, a 24 basis point decrease from 3.62 percent for the same period in 2011.

The following table reflects the components of net interest income, setting forth for the periods presented herein: (1) average assets, liabilities and shareholders' equity, (2) interest income earned on interest-earning assets and interest expense paid on interest-bearing liabilities, (3) average yields earned on interest-earning assets and average rates paid on interest-bearing liabilities, (4) net interest spread (which is the average yield on interest-earning assets less the average rate on interest-bearing liabilities), and (5) net interest income/margin on average earning assets. Rates/Yields are computed on a fully tax-equivalent basis, assuming a federal income tax rate of 34 percent.

Consolidated Average Balance Sheets

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

	For the three months ended June 30,					
	2012			2011		
	Average Balance	Interest	Rate/Yield	Average Balance	Interest	Rate/Yield
ASSETS						
Interest-earning assets:						
Federal funds sold and interest-bearing deposits	$ 30,832	$ 11	0.14 %	$ 40,499	$ 9	0.09 %
Federal Home Loan Bank stock	3,993	44	4.43	4,097	35	3.43
Securities:						
Securities available for sale	103,958	741	2.85	103,750	939	3.62
Securities held to maturity	17,499	170	3.89	14,841	185	4.99
Total securities (A)	121,457	911	3.00	118,591	1,124	3.79
Loans:						
SBA loans	69,273	846	4.89	85,678	1,191	5.56
SBA 504 loans	46,804	691	5.94	58,999	834	5.67
Commercial loans	303,409	4,216	5.59	284,503	4,581	6.46
Residential mortgage loans	133,643	1,582	4.74	132,386	1,846	5.58
Consumer loans	45,658	529	4.66	52,316	629	4.82
Total loans (B)	598,787	7,864	5.28	613,882	9,081	5.93
Total interest-earning assets	$ 755,069	$ 8,830	4.70 %	$ 777,069	$ 10,249	5.28 %
Noninterest-earning assets:						
Cash and due from banks	16,101			16,243		
Allowance for loan losses	(16,980)			(16,050)		
Other assets	39,774			39,903		
Total noninterest-earning assets	38,895			40,096		
Total assets	$ 793,964			$ 817,165		
LIABILITIES AND SHAREHOLDERS' EQUITY						
Interest-bearing liabilities:						
Interest-bearing demand deposits	$ 110,343	$ 123	0.45 %	$ 104,149	$ 143	0.55 %
Savings deposits	270,990	287	0.43	286,738	584	0.82
Time deposits	138,554	689	2.00	168,448	1,045	2.49
Total interest-bearing deposits	519,887	1,099	0.85	559,335	1,772	1.27
Borrowed funds and subordinated debentures	90,465	816	3.57	90,465	953	4.17
Total interest-bearing liabilities	$ 610,352	$ 1,915	1.25 %	$ 649,800	$ 2,725	1.67 %
Noninterest-bearing liabilities:						
Noninterest-bearing demand deposits	106,043			92,090		
Other liabilities	3,438			4,760		
Total noninterest-bearing liabilities	109,481			96,850		
Total shareholders' equity	74,131			70,515		
Total liabilities and shareholders' equity	$ 793,964			$ 817,165		