UNITY BANCORP INC /NJ/
Form 10-Q
August 10, 2010

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

FORM 10-Q

(Mark One)
(X) QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED June 30, 2010

OR

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

Commission file number 1-12431

Unity Bancorp, Inc.
(Exact Name of Registrant as Specified in Its Charter)

New Jersey (State or Other Jurisdiction of Incorporation or Organization)	22-3282551 (I.R.S. Employer Identification No.)
64 Old Highway 22, Clinton, NJ (Address of Principal Executive Offices)	08809 (Zip Code)

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

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934, as amended, during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days:
Yes x No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a nonaccelerated filer (as defined in Exchange Act Rule 12b-2):
Large accelerated filer o Accelerated filer o Nonaccelerated filer o Smaller reporting company x

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

The number of shares outstanding of each of the registrant's classes of common equity stock, as of August 1, 2010
common stock, no par value: 7,176,123 shares outstanding

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PART I - CONSOLIDATED FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements (Unaudited)

Unity Bancorp, Inc.
Consolidated Balance Sheets
(Unaudited)

(In thousands)	June 30, 2010	December 31, 2009	June 30, 2009
ASSETS			
Cash and due from banks	$ 18,016	$ 23,517	$ 17,295
Federal funds sold and interest-bearing deposits	37,478	50,118	37,232
Cash and cash equivalents	55,494	73,635	54,527
Securities:			
Available for sale	121,628	140,770	132,719
Held to maturity (fair value of $22,563, $28,406 and $31,634, respectively)	22,034	28,252	32,075
Total securities	143,662	169,022	164,794
Loans:			
SBA held for sale	22,093	21,406	23,161
SBA held to maturity	73,298	77,844	82,157
SBA 504	65,343	70,683	72,619
Commercial	285,173	293,739	299,411
Residential mortgage	132,993	133,059	125,466
Consumer	58,280	60,285	62,517
Total loans	637,180	657,016	665,331
Less: Allowance for loan losses	13,946	13,842	10,665
Net loans	623,234	643,174	654,666
Premises and equipment, net	11,348	11,773	12,067
Deferred tax assets	7,485	7,308	7,610
Bank owned life insurance	8,653	6,002	5,890
Prepaid FDIC insurance	3,836	4,739	-
Federal Home Loan Bank stock	4,656	4,677	5,127
Accrued interest receivable	3,972	4,225	4,263
Other real estate owned	3,728	1,530	466
Goodwill and other intangibles	1,552	1,559	1,566
SBA servicing assets	660	897	1,142
Other assets	1,455	1,816	1,328
Total Assets	$ 869,735	$ 930,357	$ 913,446
LIABILITIES AND SHAREHOLDERS' EQUITY			
Liabilities:			
Deposits:			
Noninterest-bearing demand deposits	$ 87,908	$ 80,100	$ 83,639
Interest-bearing demand deposits	98,316	100,046	84,842

Savings deposits	291,355	286,334	211,876
Time deposits, under $100,000	143,617	183,377	239,893
Time deposits, $100,000 and over	72,036	108,382	111,513
Total deposits	693,232	758,239	731,763
Borrowed funds	87,672	85,000	95,000
Subordinated debentures	15,465	15,465	15,465
Accrued interest payable	661	710	847
Accrued expenses and other liabilities	3,072	3,078	3,307
Total Liabilities	800,102	862,492	846,382
Commitments and contingencies	-	-	-
Shareholders' equity:			
Preferred stock, no par value, 500 shares authorized	18,770	18,533	18,305
Common stock, no par value, 12,500 shares authorized	55,592	55,454	55,264
Retained earnings (deficit)	(815)	(1,492)	(135)
Treasury stock at cost	(4,169)	(4,169)	(4,169)
Accumulated other comprehensive income (loss), net of tax	255	(461)	(2,201)
Total Shareholders' Equity	69,633	67,865	67,064
Total Liabilities and Shareholders' Equity	$ 869,735	$ 930,357	$ 913,446
Preferred shares	21	21	21
Issued common shares	7,579	7,569	7,544
Outstanding common shares	7,154	7,144	7,119

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

Unity Bancorp
Consolidated Statements of Operations
(Unaudited)

	For the three months ended June 30,		For the six months ended June 30,	
(In thousands, except per share amounts)	2010	2009	2010	2009
INTEREST INCOME				
Federal funds sold and interest-bearing deposits	$ 29	$ 29	$ 55	$ 46
Federal Home Loan Bank stock	49	122	83	118
Securities:				
Available for sale	1,054	1,509	2,334	3,188
Held to maturity	250	391	588	777
Total securities	1,304	1,900	2,922	3,965
Loans:				
SBA	1,300	1,564	2,752	3,171
SBA 504	1,091	1,285	2,177	2,516
Commercial	4,488	5,051	9,092	10,067
Residential mortgage	1,959	1,783	3,921	3,646
Consumer	724	797	1,455	1,592
Total loans	9,562	10,480	19,397	20.992
Total interest income	10,944	12,531	22,457	25,121
INTEREST EXPENSE				
Interest-bearing demand deposits	188	267	446	537
Savings deposits	728	912	1,629	1,556
Time deposits	1,687	3,409	3,500	7,133
Borrowed funds and subordinated debentures	1,078	1,085	2,155	2,263
Total interest expense	3,681	5,673	7,730	11,489
Net interest income	7,263	6,858	14,727	13,632
Provision for loan losses	1,500	1,500	3,000	3,000
Net interest income after provision for loan losses	5,763	5,358	11,727	10,632
NONINTEREST INCOME (LOSS)				
Branch fee income	331	335	692	665
Service and loan fee income	245	294	454	547
Gain on sale of SBA loans held for sale, net	147	-	147	29
Gain on sale of mortgage loans	112	49	258	113
Bank owned life insurance	78	55	151	110
Total other-than-temporary impairment charges on securities	-	(2,555)	-	(2,555)
Portion of loss recognized in other comprehensive income (before taxes)	-	806	-	806
Net other-than-temporary impairment charges recognized in earnings	-	(1,749)	-	(1,749)
Net security gains	4	2	8	517
Other income	253	107	370	209
Total noninterest income (loss)	1,170	(907)	2,080	441

NONINTEREST EXPENSE				
Compensation and benefits	2,822	2,853	5,821	5,477
Occupancy	608	647	1,285	1,334
Processing and communications	555	482	1,080	1,023
Furniture and equipment	447	471	870	966
Professional services	199	260	428	506
Loan collection costs	243	180	427	379
OREO expenses	157	13	187	17
Deposit insurance	320	708	650	1,009
Advertising	241	151	348	226
Other expenses	448	438	885	821
Total noninterest expense	6,040	6,203	11,981	11,758
Income (loss) before provision (benefit) for income taxes	893	(1,752)	1,826	(685)
Provision (benefit) for income taxes	212	(552)	397	(216)
Net income (loss)	681	(1,200)	1,429	(469)
Preferred stock dividends and discount accretion	379	372	752	751
Income available (loss attributable) to common shareholders	$ 302	$ (1,572)	$ 677	$ (1,220)
Net income (loss) per common share - Basic	$ 0.04	$ (0.22)	$ 0.09	$ (0.17)
- Diluted	0.04	(0.22)	0.09	(0.17)
Weighted average common shares outstanding - Basic	7,156	7,119	7,153	7,119
- Diluted	7,475	7,119	7,392	7,119

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

Unity Bancorp, Inc.
Consolidated Statements of Changes in Shareholders' Equity
For the six months ended June 30, 2010 and 2009

(In thousands)	Preferred Stock	Common Stock Shares	Common Stock Amount	Retained Earnings (Deficit)	Treasury Stock	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
Balance, December 31, 2008	$ 18,064	7,119	$ 55,179	$ 1,085	$ (4,169)	$ (2,356)	$ 67,803
Comprehensive income (loss):							
Net loss				(469)			(469)
Net noncredit unrealized losses on held to maturity debt securities						(532)	(532)
Net unrealized gains on securities						572	572
Net unrealized gains on cash flow hedge derivatives						115	115
Total comprehensive loss							(314)
Accretion of discount on preferred stock	241			(241)			-
Dividends on preferred stock (5% annually)				(510)			(510)
Common stock issued and related tax effects (a)			85				85
Balance, June 30, 2009	$ 18,305	7,119	$ 55,264	$ (135)	$ (4,169)	$ (2,201)	$ 67,064

(In thousands)	Preferred Stock	Common Stock Shares	Common Stock Amount	Retained Earnings (Deficit)	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
Balance, December 31, 2009	$ 18,533	7,144	$ 55,454	$ (1,492)	$ (4,169)	$ (461)	$ 67,865
Comprehensive income:							
Net income				1,429			1,429
Net unrealized gains on securities						666	666
Net unrealized gains on cash flow hedge derivatives						50	50
Total comprehensive income							2,145
Accretion of discount on preferred stock	237			(237)			-

Dividends on preferred stock (5% annually)				(515)			(515)
Common stock issued and related tax effects (a)		10	138				138
Balance, June 30, 2010	$ 18,770	7,154	$ 55,592	$ (815)	$ (4,169)	$ 255	$ 69,633

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

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

Unity Bancorp, Inc.
Consolidated Statements of Cash Flows
(Unaudited)

	For the six months ended June 30,	
(In thousands)	2010	2009
OPERATING ACTIVITIES		
Net income (loss)	$ 1,429	$ (469)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Provision for loan losses	3,000	3,000
Net amortization of purchase premiums and discounts on securities	514	190
Depreciation and amortization	609	803
Deferred income tax benefit	(664)	(1,412)
Other-than-temporary impairment charges on securities	-	1,749
Net security gains	(8)	(517)
Stock compensation expense	140	133
Gain on sale of SBA loans held for sale, net	(147)	(29)
Gain on sale of mortgage loans	(258)	(113)
Origination of mortgage loans held for sale	(14,314)	(8,718)
Origination of SBA loans held for sale	(2,101)	(1,943)
Proceeds from the sale of mortgage loans held for sale, net	14,572	8,831
Proceeds from the sale of SBA loans held for sale, net	1,561	867
Loss on the sale of premises and equipment	3	-
Net change in other assets and liabilities	1,591	2,085
Net cash provided by operating activities	5,927	4,457
INVESTING ACTIVITIES:		
Purchases of securities held to maturity	-	(4,036)
Purchases of securities available for sale	(20,978)	(63,550)
Purchases of Federal Home Loan Bank stock, at cost	-	(8,469)
Maturities and principal payments on securities held to maturity	4,179	2,640
Maturities and principal payments on securities available for sale	32,041	24,533
Proceeds from sale of securities held to maturity	1,893	-
Proceeds from sale of securities available for sale	8,838	23,116
Proceeds from redemption of Federal Home Loan Bank stock	21	8,199
Proceeds from the sale of other real estate owned	1,954	820
Net decrease in loans	13,475	18,347
Purchase of bank owned life insurance	(2,500)	-
Proceeds from the sale of premises and equipment	26	-
Purchases of premises and equipment	(207)	(148)
Net cash provided by investing activities	38,742	1,452

FINANCING ACTIVITIES:				
Net (decrease) increase in deposits		(65,007)		24,646
Proceeds from new borrowings		2,672		10,000
Repayments of borrowings		-		(20,000)
Proceeds from the exercise of stock options, including related tax benefits		41		-
Cash dividends paid on preferred stock		(516)		(459)
Net cash (used in) provided by financing activities		(62,810)		14,187
(Decrease) increase in cash and cash equivalents		(18,141)		20,096
Cash and cash equivalents, beginning of period		73,635		34,431
Cash and cash equivalents, end of period	$	55,494	$	54,527
SUPPLEMENTAL DISCLOSURES:				
Cash:				
Interest paid	$	7,779	$	11,447
Income taxes paid		954		814
Noncash investing activities:				
Transfer of loans to other real estate owned		4,152		577

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

Unity Bancorp, Inc.
Notes to the Consolidated Financial Statements (Unaudited)
June 30, 2010

NOTE 1. Significant Accounting Policies

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

Estimates that are particularly susceptible to significant changes relate to the determination of the allowance for loan losses. Management believes that the allowance for loan losses is adequate. While management uses available information to recognize losses on loans, future additions to the allowance for loan losses may be necessary based on changes in economic conditions. The interim unaudited consolidated financial statements included herein have been prepared in accordance with instructions for Form 10-Q and the rules and regulations of the Securities and Exchange Commission ("SEC"). The results of operations for the three and six months ended June 30, 2010 are not necessarily indicative of the results which may be expected for the entire year. As used in this Form 10-Q, "we" and "us" and "our" refer to Unity Bancorp, Inc., and its consolidated subsidiary, Unity Bank, depending on the context. Interim financial statements should be read in conjunction with the Company's consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2009.

Accounting Standards Codification

The Financial Accounting Standards Board's ("FASB") Accounting Standards Codification ("ASC") became effective on July 1, 2009. At that date, the ASC became FASB's officially recognized source of authoritative U.S. generally accepted accounting principles ("GAAP") applicable to all public and nonpublic nongovernmental entities, superseding existing FASB, American Institute of Certified Public Accountants ("AICPA"), Emerging Issues Task Force ("EITF") and related literature. Rules and interpretive releases of the SEC under the authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. All other accounting literature is considered nonauthoritative. The switch to the ASC affects the way companies refer to U.S. GAAP in financial statements and accounting policies. Citing particular content in the ASC involves specifying the unique numeric path to the content through the Topic, Subtopic, Section and Paragraph structure.

Stock Transactions

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

Stock Option Plans

Grants under the Company's incentive and nonqualified option plans generally vest over 3 years and must be exercised within 10 years of the date of grant. The exercise price of each option is the market price on the date of grant. As of June 30, 2010, 1,520,529 shares have been reserved for issuance upon the exercise of options, 868,356 option grants are outstanding, and 643,890 option grants have been exercised, forfeited or expired, leaving 8,283 shares available for grant.

No options were granted during the three or six months ended June 30, 2010 or 2009.

FASB ASC Topic 718, "Compensation - Stock Compensation," requires an entity to recognize the fair value of equity awards as compensation expense over the period during which an employee is required to provide service in exchange for such an award (vesting period). Compensation expense related to stock options totaled $52 thousand and $31 thousand for the three months ended June 30, 2010 and 2009, respectively. The related income tax benefit was approximately $21 thousand and $17 thousand for the three months ended June 30, 2010 and 2009, respectively. Compensation expense related to stock options totaled $83 thousand and $72 thousand for the six months ended June 30, 2010 and 2009, respectively. The related income tax benefit was approximately $33 thousand and $35 thousand for the six months ended June 30, 2010 and 2009, respectively.

Transactions under the Company's stock option plans for the six months ended June 30, 2010 are summarized in the following table:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Outstanding at December 31, 2009	886,286	$ 5.73	4.6	$ 293,911
Options granted	-	-		
Options exercised	(12,406)	2.79		
Options forfeited	(5,524)	4.44		
Options expired	-	-		
Outstanding at June 30, 2010	868,356	$ 5.78	4.0	$ 881,158
Exercisable at June 30, 2010	717,546	$ 6.03	3.0	$ 712,890

As of June 30, 2010, unrecognized compensation costs related to nonvested share-based compensation arrangements granted under the Company's stock option plans totaled approximately $177 thousand. That cost is expected to be recognized over a weighted average period of 1.8 years.

The following table summarizes information about stock options outstanding at June 30, 2010:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Shares Outstanding	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Shares Exercisable	Weighted Average Exercise Price
0.00 $- 4.00	400,975	3.5	$3.33	296,728	$3.13
4.01 - 8.00	254,706	4.6	5.72	208,143	5.62
8.01 - 12.00	134,535	3.6	9.18	134,535	9.18
12.01 - 16.00	78,140	5.4	12.76	78,140	12.76
Total	868,356	4.0	$5.78	717,546	$6.03

The following table presents information about options exercised during the three and six months ended June 30, 2010 and 2009:

	Three months ended June 30,		Six months ended June 30,	
	2010	2009	2010	2009
Number of options exercised	667	-	12,406	-
Total intrinsic value of options exercised	$ 627	$ -	$ 16,399	$ -
Cash received from options exercised	2,921	-	34,652	-
Tax deduction realized from options exercised	-	-	6,299	-

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

Restricted Stock Awards

Restricted stock awards granted to date vest over a period of 4 years and are recognized as compensation to the recipient over the vesting period. The awards are recorded at fair market value and amortized into salary expense on a straight line basis over the vesting period. As of June 30, 2010, 121,551 shares of restricted stock were reserved for issuance, of which 25,535 shares are available for grant.

No restricted stock awards were granted during the three or six months ended June 30, 2010 or 2009.

Compensation expense related to the restricted stock awards totaled $35 thousand and $17 thousand for the three months ended June 30, 2010 and 2009, respectively. Compensation expense related to the restricted stock awards totaled $57 thousand and $62 thousand for the six months ended June 30, 2010 and 2009, respectively. As of June 30, 2010, there was approximately $153 thousand of unrecognized compensation cost related to nonvested restricted stock awards granted under the Company’s stock incentive plans. That cost is expected to be recognized over a weighted average period of 2.4 years.

The following table summarizes nonvested restricted stock activity for the six months ended June 30, 2010:

	Shares	Average Grant Date Fair Value
Nonvested restricted stock at December 31, 2009	54,281	$ 7.25
Granted	-	-
Vested	(14,637)	11.36
Forfeited	(2,427)	6.18
Nonvested restricted stock at June 30, 2010	37,217	$ 5.71

Income Taxes

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

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

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

Derivative Instruments and Hedging Activities

The Company uses derivative instruments, such as interest rate swaps, to manage interest rate risk. The Company recognizes all derivative instruments at fair value as either assets or liabilities in other assets or other liabilities. The accounting for changes in the fair value of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as an accounting hedge, the gain or loss is recognized in trading noninterest income. As of June 30, 2010, all of the Company's derivative instruments qualified as hedging instruments.

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

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

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

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

Loans Held To Maturity and Loans Held For Sale

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

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

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

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

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

The Company evaluates its loans for impairment. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. The Company has defined impaired loans to be all troubled debt restructurings and nonaccrual loans. Troubled debt restructurings occur when a creditor, for economic or legal reasons related to a debtor’s financial condition, grants a concession to the debtor that it would not otherwise consider, such as a below market interest rate. Impairment is measured based on a loan’s observable market price or the fair value of collateral, net of estimated costs to sell, if the loan is collateral dependent. If the measure of the impaired loan is less than the recorded investment in the loan, the Company establishes a valuation allowance, or adjusts existing valuation allowances, with a corresponding charge or credit to the provision for loan losses.

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

The Company originates loans to customers under an SBA program that generally provides for SBA guarantees of up to 90 percent of each loan. In the past, the Company generally sold the guaranteed portion of its SBA loans to a third party and retained the servicing, holding the nonguaranteed portion in its portfolio. During late 2008, the Company withdrew from SBA lending outside of its primary trade area, but continues to offer SBA loan products as an additional credit product within its primary trade area. If sales of SBA loans do occur, the premium received on the sale and the present value of future cash flows of the servicing assets are recognized in income. However, new authoritative accounting guidance under FASB ASC Topic 860, “Transfers and Servicing,” requires that the gains on sales of SBA 7(a) loans be deferred for a 90-day period after the sale, which coincides with the buyback or warranty period required by the SBA for all secondary market sales.

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

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

Allowance for Loan Losses and Unfunded Loan Commitments

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

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

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

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

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

Other-Than-Temporary Impairment

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

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

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

NOTE 2. Litigation

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

NOTE 3. Net Income per Share

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

Diluted net income per common share is computed similarly to that of basic net income per common share, except that the denominator is increased to include the number of additional common shares that would have been outstanding if all potentially dilutive common shares, principally stock options, were issued during the reporting period utilizing the Treasury stock method. However, when a net loss rather than net income is recognized, diluted earnings per share equals basic earnings per share.

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

	Three months ended June 30,		Six months ended June 30,	
(In thousands, except per share amounts)	2010	2009	2010	2009
Net income (loss)	$ 681	$ (1,200)	$ 1,429	$ (469)
Less: Preferred stock dividends and discount accretion	379	372	752	751
Income available (loss attributable) to common shareholders	$ 302	$ (1,572)	$ 677	$ (1,220)
Weighted average common shares outstanding - Basic	7,156	7,119	7,153	7,119
Plus: Potential dilutive common stock equivalents	319	-	239	-
Weighted average common shares outstanding - Diluted	7,475	7,119	7,392	7,119
Net income (loss) per common share -				
Basic	$ 0.04	$ (0.22)	$ 0.09	$ (0.17)
Diluted	0.04	(0.22)	0.09	(0.17)
Stock options and common stock excluded from the income per share computation as their effect would have been anti-dilutive	566	1,424	750	1,424

The number of anti-dilutive stock options and common stock warrants for the three and six months ended June 30, 2010 and 2009 include the issuance of common stock warrants to the U.S. Department of Treasury under the Capital Purchase Program in December 2008.

NOTE 4. Income Taxes

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

The Company did not recognize or accrue any interest or penalties related to income taxes during the three or six months ended June 30, 2010 and 2009. The Company does not have an accrual for uncertain tax positions as of June

30, 2010 or December 31, 2009, as deductions taken and benefits accrued are based on widely understood administrative practices and procedures and are based on clear and unambiguous tax law. Tax returns for all years 2006 and thereafter are subject to future examination by tax authorities.

NOTE 5. Other Comprehensive Income (Loss)

Changes in Other Comprehensive Income (Loss) for the six months ended June 30, 2010 and 2009:

(In thousands)	Pre-tax	Tax	After-tax
Net noncredit unrealized losses on held to maturity debt securities with other-than-temporary impairment:			
Balance at December 31, 2008			$-
Noncredit unrealized holding loss on securities arising during the period	(806)	(274)	(532)
Balance at June 30, 2009			$(532)
Net unrealized gains (losses) on securities:			
Balance at December 31, 2008			$(1,728)
Unrealized holding gain on securities arising during the period	$1,406	$490	916
Less: Reclassification adjustment for gains included in net income	517	173	344
Net unrealized gain on securities arising during the period	889	317	572
Balance at June 30, 2009			(1,156)
Balance at December 31, 2009			5
Unrealized holding gain on securities arising during the period	1,127	456	671
Less: Reclassification adjustment for gains included in net income	8	3	5
Net unrealized gain on securities arising during the period	1,119	453	666
Balance at June 30, 2010			$671
Net unrealized losses on cash flow hedges:			
Balance at December 31, 2008			$(628)
Unrealized holding gain on cash flow hedges arising during the period	$185	$70	115
Balance at June 30, 2009			(513)
Balance at December 31, 2009			(466)
Unrealized holding gain on cash flow hedges arising during the period	83	33	50
Balance at June 30, 2010			(416)
Total Accumulated Other Comprehensive Income at June 30, 2010			$255

Changes in Other Comprehensive Income (Loss) for the three months ended June 30, 2010 and 2009:

(In thousands)	Pre-tax	Tax	After-tax
Net noncredit unrealized losses on held to maturity debt securities with other-than-temporary impairment:			
Balance at March 31, 2009			-
Noncredit unrealized holding loss on securities arising during the period	(806)	(274)	(532)
Balance at June 30, 2009			(532)
Net unrealized security gains (losses) on securities			
Balance at March 31, 2009			(2,513)
Unrealized holding gain on securities arising during the period	1,507	148	1,359
Less: Reclassification adjustment for gains included in net income	2	-	2
Net unrealized gain on securities arising during the period	1,505	148	1,357
Balance at June 30, 2009			(1,156)
Balance at March 31, 2010			277
Unrealized holding gain on securities arising during the period	659	263	396
Less: Reclassification adjustment for gains included in net income	4	2	2
Net unrealized gain on securities arising during the period	655	261	394
Balance at June 30, 2010			671
Net unrealized losses on cash flow hedges	Pre-tax	Tax	After-tax
Balance at March 31, 2009			(603)
Unrealized holding gain on cash flow hedges arising during the period	145	55	90
Balance at June 30, 2009			(513)
Balance at March 31, 2010			(465)
Unrealized holding gain on cash flow hedges arising during the period	82	33	49
Balance at June 30, 2010			(416)
Total Accumulated Other Comprehensive Loss at June 30, 2010			255

NOTE 6. Fair Value

Fair Value Measurement

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

Level 1 Inputs

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

Level 2 Inputs

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

Level 3 Inputs

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

Fair Value on a Recurring Basis

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

Securities Available for Sale

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

As of June 30, 2010, the fair value of the Company's AFS securities portfolio was $121.6 million. Approximately 79 percent of the portfolio was made up of residential mortgage-backed securities, which had a fair value of $96.1 million at June 30, 2010. Approximately $79.5 million of the residential mortgage-backed securities were issued or are guaranteed by the Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA") or the Federal Home Loan Mortgage Corporation ("FHLMC"). The underlying loans for these securities are residential mortgages that are geographically dispersed throughout the United States. All AFS securities were classified as Level 2 assets at June 30, 2010. The valuation of AFS securities using Level 2 inputs was primarily determined using the market approach, which uses quoted prices for similar assets or liabilities in active markets and all other relevant information. It includes model pricing, defined as valuing securities based upon their relationship with other benchmark securities.

SBA Servicing Assets
SBA servicing assets do not trade in an active, open market with readily observable prices. The Company estimates the fair value of SBA servicing assets using discounted cash flow models incorporating numerous assumptions from the perspective of a market participant including market discount rates and prepayment speeds. The fair value of SBA servicing assets as of June 30, 2010 was determined using a discount rate of 15 percent, conditional prepayment rates of 15 to 18, and interest strip multiples ranging from 2.08 to 3.80, depending on each individual credit. Due to the nature of the valuation inputs, SBA servicing assets are classified as Level 3 assets.

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

There were no changes in the inputs or methodologies used to determine fair value during the periods ended June 30, 2010 as compared to the periods ended December 31, 2009 and June 30, 2009. The tables below present the balances of assets and liabilities measured at fair value on a recurring basis as of June 30, 2010 and December 31, 2009.

	As of June 30, 2010			
(In thousands)	Level 1	Level 2	Level 3	Total
Financial Assets:				
Securities available for sale:				
U.S. government sponsored entities	$-	$18,650	$-	$18,650
State and political subdivisions	-	2,963	-	2,963
Residential mortgage-backed securities	-	96,095	-	96,095
Commercial mortgage-backed securities	-	2,766	-	2,766
Trust preferred securities	-	565	-	565
Other equities	-	589	-	589
Total securities available for sale	-	121,628	-	121,628
SBA servicing assets	-	-	660	660
Financial Liabilities:				
Interest rate swap agreements	-	694	-	694

	As of December 31, 2009			
(In thousands)	Level 1	Level 2	Level 3	Total
Financial Assets:				
Securities available for sale:				
U.S. government sponsored entities	$500	$15,507	$-	$16,007
State and political subdivisions	-	2,942	-	2,942
Residential mortgage-backed securities	8,756	107,469	-	116,225
Commercial mortgage-backed securities	-	4,627	-	4,627
Trust preferred securities	-	390	-	390
Other equities	-	579	-	579
Total securities available for sale	9,256	131,514	-	140,770
SBA servicing assets	-	-	897	897
Financial Liabilities:				
Interest rate swap agreements	-	777	-	777

The changes in Level 1 assets and liabilities measured at fair value on a recurring basis as of June 30, 2010 are summarized as follows:

	As of June 30, 2010
(In thousands)	Securities Available for Sale
Beginning balance December 31, 2009	$ 9,256
Total net gains (losses) included in:	
Net income	-
Other comprehensive income	-
Purchases, sales, issuances and settlements, net	(500)
Transfers in and/or out of Level 1 (a)	(8,756)
Ending balance June 30, 2010	$ -

(a) Transferred from Level 1 to Level 2 because of lack of observable market data due to decreased market activity for these securities. The transferred available for sale securities consisted entirely of residential mortgage-backed securities.

The changes in Level 2 assets and liabilities measured at fair value on a recurring basis as of June 30, 2010 are summarized as follows:

	As of June 30, 2010	
(In thousands)	Securities Available for Sale	Interest Rate Swap Agreements
Beginning balance December 31, 2009	$ 131,514	$ 777
Total net gains (losses) included in:		
Net income	94	-
Other comprehensive income	1,119	(83)
Purchases, sales, issuances and settlements, net	(19,855)	-
Transfers in and/or out of Level 2 (a)	8,756	-
Ending balance June 30, 2010	$ 121,628	$ 694

(a) Transferred from Level 1 to Level 2 because of lack of observable market data due to decreased market activity for these securities. The transferred available for sale securities consisted entirely of residential mortgage-backed securities.

The changes in Level 3 assets and liabilities measured at fair value on a recurring basis as of June 30, 2010 and 2009 are summarized as follows:

	As of June 30, 2010
(In thousands)	SBA Servicing Assets
Beginning balance December 31, 2009	$ 897
Total net gains (losses) included in:	
Net income	-
Other comprehensive income	-
Purchases, sales, issuances and settlements, net	(237)
Transfers in and/or out of Level 3	-
Ending balance June 30, 2010	$ 660

	As of June 30, 2009
(In thousands)	SBA Servicing Assets
Beginning balance December 31, 2008	$ 1,503
Total net gains (losses) included in:	
Net income	-
Other comprehensive income	-
Purchases, sales, issuances and settlements, net	(361)
Transfers in and/or out of Level 3	-
Ending balance June 30, 2009	$ 1,142

There were no gains or losses (realized or unrealized) included in earnings for assets and liabilities held at June 30, 2010 or 2009.

Fair Value on a Nonrecurring Basis

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

SBA Loans Held for Sale
The fair value of SBA loans held for sale was determined using a market approach that includes significant other observable inputs (Level 2 Inputs). The Level 2 fair values were estimated using quoted prices for similar assets in active markets.

Other Real Estate Owned ("OREO")
The fair value was determined using appraisals, which may be discounted based on management's review and changes in market conditions (Level 3 Inputs).

Impaired Collateral Dependent Loans
The fair value of impaired collateral dependent loans is derived in accordance with FASB ASC Topic 310, "Receivables." Fair value is determined based on the loan's observable market price or the fair value of the collateral. The valuation allowance for impaired loans is included in the allowance for loan losses in the consolidated balance sheets. During the six months ended June 30, 2010, the valuation allowance for impaired loans decreased $864 thousand from $2.5 million at December 31, 2009 to $1.6 million at June 30, 2010. During the twelve months ended December 31, 2009, the valuation allowance for impaired loans increased $1.5 million from $957 thousand at December 31, 2008 to $2.5 million at December 31, 2009.

The following tables present the assets and liabilities carried on the balance sheet by caption and by level within the hierarchy (as described above) as of June 30, 2010 and December 31, 2009:

	As of June 30, 2010				
(In thousands)	Level 1	Level 2	Level 3	Total	Total fair value gain (loss) during six months ended June 30, 2010
Financial Assets:					
SBA loans held for sale	$ -	$ 23,534	$ -	$ 23,534	$ -
Other real estate owned ("OREO")	-	-	3,728	3,728	-
Impaired collateral dependent loans	-	-	21,712	21,712	864

	As of December 31, 2009				
(In thousands)	Level 1	Level 2	Level 3	Total	Total fair value gain (loss) during twelve months ended December 31, 2009
Financial Assets:					

SBA loans held for sale	$ -	$ 22,407	$ -	$ 22,407	$ -
Other real estate owned ("OREO")	-	-	1,530	1,530	(150)
Impaired collateral dependent loans	-	-	21,713	21,713	(1,507)

Fair Value of Financial Instruments

FASB ASC Topic 825, "Financial Instruments," requires the disclosure of the estimated fair value of certain financial instruments, including those financial instruments for which the Company did not elect the fair value option. These estimated fair values as of June 30, 2010 and December 31, 2009 have been determined using available market information and appropriate valuation methodologies. Considerable judgment is required to interpret market data to develop estimates of fair value. The estimates presented are not necessarily indicative of amounts the Company could realize in a current market exchange. The use of alternative market assumptions and estimation methodologies could have had a material effect on these estimates of fair value. The methodology for estimating the fair value of financial assets and liabilities that are measured on a recurring or nonrecurring basis are discussed above. The following methods and assumptions were used to estimate the fair value of other financial instruments for which it is practicable to estimate that value:

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

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

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

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

Borrowed Funds & Subordinated Debentures
The fair value of borrowings is estimated by discounting the projected future cash flows using current market rates.

Accrued Interest
The carrying amounts of accrued interest approximate fair value.

Standby Letters of Credit
At June 30, 2010, the Bank had standby letters of credit outstanding of $3.4 million, as compared to $6.4 million at December 31, 2009. The fair value of these commitments is nominal.

The table below presents the estimated fair values of the Company's financial instruments as of June 30, 2010 and December 31, 2009:

	June 30, 2010		December 31, 2009	
(In thousands)	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and cash equivalents	$55,494	$55,494	$73,635	$73,635
Securities available for sale	121,628	121,628	140,770	140,770
Securities held to maturity	22,034	22,563	28,252	28,406

Loans, net of allowance for loan losses	623,234	623,380	643,174	640,246
Federal Home Loan Bank stock	4,656	4,656	4,677	4,677
SBA servicing assets	660	660	897	897
Accrued interest receivable	3,972	3,972	4,225	4,225
Financial liabilities:				
Deposits	693,232	677,788	758,239	739,909
Borrowed funds and subordinated debentures	103,137	115,778	100,465	113,227
Accrued interest payable	661	661	710	710
Interest rate swap agreements	694	694	777	777

Note 7. Securities

This table provides the major components of securities available for sale ("AFS") and held to maturity ("HTM") at amortized cost and estimated fair value at June 30, 2010 and December 31, 2009 :

	June 30, 2010				December 31, 2009			
(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available for sale:								
US Government sponsored entities	$ 18,520	$ 131	$ (1)	$ 18,650	$ 16,198	$ 20	$ (211)	$ 16,007
State and political subdivisions	2,946	24	(7)	2,963	2,946	9	(13)	2,942
Residential mortgage-backed securities	94,672	2,089	(666)	96,095	115,397	1,849	(1,021)	116,225
Commercial mortgage-backed securities	2,792	9	(35)	2,766	4,651	-	(24)	4,627
Trust preferred securities	977	-	(412)	565	976	-	(586)	390
Other equities	610	-	(21)	589	610	-	(31)	579
Total securities available for sale	$ 120,517	$ 2,253	$ (1,142)	$ 121,628	$ 140,778	$ 1,878	$ (1,886)	$ 140,770
Held to maturity:								
US Government sponsored entities	$ 2,000	$ 31	$ -	$ 2,031	$ 2,000	$ 76	$ -	$ 2,076
State and political subdivisions	862	-	(9)	853	3,156	4	(92)	3,068
Residential mortgage-backed securities	14,899	538	(319)	15,118	18,700	545	(527)	18,718
Commercial mortgage-backed securities	4,223	325	-	4,548	4,346	185	-	4,531
Trust preferred securities	50	-	(37)	13	50	-	(37)	13
Total securities held to maturity	$ 22,034	$ 894	$ (365)	$ 22,563	$ 28,252	$ 810	$ (656)	$ 28,406

The table below provides the remaining contractual maturities and yields of securities within the investment portfolios. The carrying value of securities at June 30, 2010 is primarily distributed by contractual maturity. Mortgage-backed securities and other securities, which may have principal prepayment provisions, are distributed based on contractual maturity. Expected maturities will differ materially from contractual maturities as a result of early prepayments and calls. The total weighted average yield excludes equity securities.

	After one year	After five years	After ten years

	Within one year		through five years		through ten years				Total carrying value	
(In thousands)	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Available for sale at fair value:										
US Government sponsored entities	$ -	- %	$ 5,452	1.45 %	$ 10,151	2.98 %	$ 3,047	4.20 %	$ 18,650	2.73 %
State and political subdivisions	-	-	-	-	703	3.83	2,260	3.93	2,963	3.91
Residential mortgage-backed securities	161	3.73	1,417	3.77	7,138	4.66	87,379	3.52	96,095	3.61
Commercial mortgage-backed securities	-	-	-	-	-	-	2,766	5.99	2,766	5.99
Trust preferred securities	-	-	-	-	-	-	565	1.31	565	1.31
Other equities	-	-	-	-	-	-	589	4.20	589	4.20
Total securities available for sale	$ 161	3.73 %	$ 6,869	1.93 %	$ 17,992	3.53 %	$ 96,606	3.62 %	$ 121,628	3.53 %
Held to maturity at cost:										
US Government sponsored entities	$ 2,000	4.97 %	$ -	- %	$ -	- %	$ -	- %	$ 2,000	4.97 %
State and political subdivisions	-	-	-	-	-	-	862	4.34	862	4.34
Residential mortgage-backed securities	-	-	646	4.31	4,628	4.83	9,625	4.22	14,899	4.41
Commercial mortgage-backed securities	-	-	-	-	-	-	4,223	5.28	4,223	5.28
Trust preferred securities	-	-	-	-	-	-	50	-	50	-
Total securities held to maturity	$ 2,000	4.97 %	$ 646	4.31 %	$ 4,628	4.83 %	$ 14,760	4.52 %	$ 22,034	4.62 %

The fair value of securities with unrealized losses by length of time that the individual securities have been in a continuous unrealized loss position at June 30, 2010 and December 31, 2009 are as follows:

		June 30, 2010					
		Less than 12 months		12 months and greater		Total	
(In thousands)	Total Number in a Loss Position	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
Available for sale:							
U.S. Government sponsored entities	2	$ -	$ -	$ 91	$ (1)	$ 91	$ (1)
State and political subdivisions	4	793	(7)	-	-	793	(7)
Residential mortgage-backed securities	17	10,088	(92)	6,211	(574)	16,298	(666)
Commercial mortgage-backed securities	2	-	-	2,321	(35)	2,321	(35)
Trust preferred securities	1	-	-	565	(412)	565	(412)
Other equities	3	-	-	589	(21)	589	(21)
Total temporarily impaired investments	29	$ 10,881	$ (99)	$ 9,777	$ (1,043)	$ 20,657	$ (1,142)
Held to maturity:							
State and political subdivisions	1	$ 853	$ (9)	$ -	$ -	$ 853	$ (9)
Residential mortgage-backed securities	4	-	-	3,492	(319)	3,492	(319)
Trust preferred securities	2	5	(6)	8	(31)	13	(37)
Total temporarily impaired investments	7	$ 858	$ (15)	$ 3,500	$ (350)	$ 4,358	$ (365)

		December 31, 2009					
		Less than 12 months		12 months and greater		Total	
(In thousands)	Total Number in a Loss Position	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
Available for sale:							
U.S. Government sponsored entities	10	$ 12,807	$ (210)	$ 96	$ (1)	$ 12,903	$ (211)
State and political subdivisions	7	1,820	(13)	-	-	1,820	(13)
	24	17,372	(207)	7,735	(814)	25,107	(1,021)

Residential mortgage-backed securities							
Commercial mortgage-backed securities	4	4,627	(24)	-	-	4,627	(24)
Trust preferred securities	1	-	-	390	(586)	390	(586)
Other equities	3	-	-	579	(31)	579	(31)
Total temporarily impaired investments	49	$ 36,626	$ (454)	$ 8,800	$ (1,432)	$ 45,426	$ (1,886)
Held to maturity:							
State and political subdivisions	6	$ 1,753	$ (32)	$ 999	$ (60)	$ 2,752	$ (92)
Residential mortgage-backed securities	5	124	(10)	3,844	(517)	3,968	(527)
Trust preferred securities	2	5	(6)	26	(31)	31	(37)
Total temporarily impaired investments	13	$ 1,882	$ (48)	$ 4,869	$ (608)	$ 6,751	$ (656)

Unrealized Losses

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

U.S. Government sponsored entities and state and political subdivision securities: The unrealized losses on investments in this type of security were caused by the increase in interest rate spreads. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the par value of the investment. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be at maturity, the Company does not consider these investments to be other-than-temporarily impaired as of June 30, 2010.

Residential and commercial mortgage-backed securities: The unrealized losses on investments in mortgage-backed securities were caused by interest rate increases. The majority of contractual cash flows of these securities are guaranteed by Fannie Mae, Ginnie Mae and the Federal Home Loan Mortgage Corporation. It is expected that the securities would not be settled at a price significantly less than the par value of the investment. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be at maturity, the Company does not consider these investments to be other-than-temporarily impaired as of June 30, 2010.

Trust preferred securities: The unrealized losses on trust preferred securities were caused by an inactive trading market and changes in market credit spreads. At June 30, 2010, this category consisted primarily of one single-issuer trust preferred security. The company that issued the trust preferred security is considered a well capitalized institution per regulatory standards and significantly strengthened its capital position in 2009 through a public offering and other capital raising measures. In addition, the company has ample liquidity and bolstered its allowance for loan losses in 2009. The contractual terms do not allow the security to be settled at a price less than the par value. Because the Company does not intend to sell the security and it is not more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis, which may be at maturity, the Company does not consider this security to be other-than-temporarily impaired as of June 30, 2010.

Other equity securities: Included in this category is stock of other financial institutions. The unrealized losses on other equity securities are caused by decreases in the market prices of the shares. The Company has evaluated the prospects of the issuer and has forecasted a recovery period; therefore these investments are not considered other-than-temporarily impaired as of June 30, 2010.

Realized Gains and Losses and Other-than-temporary Impairment

The net realized gains and losses are included in noninterest income in the Consolidated Statements of Operations as net securities gains (losses). For the three months ended June 30, 2010 and 2009, gross realized gains on sales of securities amounted to $4 thousand and $2 thousand, respectively, while there were no gross realized losses during those periods. For the six months ended June 30, 2010 and 2009, gross realized gains on sales of securities amounted to $248 thousand and $517 thousand, respectively, while gross realized losses amounted to $240 thousand and $0, respectively. The gross gains during the six months ended June 30, 2010 are primarily attributed to the Company selling approximately $6.4 million in book value of mortgage-backed securities, resulting in pretax gains of approximately $241 thousand on the sales, one called structured agency security with a resulting gain of $3 thousand, and one called municipal security with a resulting gain of $4 thousand. These gains were partially offset by losses of $150 thousand on the sale of two mortgage-backed securities and losses of $90 thousand on the sale of five held to maturity tax-exempt municipal securities with a total book value of approximately $2.0 million. Although designated as held to maturity, these municipal securities were sold due to deterioration in the issuer's creditworthiness, as evidenced by downgrades in their credit ratings. The gross gains of $517 thousand for the same period in 2009 are attributed to the Company selling approximately $19.6 million in book value of mortgage-backed securities. There were no losses during the six months ended June 30, 2009.

Also included in noninterest income are other-than-temporary-impairment charges of $1.7 million for the six months ended June 30, 2009. During the second quarter of 2009, the Company recognized $1.7 million of credit related other-than-temporary impairment losses on two held to maturity securities due to the deterioration in the underlying collateral. In estimating the present value of the expected cash flows on the two collateralized debt obligations which were other-than-temporarily impaired as of June 30, 2009, the following assumptions were made:

- Moderate conditional repayment rates (“CRR”) were used due to the lack of new trust preferred issuances and the poor conditions of the financial industry. CRR of 2 percent were used for performing issuers and 0 percent for nonperformers.

- Conditional deferral rates (“CDR”) have been established based on the financial condition of the underlying trust preferred issuers in the pools. These ranged from 0.75 percent to 3.50 percent for performing issuers. Nonperforming issues were stated at 100 percent CDR.

- Expected loss severities of 95 percent were assumed (i.e. recoveries occur on only 5 percent of defaulted securities) for all performing issuers and ranged from 80.25 percent to 87.46 percent for nonperforming issues.

- Internal rates of return (“IRR”) are the pre-tax yield used to discount the future cash flow stream expected from the collateral cash flows. The IRR used was 17 percent.

These two pooled trust preferred securities which had a cost basis of $3.0 million, had been previously written down $306 thousand in December of 2008 and again by $862 thousand in December 2009. For the assumptions used in estimating the present value of the expected cash flows on these two securities as of December 31, 2008 and December 31, 2009, refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2009. After the above charges, the two issues of pooled trust preferred securities have a remaining book value of approximately $50 thousand as of June 30, 2010.

Gross realized gains (losses) on securities and other-than-temporary impairment charges for the three and six months ended June 30, 2010 and 2009 are detailed in the table below:

	For the three months ended June 30,		For the six months ended June 30,	
(In thousands)	2010	2009	2010	2009
Available for sale:				
Realized gains	$ -	$ 2	$ 244	$ 517
Realized losses	-	-	(150)	-
Total securities available for sale	$ -	$ 2	$ 94	$ 517
Held to maturity:				
Realized gains	$ 4	$ -	$ 4	$ -
Realized losses	-	-	(90)	-
Other than temporary impairment charges	-	(1,749)	-	(1,749)
Total securities held to maturity	$ 4	$ (1,749)	$ (86)	$ (1,749)
Net realized gains on sales of securities and other-than-temporary impairment charges	$ 4	$ (1,747)	$ 8	$ (1,232)

Pledged Securities

Securities with a carrying value of $65.1 million and $71.4 million at June 30, 2010 and December 31, 2009, respectively, were pledged to secure Government deposits, secure other borrowings and for other purposes required or permitted by law. Included in these figures was $3.0 million and $2.9 million pledged to secure Government deposits at June 30, 2010 and December 31, 2009, respectively, per the requirements of the New Jersey Department of Banking and Insurance.

Note 8. Allowance for Loan Losses and Unfunded Loan Commitments

The allowance for loan losses is based on estimates. Ultimate losses may vary from current estimates. These estimates are reviewed periodically and, as adjustments become known, they are reflected in operations in the periods in which they become known.

An analysis of the change in the allowance for loan losses for the three and six months ended June 30, 2010 and 2009:

	For the three months ended June 30,		For the six months ended June 30,	
(In thousands)	2010	2009	2010	2009
Balance, beginning of period	$ 14,055	$ 10,307	$ 13,842	$ 10,326
Provision charged to expense	1,500	1,500	3,000	3,000
Charge-offs	1,672	1,277	3,003	2,890
Recoveries	63	135	107	229
Net charge-offs	1,609	1,142	2,896	2,661
Balance, end of period	$ 13,946	$ 10,665	$ 13,946	$ 10,665

The Company maintains an allowance for unfunded loan commitments that is maintained at a level that management believes is adequate to absorb estimated probable losses. Adjustments to the allowance are made through other expense and applied to the allowance which is maintained in other liabilities. The commitment reserve was $65 thousand and $76 thousand at June 30, 2010 and December 31, 2009, respectively.

Note 9. New Accounting Pronouncements