

SI Financial Group, Inc.  
Form 10-Q  
August 05, 2015

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

FORM 10-Q  
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT  
OF 1934

For the Quarterly Period Ended June 30, 2015

OR  
o 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: 0-54241

SI FINANCIAL GROUP, INC.  
(Exact name of registrant as specified in its charter)

Maryland 80-0643149  
(State or other jurisdiction of incorporation or (I.R.S. Employer Identification No.)  
organization)

803 Main Street, Willimantic, Connecticut 06226  
(Address of principal executive offices) (Zip Code)

(860) 423-4581  
(Registrant's telephone number, including area code)

Not Applicable  
(Former name, former address and former fiscal year, if changed since last report)

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 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 has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

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

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

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

As of July 31, 2015, there were 12,227,845 shares of the registrant's common stock outstanding.

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements.

## SI FINANCIAL GROUP, INC.

## CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Amounts / Unaudited)

|   | June 30,<br>2015 | December 31,<br>2014 |
|---|------------------|----------------------|
| <b>ASSETS:</b>  |                  |                      |
| Cash and due from banks:  |                  |                      |
| Noninterest-bearing   | \$ 16,693        | \$ 18,965            |
| Interest-bearing  | 22,892           | 20,286               |
| Total cash and cash equivalents   | 39,585           | 39,251               |
| Available for sale securities, at fair value  | 170,803          | 173,040              |
| Loans held for sale   | 1,240            | 747                  |
| Loans receivable (net of allowance for loan losses of \$8,437 at June 30, 2015 and \$7,797 at December 31, 2014)  | 1,100,772        | 1,044,864            |
| Federal Home Loan Bank stock, at cost   | 10,962           | 10,333               |
| Federal Reserve Bank stock, at cost   | 3,621            | —                    |
| Bank-owned life insurance   | 21,609           | 21,306               |
| Premises and equipment, net   | 22,130           | 21,711               |
| Goodwill and other intangibles  | 18,396           | 18,697               |
| Accrued interest receivable   | 4,033            | 3,853                |
| Deferred tax asset, net   | 7,861            | 8,048                |
| Other real estate owned, net  | 1,420            | 1,271                |
| Other assets  | 6,917            | 7,412                |
| Total assets  | \$ 1,409,349     | \$ 1,350,533         |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY:</b>  |                  |                      |
| Liabilities:  |                  |                      |
| Deposits:   |                  |                      |
| Noninterest-bearing   | \$ 150,920       | \$ 146,062           |
| Interest-bearing  | 879,208          | 864,651              |
| Total deposits  | 1,030,128        | 1,010,713            |
| Mortgagors' and investors' escrow accounts  | 3,900            | 3,600                |
| Federal Home Loan Bank advances   | 192,193          | 148,277              |
| Junior subordinated debt owed to unconsolidated trust   | 8,248            | 8,248                |
| Accrued expenses and other liabilities  | 22,259           | 21,956               |
| Total liabilities   | 1,256,728        | 1,192,794            |
| Shareholders' Equity:   |                  |                      |
| Preferred stock (\$.01 par value; 1,000,000 shares authorized; none issued)   | —                | —                    |
| Common stock (\$.01 par value; 35,000,000 shares authorized; 12,227,845 shares and 12,776,426 shares issued and outstanding at June 30, 2015 and December 31, 2014, respectively) | 122              | 128                  |
| Additional paid-in-capital  | 124,771          | 125,459              |
| Unallocated common shares held by ESOP  | (3,888           | ) (4,128             |
| Unearned restricted shares  | (1,115           | ) (1,312             |

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|  |             |             |
|--|-------------|-------------|
| Retained earnings                          | 32,449      | 37,497      |
| Accumulated other comprehensive income     | 282         | 95          |
| Total shareholders' equity                 | 152,621     | 157,739     |
| Total liabilities and shareholders' equity | \$1,409,349 | \$1,350,533 |

See accompanying notes to unaudited interim consolidated financial statements.

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SI FINANCIAL GROUP, INC.  
CONSOLIDATED STATEMENTS OF INCOME  
(In Thousands, Except Per Share Amounts / Unaudited)

|   | Three Months Ended<br>June 30, |          | Six Months Ended<br>June 30, |          |
|---|--------------------------------|----------|------------------------------|----------|
|   | 2015                           | 2014     | 2015                         | 2014     |
| Interest and dividend income:                                 |                                |          |                              |          |
| Loans, including fees   | \$10,931                       | \$10,667 | \$21,545                     | \$21,754 |
| Securities:   |                                |          |                              |          |
| Taxable interest  | 717                            | 894      | 1,450                        | 1,774    |
| Tax-exempt interest   | 27                             | 59       | 86                           | 101      |
| Dividends   | 96                             | 48       | 141                          | 97       |
| Other   | 19                             | 15       | 38                           | 28       |
| Total interest and dividend income                            | 11,790                         | 11,683   | 23,260                       | 23,754   |
| Interest expense:   |                                |          |                              |          |
| Deposits  | 1,379                          | 1,359    | 2,747                        | 2,678    |
| Federal Home Loan Bank advances                               | 682                            | 637      | 1,278                        | 1,319    |
| Subordinated debt and other borrowings                        | 84                             | 84       | 167                          | 167      |
| Total interest expense  | 2,145                          | 2,080    | 4,192                        | 4,164    |
| Net interest income   | 9,645                          | 9,603    | 19,068                       | 19,590   |
| Provision for loan losses                                     | 360                            | 415      | 695                          | 845      |
| Net interest income after provision for loan losses           | 9,285                          | 9,188    | 18,373                       | 18,745   |
| Noninterest income:   |                                |          |                              |          |
| Service fees  | 1,692                          | 1,785    | 3,340                        | 3,503    |
| Wealth management fees  | 315                            | 310      | 613                          | 633      |
| Increase in cash surrender value of bank-owned life insurance | 142                            | 144      | 303                          | 286      |
| Net gain on sales of securities                               | 132                            | 29       | 132                          | 64       |
| Mortgage banking  | 130                            | 155      | 277                          | 315      |
| Net loss on fair value of derivatives                         | (10)                           | (26)     | (15)                         | (9)      |
| Other   | 209                            | 65       | 297                          | 442      |
| Total noninterest income                                      | 2,610                          | 2,462    | 4,947                        | 5,234    |
| Noninterest expenses:   |                                |          |                              |          |
| Salaries and employee benefits                                | 5,129                          | 5,031    | 10,073                       | 10,231   |
| Occupancy and equipment                                       | 1,791                          | 1,862    | 3,844                        | 3,969    |
| Computer and electronic banking services                      | 1,458                          | 1,313    | 2,755                        | 2,665    |
| Outside professional services                                 | 508                            | 553      | 974                          | 1,002    |
| Marketing and advertising                                     | 274                            | 312      | 520                          | 538      |
| Supplies  | 144                            | 151      | 292                          | 319      |
| FDIC deposit insurance and regulatory assessments             | 248                            | 301      | 493                          | 650      |
| Core deposit intangible amortization                          | 151                            | 149      | 301                          | 313      |
| Other real estate operations                                  | 202                            | 62       | 284                          | 231      |
| Other   | 501                            | 603      | 931                          | 1,373    |
| Total noninterest expenses                                    | 10,406                         | 10,337   | 20,467                       | 21,291   |

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|                                    |         |        |         |         |
|------------------------------------|---------|--------|---------|---------|
| Income before income tax provision | 1,489   | 1,313  | 2,853   | 2,688   |
| Income tax provision               | 484     | 399    | 927     | 868     |
| Net income                         | \$1,005 | \$914  | \$1,926 | \$1,820 |
| Earnings per share:                |         |        |         |         |
| Basic                              | \$0.08  | \$0.07 | \$0.16  | \$0.15  |
| Diluted                            | \$0.08  | \$0.07 | \$0.16  | \$0.15  |

See accompanying notes to unaudited interim consolidated financial statements.

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SI FINANCIAL GROUP, INC.  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(In Thousands / Unaudited)

|   | Three Months Ended<br>June 30, |         | Six Months Ended<br>June 30, |         |
|---|--------------------------------|---------|------------------------------|---------|
|   | 2015                           | 2014    | 2015                         | 2014    |
| Net income  | \$1,005                        | \$914   | \$1,926                      | \$1,820 |
| Other comprehensive income (loss), net of tax:                                |                                |         |                              |         |
| Available for sale securities:  |                                |         |                              |         |
| Net unrealized holding gains (losses)   | (480                           | ) 588   | 222                          | 928     |
| Reclassification adjustment for gains recognized in net income <sup>(1)</sup> | (87                            | ) (19   | ) (87                        | ) (42   |
| Net unrealized holding gains (losses) on available for sale securities        | (567                           | ) 569   | 135                          | 886     |
| Net unrealized gain on interest-rate swap derivative                          | 27                             | 23      | 52                           | 46      |
| Other comprehensive income (loss)   | (540                           | ) 592   | 187                          | 932     |
| Comprehensive income  | \$465                          | \$1,506 | \$2,113                      | \$2,752 |

<sup>(1)</sup> Amounts are included in net gain on sales of securities in noninterest income on the consolidated statements of income. Income tax expense associated with the reclassification adjustment for both the three and six months ended June 30, 2015 was \$45,000 and for the three and six months ended June 30, 2014, was \$10,000 and \$22,000, respectively.

See accompanying notes to unaudited interim consolidated financial statements.

SI FINANCIAL GROUP, INC.  
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY  
FOR THE SIX MONTHS ENDED JUNE 30, 2015  
(In Thousands, Except Share Data / Unaudited)

|  | Common Stock |         | Additional<br>Paid-in<br>Capital | Unallocated                         |                                  | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income | Total<br>Shareholders'<br>Equity |
|--|--------------|---------|----------------------------------|-------------------------------------|----------------------------------|----------------------|---|----------------------------------|
|  | Shares       | Dollars |                                  | Common<br>Shares<br>Held<br>by ESOP | Unearned<br>Restricted<br>Shares |                      |   |                                  |
| Balance at December 31, 2014               | 12,776,426   | \$ 128  | \$ 125,459                       | \$ (4,128 )                         | \$ (1,312 )                      | \$ 37,497            | \$ 95   | \$ 157,739                       |
| Comprehensive income                       | —            | —       | —                                | —                                   | —                                | 1,926                | 187   | 2,113                            |
| Cash dividends declared (\$0.08 per share) | —            | —       | —                                | —                                   | —                                | (973 )               | —   | (973 )                           |
| Equity incentive plans compensation        | —            | —       | 155                              | —                                   | 197                              | —                    | —   | 352                              |
| Allocation of 24,318 ESOP shares           | —            | —       | 43                               | 240                                 | —                                | —                    | —   | 283                              |
| Tax benefit from share-based compensation  | —            | —       | 5                                | —                                   | —                                | —                    | —   | 5                                |
| Stock options exercised                    | 296,648      | 3       | 3,263                            | —                                   | —                                | —                    | —   | 3,266                            |
| Common shares repurchased                  | (845,229 )   | (9 )    | (4,154 )                         | —                                   | —                                | (6,001 )             | —   | (10,164 )                        |
| Balance at June 30, 2015                   | 12,227,845   | \$ 122  | \$ 124,771                       | \$ (3,888 )                         | \$ (1,115 )                      | \$ 32,449            | \$ 282  | \$ 152,621                       |

See accompanying notes to unaudited interim consolidated financial statements.

SI FINANCIAL GROUP, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(In Thousands / Unaudited)

|   | Six Months Ended |           |
|---|------------------|-----------|
|   | June 30,         |           |
|   | 2015             | 2014      |
| Cash flows from operating activities:   |                  |           |
| Net income  | \$1,926          | \$1,820   |
| Adjustments to reconcile net income to net cash provided by operating activities:     |                  |           |
| Provision for loan losses   | 695              | 845       |
| Employee stock ownership plan expense   | 283              | 282       |
| Equity incentive plan expense   | 352              | 381       |
| Excess tax benefit from share-based compensation                                      | (5               | ) (3      |
| Amortization of investment premiums and discounts, net                                | 586              | 512       |
| Amortization of loan premiums and discounts, net                                      | 938              | 641       |
| Depreciation and amortization of premises and equipment                               | 1,372            | 1,277     |
| Amortization of core deposit intangible   | 301              | 313       |
| Amortization of deferred debt issue costs   | 13               | 66        |
| Net gain on sales of securities   | (132             | ) (64     |
| Net loss on fair value of derivatives   | 15               | 9         |
| Deferred income tax provision (benefit)   | 89               | (46       |
| Loans originated for sale   | (14,134          | ) (8,497  |
| Proceeds from sale of loans held for sale   | 13,729           | 9,761     |
| Net gain on sales of loans held for sale  | (156             | ) (185    |
| Net loss on sales or write-downs of other real estate owned                           | 122              | 39        |
| Increase in cash surrender value of bank-owned life insurance                         | (303             | ) (286    |
| Impairment charge on long-lived assets  | —                | 175       |
| Change in operating assets and liabilities:   |                  |           |
| Accrued interest receivable   | (180             | ) 124     |
| Other assets  | 568              | 2,488     |
| Accrued expenses and other liabilities  | 367              | 1,283     |
| Net cash provided by operating activities   | 6,446            | 10,935    |
| Cash flows from investing activities:   |                  |           |
| Purchases of available for sale securities  | (22,407          | ) (20,675 |
| Proceeds from sales of available for sale securities                                  | 9,703            | 1,109     |
| Proceeds from maturities of and principal repayments on available for sale securities | 14,693           | 18,191    |
| Purchases of Federal Home Loan Bank stock   | (629             | ) —       |
| Purchases of Federal Reserve Bank stock   | (3,621           | ) —       |
| Redemption of Federal Home Loan Bank stock  | —                | 1,160     |
| Loan principal collections, net of originations                                       | 9,366            | 33,484    |
| Purchases of loans  | (67,240          | ) (25,832 |
| Proceeds from sales of other real estate owned  | 62               | 816       |
| Purchases of premises and equipment   | (1,791           | ) (1,158  |
| Net cash provided by (used in) investing activities                                   | (61,864          | ) 7,095   |

SI FINANCIAL GROUP, INC.  
CONSOLIDATED STATEMENTS OF CASH FLOWS (Concluded)  
(In Thousands / Unaudited)

|  | Six Months Ended |          |
|--|------------------|----------|
|  | June 30,         |          |
|  | 2015             | 2014     |
| Cash flows from financing activities:                      |                  |          |
| Net increase in deposits                                   | 19,415           | 21,472   |
| Net increase in mortgagors' and investors' escrow accounts | 300              | 87       |
| Proceeds from Federal Home Loan Bank advances              | 78,478           | 10,000   |
| Repayments of Federal Home Loan Bank advances              | (34,575)         | (27,797) |
| Excess tax benefit from share-based compensation           | 5                | 3        |
| Cash dividends on common stock                             | (973)            | (739)    |
| Stock options exercised                                    | 703              | 352      |
| Common shares repurchased                                  | (7,601)          | (316)    |
| Net cash provided by financing activities                  | 55,752           | 3,062    |
| Net change in cash and cash equivalents                    | 334              | 21,092   |
| Cash and cash equivalents at beginning of period           | 39,251           | 27,321   |
| Cash and cash equivalents at end of period                 | \$39,585         | \$48,413 |
| Supplemental cash flow information:                        |                  |          |
| Interest paid  | \$4,199          | \$4,201  |
| Income taxes received, net                                 | 470              | 850      |
| Transfer of loans to other real estate owned               | 385              | 90       |
| Stock options exercised by net-share settlement            | 2,563            | 190      |

See accompanying notes to unaudited interim consolidated financial statements.

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2015 AND 2014 AND DECEMBER 31, 2014

NOTE 1. NATURE OF BUSINESS AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

SI Financial Group, Inc. (the “Company”) is the holding company for Savings Institute Bank and Trust Company (the “Bank”). Established in 1842, the Bank is a community-oriented financial institution headquartered in Willimantic, Connecticut. The Bank provides a variety of financial services to individuals, businesses and municipalities through its twenty-six offices in eastern Connecticut and Rhode Island. Its primary products include savings, checking and certificate of deposit accounts, residential and commercial mortgage loans, commercial business loans and consumer loans. In addition, wealth management services, which include trust, financial planning, life insurance and investment services, are offered to individuals and businesses through the Bank’s offices. The Company does not conduct any material business other than owning all of the stock of the Bank and making payments on the subordinated debentures held by the Company.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company, its wholly-owned subsidiary, the Bank, and the Bank’s wholly-owned subsidiaries, SI Mortgage Company and SI Realty Company, Inc. All significant intercompany accounts and transactions have been eliminated.

Basis of Financial Statement Presentation

The interim consolidated financial statements and related notes have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information, with the instructions to Form 10-Q and Rule 10.01 of Regulation S-X of the Securities and Exchange Commission and general practices within the banking industry. Accordingly, certain information and footnote disclosures required by GAAP for complete financial statements have been omitted. Information in the accompanying interim consolidated financial statements and notes to the financial statements of the Company as of June 30, 2015 and for the three and six months ended June 30, 2015 and 2014 is unaudited. These unaudited interim consolidated financial statements and related notes should be read in conjunction with the audited financial statements of the Company and the accompanying notes for the year ended December 31, 2014 contained in the Company’s Form 10-K.

In the opinion of management, the accompanying unaudited interim consolidated financial statements reflect all of the adjustments, consisting only of normal and recurring adjustments, necessary for a fair presentation of the financial condition, results of operations and cash flows as of and for the periods covered herein. The results of operations for the three and six months ended June 30, 2015 are not necessarily indicative of the operating results for the year ending December 31, 2015 or for any other period.

In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosures of contingent assets and liabilities, as of the date of the balance sheets and reported amounts of revenues and expenses for the periods presented. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, deferred income taxes and the impairment of long-lived assets.

Reclassifications

Amounts in the Company's prior year consolidated financial statements are reclassified to conform to the current year presentation. Such reclassifications have no effect on net income.

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2015 AND 2014 AND DECEMBER 31, 2014

Loans Receivable

Loans receivable are stated at current unpaid principal balances, net of the allowance for loan losses and deferred loan origination fees and costs. Management has the ability and intent to hold its loans receivable for the foreseeable future or until maturity or pay-off.

A loan is impaired when, based on current information and events, it is probable the Company will be unable to collect all contractual principal and interest payments due in accordance with the terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Impairment is measured on a loan by loan basis for residential and commercial mortgage loans and commercial business loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not typically identify individual consumer loans for impairment disclosures, unless such loans are subject to a troubled debt restructuring ("TDR") agreement.

The Company periodically may agree to modify the contractual terms of loans. When a loan is modified and concessions have been made to the original contractual terms, such as reductions of interest rates or deferral of interest or principal payments due to the borrower's financial condition, the modification is considered a TDR.

Management considers all nonaccrual loans, with the exception of certain consumer loans, to be impaired. Also, all TDRs are initially classified as impaired. In most cases, loan payments less than 90 days past due are considered minor collection delays and the related loans are generally not considered impaired.

Allowance for Loan Losses

The allowance for loan losses, a material estimate which could change significantly in the near-term, is established through a provision for loan losses charged to earnings to account for losses that are inherent in the loan portfolio and estimated to occur, and is maintained at a level that management considers adequate to absorb losses in the loan portfolio. Loan losses are charged against the allowance for loan losses when management believes the uncollectibility of the principal loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance for loan losses when received. In the determination of the allowance for loan losses, management may obtain independent appraisals for significant properties, if necessary.

Management's judgment in determining the adequacy of the allowance is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. The allowance for loan losses is evaluated on a monthly basis by management and is based on the evaluation of the known and inherent risk characteristics and size and composition of the loan portfolio, the assessment of current economic and real estate market conditions, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, historical loan loss experience, the level and trends of nonperforming loans, delinquencies, classified assets and loan charge-offs and evaluations of loans and other relevant factors.

The allowance for loan losses consists of the following key elements:

Specific allowance for identified impaired loans. For loans identified as impaired, an allowance is established when the present value of expected cash flows (or observable market price of the loan or fair value of the collateral if the loan is collateral dependent) of the impaired loan is lower than the carrying value of that loan.

General valuation allowance. The general component represents a valuation allowance on the remainder of the loan portfolio, after excluding impaired loans. For this portion of the allowance, loans are segregated by category and assigned an allowance percentage based on historical loan loss experience



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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2015 AND 2014 AND DECEMBER 31, 2014

adjusted for qualitative factors stratified by the following loan segments: residential one- to four-family, multi-family and commercial real estate, construction, commercial business and consumer. Management uses a rolling average of historical losses based on the time frame appropriate to capture relevant loss data for each loan segment. This historical loss factor is adjusted for the following qualitative factors: changes in lending policies and procedures, including changes in underwriting standards and collection, charge-off and recovery practices; changes in international, national, regional and local economic and business conditions and developments that affect the collectibility of the portfolio, including the condition of various market segments; changes in the nature and volume of the loan portfolio and in the terms of the loans; changes in the experience, ability, and depth of lending management and other relevant staff; changes in the volume and severity of past due loans, the volume of nonaccrual loans and the volume and severity of adversely classified or graded loans; changes in the quality of the loan review system; changes in the underlying collateral for collateral-dependent loans; the existence and effect of any concentrations of credit and changes in the level of such concentrations; the effect of other external factors such as competition and legal and regulatory capital requirements on the level of estimated credit losses in the portfolio.

The qualitative factors are determined based on the following various risk characteristics for each loan segment. Risk characteristics relevant to each portfolio segment are as follows:

**Residential – One- to Four-Family –** The Bank primarily originates conventional loans with loan-to-value ratios less than 95% and generally originates loans with loan-to-value ratios in excess of 80% only when secured by first liens on owner-occupied one- to four-family residences. Loans with loan-to-value ratios in excess of 80% generally require private mortgage insurance or additional collateral. All loans in this segment are collateralized by owner-occupied residential real estate and repayment is dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment rates and housing prices, will have an effect on the credit quality of this segment.

**Multi-family and Commercial –** Loans in this segment are originated for the purpose of acquiring, developing, improving or refinancing multi-family and commercial real estate where the property is the primary collateral securing the loan, and the income generated from the property is the primary repayment source. The underlying cash flows generated by the properties can be adversely impacted by the economy as evidenced by increased vacancy rates. Payments on loans secured by income-producing properties often depend on the successful operation and management of the properties. Management continually monitors the cash flows of these loans.

**Construction –** This segment includes loans to individuals, and to a lesser extent, builders to finance the construction of residential dwellings. The Bank also originates construction loans for commercial development projects. Upon the completion of construction, the loan generally converts to a permanent mortgage loan. Credit risk is affected by cost overruns, correct estimates of the sale price of the property, time to sell at an adequate price and market conditions.

**Commercial Business –** Loans in this segment are made to businesses and are generally secured by assets of the business. Repayment is expected from the cash flows of the business. A weakened economy and reduced viability of the industry in which the customer operates will have a negative impact on the credit quality in this segment. The Bank also provides loans to investors in the time share industry, which are secured by consumer receivables, and provides loans for capital improvements to condominium associations, which are secured by the assigned rights to levy special assessments to condominium owners.

Consumer – Loans in this segment primarily include home equity lines of credit (representing both first and second liens), indirect automobile loans and, to a lesser extent, loans secured by marketable

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securities, passbook or certificate accounts, motorcycles, automobiles and recreational vehicles, as well as unsecured loans. Consumer loan collections depend on the borrower's continuing financial stability, and therefore, are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy.

In computing the allowance for loan losses, we do not assign a general valuation allowance to the Small Business Administration ("SBA") and United States Department of Agriculture ("USDA") loans that we purchase as such loans are fully guaranteed. These loans are included in commercial business loans. See Note 4 for details.

The majority of the Company's loans are collateralized by real estate located in eastern Connecticut and Rhode Island. To a lesser extent, certain commercial real estate loans are secured by collateral located outside of our primary market area. Accordingly, the collateral value of a substantial portion of the Company's loan portfolio and real estate acquired through foreclosure is susceptible to changes in local market conditions.

Although management believes it uses the best information available to establish the allowance for loan losses, future adjustments to the allowance for loan losses may be necessary and the Company's results of operations could be adversely affected if circumstances differ substantially from the assumptions used in making the determinations. Furthermore, while management believes it has established the allowance for loan losses in conformity with GAAP, our regulators, in reviewing the loan portfolio, may request us to increase our allowance for loan losses based on judgments different from ours. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, the existing allowance for loan losses may not be adequate or increases may be necessary should the quality of any loans deteriorate as a result of the factors discussed above. Any material increase in the allowance for loan losses would adversely affect the Company's financial condition and results of operations.

**Interest and Fees on Loans**

Interest on loans is accrued and included in net interest income based on contractual rates applied to principal amounts outstanding. Accrual of interest is discontinued when loan payments are 90 days or more past due, based on contractual terms, or when, in the judgment of management, collectibility of the loan or loan interest becomes uncertain. Subsequent recognition of income occurs only to the extent payment is received subject to management's assessment of the collectibility of the remaining interest and principal. A nonaccrual loan is restored to accrual status when it is no longer delinquent and collectibility of interest and principal is no longer in doubt and the borrower has made regular payments in accordance with the terms of the loan over a period of at least six months. Interest collected on nonaccrual loans is recognized only to the extent cash payments are received, and may be recorded as a reduction to principal if the collectibility of the principal balance of the loan is unlikely.

Loan origination fees, direct loan origination costs and loan purchase premiums are deferred, and the net amount is recognized as an adjustment of the related loan's yield utilizing the interest method over the contractual life of the loan. In addition, discounts related to fair value adjustments for loans receivable acquired in a business combination or asset purchase are accreted into earnings over the contractual term as an adjustment of the loan's yield. The Company periodically evaluates the cash flows expected to be collected for loans acquired with deteriorated credit quality. Changes in the expected cash flows compared to the expected cash flows as of the date of acquisition may impact the accretable yield or result in a charge to the provision for loan losses to the extent of a shortfall.

**Common Share Repurchases**

The Company is chartered in the state of Maryland. Maryland law does not provide for treasury shares, rather shares repurchased by the Company constitute authorized but unissued shares. GAAP states that accounting for treasury stock shall conform to state law. Therefore, the cost of shares repurchased by the Company has been allocated to common stock, additional paid-in capital and retained earnings balances.

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Recent Accounting Pronouncements

Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. In January 2014, the Financial Accounting Standards Board ("FASB") issued amended guidance that clarifies when a creditor should be considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan such that the loan receivable should be derecognized and the real estate property recognized. The amended guidance clarifies that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. In addition, the amended guidance requires interim and annual disclosures of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amended guidance may be applied prospectively or through a modified retrospective approach and is effective for fiscal years, and interim periods within those years, beginning after December 15, 2014, with early adoption permitted. The adoption of the amended guidance did not have a material impact on the Company's consolidated financial statements.

Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40): Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure - In August 2014, the FASB issued amended guidance that addresses the diversity in practice regarding the classification and measurement of foreclosed loans which were part of a government-sponsored loan guarantee program (e.g. HUD, FHA, VA). The amended guidance outlines certain criteria that, if met, the loan (residential or commercial) should be derecognized and a separate other receivable should be recorded upon foreclosure at the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. This amended guidance will be effective for annual reporting periods beginning after December 15, 2014, including interim periods within that reporting period. Early adoption is permitted, provided the entity has adopted Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. The amended guidance should be adopted either prospectively or on a modified retrospective basis. The adoption of the amended guidance did not have a material impact on the Company's consolidated financial statements.

Interest - Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Costs - In April 2015, the FASB issued guidance, as part of its initiative to reduce complexity in accounting standards, simplifying the presentation of debt issuance costs. The amended guidance requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The amended guidance should be applied on a retrospective basis and is effective for fiscal years, and interim periods within those years, beginning after December 15, 2015, with early adoption permitted. The adoption of the amended guidance is not expected to have a material impact on the Company's consolidated financial statements.

NOTE 2. EARNINGS PER SHARE

Basic earnings per share is calculated by dividing the net income available to common shareholders by the weighted average number of common shares outstanding during the period. Unvested restricted shares are considered outstanding in the computation of basic earnings per share since the shares participate in dividends and the rights to the dividends are non-forfeitable. Diluted earnings per share is computed in a manner similar to basic earnings per share except that the weighted average number of common shares outstanding is increased to include the incremental common shares (as computed using the treasury stock method) that would have been outstanding if all potentially dilutive common stock equivalents were issued during the period. The Company's

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common stock equivalents relate solely to stock options. Repurchased common shares and unallocated common shares held by the Bank's ESOP are not deemed outstanding for earnings per share calculations.

Anti-dilutive shares are common stock equivalents with weighted average exercise prices in excess of the weighted average market value for the periods presented, and are not considered in diluted earnings per share calculations. The Company had anti-dilutive common shares outstanding of 333,728 and 353,332 for the three and six months ended June 30, 2015, respectively, and 384,289 and 389,393 for the three and six months ended June 30, 2014, respectively.

The computation of earnings per share is as follows:

|   | Three Months Ended                               |            | Six Months Ended |            |
|---|--|------------|------------------|------------|
|   | June 30,<br>2015                                 | 2014       | June 30,<br>2015 | 2014       |
|   | (Dollars in Thousands, Except Per Share Amounts) |            |                  |            |
| Net income                                  | \$1,005  | \$914      | \$1,926          | \$1,820    |
| Weighted average common shares outstanding: |  |            |                  |            |
| Basic                                       | 12,006,510                                       | 12,341,727 | 12,160,268       | 12,318,604 |
| Effect of dilutive stock options            | 25,103   | 45,706     | 31,872           | 46,979     |
| Diluted                                     | 12,031,613                                       | 12,387,433 | 12,192,140       | 12,365,583 |
| Earnings per share:                         |  |            |                  |            |
| Basic                                       | \$0.08   | \$0.07     | \$0.16           | \$0.15     |
| Diluted                                     | \$0.08   | \$0.07     | \$0.16           | \$0.15     |

## NOTE 3. SECURITIES

## Available for Sale Securities

The amortized cost, gross unrealized gains and losses and fair values of available for sale securities at June 30, 2015 and December 31, 2014 are as follows:

|   | June 30, 2015     |                              |                               |               |
|---|-------------------|------------------------------|-------------------------------|---------------|
|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|   | (In Thousands)    |                              |                               |               |
| Debt securities:                                |                   |                              |                               |               |
| U.S. Government and agency obligations          | \$70,210          | \$505                        | \$(233)                       | ) \$70,482    |
| Government-sponsored enterprises                | 21,346            | 197                          | (1)                           | ) 21,542      |
| Mortgage-backed securities: <sup>(1)</sup>      |                   |                              |                               |               |
| Agency - residential                            | 71,620            | 806                          | (934)                         | ) 71,492      |
| Non-agency - residential                        | 241               | 2                            | (5)                           | ) 238         |
| Corporate debt securities                       | 1,000             | —                            | —                             | 1,000         |
| Collateralized debt obligation                  | 1,153             | —                            | (5)                           | ) 1,148       |
| Obligations of state and political subdivisions | 1,535             | 145                          | —                             | 1,680         |

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|                                     |           |         |          |             |
|-------------------------------------|-----------|---------|----------|-------------|
| Tax-exempt securities               | 3,191     | 31      | (1       | ) 3,221     |
| Total available for sale securities | \$170,296 | \$1,686 | \$(1,179 | ) \$170,803 |

<sup>(1)</sup> Agency securities refer to debt obligations issued or guaranteed by government corporations or government-sponsored enterprises (“GSEs”). Non-agency securities, or private-label securities, are the sole obligation of their issuer and are not guaranteed by any of the GSEs or the U.S. Government.

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|   | December 31, 2014 |                              |                               |               |
|---|-------------------|------------------------------|-------------------------------|---------------|
|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|   | (In Thousands)    |                              |                               |               |
| Debt securities:                                |                   |                              |                               |               |
| U.S. Government and agency obligations          | \$66,232          | \$385                        | \$(226)                       | ) \$66,391    |
| Government-sponsored enterprises                | 27,435            | 120                          | (67)                          | ) 27,488      |
| Mortgage-backed securities: <sup>(1)</sup>      |                   |                              |                               |               |
| Agency - residential                            | 67,008            | 907                          | (1,065)                       | ) 66,850      |
| Non-agency - residential                        | 254               | 3                            | (4)                           | ) 253         |
| Corporate debt securities                       | 1,000             | —                            | —                             | 1,000         |
| Collateralized debt obligation                  | 1,188             | —                            | (7)                           | ) 1,181       |
| Obligations of state and political subdivisions | 3,039             | 167                          | (6)                           | ) 3,200       |
| Tax-exempt securities                           | 6,583             | 97                           | (3)                           | ) 6,677       |
| Total available for sale securities             | \$172,739         | \$1,679                      | \$(1,378)                     | ) \$173,040   |

<sup>(1)</sup> Agency securities refer to debt obligations issued or guaranteed by government corporations or GSEs. Non-agency securities, or private-label securities, are the sole obligation of their issuer and are not guaranteed by any of the GSEs or the U.S. Government.

The amortized cost and fair value of debt securities by contractual maturities at June 30, 2015 are presented below. Maturities are based on the final contractual payment dates and do not reflect the impact of potential prepayments or early redemptions. Because mortgage-backed securities ("MBS") are not due at a single maturity date, they are not included in the maturity categories in the following maturity summary.

|                             | Amortized<br>Cost | Fair<br>Value |
|-----------------------------|-------------------|---------------|
|                             | (In Thousands)    |               |
| Within 1 year               | \$2,540           | \$2,548       |
| After 1 but within 5 years  | 46,068            | 46,543        |
| After 5 but within 10 years | 10,699            | 10,713        |
| After 10 years              | 39,128            | 39,269        |
|                             | 98,435            | 99,073        |
| Mortgage-backed securities  | 71,861            | 71,730        |
| Total debt securities       | \$170,296         | \$170,803     |

The following is a summary of realized gains and losses on the sales of securities for the three and six months ended June 30, 2015 and 2014:

| Three Months Ended<br>June 30, |      | Six Months Ended<br>June 30, |      |
|--------------------------------|------|------------------------------|------|
| 2015                           | 2014 | 2015                         | 2014 |
| (In Thousands)                 |      |                              |      |

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|                                 |        |       |        |       |
|---------------------------------|--------|-------|--------|-------|
| Gross gains on sales            | \$ 132 | \$ 29 | \$ 132 | \$ 64 |
| Gross losses on sales           | —      | —     | —      | —     |
| Net gain on sales of securities | \$ 132 | \$ 29 | \$ 132 | \$ 64 |

Proceeds from the sale of available for sale securities were \$9.7 million for both the three and six months ended June 30, 2015, and \$1.0 million and \$1.1 million for the three and six months ended June 30, 2014, respectively.

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The following tables present information pertaining to securities with gross unrealized losses at June 30, 2015 and December 31, 2014, aggregated by investment category and length of time the individual securities have been in a continuous unrealized loss position.

| June 30, 2015                                   | Less Than 12 Months |                   | 12 Months Or More |                   | Total      |                   |
|---|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
|   | (In Thousands)      |                   |                   |                   |            |                   |
| U.S. Government and agency obligations          | \$8,400             | \$39              | \$15,373          | \$194             | \$23,773   | \$233             |
| Government sponsored enterprises                | 998                 | 1                 | —                 | —                 | 998        | 1                 |
| Mortgage-backed securities:                     |                     |                   |                   |                   |            |                   |
| Agency - residential                            | 7,497               | 18                | 29,568            | 916               | 37,065     | 934               |
| Non-agency - residential                        | —                   | —                 | 118               | 5                 | 118        | 5                 |
| Collateralized debt obligation                  | 1,148               | 5                 | —                 | —                 | 1,148      | 5                 |
| Tax-exempt securities                           | 585                 | 1                 | —                 | —                 | 585        | 1                 |
| Total   | \$18,628            | \$64              | \$45,059          | \$1,115           | \$63,687   | \$1,179           |
|   |                     |                   |                   |                   |            |                   |
| December 31, 2014                               | Less Than 12 Months |                   | 12 Months Or More |                   | Total      |                   |
|   | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
|   | (In Thousands)      |                   |                   |                   |            |                   |
| U.S. Government and agency obligations          | \$9,273             | \$15              | \$16,655          | \$211             | \$25,928   | \$226             |
| Government-sponsored enterprises                | 6,974               | 4                 | 3,973             | 63                | 10,947     | 67                |
| Mortgage-backed securities:                     |                     |                   |                   |                   |            |                   |
| Agency - residential                            | 4,251               | 122               | 32,127            | 943               | 36,378     | 1,065             |
| Non-agency - residential                        | —                   | —                 | 127               | 4                 | 127        | 4                 |
| Collateralized debt obligation                  | 1,181               | 7                 | —                 | —                 | 1,181      | 7                 |
| Obligations of state and political subdivisions | —                   | —                 | 668               | 6                 | 668        | 6                 |
| Tax-exempt securities                           | 1,141               | 3                 | —                 | —                 | 1,141      | 3                 |
| Total   | \$22,820            | \$151             | \$53,550          | \$1,227           | \$76,370   | \$1,378           |

At June 30, 2015, thirty-one debt securities with gross unrealized losses had aggregate depreciation of approximately 1.82% of the Company's amortized cost basis. The majority of the unrealized losses are related to the Company's agency MBS. There were no investments deemed other-than-temporarily impaired for the three and six months ended June 30, 2015 and 2014. The following summarizes, by security type, the basis for management's determination during the preparation of the financial statements that the applicable investments within the Company's securities portfolio were not other-than-temporarily impaired at June 30, 2015.

U.S. Government and Agency Obligations. The unrealized losses on the Company's U.S. Government and agency obligations related primarily to a widening of the rate spread to comparable treasury securities. Because the decline in

market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell the securities before their anticipated recovery, which may be at maturity, the Company did not consider these securities to be other-than-temporarily impaired at June 30, 2015.

Government Sponsored Enterprises. The unrealized losses on the Company's government sponsored enterprises were caused by interest rate movement. The contractual cash flows of these investments are guaranteed by a

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government sponsored agency. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of our investment. As a result of (1) the decline in market value being attributable to changes in interest rates and not credit quality, (2) the Company's position that it does not intend to sell these securities and (3) it is not more likely than not that the Company will be required to sell the securities before their anticipated recovery, which may be at maturity, the Company did not consider these securities to be other-than-temporarily impaired at June 30, 2015.

Mortgage-backed Securities - Agency - Residential. The unrealized losses on the Company's agency-residential mortgage-backed securities were caused by increases in the rate spread to comparable treasury securities. The Company does not expect these securities to settle at a price less than the amortized cost basis of the investments. Because the Company does not intend to sell the investments and it is not more likely than not the Company will be required to sell the investments before the recovery of their amortized cost basis, which may be at maturity, the Company did not consider these investments to be other-than-temporarily impaired at June 30, 2015.

Mortgage-backed Securities - Non-agency - Residential. The unrealized losses on the Company's non-agency - residential mortgage-backed securities relate to one investment which has been evaluated by management and no potential credit losses were identified. Because the Company does not intend to sell this security and it is not more likely than not that the Company will be required to sell this security before the recovery of its amortized cost basis, which may be maturity, the Company did not consider this investment to be other-than-temporarily impaired at June 30, 2015.

Collateralized Debt Obligations. The unrealized losses on the Company's collateralized debt obligations relate to one investment in a pooled trust preferred security ("PTPS"). The PTPS market has stabilized at depressed market values as a result of market saturation. Transactions for PTPS have been limited and have occurred primarily as a result of distressed or forced liquidation sales. The securities were widely held by hedge funds and European banks and used to offset interest rate exposure tied to LIBOR. As positions unwound, an excess supply of these securities have saturated the market.

Management evaluated current credit ratings, credit support and stress testing for future defaults related to the Company's PTPS. Management also reviewed analytics provided by the trustee and independent OTTI reviews and associated cash flow analyses performed by an independent third party. The unrealized losses on the Company's PTPS investment were caused by a lack of liquidity, credit downgrades and decreasing credit support. The increased number of bank and insurance company failures has decreased the level of credit support for this investment. A number of lower tranches have foregone payments or have received payment in kind through increased principal allocations. However, the number of deferring securities has been decreasing and a number of reinstatements have occurred recently. The Company's PTPS was upgraded to investment grade and based on its senior credit profile, management does not believe this investment will suffer from any further credit-related losses. Because the Company does not intend to sell the investment and it is not more likely than not the Company will be required to sell the investment before recovery of its amortized cost basis, which may be at maturity, the Company did not record impairment losses as of June 30, 2015.

Tax-exempt Securities. The unrealized losses on the Company's tax-exempt securities relate to one set of municipal general obligation bonds. The unrealized losses were mainly attributable to the widening of interest rate spreads for

these securities since the purchase date. Management monitors the financial data of the individual municipalities to ensure that they meet minimum credit standards. Since the Company does not intend to sell this security before recovery of its amortized cost basis, which may be at maturity, the Company did not record an impairment loss at June 30, 2015.

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## NOTE 4. LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

## Loan Portfolio

The composition of the Company's loan portfolio at June 30, 2015 and December 31, 2014 is as follows:

|  | June 30, 2015<br>(In Thousands) | December 31, 2014 |
|--|---------------------------------|-------------------|
| Real estate loans:                           |                                 |                   |
| Residential - 1 to 4 family                  | \$430,869                       | \$430,575         |
| Multi-family and commercial                  | 302,659                         | 298,320           |
| Construction                                 | 19,567                          | 13,579            |
| Total real estate loans                      | 753,095                         | 742,474           |
| Commercial business loans:                   |                                 |                   |
| SBA and USDA guaranteed                      | 160,250                         | 118,466           |
| Time share                                   | 46,712                          | 45,669            |
| Condominium association                      | 23,148                          | 21,386            |
| Other  | 67,464                          | 66,446            |
| Total commercial business loans              | 297,574                         | 251,967           |
| Consumer loans:                              |                                 |                   |
| Home equity                                  | 52,346                          | 51,093            |
| Indirect automobile                          | 2,731                           | 3,692             |
| Other  | 1,869                           | 1,864             |
| Total consumer loans                         | 56,946                          | 56,649            |
| Total loans                                  | 1,107,615                       | 1,051,090         |
| Deferred loan origination costs, net of fees | 1,594                           | 1,571             |
| Allowance for loan losses                    | (8,437)                         | (7,797)           |
| Loans receivable, net                        | \$1,100,772                     | \$1,044,864       |

The Company purchased commercial business loans totaling \$67.2 million during the six months months ended June 30, 2015. For the twelve months ended December 31, 2014, the Company purchased commercial loans totaling \$59.9 million.

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## Allowance for Loan Losses

Changes in the allowance for loan losses for the three and six months ended June 30, 2015 and 2014 are as follows:

| Three Months Ended<br>June 30, 2015        | Residential -<br>1 to 4 Family | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total   |   |
|--|--------------------------------|-----------------------------------|--------------|------------------------|----------|---------|---|
| (In Thousands)                             |                                |                                   |              |                        |          |         |   |
| Balance at beginning of period             | \$976                          | \$3,646                           | \$292        | \$2,566                | \$602    | \$8,082 |   |
| Provision for loan losses                  | 19                             | 117                               | 142          | 51                     | 31       | 360     |   |
| Loans charged-off                          | (11                            | ) —                               | —            | —                      | —        | (11     | ) |
| Recoveries of loans previously charged-off | 2                              | 3                                 | —            | 1                      | —        | 6       |   |
| Balance at end of period                   | \$986                          | \$3,766                           | \$434        | \$2,618                | \$633    | \$8,437 |   |
|  |                                |                                   |              |                        |          |         |   |
| Six Months Ended<br>June 30, 2015          | Residential -<br>1 to 4 Family | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total   |   |
| (In Thousands)                             |                                |                                   |              |                        |          |         |   |
| Balance at beginning of period             | \$955                          | \$3,607                           | \$254        | \$2,382                | \$599    | \$7,797 |   |
| Provision for loan losses                  | 44                             | 176                               | 180          | 260                    | 35       | 695     |   |
| Loans charged-off                          | (46                            | ) (20                             | ) —          | (25                    | ) (1     | ) (92   | ) |
| Recoveries of loans previously charged-off | 33                             | 3                                 | —            | 1                      | —        | 37      |   |
| Balance at end of period                   | \$986                          | \$3,766                           | \$434        | \$2,618                | \$633    | \$8,437 |   |
|  |                                |                                   |              |                        |          |         |   |
| Three Months Ended<br>June 30, 2014        | Residential -<br>1 to 4 Family | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total   |   |
| (In Thousands)                             |                                |                                   |              |                        |          |         |   |
| Balance at beginning of period             | \$948                          | \$3,602                           | \$184        | \$1,995                | \$523    | \$7,252 |   |
| Provision for loan losses                  | 125                            | 5                                 | 37           | 213                    | 35       | 415     |   |
| Loans charged-off                          | (106                           | ) (143                            | ) —          | —                      | (4       | ) (253  | ) |
| Recoveries of loans previously charged-off | 17                             | 1                                 | —            | —                      | 13       | 31      |   |
| Balance at end of period                   | \$984                          | \$3,465                           | \$221        | \$2,208                | \$567    | \$7,445 |   |
|  |                                |                                   |              |                        |          |         |   |
| Six Months Ended<br>June 30, 2014          | Residential -<br>1 to 4 Family | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total   |   |
| (In Thousands)                             |                                |                                   |              |                        |          |         |   |
|  | \$975                          | \$3,395                           | \$169        | \$1,875                | \$502    | \$6,916 |   |



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|  |       |         |       |         |       |         |
|--|-------|---------|-------|---------|-------|---------|
| Balance at beginning of period             |       |         |       |         |       |         |
| Provision for loan losses                  | 158   | 212     | 52    | 343     | 80    | 845     |
| Loans charged-off                          | (180  | ) (143  | ) —   | (13     | ) (33 | ) (369  |
| Recoveries of loans previously charged-off | 31    | 1       | —     | 3       | 18    | 53      |
| Balance at end of period                   | \$984 | \$3,465 | \$221 | \$2,208 | \$567 | \$7,445 |

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2015 AND 2014 AND DECEMBER 31, 2014

Further information pertaining to the allowance for loan losses at June 30, 2015 and December 31, 2014 is as follows:

| June 30, 2015  | Residential -<br>1 to 4 Family | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total       |
|--|--------------------------------|-----------------------------------|--------------|------------------------|----------|-------------|
|  | (In Thousands)                 |                                   |              |                        |          |             |
| Allowance for loans individually evaluated and deemed to be impaired                     | \$264                          | \$43                              | \$—          | \$124                  | \$3      | \$434       |
| Allowance for loans individually or collectively evaluated and not deemed to be impaired | 722                            | 3,723                             | 434          | 2,494                  | 630      | 8,003       |
| Allowance for loans acquired with deteriorated credit quality                            | —                              | —                                 | —            | —                      | —        | —           |
| Total loan loss allowance  | \$986                          | \$3,766                           | \$434        | \$2,618                | \$633    | \$8,437     |
| Loans individually evaluated and deemed to be impaired                                   | \$5,489                        | \$2,258                           | \$—          | \$1,183                | \$82     | \$9,012     |
| Loans individually or collectively evaluated and not deemed to be impaired               | 425,013                        | 296,749                           | 19,567       | 296,043                | 56,864   | 1,094,236   |
| Amount of loans acquired with deteriorated credit quality                                | 367                            | 3,652                             | —            | 348                    | —        | 4,367       |
| Total loans  | \$430,869                      | \$302,659                         | \$19,567     | \$297,574              | \$56,946 | \$1,107,615 |
| December 31, 2014  | Residential -<br>1 to 4 Family | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total       |
|  | (In Thousands)                 |                                   |              |                        |          |             |
| Allowance for loans individually evaluated and deemed to be impaired                     | \$287                          | \$52                              | \$—          | \$20                   | \$—      | \$359       |
| Allowance for loans individually or collectively evaluated and not deemed to be impaired | 668                            | 3,555                             | 254          | 2,362                  | 599      | 7,438       |
| Allowance for loans acquired with deteriorated credit quality                            | —                              | —                                 | —            | —                      | —        | —           |
| Total loan loss allowance  | \$955                          | \$3,607                           | \$254        | \$2,382                | \$599    | \$7,797     |

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|  |           |           |          |           |          |             |
|--|-----------|-----------|----------|-----------|----------|-------------|
| Loans individually evaluated and deemed to be impaired                     | \$5,318   | \$1,872   | \$—      | \$470     | \$—      | \$7,660     |
| Loans individually or collectively evaluated and not deemed to be impaired | 424,885   | 292,215   | 13,579   | 251,140   | 56,649   | 1,038,468   |
| Amount of loans acquired with deteriorated credit quality                  | 372       | 4,233     | —        | 357       | —        | 4,962       |
| Total loans  | \$430,575 | \$298,320 | \$13,579 | \$251,967 | \$56,649 | \$1,051,090 |

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## Past Due Loans

The following represents an aging of loans at June 30, 2015 and December 31, 2014:

| June 30, 2015               | 30-59<br>Days<br>Past Due | 60-89<br>Days<br>Past Due | 90 Days or<br>More<br>Past Due | Total 30<br>Days or<br>More<br>Past Due | Current     | Total<br>Loans |
|-----------------------------|---------------------------|---------------------------|--------------------------------|---|-------------|----------------|
| (In Thousands)              |                           |                           |                                |   |             |                |
| Real Estate:                |                           |                           |                                |   |             |                |
| Residential - 1 to 4 family | \$6                       | \$746                     | \$1,357                        | \$2,109                                 | \$428,760   | \$430,869      |
| Multi-family and commercial | 3,169                     | 1,261                     | 937                            | 5,367                                   | 297,292     | 302,659        |
| Construction                | —                         | —                         | —                              | —                                       | 19,567      | 19,567         |
| Commercial Business:        |                           |                           |                                |   |             |                |
| SBA and USDA guaranteed     | 988                       | —                         | —                              | 988                                     | 159,262     | 160,250        |
| Time share                  | —                         | —                         | —                              | —                                       | 46,712      | 46,712         |
| Condominium association     | —                         | —                         | —                              | —                                       | 23,148      | 23,148         |
| Other                       | 452                       | 97                        | 1,159                          | 1,708                                   | 65,756      | 67,464         |
| Consumer:                   |                           |                           |                                |   |             |                |
| Home equity                 | 358                       | —                         | 42                             | 400                                     | 51,946      | 52,346         |
| Indirect automobile         | 40                        | 8                         | —                              | 48                                      | 2,683       | 2,731          |
| Other                       | —                         | —                         | —                              | —                                       | 1,869       | 1,869          |
| Total                       | \$5,013                   | \$2,112                   | \$3,495                        | \$10,620                                | \$1,096,995 | \$1,107,615    |

  

| December 31, 2014           | 30-59<br>Days<br>Past Due | 60-89<br>Days<br>Past Due | 90 Days or<br>More<br>Past Due | Total 30<br>Days or<br>More<br>Past Due | Current     | Total<br>Loans | Past Due<br>90 Days or<br>More and<br>Accruing |
|-----------------------------|---------------------------|---------------------------|--------------------------------|---|-------------|----------------|--|
| (In Thousands)              |                           |                           |                                |   |             |                |  |
| Real Estate:                |                           |                           |                                |   |             |                |  |
| Residential - 1 to 4 family | \$4,194                   | \$258                     | \$1,602                        | \$6,054                                 | \$424,521   | \$430,575      | \$—  |
| Multi-family and commercial | 768                       | 794                       | 775                            | 2,337                                   | 295,983     | 298,320        | —  |
| Construction                | —                         | —                         | —                              | —                                       | 13,579      | 13,579         | —  |
| Commercial Business:        |                           |                           |                                |   |             |                |  |
| SBA and USDA guaranteed     | 1,536                     | —                         | 459                            | 1,995                                   | 116,471     | 118,466        | 459  |
| Time share                  | —                         | —                         | —                              | —                                       | 45,669      | 45,669         | —  |
| Condominium association     | —                         | —                         | —                              | —                                       | 21,386      | 21,386         | —  |
| Other                       | 50                        | —                         | 446                            | 496                                     | 65,950      | 66,446         | —  |
| Consumer:                   |                           |                           |                                |   |             |                |  |
| Home equity                 | 20                        | 158                       | 23                             | 201                                     | 50,892      | 51,093         | —  |
| Indirect automobile         | 103                       | 10                        | —                              | 113                                     | 3,579       | 3,692          | —  |
| Other                       | —                         | —                         | —                              | —                                       | 1,864       | 1,864          | —  |
| Total                       | \$6,671                   | \$1,220                   | \$3,305                        | \$11,196                                | \$1,039,894 | \$1,051,090    | \$459  |

The Company did not have any loans that were past due 90 days or more and still accruing interest at June 30, 2015.

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JUNE 30, 2015 AND 2014 AND DECEMBER 31, 2014

## Impaired and Nonaccrual Loans

The following is a summary of impaired loans and nonaccrual loans at June 30, 2015 and December 31, 2014:

| June 30, 2015                                    | Impaired Loans <sup>(1)</sup> |                                |                      |                     |
|--|-------------------------------|--------------------------------|----------------------|---------------------|
|  | Recorded<br>Investment        | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Nonaccrual<br>Loans |
|  | (In Thousands)                |                                |                      |                     |
| Impaired loans without valuation allowance:      |                               |                                |                      |                     |
| Real Estate:                                     |                               |                                |                      |                     |
| Residential - 1 to 4 family                      | \$3,695                       | \$3,695                        | \$—                  | \$3,213             |
| Multi-family and commercial                      | 4,700                         | 4,897                          | —                    | 1,230               |
| Commercial business - Other                      | 1,083                         | 1,083                          | —                    | 711                 |
| Consumer - Home equity                           | 42                            | 42                             | —                    | 42                  |
| Total impaired loans without valuation allowance | 9,520                         | 9,717                          | —                    | 5,196               |
| Impaired loans with valuation allowance:         |                               |                                |                      |                     |
| Real Estate:                                     |                               |                                |                      |                     |
| Residential - 1 to 4 family                      | 2,161                         | 2,172                          | 264                  | 150                 |
| Multi-family and commercial                      | 1,210                         | 1,320                          | 43                   | 63                  |
| Commercial business - Other                      | 448                           | 448                            | 124                  | 448                 |
| Consumer - Home equity                           | 40                            | 40                             | 3                    | 40                  |
| Total impaired loans with valuation allowance    | 3,859                         | 3,980                          | 434                  | 701                 |
| Total impaired loans                             | \$13,379                      | \$13,697                       | \$434                | \$5,897             |

<sup>(1)</sup> Includes loans acquired with deteriorated credit quality from the Newport Federal Savings Bank ("Newport") merger, and performing troubled debt restructurings.

| December 31, 2014                                | Impaired Loans <sup>(1)</sup> |                                |                      |                     |
|--|-------------------------------|--------------------------------|----------------------|---------------------|
|  | Recorded<br>Investment        | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Nonaccrual<br>Loans |
|  | (In Thousands)                |                                |                      |                     |
| Impaired loans without valuation allowance:      |                               |                                |                      |                     |
| Real Estate:                                     |                               |                                |                      |                     |
| Residential - 1 to 4 family                      | \$3,414                       | \$3,485                        | \$—                  | \$2,923             |
| Multi-family and commercial                      | 4,815                         | 5,102                          | —                    | 775                 |
| Commercial business - Other                      | 645                           | 645                            | —                    | 264                 |
| Consumer - Home equity                           | —                             | —                              | —                    | 23                  |
| Total impaired loans without valuation allowance | 8,874                         | 9,232                          | —                    | 3,985               |
| Impaired loans with valuation allowance:         |                               |                                |                      |                     |
| Real Estate:                                     |                               |                                |                      |                     |
| Residential - 1 to 4 family                      | 2,276                         | 2,304                          | 287                  | 244                 |
| Multi-family and commercial                      | 1,290                         | 1,290                          | 52                   | 132                 |

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|   |          |          |       |         |
|---|----------|----------|-------|---------|
| Commercial business - Other                   | 182      | 182      | 20    | 182     |
| Total impaired loans with valuation allowance | 3,748    | 3,776    | 359   | 558     |
| Total impaired loans                          | \$12,622 | \$13,008 | \$359 | \$4,543 |

(1) Includes loans acquired with deteriorated credit quality from the Newport merger, and performing troubled debt restructurings.

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The Company reviews and establishes, if necessary, an allowance for certain impaired loans for the amount by which the present value of expected cash flows (or observable market price of loan or fair value of the collateral if the loan is collateral dependent) are lower than the carrying value of the loan. At June 30, 2015 and December 31, 2014, the Company concluded that certain impaired loans required no valuation allowance as a result of management's measurement of impairment. No additional funds are committed to be advanced to those borrowers whose loans are deemed impaired.

Additional information related to impaired loans is as follows:

|                                | Three Months Ended<br>June 30, 2015 |                                  |   | Six Months Ended<br>June 30, 2015 |                                  |   |
|--------------------------------|-------------------------------------|----------------------------------|---|-----------------------------------|----------------------------------|---|
|                                | Average<br>Recorded<br>Investment   | Interest<br>Income<br>Recognized | Interest<br>Income<br>Recognized<br>on Cash Basis | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Interest<br>Income<br>Recognized<br>on Cash Basis |
|                                | (In Thousands)                      |                                  |   |                                   |                                  |   |
| Real Estate:                   |                                     |                                  |   |                                   |                                  |   |
| Residential - 1 to 4 family    | \$5,659                             | \$26                             | \$—   | \$5,652                           | \$52                             | \$1   |
| Multi-family and<br>commercial | 5,823                               | 68                               | —   | 5,996                             | 147                              | —   |
| Commercial business - Other    | 1,311                               | 2                                | —   | 1,144                             | 8                                | —   |
| Consumer - Home equity         | 54                                  | —                                | —   | 32                                | —                                | —   |
| Total                          | \$12,847                            | \$96                             | \$—   | \$12,824                          | \$207                            | \$1   |

|                                | Three Months Ended<br>June 30, 2014 |                                  |   | Six Months Ended<br>June 30, 2014 |                                  |   |
|--------------------------------|-------------------------------------|----------------------------------|---|-----------------------------------|----------------------------------|---|
|                                | Average<br>Recorded<br>Investment   | Interest<br>Income<br>Recognized | Interest<br>Income<br>Recognized<br>on Cash Basis | Average<br>Recorded<br>Investment | Interest<br>Income<br>Recognized | Interest<br>Income<br>Recognized<br>on Cash Basis |
|                                | (In Thousands)                      |                                  |   |                                   |                                  |   |
| Real Estate:                   |                                     |                                  |   |                                   |                                  |   |
| Residential - 1 to 4 family    | \$6,136                             | \$68                             | \$42  | \$6,361                           | \$90                             | \$43  |
| Multi-family and<br>commercial | 6,805                               | 79                               | —   | 7,412                             | 242                              | 72  |
| Commercial business - Other    | 946                                 | 11                               | 5   | 1,206                             | 28                               | 15  |
| Consumer - Home equity         | 46                                  | 1                                | 1   | 89                                | 1                                | 1   |
| Consumer - Other               | 20                                  | —                                | —   | 10                                | —                                | —   |
| Total                          | \$13,953                            | \$159                            | \$48  | \$15,078                          | \$361                            | \$131   |

## Credit Quality Information

The Company utilizes an eight-grade internal loan rating system for all loans in the portfolio, with the exception of its purchased SBA and USDA commercial business loans that are fully guaranteed by the U.S. government, as follows:

- o Pass (Ratings 1-4): Loans in these categories are considered low to average risk.



- o Special Mention (Rating 5): Loans in this category are starting to show signs of potential weakness and are being closely monitored by management.

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Substandard (Rating 6): Generally, a loan is considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligors and/or the collateral pledged. There is a distinct possibility that the Company will sustain some loss if the weakness is not corrected.

Doubtful (Rating 7): Loans classified as doubtful have all the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, highly questionable and improbable.

Loss (Rating 8): Loans in this category are considered uncollectible and of such little value that their continuance as assets is not warranted.

Management periodically reviews the ratings described above and the Company's internal audit function reviews components of the credit files, including the assigned risk ratings, of certain commercial loans as part of its loan review.

The following tables present the Company's loans by risk rating at June 30, 2015 and December 31, 2014:

| June 30, 2015                   | Not Rated      | Pass      | Special<br>Mention | Substandard | Doubtful | Loss | Total       |
|---------------------------------|----------------|-----------|--------------------|-------------|----------|------|-------------|
|                                 | (In Thousands) |           |                    |             |          |      |             |
| Real Estate:                    |                |           |                    |             |          |      |             |
| Residential - 1 to 4 family     | \$—            | \$423,255 | \$1,631            | \$5,983     | \$—      | \$—  | \$430,869   |
| Multi-family and commercial     | —              | 276,165   | 12,946             | 13,548      | —        | —    | 302,659     |
| Construction                    | —              | 19,567    | —                  | —           | —        | —    | 19,567      |
| Total real estate loans         | —              | 718,987   | 14,577             | 19,531      | —        | —    | 753,095     |
| Commercial Business:            |                |           |                    |             |          |      |             |
| SBA and USDA guaranteed         | 160,250        | —         | —                  | —           | —        | —    | 160,250     |
| Time share                      | —              | 46,712    | —                  | —           | —        | —    | 46,712      |
| Condominium association         | —              | 23,148    | —                  | —           | —        | —    | 23,148      |
| Other                           | —              | 62,282    | 2,624              | 2,558       | —        | —    | 67,464      |
| Total commercial business loans | 160,250        | 132,142   | 2,624              | 2,558       | —        | —    | 297,574     |
| Consumer:                       |                |           |                    |             |          |      |             |
| Home equity                     | —              | 52,144    | 72                 | 130         | —        | —    | 52,346      |
| Indirect automobile             | —              | 2,731     | —                  | —           | —        | —    | 2,731       |
| Other                           | —              | 1,869     | —                  | —           | —        | —    | 1,869       |
| Total consumer loans            | —              | 56,744    | 72                 | 130         | —        | —    | 56,946      |
| Total loans                     | \$160,250      | \$907,873 | \$17,273           | \$22,219    | \$—      | \$—  | \$1,107,615 |

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| December 31, 2014               | Not Rated      | Pass      | Special<br>Mention | Substandard | Doubtful | Loss | Total       |
|---------------------------------|----------------|-----------|--------------------|-------------|----------|------|-------------|
|                                 | (In Thousands) |           |                    |             |          |      |             |
| Real Estate:                    |                |           |                    |             |          |      |             |
| Residential - 1 to 4 family     | \$—            | \$423,134 | \$1,430            | \$6,011     | \$—      | \$—  | \$430,575   |
| Multi-family and commercial     | —              | 269,680   | 17,058             | 11,582      | —        | —    | 298,320     |
| Construction                    | —              | 13,579    | —                  | —           | —        | —    | 13,579      |
| Total real estate loans         | —              | 706,393   | 18,488             | 17,593      | —        | —    | 742,474     |
| Commercial Business:            |                |           |                    |             |          |      |             |
| SBA and USDA guaranteed         | 118,466        | —         | —                  | —           | —        | —    | 118,466     |
| Time share                      | —              | 45,669    | —                  | —           | —        | —    | 45,669      |
| Condominium association         | —              | 21,386    | —                  | —           | —        | —    | 21,386      |
| Other                           | —              | 61,835    | 2,709              | 1,902       | —        | —    | 66,446      |
| Total commercial business loans | 118,466        | 128,890   | 2,709              | 1,902       | —        | —    | 251,967     |
| Consumer:                       |                |           |                    |             |          |      |             |
| Home equity                     | —              | 50,965    | 57                 | 71          | —        | —    | 51,093      |
| Indirect automobile             | —              | 3,692     | —                  | —           | —        | —    | 3,692       |
| Other                           | —              | 1,864     | —                  | —           | —        | —    | 1,864       |
| Total consumer loans            | —              | 56,521    | 57                 | 71          | —        | —    | 56,649      |
| Total loans                     | \$118,466      | \$891,804 | \$21,254           | \$19,566    | \$—      | \$—  | \$1,051,090 |

**Troubled Debt Restructurings**

A modified loan is considered a TDR when two conditions are met: 1) the borrower is experiencing documented financial difficulty and 2) concessions are made by the Company that would not otherwise be considered for a borrower with similar risk characteristics. The most common types of modifications include below market interest rate reductions, deferrals of principal and maturity extensions. Modified terms are dependent upon the financial position and needs of the individual borrower. If the modification agreement is violated, the loan is handled by the Company's Collections Department for resolution, which may result in foreclosure. The Company's determination of whether a loan modification is a TDR considers the individual facts and circumstances surrounding each modification.

The Company's nonaccrual policy is followed for TDRs. If the loan was current prior to modification, nonaccrual status would not be required. If the loan was on nonaccrual prior to modification or if the payment amount significantly increases, the loan will remain on nonaccrual for a period of at least six months. Loans qualify for return to accrual status once the borrower has demonstrated the willingness and the ability to perform in accordance with the restructured terms of the loan agreement for a period of not less than six consecutive months.

All TDRs are initially reported as impaired. Impaired classification may be removed after a year following the restructure if the borrower demonstrates compliance with the modified terms and the restructuring agreement specifies an interest rate equal to that which would be provided to a borrower with similar risk characteristics at the time of restructuring.



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The following table provides information on loans modified as TDRs during the three and six months ended June 30, 2015 and 2014. During the modification process, there were no loan charge-offs or principal reductions for the loans included in the table below.

|                             | Three Months Ended June 30,<br>2015          |                        |  | 2014               |                        |  |
|-----------------------------|--|------------------------|--|--------------------|------------------------|--|
|                             | Number of<br>Loans<br>(Dollars in Thousands) | Recorded<br>Investment | Allowance<br>for Loan<br>Losses (End<br>of Period) | Number of<br>Loans | Recorded<br>Investment | Allowance<br>for Loan<br>Losses (End<br>of Period) |
| Residential - 1 to 4 family | —  | \$—                    | \$—  | 1                  | \$102                  | \$—  |
| Multi-family and commercial | —  | —                      | —  | 1                  | 259                    | —  |
| Commercial business - other | —  | —                      | —  | 2                  | 319                    | 1  |
| Total                       | —  | \$—                    | \$—  | 4                  | \$680                  | \$1  |

|                             | Six Months Ended June 30,<br>2015            |                        |  | 2014               |                        |  |
|-----------------------------|--|------------------------|--|--------------------|------------------------|--|
|                             | Number of<br>Loans<br>(Dollars in Thousands) | Recorded<br>Investment | Allowance<br>for Loan<br>Losses (End<br>of Period) | Number of<br>Loans | Recorded<br>Investment | Allowance<br>for Loan<br>Losses (End<br>of Period) |
| Residential - 1 to 4 family | —  | \$—                    | \$—  | 1                  | \$102                  | \$—  |
| Multi-family and commercial | —  | —                      | —  | 2                  | 1,427                  | —  |
| Commercial business - other | 1  | 24                     | —  | 2                  | 319                    | 1  |
| Total                       | 1  | \$24                   | \$—  | 5                  | \$1,848                | \$1  |

The following table provides the recorded investment, by type of modification, during the three and six months ended June 30, 2015 and 2014 for modified loans identified as TDRs.

|   | Three Months Ended June 30, |       | Six Months Ended June 30, |         |
|---|-----------------------------|-------|---------------------------|---------|
|   | 2015                        | 2014  | 2015                      | 2014    |
|   | (In Thousands)              |       |                           |         |
| Interest rate adjustments                       | \$—                         | \$388 | \$—                       | \$388   |
| Combination of rate and payment <sup>(1)</sup>  | —                           | 292   | —                         | 292     |
| Combination of rate and maturity <sup>(2)</sup> | —                           | —     | 24                        | 1,168   |
| Total   | \$—                         | \$680 | \$24                      | \$1,848 |

<sup>(1)</sup> Terms include combination of interest rate adjustments and interest-only payment with deferral of principal.

<sup>(2)</sup> Terms include combination of interest rate adjustments and extensions of maturity.

There were no TDRs in payment default (defined as 90 days or more past due) within twelve months of restructure for the three and six months ended June 30, 2015 and 2014.

As of June 30, 2015, the Company held \$1.1 million in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction.

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## Loans Acquired with Deteriorated Credit Quality

The following is a summary of loans acquired with evidence of credit deterioration from Newport as of June 30, 2015 and December 31, 2014.

|                                 | Contractual<br>Required<br>Payments<br>Receivable<br>(In Thousands) | Cash Expected<br>To Be Collected | Non-Accrutable<br>Discount | Accrutable<br>Yield | Loans<br>Receivable |
|---------------------------------|---|----------------------------------|----------------------------|---------------------|---------------------|
| Balance at December 31,<br>2014 | \$5,799   | \$4,962                          | \$837                      | \$—                 | \$4,962             |
| Collections                     | (79 )   | (75 )                            | (4 )                       | —                   | (75 )               |
| Dispositions                    | (579 )  | (520 )                           | (59 )                      | —                   | (520 )              |
| Balance at June 30, 2015        | \$5,141   | \$4,367                          | \$774                      | \$—                 | \$4,367             |

## NOTE 5. PREMISES AND EQUIPMENT

Premises and equipment at June 30, 2015 and December 31, 2014 are summarized as follows:

|   | June 30, 2015<br>(In Thousands) | December 31, 2014 |
|---|---------------------------------|-------------------|
| Land                                      | \$4,746                         | \$4,746           |
| Buildings                                 | 14,010                          | 11,879            |
| Leasehold improvements                    | 10,535                          | 10,802            |
| Furniture and equipment                   | 13,358                          | 12,741            |
| Construction in process                   | 18                              | 1,233             |
|   | 42,667                          | 41,401            |
| Accumulated depreciation and amortization | (20,537 )                       | (19,690 )         |
| Premises and equipment, net               | \$22,130                        | \$21,711          |

At December 31, 2014, construction in process related to design and site costs associated with a new branch location.

At June 30, 2015, construction in process related to the project to redesign traffic flow at an existing branch.

## NOTE 6. OTHER COMPREHENSIVE INCOME

Accounting principles generally require recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities are reported as a separate component of shareholders' equity on the balance sheet, such items, along with net income, are components of comprehensive income.





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Components of other comprehensive income and related tax effects are as follows:

|   | Six Months Ended June 30, 2015 |                |                      |
|---|--------------------------------|----------------|----------------------|
|   | Before Tax<br>Amount           | Tax<br>Effects | Net of Tax<br>Amount |
| Securities:   | (In Thousands)                 |                |                      |
| Unrealized holding gains on available for sale securities               | \$338                          | \$(116)        | ) \$222              |
| Reclassification adjustment for gains recognized in net income          | (132)                          | ) 45           | (87)                 |
| Unrealized holding gains on available for sale securities, net of taxes | 206                            | (71)           | ) 135                |
| Derivative instrument:  |                                |                |                      |
| Change in fair value of effective cash flow hedging derivative          | 79                             | (27)           | ) 52                 |
| Other comprehensive income  | \$285                          | \$(98)         | ) \$187              |

The components of accumulated other comprehensive income included in shareholders' equity are as follows:

|   | June 30, 2015        |                |                      |
|---|----------------------|----------------|----------------------|
|   | Before Tax<br>Amount | Tax<br>Effects | Net of Tax<br>Amount |
|   | (In Thousands)       |                |                      |
| Net unrealized gains on available for sale securities         | \$507                | \$(173)        | ) \$334              |
| Net unrealized loss on effective cash flow hedging derivative | (78)                 | ) 26           | (52)                 |
| Accumulated other comprehensive income                        | \$429                | \$(147)        | ) \$282              |

|   | December 31, 2014    |                |                      |
|---|----------------------|----------------|----------------------|
|   | Before Tax<br>Amount | Tax<br>Effects | Net of Tax<br>Amount |
|   | (In Thousands)       |                |                      |
| Net unrealized gains on available for sale securities         | \$301                | \$(102)        | ) \$199              |
| Net unrealized loss on effective cash flow hedging derivative | (157)                | ) 53           | (104)                |
| Accumulated other comprehensive income                        | \$144                | \$(49)         | ) \$95               |

## NOTE 7. REGULATORY CAPITAL

The Company and the Bank are subject to regulatory capital adequacy requirements promulgated by federal bank regulatory agencies. Failure by the Company or the Bank to meet minimum capital requirements could result in certain mandatory and discretionary actions by regulators that could have a material adverse effect on our consolidated financial statements. The following tables present regulatory capital information for the Company and the Bank. Information presented for June 30, 2015 reflects the Basel III capital requirements that became effective January 1, 2015 for both the Company and the Bank and changed the inputs and methodology for computing capital. Prior to January 1, 2015, the Bank was subject to capital requirements under Basel I and there were no capital requirements for the Company. Under these capital requirements, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and the Bank's assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classifications are

also subject to qualitative judgments by regulators about components, risk weightings and other factors.



Beginning January 1, 2016, Basel III implements a requirement for all banking organizations to maintain a capital conservation buffer above the minimum risk-based capital requirements in order to avoid certain limitations on capital distributions, stock repurchases and discretionary bonus payments to executive officers. The capital conservation buffer will be exclusively composed of common equity tier 1 capital, and it applies to each of the three risk-based capital ratios, but not the leverage ratio. On January 1, 2016, the Company and the Bank will be expected to comply with the capital conservation buffer requirement, which will increase the three risk-based capital ratios by 0.625% each year through 2019, at which point, the minimum common equity tier 1 risk-based, tier 1 risk-based and total risk-based capital ratios will be 7.0%, 8.5% and 10.5%, respectively.

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NOTE 8. FAIR VALUE OF ASSETS AND LIABILITIES

Fair Value Hierarchy

The Company groups its assets and liabilities in three levels based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. Transfers between levels are recognized at the end of a reporting period, if applicable.

Valuation is based on quoted prices in active markets for identical assets or liabilities. Level 1 assets and Level 1 liabilities generally include debt and equity securities that are traded in an active exchange market. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2: Valuation is based on observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3: Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using unobservable inputs to 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.

Determination of Fair Value

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. The fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

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

**Cash and cash equivalents.** The carrying amounts of cash and cash equivalents approximate the fair values based on the short-term nature of the assets.

**Securities available for sale.** Included in the available for sale category are debt securities. The securities measured at fair value in Level 1 are based on quoted market prices in an active exchange market. Securities measured at fair value in Level 2 are based on pricing models that consider standard input factors such as observable market data,

benchmark yields, interest rate volatilities, broker/dealer quotes, credit spreads and new issue data. The Company utilizes a nationally-recognized, third-party pricing service to estimate fair value measurements for the majority of its portfolio. The pricing service evaluates each asset class based on relevant market information considering observable data, but these prices do not represent binding quotes. The fair value prices on all investments are reviewed for reasonableness by management. Securities measured at fair value in Level 3 include one collateralized debt obligation that is backed by trust preferred securities issued by banks and insurance companies. Management determined

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that an orderly and active market for these securities and similar securities did not exist based on a significant reduction in trading volume and widening spreads relative to historical levels. The Company estimates future cash flows discounted using a rate management believes is representative of current market conditions. Factors in determining the discount rate include the current level of deferrals and/or defaults, changes in credit rating and the financial condition of the debtors within the underlying securities, broker quotes for securities with similar structure and credit risk, interest rate movements and pricing for new issuances.

• Federal Home Loan Bank stock. The carrying value of Federal Home Loan Bank ("FHLB") stock approximates fair value based on the redemption provisions of the FHLB.

• Federal Reserve Bank stock. The carrying value of Federal Reserve Bank ("FRB") stock approximates fair value based on the redemption provisions of the FRB.

• Loans held for sale. The fair value of loans held for sale is estimated using quoted market prices.

• Loans receivable. For variable rate loans that reprice frequently and have no significant change in credit risk, fair values are based on carrying values. The fair value of fixed-rate loans are estimated by discounting the future cash flows using the rates at the end of the period in which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. Fair values for nonperforming loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

• Accrued interest receivable. The carrying amount of accrued interest approximates fair value.

• Deposits. The fair value of demand deposits, negotiable orders of withdrawal, regular savings, certain money market deposits and mortgagors' and investors' escrow accounts is the amount payable on demand at the reporting date. The fair value of certificates of deposit and other time deposits is estimated using a discounted cash flow calculation that applies interest rates currently being offered for deposits of similar remaining maturities to a schedule of aggregated expected maturities on such deposits.

• Federal Home Loan Bank advances. The fair value of the advances is estimated using a discounted cash flow calculation that applies current FHLB interest rates for advances of similar maturity to a schedule of maturities of such advances.

• Junior subordinated debt owed to unconsolidated trust. Rates currently available for debt with similar terms and remaining maturities are used to estimate fair value of existing debt.

• Interest rate swap agreements. The fair values of the Company's interest rate swaps are obtained from a third-party pricing service and are determined using a discounted cash flow analysis on the expected cash flows of the derivative. The pricing analysis is based on observable inputs for the contractual term of the derivative, including the period to maturity and interest rate curves.

• Forward loan sale commitments and derivative loan commitments. Forward loan sale commitments and derivative loan commitments are based on the fair values of the underlying mortgage loans, including the servicing rights for

derivative loan commitments, and the probability of such commitments being exercised. Significant management judgment and estimation is required in determining these fair value measurements.



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Off-balance sheet instruments. Fair values for off-balance sheet lending commitments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standings.

## Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following tables present assets and liabilities measured at fair value on a recurring basis as of June 30, 2015 and December 31, 2014. The Company had no significant transfers into or out of Levels 1, 2 or 3 during the three and six months ended June 30, 2015.

|   | June 30, 2015             |           |         | Total     |
|---|---------------------------|-----------|---------|-----------|
|   | Level 1<br>(In Thousands) | Level 2   | Level 3 |           |
| Assets:   |                           |           |         |           |
| U.S. Government and agency obligations                        | \$25,197                  | \$45,285  | \$—     | \$70,482  |
| Government-sponsored enterprises                              | —                         | 21,542    | —       | 21,542    |
| Mortgage-backed securities                                    | —                         | 71,730    | —       | 71,730    |
| Corporate debt securities                                     | —                         | 1,000     | —       | 1,000     |
| Collateralized debt obligation                                | —                         | —         | 1,148   | 1,148     |
| Obligations of state and political subdivisions               | —                         | 1,680     | —       | 1,680     |
| Tax-exempt securities   | —                         | 3,221     | —       | 3,221     |
| Forward loan sale commitments and derivative loan commitments | —                         | —         | 52      | 52        |
| Total assets  | \$25,197                  | \$144,458 | \$1,200 | \$170,855 |
| Liabilities:  |                           |           |         |           |
| Forward loan sale commitments and derivative loan commitments | \$—                       | \$—       | \$4     | \$4       |
| Interest rate swap agreements                                 | —                         | 207       | —       | 207       |
| Total liabilities   | \$—                       | \$207     | \$4     | \$211     |
| December 31, 2014   |                           |           |         |           |
|   | Level 1<br>(In Thousands) | Level 2   | Level 3 | Total     |
| Assets:   |                           |           |         |           |
| U.S. Government and agency obligations                        | \$21,001                  | \$45,390  | \$—     | \$66,391  |
| Government-sponsored enterprises                              | —                         | 27,488    | —       | 27,488    |
| Mortgage-backed securities                                    | —                         | 67,103    | —       | 67,103    |
| Corporate debt securities                                     | —                         | 1,000     | —       | 1,000     |
| Collateralized debt obligation                                | —                         | —         | 1,181   | 1,181     |
| Obligations of state and political subdivisions               | —                         | 3,200     | —       | 3,200     |
| Tax-exempt securities   | —                         | 6,677     | —       | 6,677     |
| Forward loan sale commitments and derivative loan commitments | —                         | —         | 59      | 59        |

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|                               |          |           |         |           |
|-------------------------------|----------|-----------|---------|-----------|
| Total assets                  | \$21,001 | \$150,858 | \$1,240 | \$173,099 |
| Liabilities:                  |          |           |         |           |
| Interest rate swap agreements | \$—      | \$271     | \$—     | \$271     |
| Total liabilities             | \$—      | \$271     | \$—     | \$271     |

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The following table shows a reconciliation of the beginning and ending balances for Level 3 assets:

|  | Collateralized<br>Debt<br>Obligations<br>(In Thousands) | Derivative Loan and<br>Forward Loan Sale<br>Commitments, Net |
|--|---|--|
| Balance at December 31, 2014                                   | \$ 1,181  | \$ 59  |
| Total realized losses included in net income                   | —   | (11  |
| Total unrealized losses included in other comprehensive income | (33   | ) —  |
| Balance at June 30, 2015                                       | \$ 1,148  | \$ 48  |

## Assets and Liabilities Measured at Fair Value on a Nonrecurring Basis

The Company may also be required, from time to time, to measure certain other financial assets on a nonrecurring basis in accordance with generally accepted accounting principles. These adjustments to fair value usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets. The following table summarizes the fair value hierarchy used to determine each adjustment and the carrying value of the related individual assets at June 30, 2015 and December 31, 2014. There were no liabilities measured at fair value on a nonrecurring basis at June 30, 2015 and December 31, 2014.

|                         | At June 30, 2015 |         |         | At December 31, 2014 |         |         |
|-------------------------|------------------|---------|---------|----------------------|---------|---------|
|                         | Level 1          | Level 2 | Level 3 | Level 1              | Level 2 | Level 3 |
|                         | (In Thousands)   |         |         |                      |         |         |
| Impaired loans          | \$—              | \$—     | \$422   | \$—                  | \$—     | \$356   |
| Other real estate owned | —                | —       | 1,420   | —                    | —       | 1,271   |
| Total assets            | \$—              | \$—     | \$1,842 | \$—                  | \$—     | \$1,627 |

The following table summarizes losses resulting from fair value adjustments for assets measured at fair value on a nonrecurring basis.

|                         | Three Months Ended June 30, |         | Six Months Ended June 30, |       |
|-------------------------|-----------------------------|---------|---------------------------|-------|
|                         | 2015                        | 2014    | 2015                      | 2014  |
|                         | (In Thousands)              |         |                           |       |
| Impaired loans          | \$(71                       | ) \$212 | \$148                     | \$268 |
| Other real estate owned | 122                         | —       | 122                       | 15    |
| Total losses            | \$51                        | \$212   | \$270                     | \$283 |

The Company measures the impairment of loans that are collateral dependent based on the fair value of the collateral (Level 3). The fair value of collateral used by the Company represents the amount expected to be received from the sale of the property, net of selling costs, as determined by an independent, licensed or certified appraiser using observable market data. This data includes information such as selling price of similar properties, expected future cash flows or earnings of the subject property based on current market expectations, and relevant legal, physical and economic factors. The appraised values of collateral are adjusted as necessary by management based on observable inputs for specific properties. Losses applicable to write-downs of impaired loans are based on the appraised market

value of the underlying collateral, assuming foreclosure of these loans is imminent.

The amount of other real estate owned represents the carrying value of the collateral based on the appraised value of the underlying collateral less estimated selling costs. The loss on foreclosed assets represents adjustments in the valuation recorded during the time period indicated and not for losses incurred on sales.

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## Summary of Fair Values of Financial Instruments

The estimated fair values and related carrying or notional amounts of the Company's financial instruments are presented in the following table. Certain financial instruments and all nonfinancial instruments are exempt from disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

Management uses its best judgment in estimating the fair value of the Company's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates presented herein are not necessarily indicative of the amounts the Company could have realized in a sales transaction at June 30, 2015 and December 31, 2014. The estimated fair value amounts at June 30, 2015 and December 31, 2014 have been measured as of each respective date, and have not been re-evaluated or updated for purposes of the consolidated financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each period-end. The information presented should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only required for a limited portion of the Company's assets. Due to the wide range of valuation techniques and the degree of subjectivity used in making the estimate, comparisons between the Company's disclosures and those of other banks may not be meaningful.

As of June 30, 2015 and December 31, 2014, the recorded carrying amounts and estimated fair values of the Company's financial instruments are as follows:

|   | June 30, 2015      |          |         |           |           |
|---|--------------------|----------|---------|-----------|-----------|
|   | Carrying<br>Amount | Level 1  | Level 2 | Level 3   | Total     |
| (In Thousands)  |                    |          |         |           |           |
| Financial Assets:                                     |                    |          |         |           |           |
| Cash and cash equivalents                             | \$39,585           | \$39,585 | \$—     | \$—       | \$39,585  |
| Available for sale securities                         | 170,803            | 25,197   | 144,458 | 1,148     | 170,803   |
| Loans held for sale                                   | 1,240              | —        | —       | 1,252     | 1,252     |
| Loans receivable, net                                 | 1,100,772          | —        | —       | 1,110,263 | 1,110,263 |
| Federal Home Loan Bank stock                          | 10,962             | —        | —       | 10,962    | 10,962    |
| Federal Reserve Bank stock                            | 3,621              | —        | —       | 3,621     | 3,621     |
| Accrued interest receivable                           | 4,033              | —        | —       | 4,033     | 4,033     |
| Financial Liabilities:                                |                    |          |         |           |           |
| Deposits  | 1,030,128          | —        | —       | 1,033,672 | 1,033,672 |
| Mortgagors' and investors' escrow accounts            | 3,900              | —        | —       | 3,900     | 3,900     |
| Federal Home Loan Bank advances                       | 192,193            | —        | 192,863 | —         | 192,863   |
| Junior subordinated debt owed to unconsolidated trust | 8,248              | —        | 5,654   | —         | 5,654     |
| On-balance Sheet Derivative Financial Instruments:    |                    |          |         |           |           |
| Assets:   |                    |          |         |           |           |
| Derivative loan commitments                           | 34                 | —        | —       | 34        | 34        |
| Forward loan sale commitments                         | 18                 | —        | —       | 18        | 18        |
| Liabilities:  |                    |          |         |           |           |
| Derivative loan commitments                           | 4                  | —        | —       | 4         | 4         |

|                               |     |   |     |   |     |
|-------------------------------|-----|---|-----|---|-----|
| Interest rate swap agreements | 207 | — | 207 | — | 207 |
|-------------------------------|-----|---|-----|---|-----|

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|   | December 31, 2014  |          |         |           |           |
|---|--------------------|----------|---------|-----------|-----------|
|   | Carrying<br>Amount | Level 1  | Level 2 | Level 3   | Total     |
| Financial Assets:                                     |                    |          |         |           |           |
| (In Thousands)  |                    |          |         |           |           |
| Cash and cash equivalents                             | \$39,251           | \$39,251 | \$—     | \$—       | \$39,251  |
| Available for sale securities                         | 173,040            | 21,001   | 150,858 | 1,181     | 173,040   |
| Loans held for sale                                   | 747                | —        | —       | 747       | 747       |
| Loans receivable, net                                 | 1,044,864          | —        | —       | 1,063,121 | 1,063,121 |
| Federal Home Loan Bank stock                          | 10,333             | —        | —       | 10,333    | 10,333    |
| Accrued interest receivable                           | 3,853              | —        | —       | 3,853     | 3,853     |
| Financial Liabilities:                                |                    |          |         |           |           |
| Deposits  | 1,010,713          | —        | —       | 1,013,614 | 1,013,614 |
| Mortgagors' and investors' escrow accounts            | 3,600              | —        | —       | 3,600     | 3,600     |
| Federal Home Loan Bank advances                       | 148,277            | —        | 149,380 | —         | 149,380   |
| Junior subordinated debt owed to unconsolidated trust | 8,248              | —        | 5,815   | —         | 5,815     |
| On-balance Sheet Derivative Financial Instruments:    |                    |          |         |           |           |
| Assets:   |                    |          |         |           |           |
| Derivative loan commitments                           | 59                 | —        | —       | 59        | 59        |
| Liabilities:  |                    |          |         |           |           |
| Interest rate swap agreements                         | 271                | —        | 271     | —         | 271       |

## NOTE 9. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

## Derivative Financial Instruments

The Company has stand-alone derivative financial instruments in the form of interest rate swap agreements, which derive their value from underlying interest rates. These transactions involve both credit and market risk. The notional amounts are amounts on which calculations, payments and the value of the derivatives are based. Notional amounts do not represent direct credit exposures. Direct credit exposure is limited to the net difference between the calculated amounts to be received and paid, if any. Such difference, which represents the fair value of the derivative instruments, is reflected on the Company's balance sheets as other assets and other liabilities. The Company is exposed to credit-related losses in the event of nonperformance by the counterparties to these agreements. The Company controls the credit risk of its financial contracts through credit approvals, limits and monitoring procedures and does not expect any counterparties to fail their obligations.

Derivative instruments are generally either negotiated over-the-counter contracts or standardized contracts executed on a recognized exchange. Negotiated over-the-counter derivative contracts are generally entered into between two counterparties that negotiate specific agreement terms, including the underlying instrument, amount, exercise prices and maturity.

## Derivative Instruments Designated As Hedging Instruments

The Company uses long-term variable rate debt as a source of funds for use in the Company's lending and investment activities and other general business purposes. These debt obligations expose the Company to variability in interest payments due to changes in interest rates. If interest rates increase, interest expense increases. Conversely, if interest rates decrease, interest expense decreases. Management believes it is prudent to limit the variability of a portion of its interest payments and, therefore, generally hedges a portion of its variable-rate interest payments. To meet this objective, management entered into an interest rate swap agreement, characterized as a cash flow hedge, whereby the Company receives variable interest rate payments determined by three-month LIBOR in exchange for making payments at a fixed interest rate.



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At June 30, 2015 and December 31, 2014, information pertaining to the outstanding interest rate swap agreement used to hedge variable rate debt is as follows:

|  | June 30, 2015          | December 31, 2014 |   |
|--|------------------------|-------------------|---|
|  | (Dollars in Thousands) |                   |   |
| Notional amount                                | \$8,000                | \$8,000           |   |
| Weighted average fixed pay rate                | 2.44                   | % 2.44            | % |
| Weighted average variable receive rate         | 0.29                   | % 0.24            | % |
| Weighted average maturity in years             | 0.5                    | 1.0               |   |
| Unrealized loss relating to interest rate swap | \$78                   | \$157             |   |

At June 30, 2015 and December 31, 2014, the unrealized loss related to the above mentioned interest rate swap was recorded as a derivative liability. Changes in the fair value of an interest rate swap designated as a hedging instrument of the variability of cash flows associated with long-term debt are reported in other comprehensive income. These amounts are subsequently reclassified into interest expense as a yield adjustment in the same period in which the related interest on the long-term debt affects earnings.

Risk management results for the periods ended June 30, 2015 and December 31, 2014 related to the balance sheet hedging of long-term debt indicate the hedge was 100% effective and there was no component of the derivative instrument's loss which was excluded from the assessment of hedge effectiveness.

The Company's derivative contract contains a provision establishing a collateral requirement (subject to minimum collateral posting thresholds) based on the Company's external credit rating. If the Company's junior subordinated debt rating was to fall below the level generally recognized as investment grade, the counterparty to such derivative contract could require additional collateral on the derivative transaction in a net liability position (after considering the effect of bilateral netting arrangements and posted collateral). The Company had posted collateral of \$400,000 in the normal course of business for a derivative instrument, with a credit-related contingent feature, that was in a net liability position at June 30, 2015 and December 31, 2014.

Derivative Instruments Not Designated As Hedging Instruments

Certain derivative instruments do not meet the requirements to be accounted for as hedging instruments. These undesignated derivative instruments are recognized on the consolidated balance sheets at fair value, with changes in fair value recorded in noninterest income.

Interest Rate Swap Agreement - In 2012, management entered into an interest rate swap agreement that does not meet the strict hedge accounting requirements of FASB's "Derivatives and Hedging" standard to manage the Company's exposure to interest rate movements and other identified risks. At June 30, 2015 and December 31, 2014, information pertaining to the Company's interest rate swap agreement not designated as a hedge is as follows:

|                                 | June 30, 2015          | December 31, 2014 |   |
|---------------------------------|------------------------|-------------------|---|
|                                 | (Dollars in Thousands) |                   |   |
| Notional amount                 | \$15,000               | \$15,000          |   |
| Weighted average fixed pay rate | 1.26                   | % 1.26            | % |

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|  |       |   |       |   |
|--|-------|---|-------|---|
| Weighted average variable receive rate         | 0.28  | % | 0.25  | % |
| Weighted average maturity in years             | 1.5   |   | 2.0   |   |
| Unrealized loss relating to interest rate swap | \$129 |   | \$114 |   |

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The Company reported a loss in fair value on the interest rate swap not designated as a hedge in noninterest income of \$10,000 and \$15,000 for the three and six months ended June 30, 2015, respectively, and a loss in fair value of \$26,000 and \$9,000 for the three and six months ended June 30, 2014, respectively.

**Derivative Loan Commitments - Mortgage loan commitments** are referred to as derivative loan commitments if the loan that will result from exercise of the commitment will be held for sale upon funding. The Company enters into commitments to fund residential mortgage loans at specified times in the future, with the intention that these loans will subsequently be sold in the secondary market. A mortgage loan commitment binds the Company to lend funds to a potential borrower at a specified interest rate and within a specified period of time, generally up to 60 days after inception of the rate lock.

Outstanding derivative loan commitments expose the Company to the risk that the price of the loans arising from exercise of the loan commitment might decline from inception of the rate lock to funding of the loan due to increases in mortgage interest rates. If interest rates increase, the values of these loan commitments decrease. Conversely, if interest rates decrease, the value of these loan commitments increase. The notional amount of undesignated mortgage loan commitments was \$6.3 million at June 30, 2015. At June 30, 2015, the fair value of such commitments was a net asset of \$30,000.

**Forward Loan Sale Commitments** - To protect against the price risk inherent in derivative loan commitments, the Company utilizes “mandatory delivery” forward loan sale commitments to mitigate the risk of potential decreases in the value of loans that would result from the exercise of the derivative loan commitments.

With a “mandatory delivery” contract, the Company commits to deliver a certain principal amount of mortgage loans to an investor at a specified price on or before a specified date. If the Company fails to deliver the amount of mortgages necessary to fulfill the commitment by the specified date, it is obligated to pay a “pair-off” fee, based on then-current market prices, to the investor to compensate the investor for the shortfall.

The Company expects that these forward loan sale commitments will experience changes in fair value opposite to the change in fair value of derivative loan commitments. The notional amount of undesignated forward loan sale commitments was \$3.3 million at June 30, 2015. At June 30, 2015, the fair value of such commitments was a net asset of \$18,000.

**Interest Rate Risk Management - Derivative Instruments**

The following table presents the fair values of derivative instruments as well as their classification on the consolidated balance sheets at June 30, 2015 and December 31, 2014.

| Balance Sheet Location                       | June 30, 2015   |                      | December 31, 2014 |                      |
|--|-----------------|----------------------|-------------------|----------------------|
|  | Notional Amount | Estimated Fair Value | Notional Amount   | Estimated Fair Value |
| Derivative designated as hedging instrument: |                 |                      |                   |                      |
| Interest rate swap                           | \$8,000         | \$(78 )              | \$8,000           | \$(157 )             |

Derivatives not designated as hedging instruments:

|                               |                   |        |      |   |        |      |   |
|-------------------------------|-------------------|--------|------|---|--------|------|---|
| Interest rate swap            | Other Liabilities | 15,000 | (129 | ) | 15,000 | (114 | ) |
| Derivative loan commitments   | Other Assets      | 6,301  | 30   |   | 6,436  | 59   |   |
| Forward loan sale commitments | Other Assets      | 3,269  | 18   |   | 2,754  | —    |   |

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

Management's discussion and analysis of financial condition and results of operations is intended to assist in understanding changes in the Company's financial condition as of June 30, 2015 and December 31, 2014 and the results of operations for the three and six months ended June 30, 2015 and 2014. The information contained in this section should be read in conjunction with the consolidated financial statements and notes thereto appearing in Part I, Item 1 of this document as well as with management's discussion and analysis of financial condition and results of operations and consolidated financial statements included in the Company's 2014 Annual Report on Form 10-K.

This report may contain certain "forward-looking statements" within the meaning of the federal securities laws, which are made in good faith pursuant to the "safe harbor" provisions of the Private Securities Litigation Reform Act of 1995. Forward-looking statements are generally preceded by terms such as "expects," "believes," "anticipates," "intends," "estimates," "projects" and similar expressions. These statements are not historical facts; rather, they are statements based on management's current expectations regarding our business strategies, intended results and future performance.

Management's ability to predict results or the effect of future plans or strategies is inherently uncertain. Factors that could have a material adverse effect on the operations of the Company and its subsidiaries include, but are not limited to, changes in interest rates, national and regional economic conditions, legislative and regulatory changes, monetary and fiscal policies of the United States government, including policies of the United States Treasury and the Federal Reserve Board, the quality and composition of the loan and investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in the Company's market area, changes in real estate market values in the Company's market area and changes in relevant accounting principles and guidelines. Additional factors that may affect the Company's results are discussed in the Company's Annual Report on Form 10-K and in other reports filed with the Securities and Exchange Commission. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Except as required by applicable law or regulation, the Company does not undertake, and specifically disclaims, any obligation to release publicly the result of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of the statements or to reflect the occurrence of anticipated or unanticipated events.

#### Critical Accounting Policies

The Company considers accounting policies involving significant judgments and assumptions by management that have, or could have, a material impact on the carrying value of certain assets or on income to be critical accounting policies. The Company considers the determination of allowance for loan losses, deferred income taxes and the impairment of long-lived assets to be its critical accounting policies. Additional information about the Company's accounting policies is included in the notes to the Company's consolidated financial statements contained in Part I, Item 1 of this document and in the Company's 2014 Annual Report on Form 10-K.

#### Impact of New Accounting Standards

Refer to Note 1 of the consolidated financial statements in this report for a discussion of recent accounting pronouncements.

#### Comparison of Financial Condition at June 30, 2015 and December 31, 2014

##### Assets:

Summary. Assets increased \$58.8 million, or 4.4%, to \$1.41 billion at June 30, 2015, compared to \$1.35 billion at December 31, 2014, principally due to increases of \$55.9 million in net loans receivable and \$3.6 million in Federal Reserve Bank stock, offset by a decrease of \$2.2 million in available for sale securities.



Loans Receivable, Net. Contributing to the increase of \$55.9 million in net loans receivable were increases in SBA and USDA guaranteed loans, construction loans and multi-family and commercial real estate loans. Changes in the loan portfolio consisted of the following:

**Residential Real Estate.** Residential mortgage loans comprised 38.9% of the total loan portfolio at June 30, 2015 and remained stable compared to December 31, 2014 at \$430.9 million. Residential mortgage loan originations increased \$22.6 million, or 94.1%, during the first half of 2015 over the comparable period in 2014, as a result of lower interest rates and increased activity in the housing market.

**Multi-family and Commercial Real Estate.** Multi-family and commercial real estate loans represented 27.3% of total loans at June 30, 2015 and increased \$4.3 million, or 1.5%, during the first half of 2015. Loan originations for multi-family and commercial real estate loans were \$32.1 million, representing an increase of \$9.8 million, during the first half of 2015 compared to the same period in 2014.

**Construction.** Construction loans, which include both residential and commercial construction loans, increased \$6.0 million for the first half of 2015 as a result of increased commercial construction volume.

**Commercial Business.** Commercial business loans represented 26.9% of total loans at June 30, 2015. Commercial business loans increased \$45.6 million, or 18.1%, for the first half of 2015 primarily due to increases of \$41.8 million in SBA and USDA guaranteed loans, \$1.8 million in condominium association loans and \$1.0 million each in both timeshare and other commercial loans. During 2015, SBA and USDA guaranteed loans increased as a result of purchases totaling \$52.3 million. Commercial business loan originations increased \$2.4 million as compared to the same period in 2014. At June 30, 2015, unfunded lines of credit related to time share lending totaled \$27.6 million as a result of an experienced lender dedicated to identifying new opportunities for growth within the time share industry.

**Consumer.** Consumer loans represented 5.1% of the Company's total loan portfolio at June 30, 2015. Consumer loans increased \$297,000 during the first half of 2015 primarily as a result of an increase of \$1.3 million in home equity loans, offset by a decrease of \$961,000 in indirect automobile loans. Loan originations for consumer loans totaled \$11.6 million, representing a decrease of \$4.4 million, for the first half of 2015 over the comparable period in 2014.

The allowance for loan losses totaled \$8.4 million at June 30, 2015 compared to \$7.8 million at December 31, 2014. The ratio of the allowance for loan losses to total loans increased to 0.76% at June 30, 2015 from 0.74% at December 31, 2014. This was necessitated by an increase in the commercial loan portfolio, which carries a higher degree of risk (excluding guaranteed SBA and USDA loans) than other loans held in portfolio and an increase in nonperforming assets.

The following table provides information with respect to nonperforming assets and TDRs as of the dates indicated.

|   | June 30<br>2015        | December 31,<br>2014 |  |   |
|---|------------------------|----------------------|--|---|
|   | (Dollars in Thousands) |                      |  |   |
| Nonaccrual loans:   |                        |                      |  |   |
| Real estate loans:  |                        |                      |  |   |
| Residential - 1 to 4 family   | \$3,363                | \$3,167              |  |   |
| Multi-family and commercial   | 1,293                  | 907                  |  |   |
| Total real estate loans   | 4,656                  | 4,074                |  |   |
| Commercial business loans - Other   | 1,159                  | 446                  |  |   |
| Consumer loans:   |                        |                      |  |   |
| Home equity   | 82                     | 23                   |  |   |
| Total nonaccrual loans  | 5,897                  | 4,543                |  |   |
| Accruing loans past due 90 days or more                                     | —                      | 459                  |  |   |
| Total nonperforming loans <sup>(1)</sup>                                    | 5,897                  | 5,002                |  |   |
| Other real estate owned, net <sup>(2)</sup>                                 | 1,420                  | 1,271                |  |   |
| Total nonperforming assets  | 7,317                  | 6,273                |  |   |
| Accruing troubled debt restructurings                                       | 3,349                  | 3,387                |  |   |
| Total nonperforming assets and troubled debt restructurings                 | \$10,666               | \$9,660              |  |   |
| Allowance for loan losses as a percent of nonperforming loans               | 143.07                 | % 155.88             |  | % |
| Total nonperforming loans to total loans                                    | 0.53                   | % 0.48               |  | % |
| Total nonperforming loans to total assets                                   | 0.42                   | % 0.37               |  | % |
| Total nonperforming assets and troubled debt restructurings to total assets | 0.76                   | % 0.72               |  | % |

<sup>(1)</sup> Includes nonperforming TDRs totaling \$400,000 and \$603,000 at June 30, 2015 and December 31, 2014, respectively.

<sup>(2)</sup> Other real estate owned balances are shown net of related write-downs.

The increase in nonperforming assets was primarily due to increases in nonperforming commercial business loans of \$713,000 at June 30, 2015. Nonperforming multi-family and commercial real estate loans and residential real estate loans increased \$386,000 and \$196,000, respectively, during the first half of 2015, while accruing loans past due 90 days or more decreased \$459,000.

Other real estate owned increased \$149,000 to \$1.4 million from December 31, 2014 to June 30, 2015, due to the addition of three residential properties, partially offset by the write-down of one commercial property and the sale of one residential property. At June 30, 2015, other real estate owned included four commercial properties and two residential properties.

Over the past few years, the Company has sought to restructure nonperforming loans rather than pursue foreclosure or liquidation, believing this approach achieves the best economic outcome for the Company in view of the current economic environment. Modified payment terms for TDRs generally involve deferred principal payments, interest rate concessions, a combination of deferred principal payments and interest rate concessions or a combination of maturity extensions and interest rate concessions. TDRs decreased to \$3.7 million at June 30, 2015, compared to \$4.0 million at December 31, 2014. Of the TDRs, \$3.3 million and \$3.4 million were performing in accordance with their restructured terms at both June 30, 2015 and December 31, 2014, respectively. The Company anticipates these borrowers will repay all contractual principal and interest in accordance with the terms of their restructured loan agreements.

Liabilities:



Summary. Liabilities increased \$63.9 million, or 5.4%, to \$1.26 billion at June 30, 2015 compared to \$1.19 billion at December 31, 2014. Deposits increased \$19.4 million, or 1.9%, which included increases in NOW and money market accounts of \$25.9 million, noninterest-bearing demand deposits of \$4.9 million and certificates of deposit

of \$4.4 million, partially offset by a decrease in savings accounts of \$15.9 million. Deposit growth remained strong due to marketing and promotional initiatives and competitively-priced deposit products. Borrowings (including subordinated debt) increased \$43.9 million from \$156.5 million at December 31, 2014 to \$200.4 million at June 30, 2015, resulting from the need to fund increased commercial lending activity.

#### Equity:

Summary. Shareholders' equity decreased \$5.1 million from \$157.7 million at December 31, 2014 to \$152.6 million at June 30, 2015. The decrease in shareholders' equity was attributable to the repurchase of common shares totaling \$10.2 million and dividends declared of \$973,000, offset by the exercise of stock options of \$3.3 million and net income of \$1.9 million.

Accumulated Other Comprehensive Income. Accumulated other comprehensive income is comprised of the unrealized gains and losses on available for sale securities and unrealized gains and losses on an interest rate swap designated as a hedge, net of taxes. The net unrealized gains on available for sale securities, net of taxes, totaled \$334,000 at June 30, 2015 compared to net unrealized gains of \$199,000 at December 31, 2014. The net unrealized loss on the interest rate swap, net of taxes, totaled \$52,000 at June 30, 2015 compared to \$104,000 at December 31, 2014.

#### Results of Operations for the Three and Six Months Ended June 30, 2015 and 2014

General. The Company's results of operations depend primarily on net interest income, which is the difference between the interest income earned on the Company's interest-earning assets, such as loans and investments, and the interest expense on its interest-bearing liabilities, such as deposits and borrowings. The Company also generates noninterest income such as gains on the sale of securities, fees earned from mortgage banking activities, fees from deposits, trust and investment management services, insurance commissions and other fees. The Company's noninterest expenses primarily consist of employee compensation and benefits, occupancy, computer services, furniture and equipment, outside professional services, electronic banking fees, FDIC deposit insurance and regulatory assessments, marketing and other general and administrative expenses. The Company's results of operations are also significantly affected by general economic and competitive conditions, particularly changes in market interest rates, governmental policies and actions of regulatory agencies.

Summary. The Company reported net income of \$1.0 million for the three months ended June 30, 2015 compared to \$914,000 for the three months ended June 30, 2014. The Company reported net income of \$1.9 million for the six months ended June 30, 2015 compared to \$1.8 million for the six months ended June 30, 2014.

Interest and Dividend Income. Total interest and dividend income increased \$107,000, or 0.9%, to \$11.8 million for the three months ended June 30, 2015, compared to the same period in 2014. The increase in interest and dividend income was primarily due to a higher average balance on loans, offset by a reduction in the average yield earned on interest-earning assets versus the same period in 2014. Interest income on loans and securities reflect net amortization of \$194,000 and \$102,000 for the quarters ended June 30, 2015 and 2014, respectively, related to fair value adjustments of loans and securities resulting from the Newport acquisition. The average yield earned on interest-earning assets for the three months ended June 30, 2015 decreased 6 basis points to 3.64% compared to 3.70% for the three months ended June 30, 2014. Average interest-earning assets increased \$31.4 million to \$1.30 billion during the second quarter of 2015, due to an increase in the average balance of loans of \$41.7 million, offset by decreases of \$8.1 million and \$2.2 million in the average balance of other interest-earning assets and securities, respectively, as compared to the same quarter in 2014.

Total interest and dividend income decreased \$494,000, or 2.1%, to \$23.3 million for the six months ended June 30, 2015, compared to the same period in 2014. The decrease in interest and dividend income was primarily due to the

lower average yield on interest-earning assets, offset by an increase in the average balance of loans versus the same period in 2014. Interest income on loans and securities reflect net amortization of \$364,000 and \$16,000 for the six months ended June 30, 2015 and 2014, respectively, related to fair value adjustments of loans and securities resulting from the Newport acquisition. The average yield earned on interest-earning assets

decreased 13 basis points to 3.66% for the six months ended June 30, 2015. Average interest-earning assets increased \$16.4 million to \$1.28 billion during the first six months of 2015, due to an increase of \$21.4 million in the average balance of loans, offset by decreases of \$4.3 million and \$757,000 in the average balance of other interest-earning assets and securities, respectively, as compared to the same period in 2014.

**Interest Expense.** For the quarter ended June 30, 2015, interest expense increased \$65,000, or 3.1%, resulting from a higher average balance of deposits and FHLB advances, compared to the same quarter in 2014. Higher interest expense on interest-bearing liabilities reflect net accretion of \$296,000 and \$485,000 for the three months ended June 30, 2015 and 2014, respectively, related to fair value adjustments of deposits and borrowings resulting from the Newport acquisition. Average interest-bearing deposits increased \$18.2 million to \$889.1 million for the three months ended June 30, 2015, while the average rate paid decreased 1 basis point to 0.62%, compared to the same period in 2014. Increases in the average balance of certificates of deposit and NOW and money market deposits totaled \$17.0 million and \$8.3 million, respectively, while the average balance of savings accounts decreased \$7.2 million, compared to the three months ended June 30, 2014. The average balance of FHLB advances increased \$9.4 million for the three months ended June 30, 2015, while the average rate increased 2 basis points to 1.58%.

Interest expense remained at \$4.2 million for the first half of 2015. Interest expense on deposits and borrowings reflect net accretion of \$641,000 and \$972,000 for the six months ended June 30, 2015 and 2014, respectively, related to fair value adjustments of deposits and borrowings resulting from the Newport acquisition. Average interest-bearing deposits increased \$19.0 million to \$884.2 million and the average rate paid increased 1 basis point to 0.63%. Increases in the average balance of certificates of deposit and NOW and money market deposits of \$20.7 million and \$2.3 million, respectively, were offset by a decrease in savings accounts of \$4.2 million. The average balance of FHLB advances decreased \$11.4 million while the average rate increased 6 basis points to 1.62%.

**Average Balance Sheet.** The following sets forth information regarding average balances of assets and liabilities as well as the total dollar amounts of interest income from average interest-earning assets and interest expense on average interest-bearing liabilities, resulting yields and rates paid, interest rate spread, net interest margin and the ratio of average interest-earning assets to average interest-bearing liabilities for the periods indicated.

|  | At or For the Three Months Ended June 30,<br>2015 |                         |                           | 2014               |                         |                           |   |
|--|---|-------------------------|---------------------------|--------------------|-------------------------|---------------------------|---|
|  | Average<br>Balance                                | Interest &<br>Dividends | Average<br>Yield/<br>Rate | Average<br>Balance | Interest &<br>Dividends | Average<br>Yield/<br>Rate |   |
|  | (Dollars in Thousands)                            |                         |                           |                    |                         |                           |   |
| Interest-earning assets:               |   |                         |                           |                    |                         |                           |   |
| Loans <sup>(1) (2)</sup>               | \$1,090,848                                       | \$10,931                | 4.02                      | % \$1,049,105      | \$10,667                | 4.08                      | % |
| Securities <sup>(3)</sup>              | 184,460   | 849                     | 1.85                      | 186,705            | 1,021                   | 2.19                      |   |
| Other interest-earning assets          | 24,405  | 19                      | 0.31                      | 32,495             | 15                      | 0.19                      |   |
| Total interest-earning assets          | 1,299,713   | 11,799                  | 3.64                      | 1,268,305          | 11,703                  | 3.70                      |   |
| Noninterest-earning assets             | 93,036  |                         |                           | 91,244             |                         |                           |   |
| Total assets                           | \$1,392,749                                       |                         |                           | \$1,359,549        |                         |                           |   |
| Interest-bearing liabilities:          |   |                         |                           |                    |                         |                           |   |
| Deposits:                              |   |                         |                           |                    |                         |                           |   |
| Business checking                      | \$295   | —                       | —                         | \$183              | —                       | —                         |   |
| NOW and money market                   | 465,364   | 134                     | 0.12                      | 457,070            | 148                     | 0.13                      |   |
| Savings <sup>(4)</sup>                 | 40,858  | 17                      | 0.17                      | 48,072             | 21                      | 0.18                      |   |
| Certificates of deposit <sup>(5)</sup> | 382,554   | 1,228                   | 1.29                      | 365,542            | 1,190                   | 1.31                      |   |
| Total interest-bearing deposits        | 889,071   | 1,379                   | 0.62                      | 870,867            |                         |                           |   |