

STEWARDSHIP FINANCIAL CORP  
Form 10-Q  
November 09, 2012

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF  
S 1934

For the quarterly period ended September 30, 2012

£TRANSITION REPORT PURSUANT TO 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 1-33377

Stewardship Financial Corporation

(Exact name of registrant as specified in its charter)

New Jersey 22-3351447  
(State or other jurisdiction of (I.R.S. Employer Identification No.)  
incorporation or organization)

630 Godwin Avenue, Midland Park, NJ 07432  
(Address of principal executive offices) (Zip Code)

(201) 444-7100

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(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by a checkmark 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  No

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

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 definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer   
Non-accelerated filer  (Do not check if a smaller reporting company) Smaller reporting company

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

The number of shares outstanding, net of treasury stock, of the Registrant's Common Stock, no par value, as of November 1, 2012 was 5,919,816.

**Stewardship Financial Corporation**

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Stewardship Financial Corporation and Subsidiary

Consolidated Statements of Financial Condition

(Unaudited)

|                                                                                                  | September<br>30,<br>2012 | December 31,<br>2011 |
|--------------------------------------------------------------------------------------------------|--------------------------|----------------------|
| Assets                                                                                           |                          |                      |
| Cash and due from banks                                                                          | \$16,754,000             | \$13,289,000         |
| Other interest-earning assets                                                                    | 633,000                  | 409,000              |
| Cash and cash equivalents                                                                        | 17,387,000               | 13,698,000           |
| Securities available for sale                                                                    | 173,999,000              | 170,925,000          |
| Securities held to maturity; estimated fair value of \$34,300,000 (2012) and \$40,984,000 (2011) | 31,890,000               | 38,354,000           |
| FHLB-NY stock, at cost                                                                           | 2,213,000                | 2,478,000            |
| Mortgage loans held for sale                                                                     | 938,000                  | 4,711,000            |
| Loans, net of allowance for loan losses of \$12,598,000 (2012) and \$11,604,000 (2011)           | 425,494,000              | 444,803,000          |
| Premises and equipment, net                                                                      | 5,759,000                | 6,101,000            |
| Accrued interest receivable                                                                      | 2,204,000                | 2,618,000            |
| Other real estate owned, net                                                                     | 2,985,000                | 5,288,000            |
| Bank owned life insurance                                                                        | 10,389,000               | 10,145,000           |
| Other assets                                                                                     | 10,554,000               | 9,697,000            |
| Total assets                                                                                     | \$683,812,000            | \$708,818,000        |
| Liabilities and shareholders' equity                                                             |                          |                      |
| Liabilities                                                                                      |                          |                      |
| Deposits:                                                                                        |                          |                      |
| Noninterest-bearing                                                                              | \$125,060,000            | \$115,776,000        |
| Interest-bearing                                                                                 | 458,366,000              | 477,776,000          |
| Total deposits                                                                                   | 583,426,000              | 593,552,000          |
| Federal Home Loan Bank of New York advances                                                      | 25,000,000               | 32,700,000           |
| Securities sold under agreements to repurchase                                                   | 7,342,000                | 14,342,000           |
| Subordinated debentures                                                                          | 7,217,000                | 7,217,000            |
| Accrued interest payable                                                                         | 547,000                  | 775,000              |
| Accrued expenses and other liabilities                                                           | 2,406,000                | 2,440,000            |

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|                                                                                                                                                                                     |               |               |
|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------|---------------|
| Total liabilities                                                                                                                                                                   | 625,938,000   | 651,026,000   |
| Commitments and contingencies                                                                                                                                                       | —             | —             |
| Shareholders' equity                                                                                                                                                                |               |               |
| Preferred stock, no par value; 2,500,000 shares authorized; 15,000 shares issued and outstanding at September 30, 2012 and December 31, 2011 liquidation preference of \$15,000,000 | 14,963,000    | 14,955,000    |
| Common stock, no par value; 10,000,000 shares authorized; 5,919,578 and 5,882,504 shares issued and outstanding at September 30, 2012 and December 31, 2011, respectively           | 40,585,000    | 40,420,000    |
| Retained earnings                                                                                                                                                                   | 824,000       | 1,043,000     |
| Accumulated other comprehensive income, net                                                                                                                                         | 1,502,000     | 1,374,000     |
| Total shareholders' equity                                                                                                                                                          | 57,874,000    | 57,792,000    |
| Total liabilities and shareholders' equity                                                                                                                                          | \$683,812,000 | \$708,818,000 |

See notes to unaudited consolidated financial statements.

## Stewardship Financial Corporation and Subsidiary

## Consolidated Statements of Income

(Unaudited)

|                                                      | Three Months Ended |             | Nine Months Ended |              |
|------------------------------------------------------|--------------------|-------------|-------------------|--------------|
|                                                      | September 30,      |             | September 30,     |              |
|                                                      | 2012               | 2011        | 2012              | 2011         |
| Interest income:                                     |                    |             |                   |              |
| Loans                                                | \$5,951,000        | \$6,723,000 | \$18,295,000      | \$19,829,000 |
| Securities held to maturity                          |                    |             |                   |              |
| Taxable                                              | 109,000            | 168,000     | 389,000           | 528,000      |
| Non-taxable                                          | 203,000            | 218,000     | 616,000           | 662,000      |
| Securities available for sale                        |                    |             |                   |              |
| Taxable                                              | 747,000            | 811,000     | 2,344,000         | 2,528,000    |
| Non-taxable                                          | 73,000             | 58,000      | 198,000           | 154,000      |
| FHLB dividends                                       | 26,000             | 28,000      | 83,000            | 96,000       |
| Other interest-earning assets                        | 11,000             | 12,000      | 28,000            | 29,000       |
| Total interest income                                | 7,120,000          | 8,018,000   | 21,953,000        | 23,826,000   |
| Interest expense:                                    |                    |             |                   |              |
| Deposits                                             | 802,000            | 1,205,000   | 2,679,000         | 3,774,000    |
| Borrowed money                                       | 457,000            | 527,000     | 1,402,000         | 1,596,000    |
| Total interest expense                               | 1,259,000          | 1,732,000   | 4,081,000         | 5,370,000    |
| Net interest income before provision for loan losses | 5,861,000          | 6,286,000   | 17,872,000        | 18,456,000   |
| Provision for loan losses                            | 2,000,000          | 2,330,000   | 6,665,000         | 5,920,000    |
| Net interest income after provision for loan losses  | 3,861,000          | 3,956,000   | 11,207,000        | 12,536,000   |
| Noninterest income:                                  |                    |             |                   |              |
| Fees and service charges                             | 496,000            | 501,000     | 1,542,000         | 1,550,000    |
| Bank owned life insurance                            | 83,000             | 83,000      | 244,000           | 244,000      |
| Gain on calls and sales of securities, net           | 891,000            | 454,000     | 1,336,000         | 475,000      |
| Gain on sales of mortgage loans                      | 162,000            | 245,000     | 727,000           | 835,000      |
| Miscellaneous                                        | 87,000             | 67,000      | 331,000           | 273,000      |
| Total noninterest income                             | 1,719,000          | 1,350,000   | 4,180,000         | 3,377,000    |
| Noninterest expenses:                                |                    |             |                   |              |
| Salaries and employee benefits                       | 2,394,000          | 2,380,000   | 7,037,000         | 6,877,000    |
| Occupancy, net                                       | 494,000            | 516,000     | 1,452,000         | 1,536,000    |
| Equipment                                            | 240,000            | 235,000     | 731,000           | 731,000      |
| Data processing                                      | 324,000            | 335,000     | 974,000           | 1,010,000    |
| Advertising                                          | 145,000            | 180,000     | 423,000           | 396,000      |
| FDIC insurance premium                               | 154,000            | 152,000     | 457,000           | 553,000      |

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|                                                              |           |           |            |             |
|--------------------------------------------------------------|-----------|-----------|------------|-------------|
| Loss on early extinguishment of debt                         | 691,000   | —         | 691,000    | —           |
| Miscellaneous                                                | 764,000   | 817,000   | 2,649,000  | 2,732,000   |
| Total noninterest expenses                                   | 5,206,000 | 4,615,000 | 14,414,000 | 13,835,000  |
| Income before income tax expense                             | 374,000   | 691,000   | 973,000    | 2,078,000   |
| Income tax expense                                           | 46,000    | 113,000   | 193,000    | 432,000     |
| Net income                                                   | 328,000   | 578,000   | 780,000    | 1,646,000   |
| Dividends on preferred stock and accretion                   | 112,000   | 244,000   | 225,000    | 520,000     |
| Net income available to common shareholders                  | \$216,000 | \$334,000 | \$555,000  | \$1,126,000 |
| Basic earnings per common share                              | \$0.04    | \$0.06    | \$0.09     | \$0.19      |
| Diluted earnings per common share                            | \$0.04    | \$0.06    | \$0.09     | \$0.19      |
| Weighted average number of common shares outstanding         | 5,916,123 | 5,866,575 | 5,903,598  | 5,855,663   |
| Weighted average number of diluted common shares outstanding | 5,916,123 | 5,866,575 | 5,903,598  | 5,855,663   |

See notes to unaudited consolidated financial statements.

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## Stewardship Financial Corporation and Subsidiary

## Consolidated Statement of Changes in Stockholders' Equity

(Unaudited)

## Nine Months Ended September 30, 2012

|                                                                                                                                | Preferred<br>Stock | Common Stock<br>Shares | Common Stock<br>Amount | Retained<br>Earnings | Treasury<br>Stock | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss), Net | Total         |
|--------------------------------------------------------------------------------------------------------------------------------|--------------------|------------------------|------------------------|----------------------|-------------------|----------------------------------------------------------------|---------------|
| Balance -- December 31, 2011                                                                                                   | \$ 14,955,000      | 5,882,504              | \$ 40,420,000          | \$ 1,043,000         | \$—               | \$ 1,374,000                                                   | \$ 57,792,000 |
| Cash dividends paid on common stock                                                                                            | —                  | —                      | —                      | (766,000 )           | —                 | —                                                              | (766,000 )    |
| Payment of discount on dividend<br>reinvestment plan                                                                           | —                  | —                      | (7,000 )               | —                    | —                 | —                                                              | (7,000 )      |
| Cash dividends accrued on preferred stock                                                                                      | —                  | —                      | —                      | (225,000 )           | —                 | —                                                              | (225,000 )    |
| Common stock issued under stock plans                                                                                          | —                  | 37,074                 | 172,000                | —                    | —                 | —                                                              | 172,000       |
| Amortization of issuance costs                                                                                                 | 8,000              | —                      | —                      | (8,000 )             | —                 | —                                                              | —             |
| Net income                                                                                                                     | —                  | —                      | —                      | 780,000              | —                 | —                                                              | 780,000       |
| Change in unrealized holding gains on<br>securities available for sale arising during<br>the period (net of taxes of \$67,000) | —                  | —                      | —                      | —                    | —                 | 119,000                                                        | 119,000       |
| Change in fair value of interest rate<br>swap (net of taxes of \$6,000)                                                        | —                  | —                      | —                      | —                    | —                 | 9,000                                                          | 9,000         |
| Balance -- September 30, 2012                                                                                                  | \$ 14,963,000      | 5,919,578              | \$ 40,585,000          | \$ 824,000           | \$—               | \$ 1,502,000                                                   | \$ 57,874,000 |

## Nine Months Ended September 30, 2011

|                                                      | Preferred<br>Stock | Common Stock<br>Shares | Common Stock<br>Amount | Retained<br>Earnings | Treasury<br>Stock | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss), Net | Total         |
|------------------------------------------------------|--------------------|------------------------|------------------------|----------------------|-------------------|----------------------------------------------------------------|---------------|
| Balance -- December 31, 2010                         | \$ 9,796,000       | 5,846,927              | \$ 40,516,000          | \$ 1,959,000         | \$(13,000)        | \$(126,000 )                                                   | \$ 41,126,000 |
| Proceeds from issuance of preferred stock            | 15,000,000         | —                      | —                      | —                    | —                 | —                                                              | 15,000,000    |
| Preferred stock issuance costs                       | (42,000 )          | —                      | —                      | —                    | —                 | —                                                              | (42,000 )     |
| Repurchase of preferred stock                        | (10,000,000)       | —                      | —                      | —                    | —                 | —                                                              | (10,000,000)  |
| Cash dividends paid on common stock                  | —                  | —                      | —                      | (878,000 )           | —                 | —                                                              | (878,000 )    |
| Payment of discount on dividend<br>reinvestment plan | —                  | —                      | (13,000 )              | —                    | —                 | —                                                              | (13,000 )     |



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|                                                                                                                             |               |           |              |              |        |              |
|-----------------------------------------------------------------------------------------------------------------------------|---------------|-----------|--------------|--------------|--------|--------------|
| Cash dividends accrued on preferred stock                                                                                   | —             | —         | —            | (347,000 )   | —      | —            |
| Common stock issued under dividend reinvestment plan                                                                        | —             | 10,169    | 47,000       | —            | —      | —            |
| Common stock issued under stock plans                                                                                       | —             | 15,080    | 68,000       | —            | 13,000 | —            |
| Stock option compensation expense                                                                                           | —             | —         | 19,000       | —            | —      | —            |
| Accretion of discount on preferred stock                                                                                    | 174,000       | —         | —            | (174,000 )   | —      | —            |
| Amortization of issuance costs                                                                                              | 30,000        | —         | —            | (30,000 )    | —      | —            |
| Net income                                                                                                                  | —             | —         | —            | 1,646,000    | —      | —            |
| Change in unrealized holding gains on securities available for sale arising during the period (net of taxes of \$1,498,000) | —             | —         | —            | —            | —      | 2,355,000    |
| Reclassification adjustment for gains in net income (net of taxes of \$188,000)                                             | —             | —         | —            | —            | —      | (288,000 )   |
| Change in fair value of interest rate swap (net of taxes of \$107,000)                                                      | —             | —         | —            | —            | —      | (160,000 )   |
| Balance -- September 30, 2011                                                                                               | \$ 14,958,000 | 5,872,176 | \$40,637,000 | \$ 2,176,000 | \$—    | \$ 1,781,000 |

See notes to unaudited consolidated financial statements.

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Stewardship Financial Corporation and Subsidiary  
 Consolidated Statements of Comprehensive Income  
 (Unaudited)

|                                                                                               | Three Months Ended |              | Nine Months Ended |              |
|-----------------------------------------------------------------------------------------------|--------------------|--------------|-------------------|--------------|
|                                                                                               | September 30,      |              | September 30,     |              |
|                                                                                               | 2012               | 2011         | 2012              | 2011         |
| Net income                                                                                    | \$ 328,000         | \$ 578,000   | \$ 780,000        | \$ 1,646,000 |
| Other comprehensive income:                                                                   |                    |              |                   |              |
| Change in unrealized holding gains on securities available for sale arising during the period | 794,000            | 1,741,000    | 1,522,000         | 3,852,000    |
| Reclassification adjustment for gains in net income                                           | (891,000)          | (454,000 )   | (1,336,000)       | (475,000 )   |
| Net unrealized (losses) gains                                                                 | (97,000 )          | 1,287,000    | 186,000           | 3,377,000    |
| Tax effect                                                                                    | 44,000             | (499,000 )   | (67,000 )         | (1,310,000)  |
| Net unrealized(losses) gains, net of tax amount                                               | (53,000 )          | 788,000      | 119,000           | 2,067,000    |
| Change in fair value of interest rate swap                                                    | (2,000 )           | (210,000 )   | 15,000            | (267,000 )   |
| Tax effect                                                                                    | 1,000              | 84,000       | (6,000 )          | 107,000      |
| Change in fair value of interest rate swap, net of tax amount                                 | (1,000 )           | (126,000 )   | 9,000             | (160,000 )   |
| Total other comprehensive (loss) income                                                       | (54,000 )          | 662,000      | 128,000           | 1,907,000    |
| Total comprehensive income                                                                    | \$ 274,000         | \$ 1,240,000 | \$ 908,000        | \$ 3,553,000 |

The following is a summary of the accumulated other comprehensive income balances, net of tax.

|                                                     | 09/30/12     | 12/31/11     |
|-----------------------------------------------------|--------------|--------------|
| Unrealized gain on securities available for sale    | \$ 2,029,000 | \$ 1,910,000 |
| Unrealized loss on fair value of interest rate swap | (527,000 )   | (536,000 )   |
| Accumulated other comprehensive income, net         | \$ 1,502,000 | \$ 1,374,000 |

See notes to unaudited consolidated financial statements.

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## Stewardship Financial Corporation and Subsidiary

## Consolidated Statements of Cash Flows

(Unaudited)

|                                                                                      | Nine Months Ended<br>September 30, |              |
|--------------------------------------------------------------------------------------|------------------------------------|--------------|
|                                                                                      | 2012                               | 2011         |
| Cash flows from operating activities:                                                |                                    |              |
| Net income                                                                           | \$ 780,000                         | \$ 1,646,000 |
| Adjustments to reconcile net income to<br>net cash provided by operating activities: |                                    |              |
| Depreciation and amortization of premises and equipment                              | 408,000                            | 449,000      |
| Amortization of premiums and accretion of discounts, net                             | 1,203,000                          | 977,000      |
| Accretion (amortization) of deferred loan fees                                       | 31,000                             | (31,000 )    |
| Provision for loan losses                                                            | 6,665,000                          | 5,920,000    |
| Originations of mortgage loans held for sale                                         | (49,899,000)                       | (55,354,000) |
| Proceeds from sale of mortgage loans                                                 | 54,399,000                         | 64,855,000   |
| Gain on sales of mortgage loans                                                      | (727,000 )                         | (835,000 )   |
| Gain on sales and calls of securities, net                                           | (1,336,000 )                       | (475,000 )   |
| Gain on sale of other real estate owned                                              | (432,000 )                         | —            |
| Loss on early extinguishment of debt                                                 | 691,000                            | —            |
| Deferred income tax benefit                                                          | (427,000 )                         | (1,676,000 ) |
| Decrease in accrued interest receivable                                              | 414,000                            | 146,000      |
| Decrease in accrued interest payable                                                 | (228,000 )                         | (232,000 )   |
| Earnings on bank owned life insurance                                                | (244,000 )                         | (244,000 )   |
| Stock option expense                                                                 | —                                  | 19,000       |
| (Increase) decrease in other assets                                                  | (435,000 )                         | 804,000      |
| Decrease in other liabilities                                                        | (24,000 )                          | (33,000 )    |
| Net cash provided by operating activities                                            | 10,839,000                         | 15,936,000   |
| Cash flows from investing activities:                                                |                                    |              |
| Purchase of securities available for sale                                            | (86,581,000)                       | (56,207,000) |
| Proceeds from maturities and principal repayments on securities available for sale   | 20,546,000                         | 14,362,000   |
| Proceeds from sales and calls on securities available for sale                       | 63,374,000                         | 21,423,000   |
| Proceeds from maturities and principal repayments on securities held to maturity     | 3,264,000                          | 3,950,000    |
| Proceeds from calls on securities held to maturity                                   | 3,105,000                          | 1,340,000    |
| Sale of FHLB-NY stock                                                                | 265,000                            | 6,000        |
| Net decrease (increase) in loans                                                     | 9,855,000                          | (10,858,000) |
| Proceeds from sale of other real estate owned                                        | 5,431,000                          | 366,000      |
| Additions to premises and equipment                                                  | (66,000 )                          | (223,000 )   |
| Net cash provided by (used in) investing activities                                  | 19,193,000                         | (25,841,000) |
| Cash flows from financing activities:                                                |                                    |              |

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|                                                                           |              |              |
|---------------------------------------------------------------------------|--------------|--------------|
| Net increase in noninterest-bearing deposits                              | 9,284,000    | 18,394,000   |
| Net decrease in interest-bearing deposits                                 | (19,410,000) | (6,133,000 ) |
| Net (decrease) increase in securities sold under agreements to repurchase | (7,691,000 ) | 549,000      |
| Net decrease in short term borrowings                                     | (4,700,000 ) | —            |
| Repayment of long term borrowings                                         | (3,000,000 ) | (18,000,000) |
| Proceeds from long term borrowings                                        | —            | 15,000,000   |
| Proceeds from issuance of preferred stock                                 | —            | 14,958,000   |
| Repurchase of preferred stock                                             | —            | (10,000,000) |
| Cash dividends paid on common stock                                       | (766,000 )   | (878,000 )   |
| Cash dividends paid on preferred stock                                    | (225,000 )   | (347,000 )   |
| Payment of discount on dividend reinvestment plan                         | (7,000 )     | (13,000 )    |
| Issuance of common stock                                                  | 172,000      | 128,000      |
| Net cash (used in) provided by financing activities                       | (26,343,000) | 13,658,000   |
| <br>                                                                      |              |              |
| Net increase in cash and cash equivalents                                 | 3,689,000    | 3,753,000    |
| Cash and cash equivalents - beginning                                     | 13,698,000   | 19,983,000   |
| Cash and cash equivalents - ending                                        | \$17,387,000 | \$23,736,000 |

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Stewardship Financial Corporation and Subsidiary

Consolidated Statements of Cash Flows (continued)

(Unaudited)

|                                                               | Nine Months Ended |             |
|---------------------------------------------------------------|-------------------|-------------|
|                                                               | September 30,     |             |
|                                                               | 2012              | 2011        |
| Supplemental disclosures of cash flow information:            |                   |             |
| Cash paid during the period for interest                      | \$4,309,000       | \$5,602,000 |
| Cash paid during the period for income taxes                  | \$1,299,000       | \$1,535,000 |
| Noncash investing activities - security purchases due brokers | \$—               | \$1,000,000 |
| Transfers from loans to other real estate owned               | \$2,758,000       | \$159,000   |

See notes to unaudited consolidated financial statements.

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**Stewardship Financial Corporation and Subsidiary**

**Notes to Consolidated Financial Statements**

**September 30, 2012**

**(Unaudited)**

**Note 1. Summary of Significant Accounting Policies**

Certain information and note disclosures normally included in the unaudited consolidated financial statements prepared in accordance with U.S. generally accepted accounting principles (“GAAP”) have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission (the “SEC”). These unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Stewardship Financial Corporation Annual Report on Form 10-K for the fiscal year ended December 31, 2011, filed with the SEC on March 30, 2012 (the “2011 Annual Report”).

**Principles of consolidation**

The consolidated financial statements include the accounts of Stewardship Financial Corporation and its wholly-owned subsidiary, Atlantic Stewardship Bank (the “Bank”), together referred to as “the Corporation”. The Bank includes its wholly-owned subsidiaries, Stewardship Investment Corporation, Stewardship Realty LLC, Atlantic Stewardship Insurance Company, LLC and several other subsidiaries formed to hold title to properties acquired through foreclosure or deed in lieu of foreclosure. The Bank’s subsidiaries have an insignificant impact on the Bank’s daily operations. All intercompany accounts and transactions have been eliminated in the consolidated financial statements. Certain prior period amounts have been reclassified to conform to the current presentation.

The consolidated financial statements of the Corporation have been prepared in conformity with GAAP. In preparing the financial statements, management is required to make estimates and assumptions, based on available information, that affect the amounts reported in the financial statements and disclosures provided. Actual results could differ significantly from those estimates. The allowance for loan losses and fair values of financial instruments are particularly subject to change.

**Material estimates**

Material estimates that are particularly susceptible to significant changes relate to the determination of the allowance for loan losses and fair value of financial instruments. Management believes that the allowance for loan losses is adequate. While management uses available information to recognize probable incurred losses on loans, future additions to the allowance for loan losses may be necessary based on changes in economic conditions in the market area.

### **Basis of presentation**

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 SEC and, therefore, do not include information or footnotes necessary for a complete presentation of consolidated financial condition, results of operations, and cash flows in conformity with GAAP. However, all adjustments, consisting only of normal recurring adjustments, which in the opinion of management are necessary for a fair presentation of the interim consolidated financial statements, have been included. The results of operations for the three and nine months ended September 30, 2012 are not necessarily indicative of the results which may be expected for the entire year.

### **Derivatives**

Derivative financial instruments are recognized as assets or liabilities at fair value. The Corporation's only derivative consists of an interest rate swap agreement, which is used as part of its asset liability management strategy to help manage interest rate risk related to its subordinated debentures issued in 2003 to Stewardship Statutory Trust I (the "Trust"), a statutory business trust (see Note 9 to the Notes to the Audited Consolidated Financial Statements of the Corporation contained in the 2011 Annual Report). The Corporation does not use derivatives for trading purposes.

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The Corporation designated the interest rate swap as a cash flow hedge, which is a hedge of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability. For a cash flow hedge, the change in the fair value on the derivative is reported in other comprehensive income and is reclassified into earnings in the same periods during which the hedged transaction affects earnings. Net cash settlements on this interest rate swap that qualify for hedge accounting are recorded in interest expense. Changes in fair value of derivatives that are not highly effective in hedging the changes in fair value or expected cash flows of the hedged item are recognized immediately in current earnings.

The Corporation formally documented the risk-management objective and the strategy for undertaking the hedge transaction at the inception of the hedging relationship. This documentation includes linking the fair value of the cash flow hedge to subordinated debt on the balance sheet. The Corporation formally assessed, both at the hedge's inception and on an ongoing basis, whether the derivative instrument used is highly effective in offsetting changes in cash flows of the subordinated debt.

When a cash flow hedge is discontinued but the hedged cash flows or forecasted transactions are still expected to occur, gains or losses that would be accumulated in other comprehensive income are amortized into earnings over the same periods in which the hedged transactions will affect earnings.

**Adoption of New Accounting Standards**

In June 2011, the Financial Accounting Standards Board (the "FASB") issued ASU 2011-04, "Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs." This ASU represents the converged guidance of the FASB and the International Accounting Standards Board (together, "the Boards") on fair value measurement. The collective efforts of the Boards and their staffs, reflected in ASU 2011-04, have resulted in common requirements for measuring fair value and for disclosing information about fair value measurements, including a consistent meaning of the term "fair value." The Boards have concluded the common requirements will result in greater comparability of fair value measurements presented and disclosed in financial statements prepared in accordance with GAAP and International Financial Reporting Standards. The amendments of this ASU are to be applied prospectively. The guidance is effective for interim and annual periods beginning after December 15, 2011. The adoption of this ASU did not have a significant impact on the Corporation's consolidated financial statements.

In June 2011, the FASB issued ASU 2011-05, "Comprehensive Income (Topic 220): Presentation of Comprehensive Income". This ASU provides that an entity that reports items of other comprehensive income has the option to present comprehensive income in either one or two consecutive financial statements. The guidance is effective for interim and annual periods beginning after December 15, 2011. The adoption of this ASU did not have a significant impact on the Corporation's consolidated financial statements.





Index**Note 2. Securities – Available for Sale and Held to Maturity**

The fair value of the available for sale securities and the related gross unrealized gains and losses recognized in accumulated other comprehensive income were as follows:

|                                                 | September 30, 2012 |             |                   | Fair Value    |
|-------------------------------------------------|--------------------|-------------|-------------------|---------------|
|                                                 | Amortized Cost     | Gross Gains | Unrealized Losses |               |
| U.S. Treasury                                   | \$4,009,000        | \$9,000     | \$—               | \$4,018,000   |
| U.S. government-sponsored agencies              | 29,678,000         | 61,000      | 45,000            | 29,694,000    |
| Obligations of state and political subdivisions | 13,966,000         | 493,000     | 14,000            | 14,445,000    |
| Mortgage-backed securities - residential        | 109,269,000        | 2,777,000   | 3,000             | 112,043,000   |
| Asset-backed securities (a)                     | 9,876,000          | 12,000      | 51,000            | 9,837,000     |
| Corporate debt                                  | 492,000            | 2,000       | —                 | 494,000       |
| Total debt securities                           | 167,290,000        | 3,354,000   | 113,000           | 170,531,000   |
| Other equity investments                        | 3,392,000          | 76,000      | —                 | 3,468,000     |
|                                                 | \$170,682,000      | \$3,430,000 | \$113,000         | \$173,999,000 |

|                                                 | December 31, 2011 |             |                   | Fair Value    |
|-------------------------------------------------|-------------------|-------------|-------------------|---------------|
|                                                 | Amortized Cost    | Gross Gains | Unrealized Losses |               |
| U.S. Treasury                                   | \$4,027,000       | \$23,000    | \$—               | \$4,050,000   |
| U.S. government-sponsored agencies              | 20,702,000        | 46,000      | 4,000             | 20,744,000    |
| Obligations of state and political subdivisions | 8,866,000         | 461,000     | 9,000             | 9,318,000     |
| Mortgage-backed securities - residential        | 130,912,000       | 2,583,000   | 28,000            | 133,467,000   |
| Total debt securities                           | 164,507,000       | 3,113,000   | 41,000            | 167,579,000   |
| Other equity investments                        | 3,287,000         | 59,000      | —                 | 3,346,000     |
|                                                 | \$167,794,000     | \$3,172,000 | \$41,000          | \$170,925,000 |

(a) Collateralized by student loans.

Cash proceeds realized from sales and calls of securities available for sale for the three and nine months ended September 30, 2012 were \$37,414,000 and \$63,374,000, respectively. Cash proceeds realized from sales and calls of securities available for sale for the three and nine months ended September 30, 2011 were \$15,866,000 and \$21,423,000, respectively. Gross gains realized on sales or calls during the three and nine months ended September 30, 2012 totaled \$898,000 and \$1,336,000, respectively. The tax provision related to these realized gains was \$354,000 and \$524,000, respectively. Gross losses realized on sales or calls during the three and nine months ended September 30, 2012 totaled \$7,000 and \$7,000, respectively. Gross gains realized on sales or calls during the three and

nine months ended September 30, 2011 totaled \$455,000 and \$476,000, respectively. The tax provision related to these realized gains was \$180,000 and \$188,000, respectively. Gross losses realized on sales or calls during the three and nine months ended September 30, 2011 totaled \$1,000 and \$1,000, respectively.

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The following is a summary of the held to maturity securities and related unrecognized gains and losses:

|                                                                                          | September 30, 2012 |                             |                        | Fair          |
|------------------------------------------------------------------------------------------|--------------------|-----------------------------|------------------------|---------------|
|                                                                                          | Amortized<br>Cost  | Gross Unrecognized<br>Gains | Unrecognized<br>Losses | Value         |
| U.S. government-sponsored agencies<br>Obligations of state and political<br>subdivisions | \$ 261,000         | \$ 47,000                   | \$ —                   | \$ 308,000    |
|                                                                                          | 23,105,000         | 1,563,000                   | —                      | 24,668,000    |
| Mortgage-backed securities - residential                                                 | 8,524,000          | 800,000                     | —                      | 9,324,000     |
|                                                                                          | \$ 31,890,000      | \$ 2,410,000                | \$ —                   | \$ 34,300,000 |

|                                                                                          | December 31, 2011 |                             |                        | Fair          |
|------------------------------------------------------------------------------------------|-------------------|-----------------------------|------------------------|---------------|
|                                                                                          | Amortized<br>Cost | Gross Unrecognized<br>Gains | Unrecognized<br>Losses | Value         |
| U.S. government-sponsored agencies<br>Obligations of state and political<br>subdivisions | \$ 2,770,000      | \$ 80,000                   | \$ —                   | \$ 2,850,000  |
|                                                                                          | 24,575,000        | 1,705,000                   | —                      | 26,280,000    |
| Mortgage-backed securities - residential                                                 | 11,009,000        | 845,000                     | —                      | 11,854,000    |
|                                                                                          | \$ 38,354,000     | \$ 2,630,000                | \$ —                   | \$ 40,984,000 |

There were no cash proceeds realized from calls of securities held to maturity for the three months ended September 30, 2012. Proceeds realized from calls of securities held to maturity for the nine months ended September 30, 2012 totaled \$3,105,000. Cash proceeds realized from calls of securities held to maturity for the three and nine months ended September 30, 2011 were \$340,000 and \$1,340,000, respectively. There were no gross gains realized from calls for the three months ended September 30, 2012. Gross gains realized on calls during the nine months ended September 30, 2012 totaled \$7,000. The tax provision related to these realized gains was \$3,000. There were no gross losses realized on calls during the three and nine months ended September 30, 2012. There were no gross gains and no gross losses realized from calls for the three and nine months ended September 30, 2011.

The following table presents the amortized cost and fair value of the investment securities portfolio by contractual maturity. As issuers may have the right to call or prepay obligations with or without call or prepayment premiums, the actual maturities may differ from contractual maturities. Securities not due at a single maturity date, such as mortgage-backed securities, are shown separately.

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|                                          | September 30, 2012 |               |
|------------------------------------------|--------------------|---------------|
|                                          | Amortized<br>Cost  | Fair<br>Value |
| Maturity                                 |                    |               |
| Available for sale                       |                    |               |
| Within one year                          | \$5,013,000        | \$5,030,000   |
| After one year, but within five years    | 4,976,000          | 5,013,000     |
| After five years, but within ten years   | 22,137,000         | 22,514,000    |
| After ten years                          | 16,019,000         | 16,094,000    |
| Mortgage-backed securities - residential | 109,269,000        | 112,043,000   |
| Asset-backed securities                  | 9,876,000          | 9,837,000     |
| Total                                    | \$167,290,000      | \$170,531,000 |
| Held to maturity                         |                    |               |
| Within one year                          | \$1,008,000        | \$1,026,000   |
| After one year, but within five years    | 14,768,000         | 15,702,000    |
| After five years, but within ten years   | 7,412,000          | 8,057,000     |
| After ten years                          | 178,000            | 191,000       |
| Mortgage-backed securities - residential | 8,524,000          | 9,324,000     |
| Total                                    | \$31,890,000       | \$34,300,000  |

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The following tables summarize the fair value and unrealized losses of those investment securities which reported an unrealized loss at September 30, 2012 and December 31, 2011, and if the unrealized loss was continuous for the twelve months prior to September 30, 2012 and December 31, 2011.

| Available for Sale<br>September 30, 2012           | Less than 12 Months |                      | 12 Months or Longer |                      | Total         |                      |
|----------------------------------------------------|---------------------|----------------------|---------------------|----------------------|---------------|----------------------|
|                                                    | Fair<br>Value       | Unrealized<br>Losses | Fair<br>Value       | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| U.S. Treasury                                      | \$—                 | \$—                  | \$ —                | \$ —                 | \$—           | \$—                  |
| U.S. government-<br>sponsored agencies             | 6,623,000           | (45,000 )            | —                   | —                    | 6,623,000     | (45,000 )            |
| Obligations of state and<br>political subdivisions | 3,855,000           | (14,000 )            | —                   | —                    | 3,855,000     | (14,000 )            |
| Mortgage-backed<br>securities - residential        | 1,401,000           | (3,000 )             | —                   | —                    | 1,401,000     | (3,000 )             |
| Asset-backed securities                            | 8,783,000           | (51,000 )            | —                   | —                    | 8,783,000     | (51,000 )            |
| Corporate debt                                     | —                   | —                    | —                   | —                    | —             | —                    |
| Other equity investments                           | —                   | —                    | —                   | —                    | —             | —                    |
| Total temporarily<br>impaired securities           | \$20,662,000        | \$(113,000 )         | \$ —                | \$ —                 | \$20,662,000  | \$(113,000 )         |
| <br>                                               |                     |                      |                     |                      |               |                      |
| December 31, 2011                                  | Less than 12 Months |                      | 12 Months or Longer |                      | Total         |                      |
|                                                    | Fair<br>Value       | Unrealized<br>Losses | Fair<br>Value       | Unrealized<br>Losses | Fair<br>Value | Unrealized<br>Losses |
| U.S. Treasury                                      | \$—                 | \$—                  | \$ —                | \$ —                 | \$—           | \$—                  |
| U.S. government-<br>sponsored agencies             | 1,993,000           | (4,000 )             | —                   | —                    | 1,993,000     | (4,000 )             |
| Obligations of state and<br>political subdivisions | 1,335,000           | (9,000 )             | —                   | —                    | 1,335,000     | (9,000 )             |
| Mortgage-backed<br>securities - residential        | 10,637,000          | (28,000 )            | —                   | —                    | 10,637,000    | (28,000 )            |
| Other equity investments                           | —                   | —                    | —                   | —                    | —             | —                    |
| Total temporarily<br>impaired securities           | \$13,965,000        | \$(41,000 )          | \$ —                | \$ —                 | \$13,965,000  | \$(41,000 )          |

There were no unrealized losses on held to maturity securities at either September 30, 2012 or December 31, 2011.

*Other-Than-Temporary-Impairment*

At September 30, 2012, there were no securities in a continuous loss position for 12 months or longer. The Corporation's unrealized losses are primarily due to market conditions. These securities have not been considered other than temporarily impaired as scheduled principal and interest payments have been made and management anticipates collecting the entire principal balance as scheduled. Because the decline in fair value is attributable to changes in market conditions, and not credit quality, and because the Corporation does not have the intent to sell these securities and it is likely that it will not be required to sell the securities before their anticipated recovery, the Corporation does not consider these securities to be other-than-temporarily impaired at September 30, 2012.

Index**Note 3. Loans and Nonperforming Loans**

The following table sets forth the composition of loans:

|                                      | September 30,<br>2012 | December 31,<br>2011 |
|--------------------------------------|-----------------------|----------------------|
| Commercial:                          |                       |                      |
| Secured by real estate               | \$56,329,000          | \$60,650,000         |
| Other                                | 32,670,000            | 41,850,000           |
| Commercial real estate               | 238,192,000           | 246,549,000          |
| Construction:                        |                       |                      |
| Commercial                           | 10,469,000            | 12,913,000           |
| Residential                          | —                     | 252,000              |
| Residential real estate              | 67,363,000            | 54,694,000           |
| Consumer:                            |                       |                      |
| Secured by real estate               | 32,258,000            | 38,278,000           |
| Other                                | 643,000               | 1,086,000            |
| Other                                | 75,000                | 141,000              |
| Total gross loans                    | 437,999,000           | 456,413,000          |
| Less: Deferred loan (fees) cost, net | (93,000 )             | 6,000                |
| Allowance for loan losses            | 12,598,000            | 11,604,000           |
|                                      | 12,505,000            | 11,610,000           |
| Loans, net                           | \$425,494,000         | \$444,803,000        |

Activity in the allowance for loan losses is summarized as follows for the periods indicated:

|                         | For the three months ended September 30, 2012 |                                       |                      |                                       | Balance,<br>end<br>of period |
|-------------------------|-----------------------------------------------|---------------------------------------|----------------------|---------------------------------------|------------------------------|
|                         | Balance,<br>beginning<br>of period            | Provision<br>charged<br>to operations | Loans<br>charged off | Recoveries<br>of loans<br>charged off |                              |
| Commercial              | \$6,023,000                                   | \$1,620,000                           | \$865,000            | \$167,000                             | \$6,945,000                  |
| Commercial real estate  | 4,527,000                                     | 542,000                               | 606,000              | —                                     | 4,463,000                    |
| Construction            | 514,000                                       | (137,000 )                            | 20,000               | 3,000                                 | 360,000                      |
| Residential real estate | 392,000                                       | 18,000                                | 15,000               | —                                     | 395,000                      |
| Consumer                | 437,000                                       | (28,000 )                             | 1,000                | 1,000                                 | 409,000                      |
| Other loans             | 4,000                                         | (2,000 )                              | 1,000                | 1,000                                 | 2,000                        |
| Unallocated             | 37,000                                        | (13,000 )                             | —                    | —                                     | 24,000                       |
| Total                   | \$11,934,000                                  | \$2,000,000                           | \$1,508,000          | \$172,000                             | \$12,598,000                 |



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## For the nine months ended September 30, 2012

|                         | Balance,<br>beginning<br>of period | Provision<br>charged<br>to operations | Loans<br>charged off | Recoveries<br>of loans<br>charged off | Balance,<br>end<br>of period |
|-------------------------|------------------------------------|---------------------------------------|----------------------|---------------------------------------|------------------------------|
| Commercial              | \$5,368,000                        | \$ 4,581,000                          | \$3,221,000          | \$ 217,000                            | \$6,945,000                  |
| Commercial real estate  | 4,943,000                          | 1,964,000                             | 2,445,000            | 1,000                                 | 4,463,000                    |
| Construction            | 480,000                            | 42,000                                | 165,000              | 3,000                                 | 360,000                      |
| Residential real estate | 303,000                            | 107,000                               | 15,000               | —                                     | 395,000                      |
| Consumer                | 498,000                            | (42,000 )                             | 48,000               | 1,000                                 | 409,000                      |
| Other loans             | 2,000                              | (1,000 )                              | 1,000                | 2,000                                 | 2,000                        |
| Unallocated             | 10,000                             | 14,000                                | —                    | —                                     | 24,000                       |
| Total                   | \$11,604,000                       | \$ 6,665,000                          | \$5,895,000          | \$ 224,000                            | \$12,598,000                 |

## For the three months ended September 30, 2011

|                         | Balance,<br>beginning<br>of period | Provision<br>charged<br>to operations | Loans<br>charged off | Recoveries<br>of loans<br>charged off | Balance,<br>end<br>of period |
|-------------------------|------------------------------------|---------------------------------------|----------------------|---------------------------------------|------------------------------|
| Commercial              | \$5,577,000                        | \$ 90,000                             | \$281,000            | \$ 4,000                              | \$5,390,000                  |
| Commercial real estate  | 4,197,000                          | 2,029,000                             | 747,000              | —                                     | 5,479,000                    |
| Construction            | 570,000                            | 55,000                                | 19,000               | 4,000                                 | 610,000                      |
| Residential real estate | 419,000                            | 12,000                                | 72,000               | —                                     | 359,000                      |
| Consumer                | 460,000                            | 136,000                               | 64,000               | 2,000                                 | 534,000                      |
| Other loans             | 5,000                              | (1,000 )                              | —                    | 2,000                                 | 6,000                        |
| Unallocated             | 2,000                              | 9,000                                 | —                    | —                                     | 11,000                       |
| Total                   | \$11,230,000                       | \$ 2,330,000                          | \$1,183,000          | \$ 12,000                             | \$12,389,000                 |

## For the nine months ended September 30, 2011

|                         | Balance,<br>beginning<br>of period | Provision<br>charged<br>to operations | Loans<br>charged off | Recoveries<br>of loans<br>charged off | Balance,<br>end<br>of period |
|-------------------------|------------------------------------|---------------------------------------|----------------------|---------------------------------------|------------------------------|
| Commercial              | \$3,745,000                        | \$ 2,291,000                          | \$669,000            | \$ 23,000                             | \$5,390,000                  |
| Commercial real estate  | 3,112,000                          | 3,506,000                             | 1,139,000            | —                                     | 5,479,000                    |
| Construction            | 930,000                            | (282,000 )                            | 42,000               | 4,000                                 | 610,000                      |
| Residential real estate | 184,000                            | 247,000                               | 72,000               | —                                     | 359,000                      |
| Consumer                | 510,000                            | 146,000                               | 124,000              | 2,000                                 | 534,000                      |
| Other loans             | 2,000                              | 8,000                                 | 8,000                | 4,000                                 | 6,000                        |
| Unallocated             | 7,000                              | 4,000                                 | —                    | —                                     | 11,000                       |
| Total                   | \$8,490,000                        | \$ 5,920,000                          | \$2,054,000          | \$ 33,000                             | \$12,389,000                 |

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The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on the impairment method as of September 30, 2012 and December 31, 2011.

|                                                 | September 30, 2012 |                           |              |                            |              |                |             | Total         |
|-------------------------------------------------|--------------------|---------------------------|--------------|----------------------------|--------------|----------------|-------------|---------------|
|                                                 | Commercial         | Commercial<br>Real Estate | Construction | Residential<br>Real Estate | Consumer     | Other<br>Loans | Unallocated |               |
| Allowance for loan losses:                      |                    |                           |              |                            |              |                |             |               |
| Ending allowance balance attributable to loans: |                    |                           |              |                            |              |                |             |               |
| Individually evaluated for impairment           | \$3,420,000        | \$54,000                  | \$87,000     | \$7,000                    | \$—          | \$—            | \$—         | \$3,568,000   |
| Collectively evaluated for impairment           | 3,525,000          | 4,409,000                 | 273,000      | 388,000                    | 409,000      | 2,000          | 24,000      | 9,030,000     |
| Total ending allowance balance                  | \$6,945,000        | \$4,463,000               | \$360,000    | \$395,000                  | \$409,000    | \$2,000        | \$24,000    | \$12,598,000  |
| Loans:                                          |                    |                           |              |                            |              |                |             |               |
| Loans individually evaluated for impairment     | \$12,447,000       | \$12,917,000              | \$5,723,000  | \$418,000                  | \$631,000    | \$—            | \$—         | \$32,136,000  |
| Loans collectively evaluated for impairment     | 76,552,000         | 225,275,000               | 4,746,000    | 66,945,000                 | 32,270,000   | 75,000         | —           | 405,863,000   |
| Total ending loan balance                       | \$88,999,000       | \$238,192,000             | \$10,469,000 | \$67,363,000               | \$32,901,000 | \$75,000       | \$—         | \$437,999,000 |

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|                                                 | December 31, 2011 |                           |              |                            |              |                |             | Total         |
|-------------------------------------------------|-------------------|---------------------------|--------------|----------------------------|--------------|----------------|-------------|---------------|
|                                                 | Commercial        | Commercial<br>Real Estate | Construction | Residential<br>Real Estate | Consumer     | Other<br>Loans | Unallocated |               |
| Allowance for loan losses:                      |                   |                           |              |                            |              |                |             |               |
| Ending allowance balance attributable to loans: |                   |                           |              |                            |              |                |             |               |
| Individually evaluated for impairment           | \$1,908,000       | \$947,000                 | \$266,000    | \$—                        | \$—          | \$—            | \$—         | \$3,121,000   |
| Collectively evaluated for impairment           | 3,460,000         | 3,996,000                 | 214,000      | 303,000                    | 498,000      | 2,000          | 10,000      | 8,483,000     |
| Total ending allowance balance                  | \$5,368,000       | \$4,943,000               | \$480,000    | \$303,000                  | \$498,000    | \$2,000        | \$10,000    | \$11,600,000  |
| Loans:                                          |                   |                           |              |                            |              |                |             |               |
| Loans individually evaluated for impairment     | \$10,265,000      | \$13,128,000              | \$8,653,000  | \$779,000                  | \$891,000    | \$—            | \$—         | \$33,716,000  |
| Loans collectively evaluated for impairment     | 92,235,000        | 233,421,000               | 4,512,000    | 53,915,000                 | 38,473,000   | 141,000        | —           | 422,697,000   |
| Total ending loan balance                       | \$102,500,000     | \$246,549,000             | \$13,165,000 | \$54,694,000               | \$39,364,000 | \$141,000      | \$—         | \$456,412,000 |

The following table presents the recorded investment in nonaccrual loans as of the dates indicated:

|                        | September 30,<br>2012 | December 31,<br>2011 |
|------------------------|-----------------------|----------------------|
| Commercial:            |                       |                      |
| Secured by real estate | \$ 6,169,000          | \$ 6,178,000         |
| Other                  | 3,435,000             | 2,494,000            |
| Commercial real estate | 10,354,000            | 9,302,000            |
| Construction:          |                       |                      |
| Commercial             | 3,953,000             | 7,840,000            |

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|                           |               |               |
|---------------------------|---------------|---------------|
| Residential               | —             | 252,000       |
| Residential real estate   | 418,000       | 779,000       |
| Consumer:                 |               |               |
| Secured by real estate    | 631,000       | 891,000       |
| Other                     | —             | —             |
| Other                     | —             | —             |
| Total nonperforming loans | \$ 24,960,000 | \$ 27,736,000 |

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The following presents loans individually evaluated for impairment by class of loans as of the periods indicated:

|                                     | At September 30, 2012          |                        |                                           |
|-------------------------------------|--------------------------------|------------------------|-------------------------------------------|
|                                     | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Allowance for<br>Loan Losses<br>Allocated |
| With no related allowance recorded: |                                |                        |                                           |
| Commercial:                         |                                |                        |                                           |
| Secured by real estate              | \$9,179,000                    | \$6,512,000            |                                           |
| Other                               | 531,000                        | 186,000                |                                           |
| Commercial real estate              | 14,343,000                     | 10,456,000             |                                           |
| Construction:                       |                                |                        |                                           |
| Commercial                          | 5,204,000                      | 4,709,000              |                                           |
| Residential                         | —                              | —                      |                                           |
| Residential real estate             | —                              | —                      |                                           |
| Consumer:                           |                                |                        |                                           |
| Secured by real estate              | 639,000                        | 631,000                |                                           |
| Other                               | —                              | —                      |                                           |
| Other                               | —                              | —                      |                                           |
| With an allowance recorded:         |                                |                        |                                           |
| Commercial:                         |                                |                        |                                           |
| Secured by real estate              | 1,577,000                      | 1,343,000              | \$ 311,000                                |
| Other                               | 4,439,000                      | 4,406,000              | 3,109,000                                 |
| Commercial real estate              | 2,861,000                      | 2,461,000              | 54,000                                    |
| Construction:                       |                                |                        |                                           |
| Commercial                          | 1,380,000                      | 1,014,000              | 87,000                                    |
| Residential                         | —                              | —                      | —                                         |
| Residential real estate             | 451,000                        | 418,000                | 7,000                                     |
| Consumer:                           |                                |                        |                                           |
| Secured by real estate              | —                              | —                      | —                                         |
| Other                               | —                              | —                      | —                                         |
| Other                               | —                              | —                      | —                                         |
|                                     | \$40,604,000                   | \$32,136,000           | \$ 3,568,000                              |

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|                                     | At December 31, 2011           |                        | Allowance for            |
|-------------------------------------|--------------------------------|------------------------|--------------------------|
|                                     | Unpaid<br>Principal<br>Balance | Recorded<br>Investment | Loan Losses<br>Allocated |
| With no related allowance recorded: |                                |                        |                          |
| Commercial:                         |                                |                        |                          |
| Secured by real estate              | \$3,306,000                    | \$2,831,000            |                          |
| Other                               | —                              | —                      |                          |
| Commercial real estate              | 10,691,000                     | 8,523,000              |                          |
| Construction:                       |                                |                        |                          |
| Commercial                          | 8,453,000                      | 7,609,000              |                          |
| Residential                         | —                              | —                      |                          |
| Residential real estate             | 866,000                        | 779,000                |                          |
| Consumer:                           |                                |                        |                          |
| Secured by real estate              | 911,000                        | 891,000                |                          |
| Other                               | —                              | —                      |                          |
| Other                               | —                              | —                      |                          |
| With an allowance recorded:         |                                |                        |                          |
| Commercial:                         |                                |                        |                          |
| Secured by real estate              | 7,287,000                      | 4,590,000              | \$ 468,000               |
| Other                               | 2,876,000                      | 2,844,000              | 1,440,000                |
| Commercial real estate              | 4,747,000                      | 4,605,000              | 947,000                  |
| Construction:                       |                                |                        |                          |
| Commercial                          | 1,085,000                      | 792,000                | 264,000                  |
| Residential                         | 273,000                        | 252,000                | 2,000                    |
| Residential real estate             | —                              | —                      | —                        |
| Consumer:                           |                                |                        |                          |
| Secured by real estate              | —                              | —                      | —                        |
| Other                               | —                              | —                      | —                        |
| Other                               | —                              | —                      | —                        |
|                                     | \$40,495,000                   | \$33,716,000           | \$ 3,121,000             |

|                        | For the three months ended<br>September 30, 2012 |                                  | For the nine months ended<br>September 30, 2012 |                                  |
|------------------------|--------------------------------------------------|----------------------------------|-------------------------------------------------|----------------------------------|
|                        | Average<br>Recorded<br>Investment                | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment               | Interest<br>Income<br>Recognized |
| Commercial:            |                                                  |                                  |                                                 |                                  |
| Secured by real estate | \$ 6,883,000                                     | \$ 37,000                        | \$ 6,810,000                                    | \$ 80,000                        |
| Other                  | 3,377,000                                        | 22,000                           | 3,795,000                                       | 33,000                           |
| Commercial real estate | 13,143,000                                       | 25,000                           | 13,437,000                                      | 151,000                          |
| Construction:          |                                                  |                                  |                                                 |                                  |
| Commercial             | 7,423,000                                        | 14,000                           | 6,434,000                                       | 32,000                           |

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|                           |               |           |               |            |
|---------------------------|---------------|-----------|---------------|------------|
| Residential               | 745,000       | —         | 1,239,000     | —          |
| Residential real estate   | 689,000       | —         | 598,000       | —          |
| Consumer:                 |               |           |               |            |
| Secured by real estate    | 910,000       | —         | 835,000       | —          |
| Other                     | —             | —         | —             | —          |
| Other                     | —             | —         | —             | —          |
| Total nonperforming loans | \$ 33,170,000 | \$ 98,000 | \$ 33,148,000 | \$ 296,000 |

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|                           | For the three months ended<br>September 30, 2011 |                                  | For the nine months ended<br>September 30, 2011 |                                  |
|---------------------------|--------------------------------------------------|----------------------------------|-------------------------------------------------|----------------------------------|
|                           | Average<br>Recorded<br>Investment                | Interest<br>Income<br>Recognized | Average<br>Recorded<br>Investment               | Interest<br>Income<br>Recognized |
| Commercial:               |                                                  |                                  |                                                 |                                  |
| Secured by real estate    | \$ 7,877,000                                     | \$ 26,000                        | \$ 6,954,000                                    | \$ 36,000                        |
| Other                     | 2,237,000                                        | 7,000                            | 2,062,000                                       | 19,000                           |
| Commercial real estate    | 14,890,000                                       | 46,000                           | 13,058,000                                      | 56,000                           |
| Construction:             |                                                  |                                  |                                                 |                                  |
| Commercial                | 2,607,000                                        | 9,000                            | 2,313,000                                       | 9,000                            |
| Residential               | 266,000                                          | —                                | 273,000                                         | —                                |
| Residential real estate   | 856,000                                          | —                                | 981,000                                         | —                                |
| Consumer:                 |                                                  |                                  |                                                 |                                  |
| Secured by real estate    | 831,000                                          | —                                | 830,000                                         | —                                |
| Other                     | —                                                | —                                | —                                               | —                                |
| Other                     | —                                                | —                                | —                                               | —                                |
| Total nonperforming loans | \$ 29,564,000                                    | \$ 88,000                        | \$ 26,471,000                                   | \$ 120,000                       |

The following table presents the aging of the recorded investment in past due loans by class of loans as of September 30, 2012 and December 31, 2011. Nonaccrual loans are included in the disclosure by payment status.

|                         | September 30, 2012     |                        |                                     | Total<br>Past Due | Loans<br>Not<br>Past Due | Total         |
|-------------------------|------------------------|------------------------|-------------------------------------|-------------------|--------------------------|---------------|
|                         | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | Greater than<br>90 Days<br>Past Due |                   |                          |               |
| Commercial:             |                        |                        |                                     |                   |                          |               |
| Secured by real estate  | \$989,000              | \$237,000              | \$2,976,000                         | \$4,202,000       | \$52,127,000             | \$56,329,000  |
| Other                   | 94,000                 | 3,317,000              | 327,000                             | 3,738,000         | 28,932,000               | 32,670,000    |
| Commercial real estate: | —                      | —                      | 9,872,000                           | 9,872,000         | 228,320,000              | 238,192,000   |
| Construction:           |                        |                        |                                     |                   |                          |               |
| Commercial              | —                      | —                      | 882,000                             | 882,000           | 9,587,000                | 10,469,000    |
| Residential             | —                      | —                      | —                                   | —                 | —                        | —             |
| Residential real estate | 140,000                | —                      | 418,000                             | 558,000           | 66,805,000               | 67,363,000    |
| Consumer:               |                        |                        |                                     |                   |                          |               |
| Secured by real estate  | —                      | 193,000                | 474,000                             | 667,000           | 31,591,000               | 32,258,000    |
| Other                   | —                      | —                      | —                                   | —                 | 643,000                  | 643,000       |
| Other                   | —                      | —                      | —                                   | —                 | 75,000                   | 75,000        |
| Total                   | \$1,223,000            | \$3,747,000            | \$14,949,000                        | \$19,919,000      | \$418,080,000            | \$437,999,000 |



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|                         | December 31, 2011      |                        |                                     |                   |                          |               |
|-------------------------|------------------------|------------------------|-------------------------------------|-------------------|--------------------------|---------------|
|                         | 30-59 Days<br>Past Due | 60-89 Days<br>Past Due | Greater than<br>90 Days<br>Past Due | Total<br>Past Due | Loans<br>Not<br>Past Due | Total         |
| Commercial:             |                        |                        |                                     |                   |                          |               |
| Secured by real estate  | \$875,000              | \$546,000              | \$3,977,000                         | \$5,398,000       | \$55,252,000             | \$60,650,000  |
| Other                   | 53,000                 | 260,000                | 1,752,000                           | 2,065,000         | 39,785,000               | 41,850,000    |
| Commercial real estate: | —                      | 736,000                | 5,352,000                           | 6,088,000         | 240,461,000              | 246,549,000   |
| Construction:           |                        |                        |                                     |                   |                          |               |
| Commercial              | —                      | 561,000                | 2,640,000                           | 3,201,000         | 9,712,000                | 12,913,000    |
| Residential             | —                      | —                      | 252,000                             | 252,000           | —                        | 252,000       |
| Residential real estate | —                      | —                      | 779,000                             | 779,000           | 53,915,000               | 54,694,000    |
| Consumer:               |                        |                        |                                     |                   |                          |               |
| Secured by real estate  | 581,000                | —                      | 719,000                             | 1,300,000         | 36,978,000               | 38,278,000    |
| Other                   | 4,000                  | —                      | —                                   | 4,000             | 1,082,000                | 1,086,000     |
| Other                   | —                      | —                      | —                                   | —                 | 141,000                  | 141,000       |
| Total                   | \$1,513,000            | \$2,103,000            | \$15,471,000                        | \$19,087,000      | \$437,326,000            | \$456,413,000 |

## Troubled Debt Restructurings

At September 30, 2012 and December 31, 2011, the Corporation had \$14.6 million and \$15.1 million, respectively, of loans whose terms have been modified in troubled debt restructurings. Of these loans, \$7.2 million and \$6.0 million were performing in accordance with their new terms at September 30, 2012 and December 31, 2011, respectively. The remaining troubled debt restructures are reported as nonaccrual loans. Specific reserves of \$3.3 million and \$1.2 million have been allocated for the troubled debt restructurings at September 30, 2012 and December 31, 2011, respectively. As of September 30, 2012 and December 31, 2011, the Corporation had committed \$377,000 and \$416,000, respectively, of additional funds to a single customer with an outstanding construction loan that is classified as a troubled debt restructuring.

During the nine months ended September 30, 2012, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans primarily represents an extension of the maturity date at terms more favorable than the current market term for new debt with similar risk. Many of the modifications represent the term out of previous lines of credit that were not renewed. Modifications involving an extension of the maturity date were for periods ranging from 3 to 5 years.

The following table presents loans by class modified as troubled debt restructurings that occurred during the three and nine months ended September 30, 2012:

For the three months ended

For the nine months ended

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|                                   | September 30, 2012 |                                      |                                       | September 30, 2012 |                                      |                                       |
|-----------------------------------|--------------------|--------------------------------------|---------------------------------------|--------------------|--------------------------------------|---------------------------------------|
|                                   | Number of Loans    | Pre-Modification Recorded Investment | Post-Modification Recorded Investment | Number of Loans    | Pre-Modification Recorded Investment | Post-Modification Recorded Investment |
| <b>Commercial:</b>                |                    |                                      |                                       |                    |                                      |                                       |
| Secured by real estate            | 6                  | \$ 1,581,000                         | \$ 1,581,000                          | 8                  | \$ 1,806,000                         | \$ 1,806,000                          |
| Other                             | 4                  | 660,000                              | 660,000                               | 5                  | 3,735,000                            | 3,735,000                             |
| Commercial real estate            | —                  | —                                    | —                                     | —                  | —                                    | —                                     |
| <b>Construction:</b>              |                    |                                      |                                       |                    |                                      |                                       |
| Commercial                        | 1                  | 300,000                              | 300,000                               | 1                  | 300,000                              | 300,000                               |
| Residential                       | —                  | —                                    | —                                     | —                  | —                                    | —                                     |
| Residential real estate           | —                  | —                                    | —                                     | —                  | —                                    | —                                     |
| Consumer                          | —                  | —                                    | —                                     | —                  | —                                    | —                                     |
| Secured by real estate            | —                  | —                                    | —                                     | —                  | —                                    | —                                     |
| Other                             | —                  | —                                    | —                                     | —                  | —                                    | —                                     |
| Other                             | —                  | —                                    | —                                     | —                  | —                                    | —                                     |
| Total trouble debt restructurings | 11                 | \$ 2,541,000                         | \$ 2,541,000                          | 14                 | \$ 5,841,000                         | \$ 5,841,000                          |

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For the nine months ended September 30, 2012, the troubled debt restructurings described above resulted in a \$2.1 million increase to the allowance for loan losses. Chargeoffs during the nine months ended September 30, 2012 related to these troubled debt restructurings totaled \$1.2 million..

A loan is considered to be in payment default once it is contractually 90 days past due under the modified terms. There are no troubled debt restructurings that have defaulted since modification in the last 12-month period.

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

**Credit Quality Indicators**

The Corporation categorizes certain loans into risk categories based on relevant information about the ability of the borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Corporation analyzes loans individually by classifying the loans as to credit risk. This analysis includes non-homogeneous loans, such as commercial, commercial real estate and commercial construction loans. This analysis is performed at the time the loan is originated and annually thereafter. The Corporation uses the following definitions for risk ratings.

**Special Mention** – A Special Mention asset has potential weaknesses that deserve management's close attention, which, if left uncorrected, may result in deterioration of the repayment prospects for the asset or the Bank's credit position at some future date. Special Mention assets are not adversely classified and do not expose the Bank to sufficient risk to warrant adverse classification.

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

**Doubtful** – A Doubtful loan with all weaknesses inherent in those classified as Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently know facts, conditions, and values, highly questionable or improbable. The likelihood of loss is extremely high, but because of certain important and reasonably specific factors, an estimated loss is deferred until a more exact status can be determined.

**Loss** – A loan classified Loss is considered uncollectible and of such little value that its continuance as an asset is not warranted. This classification does not necessarily mean that an asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off a basically worthless asset even though partial recovery may be effected in the future.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans. As of September 30, 2012 and December 31, 2011, and based on the most recent analysis performed at those times, the risk category of loans by class is as follows:

|                         | September 30, 2012 |                    |              |             |      |               |
|-------------------------|--------------------|--------------------|--------------|-------------|------|---------------|
|                         | Pass               | Special<br>Mention | Substandard  | Doubtful    | Loss | Total         |
| Commercial:             |                    |                    |              |             |      |               |
| Secured by real estate  | \$47,445,000       | \$3,898,000        | \$4,986,000  | \$—         | \$ — | \$56,329,000  |
| Other                   | 27,746,000         | 1,449,000          | 422,000      | 3,053,000   | —    | 32,670,000    |
| Commercial real estate: | 221,657,000        | 4,998,000          | 9,849,000    | 1,688,000   | —    | 238,192,000   |
| Construction:           |                    |                    |              |             |      |               |
| Commercial              | 4,746,000          | 1,810,000          | 3,913,000    | —           | —    | 10,469,000    |
| Residential             | —                  | —                  | —            | —           | —    | —             |
| Total                   | \$301,594,000      | \$12,155,000       | \$19,170,000 | \$4,741,000 | \$ — | \$337,660,000 |

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|                         | December 31, 2011 |                    |              |             |      |               |
|-------------------------|-------------------|--------------------|--------------|-------------|------|---------------|
|                         | Pass              | Special<br>Mention | Substandard  | Doubtful    | Loss | Total         |
| Commercial:             |                   |                    |              |             |      |               |
| Secured by real estate  | \$52,004,000      | \$3,234,000        | \$5,248,000  | \$164,000   | \$ — | \$60,650,000  |
| Other                   | 38,790,000        | 566,000            | 617,000      | 1,877,000   | —    | 41,850,000    |
| Commercial real estate: | 233,295,000       | 3,512,000          | 7,333,000    | 2,409,000   | —    | 246,549,000   |
| Construction:           |                   |                    |              |             |      |               |
| Commercial              | 4,512,000         | 1,656,000          | 6,745,000    | —           | —    | 12,913,000    |
| Residential             | —                 | —                  | 252,000      | —           | —    | 252,000       |
| Total                   | \$328,601,000     | \$8,968,000        | \$20,195,000 | \$4,450,000 | \$ — | \$362,214,000 |

The Corporation considers the performance of the loan portfolio and its impact on the allowance for loans losses. For residential real estate and consumer loan segments, the Corporation evaluates credit quality based on payment activity. The following table presents the recorded investment in residential real estate and consumer loans based on payment activity as of September 30, 2012 and December 31, 2011.

|                         | September 30, 2012 |                            |               |
|-------------------------|--------------------|----------------------------|---------------|
|                         | Current            | Past Due and<br>Nonaccrual | Total         |
| Residential real estate | \$66,805,000       | \$ 558,000                 | \$67,363,000  |
| Consumer:               |                    |                            |               |
| Secured by real estate  | 31,591,000         | 667,000                    | 32,258,000    |
| Other                   | 643,000            | —                          | 643,000       |
| Total                   | \$99,039,000       | \$ 1,225,000               | \$100,264,000 |

|                         | December 31, 2011 |                            |              |
|-------------------------|-------------------|----------------------------|--------------|
|                         | Current           | Past Due and<br>Nonaccrual | Total        |
| Residential real estate | \$53,915,000      | \$ 779,000                 | \$54,694,000 |
| Consumer:               |                   |                            |              |
| Secured by real estate  | 36,978,000        | 1,300,000                  | 38,278,000   |
| Other                   | 1,082,000         | 4,000                      | 1,086,000    |
| Total                   | \$91,975,000      | \$ 2,083,000               | \$94,058,000 |

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**Note 4. Borrowings**

On September 21, 2012 the Corporation refinanced borrowings with the FHLB in the amount of \$5 million. The FHLB amount that was repaid had a rate of 1.72% and a remaining average life of 1.9 years. The new borrowing has a stated rate of 1.16% and an average life of 5.0 years. In connection with the repayment, the Corporation incurred a prepayment premium of \$135,000 which is being amortized into earnings over the life of the new borrowings resulting in an effective interest rate for the borrowings of 1.70%.

On September 25, 2012 the Corporation repaid \$7 million of a \$14 million wholesale repurchase agreement which has a maturity in 2014. The borrowing had a current floating rate at 9.00% minus 3-month LIBOR measured on a quarterly basis with a 5.15% cap and a 0.00% floor. In connection with the repayment, the Corporation incurred a prepayment premium of \$691,000 which is included in noninterest expenses in the Consolidated Statement of Income for the three and nine months ended September 30, 2012.

**Note 5. Fair Value of Financial Instruments**

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The fair values of investment securities are determined by quoted market prices, if available (Level 1). For securities where quoted prices are not available, fair values are determined by matrix pricing, which is a mathematical technique

widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs).

The interest rate swaps are reported at fair values obtained from brokers who utilize internal models with observable market data inputs to estimate the values of these instruments (Level 2 inputs).

The Corporation measures impairment of collateralized loans based on the estimated fair value of the collateral less estimated costs to sell the collateral, incorporating assumptions that experienced parties might use in estimating the value of such collateral (Level 3 inputs). At the time a loan is considered impaired, it is valued at the lower of cost or fair value. Generally, impaired loans carried at fair value have been partially charged off or receive specific allocations of the allowance for loan losses. For collateral dependent loans, fair value is commonly based on real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments typically result in a Level 3 classification of the inputs for determining fair value. Non-real estate collateral may be valued using an appraisal, the net book value recorded for the collateral on the borrower's financial statements, or aging reports. Collateral is then adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the borrower and borrower's business, resulting in a Level 3 fair value classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

Appraisals are generally obtained to support the fair value of collateral. Appraisals for both collateral-dependent impaired loans and other real estate owned are performed by licensed appraisers whose qualifications and licenses have been reviewed and verified by the Corporation. Once received, the Lending Department reviews the assumptions and approaches utilized in the appraisal as well as the resulting fair value in comparison with independent data sources such as recent market data or industry-wide statistics.

Real estate appraisals typically incorporate measures such as recent sales prices for comparable properties. In addition, appraisers may make adjustments to the sales price of the comparable properties as deemed appropriate based on the age, condition or general characteristics of the subject property. Management generally applies a 12% discount to real estate appraised values to cover disposition / selling costs and to reflect the potential price reductions in the market necessary to complete an expedient transaction and to factor in impact of the perception that a transaction being completed by a bank may result in further price reduction pressure.

IndexAssets and Liabilities Measured on a Recurring Basis

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

|                                                    | Carrying<br>Value<br>At September 30, 2012 | Fair Value Measurements Using:                                                   |                                                           |                                                    |
|----------------------------------------------------|--------------------------------------------|----------------------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------|
|                                                    |                                            | Quoted<br>Prices in<br>Active<br>Markets<br>for Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| Assets:                                            |                                            |                                                                                  |                                                           |                                                    |
| Available for sale securities                      |                                            |                                                                                  |                                                           |                                                    |
| U.S. Treasuries                                    | \$4,018,000                                | \$4,018,000                                                                      | \$—                                                       | \$ —                                               |
| U.S. government -<br>sponsored agencies            | 29,694,000                                 | —                                                                                | 29,694,000                                                | —                                                  |
| Obligations of state and<br>political subdivisions | 14,445,000                                 | —                                                                                | 14,445,000                                                | —                                                  |
| Mortgage-backed<br>securities - residential        | 112,043,000                                | —                                                                                | 112,043,000                                               | —                                                  |
| Asset-backed securities                            | 9,837,000                                  |                                                                                  | 9,837,000                                                 |                                                    |
| Corporate debt                                     | 494,000                                    |                                                                                  | 494,000                                                   |                                                    |
| Other equity investments                           | 3,468,000                                  | 3,408,000                                                                        | 60,000                                                    | —                                                  |
| Total available for<br>sale securities             | \$173,999,000                              | \$7,426,000                                                                      | \$166,573,000                                             | \$ —                                               |
| Liabilities:                                       |                                            |                                                                                  |                                                           |                                                    |
| Interest rate swap                                 | \$878,000                                  | \$—                                                                              | \$878,000                                                 | \$ —                                               |
| At December 31, 2011                               |                                            |                                                                                  |                                                           |                                                    |
| Assets:                                            |                                            |                                                                                  |                                                           |                                                    |
| Available for sale securities                      |                                            |                                                                                  |                                                           |                                                    |
| U.S. Treasuries                                    | \$4,050,000                                | \$4,050,000                                                                      | \$—                                                       | \$—                                                |
| U.S. government -<br>sponsored agencies            | 20,744,000                                 | —                                                                                | 20,744,000                                                | —                                                  |
| Obligations of state and<br>political subdivisions | 9,318,000                                  | —                                                                                | 9,318,000                                                 | —                                                  |
| Mortgage-backed<br>securities - residential        | 133,467,000                                | —                                                                                | 133,467,000                                               | —                                                  |
| Other equity investments                           | 3,346,000                                  | 3,286,000                                                                        | 60,000                                                    | —                                                  |



|                                        |                |              |                |     |
|----------------------------------------|----------------|--------------|----------------|-----|
| Total available for<br>sale securities | \$ 170,925,000 | \$ 7,336,000 | \$ 163,589,000 | \$— |
|----------------------------------------|----------------|--------------|----------------|-----|

Liabilities:

|                    |            |     |            |     |
|--------------------|------------|-----|------------|-----|
| Interest rate swap | \$ 893,000 | \$— | \$ 893,000 | \$— |
|--------------------|------------|-----|------------|-----|

There were no transfers between Level 1 and Level 2 during the three and nine months ended September 30, 2012 or 2011.

IndexAssets and Liabilities Measured on a Non-Recurring Basis

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

|                         | Carrying<br>Value | Fair Value Measurements Using:                                                            |                                                           |                                                    |
|-------------------------|-------------------|-------------------------------------------------------------------------------------------|-----------------------------------------------------------|----------------------------------------------------|
|                         |                   | Quoted<br>Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets<br>(Level<br>1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
| At September 30, 2012   |                   |                                                                                           |                                                           |                                                    |
| Assets:                 |                   |                                                                                           |                                                           |                                                    |
| Impaired loans          |                   |                                                                                           |                                                           |                                                    |
| Commercial:             |                   |                                                                                           |                                                           |                                                    |
| Secured by real estate  | \$ 306,000        | \$ —                                                                                      | \$ —                                                      | \$ 306,000                                         |
| Other                   | —                 | —                                                                                         | —                                                         | —                                                  |
| Commercial real estate  | 2,061,000         | —                                                                                         | —                                                         | 2,061,000                                          |
| Construction:           |                   |                                                                                           |                                                           |                                                    |
| Commercial              | 927,000           | —                                                                                         | —                                                         | 927,000                                            |
| Residential             | —                 | —                                                                                         | —                                                         | —                                                  |
| Residential real estate | 411,000           | —                                                                                         | —                                                         | 411,000                                            |
| Consumer                |                   |                                                                                           |                                                           |                                                    |
| Secured by real estate  | —                 | —                                                                                         | —                                                         | —                                                  |
| Other real estate owned | 2,985,000         | —                                                                                         | —                                                         | 2,985,000                                          |
|                         | \$6,690,000       | \$ —                                                                                      | \$ —                                                      | \$ 6,690,000                                       |

At December 31, 2011

|                        |             |     |     |             |
|------------------------|-------------|-----|-----|-------------|
| Assets:                |             |     |     |             |
| Impaired loans         |             |     |     |             |
| Commercial:            |             |     |     |             |
| Secured by real estate | \$2,945,000 | \$— | \$— | \$2,945,000 |
| Other                  | —           | —   | —   | —           |
| Commercial real estate | 2,417,000   | —   | —   | 2,417,000   |
| Construction:          |             |     |     |             |
| Commercial             | 4,569,000   | —   | —   | 4,569,000   |
| Residential            | 250,000     | —   | —   | 250,000     |

|                         |              |     |     |              |
|-------------------------|--------------|-----|-----|--------------|
| Residential real estate | 779,000      | —   | —   | 779,000      |
| Consumer                |              |     |     |              |
| Secured by real estate  | 40,000       | —   | —   | 40,000       |
| Other real estate owned | 2,912,000    | —   | —   | 2,912,000    |
|                         | \$13,912,000 | \$— | \$— | \$13,912,000 |

Collateral dependent impaired loans measured for impairment using the fair value of the collateral for collateral dependent loans, had a recorded investment of \$4,082,000, with a valuation allowance of \$377,000, resulting in an additional provision for loan losses of \$657,000 and \$1,539,000 for the three and nine months ended September 30, 2012.

Collateral dependent impaired loans had a recorded investment of \$11,612,000, with a valuation allowance of \$612,000, resulting in an additional provision for loan losses of \$4,915,000 for the year ended December 31, 2011.

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For the Level 3 assets measured at fair value on a non-recurring basis at September 30, 2012, the significant unobservable inputs used in the fair value measurements were as follows:

| Assets                  | Fair Value  | Valuation Technique                                        | Unobservable Inputs                                                                                         | Range          |
|-------------------------|-------------|------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------|----------------|
| Impaired loans          | \$3,705,000 | Comparable real estate sales and / or the income approach. | Adjustments for differences between comparable sales and income data available.<br>Estimated selling costs. | 5% - 10%<br>7% |
| Other real estate owned | \$2,985,000 | Comparable real estate sales and / or the income approach. | Adjustments for differences between comparable sales and income data available.<br>Estimated selling costs. | 5% - 12%<br>7% |

Fair value estimates for the Corporation's financial instruments are summarized below:

|                                                | Carrying Value | Fair Value Measurements Using:                                 |                                               |                                           |
|------------------------------------------------|----------------|----------------------------------------------------------------|-----------------------------------------------|-------------------------------------------|
|                                                |                | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Financial assets:                              |                |                                                                |                                               |                                           |
| Cash and cash equivalents                      | \$17,387,000   | \$17,387,000                                                   | \$—                                           | \$—                                       |
| Securities available for sale                  | 173,999,000    | 7,426,000                                                      | 166,573,000                                   | —                                         |
| Securities held to maturity                    | 31,890,000     | —                                                              | 34,300,000                                    | —                                         |
| FHLB-NY stock                                  | 2,213,000      | N/A                                                            | N/A                                           | N/A                                       |
| Mortgage loans held for sale                   | 938,000        | —                                                              | 938,000                                       | —                                         |
| Loans, net                                     | 425,494,000    | —                                                              | —                                             | 441,783,000                               |
| Accrued interest receivable                    | 2,204,000      | 15,000                                                         | 685,000                                       | 1,504,000                                 |
| Financial liabilities:                         |                |                                                                |                                               |                                           |
| Deposits                                       | 583,426,000    | 424,050,000                                                    | 161,208,000                                   | —                                         |
| FHLB-NY Advances                               | 25,000,000     | —                                                              | 25,903,000                                    | —                                         |
| Securities sold under agreements to repurchase | 7,342,000      | —                                                              | 7,979,000                                     | —                                         |
| Subordinated debenture                         | 7,217,000      | —                                                              | —                                             | 7,257,000                                 |
| Accrued interest payable                       | 547,000        | 1,000                                                          | 528,000                                       | 18,000                                    |

|                    |         |   |         |   |
|--------------------|---------|---|---------|---|
| Interest rate swap | 878,000 | — | 878,000 | — |
|--------------------|---------|---|---------|---|

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|                                                   | December 31, 2011      |                         |
|---------------------------------------------------|------------------------|-------------------------|
|                                                   | Carrying<br>Amount     | Estimated<br>Fair Value |
|                                                   | (Dollars in thousands) |                         |
| Financial assets:                                 |                        |                         |
| Cash and cash equivalents                         | \$ 13,698,000          | \$ 13,698,000           |
| Securities available for sale                     | 170,925,000            | 170,925,000             |
| Securities held to maturity                       | 38,354,000             | 40,984,000              |
| FHLB-NY stock                                     | 2,478,000              | N/A                     |
| Mortgage loans held for sale                      | 4,711,000              | 4,711,000               |
| Loans, net                                        | 444,803,000            | 453,604,000             |
| Accrued interest receivable                       | 2,618,000              | 2,618,000               |
| Financial liabilities:                            |                        |                         |
| Deposits                                          | 593,552,000            | 595,939,000             |
| FHLB-NY Advances                                  | 32,700,000             | 33,482,000              |
| Securities sold under agreements<br>to repurchase | 14,342,000             | 14,786,000              |
| Subordinated debenture                            | 7,217,000              | 6,297,000               |
| Accrued interest payable                          | 775,000                | 775,000                 |
| Interest rate swap                                | 893,000                | 893,000                 |

The following methods and assumptions were used to estimate the fair value of each class of financial instruments:

**Cash and cash equivalents** – The carrying amount approximates fair value and are classified as Level 1.

**Securities available for sale and held to maturity** – The methods for determining fair values were described previously.

**FHLB-NY stock** – It is not practicable to determine the fair value of stock of the Federal Home Loan Bank of New York (“FHLB-NY”) due to restrictions placed on the transferability of the stock.

**Mortgage loans held for sale** – Loans in this category have been committed for sale to third party investors at the current carrying amount resulting in a Level 2 classification.

**Loans, net** – Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as residential and commercial mortgages, commercial and other installment loans. The fair value of loans is estimated by discounting cash flows using estimated marked discount rates which reflect the credit and interest rate risk inherent in the loans resulting in a Level 3 classification.

**Accrued interest receivable** – The carrying amount approximates fair value.

**Deposits** – The fair value of deposits, with no stated maturity, such as noninterest-bearing demand deposits, savings, NOW and money market accounts, is equal to the amount payable on demand resulting in a Level 1 classification. The fair value of the certificates of deposit is based on the discounted value of cash flows resulting in a Level 2 classification. The discount rate is estimated using marked discount rates which reflect interest rate risk inherent in the

certificates of deposit.

**FHLB-NY advances** – With respect to the FHLB-NY borrowings, the carrying amount of the borrowings which mature in one day approximates fair value. For borrowings with a longer maturity, the fair value is based on the discounted value of cash flows. The discount rate is estimated using market discount rates which reflect the interest rate risk inherent in the term borrowings resulting in a Level 2 classification.

**Securities sold under agreements to repurchase** – The carrying value approximates fair value due to the relatively short time before maturity resulting in a Level 2 classification.

**Subordinated debenture** – The fair value of the subordinated debenture is based on the discounted value of cash flows. The discount rate is estimated using market rates which reflect the interest rate risk inherent in the debenture resulting in a Level 3 classification.

**Accrued interest payable** – The carrying amount approximates fair value.

**Interest rate swap** – The methods for determining fair values were described previously.

**Commitments to extend credit** – The fair value of commitments is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present credit worthiness of the counter parties, and at September 30, 2012 and December 31, 2011 the fair value of such commitments were not material.

## Limitations

The preceding fair value estimates were made at September 30, 2012 and December 31, 2011 based on pertinent market data and relevant information on the financial instruments. These estimates do not include any premiums or discounts that could result from an offer to sell at one time the Corporation's entire holdings of a particular financial instrument or category thereof. Since no market exists for a substantial portion of the Corporation's financial instruments, fair value estimates were necessarily based on judgments with respect to future expected loss experience, current economic conditions, risk assessments of various financial instruments, and other factors. Given the subjective nature of these estimates, the uncertainties surrounding them and the matters of significant judgment that must be applied, these fair value estimates cannot be calculated with precision. Modifications in such assumptions could meaningfully alter these estimates.

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Since these fair value approximations were made solely for on and off balance sheet financial instruments at September 30, 2012 and December 31, 2011, no attempt was made to estimate the value of anticipated future business. Furthermore, certain tax implications related to the realization of unrealized gains and losses could have a substantial impact on these fair value estimates and have not been incorporated into the estimates.

**Note 6. Earnings Per Share**

Basic earnings per share is calculated by dividing net income available to common shareholders by the average daily number of common shares outstanding during the period. Common stock equivalents are not included in the calculation. Diluted earnings per share is computed similar to that of basic earnings per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if all potential dilutive common shares were issued.

The following reconciles the income available to common shareholders (numerator) and the weighted average common stock outstanding (denominator) for both basic and diluted earnings per share.

|                                             | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |             |
|---------------------------------------------|-------------------------------------|-----------|------------------------------------|-------------|
|                                             | 2012                                | 2011      | 2012                               | 2011        |
| Net income                                  | \$328,000                           | \$578,000 | \$780,000                          | \$1,646,000 |
| Dividends on preferred stock and accretion  | 112,000                             | 244,000   | 225,000                            | 520,000     |
| Net income available to common stockholders | \$216,000                           | \$334,000 | \$555,000                          | \$1,126,000 |
| Weighted average shares                     | 5,916,123                           | 5,866,575 | 5,903,598                          | 5,855,663   |
| Effect of dilutive stock options            | N/A                                 | N/A       | N/A                                | N/A         |
| Total weighted average dilutive shares      | 5,916,123                           | 5,866,575 | 5,903,598                          | 5,855,663   |
| Basic earnings per common share             | \$0.04                              | \$0.06    | \$0.09                             | \$0.19      |
| Diluted earnings per common share           | \$0.04                              | \$0.06    | \$0.09                             | \$0.19      |

For the three and nine months ended September 30, 2012, stock options to purchase 6,983 and 42,321 average shares of common stock, respectively, were not considered in computing diluted earnings per share of common stock because they were antidilutive. Stock options to purchase 64,728 shares of common stock were not considered in computing diluted earnings per share for the three and nine months ended September 30, 2011 because they were antidilutive. The U.S. Treasury's warrant to purchase 133,475 average shares of common stock was not considered in computing diluted earnings per common share in both the three and nine months ended September 30, 2011 because it



was antidilutive.

#### **Note 7. Preferred Stock**

In connection with the Corporation's participation in the U.S. Department of the Treasury's Small Business Lending Fund program ("SBLF"), a \$30 billion fund established under the Small Business Jobs Act of 2010 that encourages lending to small businesses by providing capital to qualified community banks with assets of less than \$10 billion, on September 1, 2011, the Corporation issued 15,000 shares of Senior Non-Cumulative Perpetual Preferred Stock, Series B (the "Series B Preferred Shares") to the Treasury for an aggregate purchase price of \$15 million, in cash.

Using the proceeds of the issuance of the Series B Preferred Shares, the Corporation simultaneously repurchased all 10,000 shares of its Fixed Rate Cumulative Perpetual Preferred Stock, Series A, having a liquidation preference of \$1,000 per share (the "Series A Preferred Shares") previously issued under the Treasury's Troubled Assets Relief Program Capital Purchase Program (the "CPP") for an aggregate purchase price of \$10,022,222, in cash, including accrued but unpaid dividends through the date of repurchase.

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The terms of the newly-established Series B Preferred Shares provide for a liquidation preference of \$1,000 per share and impose restrictions on the Corporation's ability to declare or pay dividends or purchase, redeem or otherwise acquire for consideration, shares of the Corporation's Common Stock and any class or series of stock of the Corporation the terms of which do not expressly provide that such class or series will rank senior or junior to the Series B Preferred Shares as to dividend rights and/or rights on liquidation, dissolution or winding up of the Corporation. Specifically, the terms provide for the payment of a non-cumulative quarterly dividend, payable in arrears, which the Corporation accrues as earned over the period that the Series B Preferred Shares are outstanding. The dividend rate can fluctuate on a quarterly basis during the first ten quarters during which the Series B Preferred Shares are outstanding, based upon changes in the level of Qualified Small Business Lending ("QSBL" as defined in the Securities Purchase Agreement) from 1% to 5% per annum and, thereafter, for the eleventh through the first half of the nineteenth dividend periods, from 1% to 7%. In general, the dividend rate decreases as the level of the Bank's QSBL increases. In the event that the Series B Preferred Shares remain outstanding for more than four and one half years, the dividend rate will be fixed at 9%. Based upon the Bank's level of QSBL over a baseline level, the dividend rate for the initial dividend period was 1%. Such dividends are not cumulative but the Corporation may only declare and pay dividends on its Common Stock (or any other equity securities junior to the Series B Preferred Stock) if it has declared and paid dividends on the Series B Preferred Shares for the current dividend period and, if, after payment of such dividend, the dollar amount of the Corporation's Tier 1 Capital would be at least 90% of the Tier 1 Capital on the date of entering into the SBLF program, excluding any subsequent net charge-offs and any redemption of the Series B Preferred Shares (the "Tier 1 Dividend Threshold"). The Tier 1 Dividend Threshold is subject to reduction, beginning on the second anniversary of the issuance and ending on the tenth anniversary, by 10% for each 1% increase in QSBL over the baseline level.

In addition, the Series B Preferred Shares are non-voting except in limited circumstances. In the event that the Corporation has not timely declared and paid dividends on the Series B Preferred Shares for six dividend periods or more, whether or not consecutive, and shares of Series B Preferred Stock with an aggregate liquidation preference of at least \$25,000,000 are still outstanding, the Treasury may designate two additional directors to be elected to the Corporation's Board of Directors. Subject to the approval of the Bank's federal banking regulator, the Federal Reserve, the Corporation may redeem the Series B Preferred Shares at any time at the Corporation's option, at a redemption price equal to the liquidation preference per share plus the per share amount of any unpaid dividends for the then-current period through the date of the redemption. The Series B Preferred Shares are includable in Tier I capital for regulatory capital.

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

**Cautionary Note Regarding Forward-Looking Statements**

This Quarterly Report on Form 10-Q contains certain "forward looking statements" with respect to Stewardship Financial Corporation (the "Corporation") within the meaning of the Private Securities Litigation Reform Act of 1995, which forward looking statements may be identified by the use of such words as "believe," "expect," "anticipate," "should," "plan," "estimate," and "potential." Examples of forward looking statements include, but are not limited to, estimates with respect to the financial condition, results of operations and business of the Corporation that are subject to various factors which could cause actual results to differ materially from these estimates. These factors include: changes in general, economic and market conditions, legislative and regulatory conditions, or the development of an interest rate environment that adversely affects the Corporation's interest rate spread or other income anticipated from operations and investments. As used in this Form 10-Q, "we", "us" and "our" refer to Stewardship Financial Corporation and its consolidated subsidiary, Atlantic Stewardship Bank, depending on the context.

**Recent Storm Related Events**

We are in the process of assessing the impact of Hurricane Sandy that occurred in late October. The storm resulted in considerable damage throughout our market area, and may have adversely affected the collateral of some of our borrowers and their ability to repay their obligations to the Bank. In addition, the power outages caused by the storm temporarily interrupted our ability to open some of our branches. These impacts could adversely affect our future earnings.

**Critical Accounting Policies and Estimates**

"Management's Discussion and Analysis of Financial Condition and Results of Operations," as well as disclosures found elsewhere in this Quarterly Report on Form 10-Q, are based upon the Corporation's consolidated financial statements, which have been prepared in conformity with U.S. generally accepted accounting principles ("GAAP"). The preparation of these financial statements requires the Corporation to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. Note 1 to the Corporation's Audited Consolidated Financial Statements for the year ended December 31, 2011 included in the 2011 Annual Report contains a summary of the Corporation's significant accounting policies. Management believes the Corporation's policy with respect to the methodology for the determination of the allowance for loan losses involves a higher degree of complexity and requires management to make difficult and subjective judgments, which often require assumptions or estimates about highly uncertain matters. Changes in these judgments, assumptions or estimates could materially impact results of operations. This critical policy and its application are periodically reviewed with the Audit Committee and the Board of Directors.

The allowance for loan losses is based upon management's evaluation of the adequacy of the allowance, including an assessment of known and inherent risks in the portfolio, giving consideration to the size and composition of the loan portfolio, actual loan loss experience, level of delinquencies, detailed analysis of individual loans for which full collectability may not be assured, the existence and estimated net realizable value of any underlying collateral and guarantees securing the loans, and current economic and market conditions. Although management uses the best information available, the level of the allowance for loan losses remains an estimate, which is subject to significant judgment and short-term change. Various regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses. Such agencies may require the Corporation to make additional provisions for loan losses based upon information available to them at the time of their examination. Furthermore, the majority of the Corporation's loans are secured by real estate in the State of New Jersey. Accordingly, the collectability of a substantial portion of the carrying value of the Corporation's loan portfolio is susceptible to changes in local market conditions and may be adversely affected should real estate values decline or the northern New Jersey area experience adverse economic changes. Future adjustments to the allowance for loan losses may be necessary due to economic, operating, regulatory and other conditions beyond the Corporation's control.

### **Financial Condition**

Total assets decreased \$25.0 million to \$683.8 million at September 30, 2012 from \$708.8 million at December 31, 2011. Cash and cash equivalents increased \$3.7 million to \$17.4 million at September 30, 2012 from \$13.7 million at December 31, 2011. Securities available for sale increased \$3.1 million to \$174.0 million while securities held to maturity decreased \$6.5 million to \$31.9 million. Net loans decreased \$19.3 million from \$444.8 million at December 31, 2011 to \$425.5 million at September 30, 2012. Increases due to new loans originated were more than offset by regular principal payments and payoffs in the first nine months of 2012. In addition, \$2.8 million of loans were transferred to other real estate owned (OREO). Loans held for sale totaled \$938,000 at September 30, 2012, a decrease from \$3.8 million at December 31, 2011. OREO reflected a net decline of \$2.3 million primarily reflecting sales of properties partially offset by the foreclosure on additional properties.

Deposits totaled \$583.4 million at September 30, 2012, a decrease of \$10.1 million from \$593.5 million at December 31, 2011. The change in total deposits consisted of a \$9.3 million increase in noninterest-bearing accounts offset by a \$19.4 million decrease in interest-bearing accounts.

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FHLB – NY advances were \$25.0 million at September 30, 2012 compared to \$32.7 million at December 31, 2011. The decrease in these borrowings was primarily the result of a decrease in assets. In addition, securities sold under agreements to repurchase declined \$7.0 million reflecting the early repayment of a portion of a wholesale repurchase agreement.

**Results of Operations**

General

The Corporation reported net income of \$328,000, or \$0.04 per diluted common share for the three months ended September 30, 2012, compared to net income of \$578,000, or \$0.06 diluted earnings per common share for the three months ended September 30, 2011. For the nine months ended September 30, 2012, the Corporation reported net income of \$780,000, or \$0.09 diluted earnings per common share. These results compare to net income of \$1.6 million, or \$0.19 per diluted common share, for the nine months ended September 30, 2011.

Net Interest Income

Net interest income for the three and nine months ended September 30, 2012 was \$5.9 million and \$17.9 million, respectively, compared to \$6.3 million and \$18.5 million recorded in the prior year periods. For the three months ended September 30, 2012, average interest-earning assets were relatively unchanged. However, the current nine month period reflects an increase in average interest-earning assets. The current year periods both include declines in the cost of interest bearing liabilities offset by declines in the yield on interest-earning assets. The net interest rate spread and net yield on interest-earning assets for the three months ended September 30, 2012 were 3.41% and 3.62%, respectively, compared to 3.61% and 3.87% for the three months ended September 30, 2011. For the nine months ended September 30, 2012, the net interest rate spread and net yield on interest-earning assets were 3.45% and 3.67%, respectively, compared to 3.61% and 3.86% for the nine months ended September 30, 2011. The net interest rate spread and net yield on interest-earning assets for the current year period reflects a decline in loan interest rates and yields on securities as well as a decline in the interest rates on deposits. The Corporation continues in its efforts to proactively manage deposit costs in an effort to mitigate the lower asset yields earned. The reduced yields on assets reflect both an elevated level of nonperforming loans as well as the historically low market rates in the current environment.

The following table reflects the components of the Corporation's net interest income for the three and nine months ended September 30, 2012 and 2011 including: (1) average assets, liabilities and stockholders' equity based on average daily balances, (2) interest income earned on interest-earning assets and interest expense paid on interest-bearing

liabilities, (3) average yields earned on interest-earning assets and average rates paid on interest-bearing liabilities, and (4) net yield on interest-earning assets. Nontaxable income from investment securities and loans is presented on a tax-equivalent basis assuming a statutory tax rate of 34% for the periods presented. This was accomplished by adjusting non-taxable income upward to make it equivalent to the level of taxable income required to earn the same amount after taxes.

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## Analysis of Net Interest Income (Unaudited)

For the Three Months Ended September 30,

|                                                | 2012                   |                    |                          | 2011                   |                    |                          |   |
|------------------------------------------------|------------------------|--------------------|--------------------------|------------------------|--------------------|--------------------------|---|
|                                                | Average                | Interest           | Average                  | Average                | Interest           | Average                  |   |
|                                                | Balance                | Income/<br>Expense | Rates<br>Earned/<br>Paid | Balance                | Income/<br>Expense | Rates<br>Earned/<br>Paid |   |
|                                                | (Dollars in thousands) |                    |                          | (Dollars in thousands) |                    |                          |   |
| Assets                                         |                        |                    |                          |                        |                    |                          |   |
| Interest-earning assets:                       |                        |                    |                          |                        |                    |                          |   |
| Loans (1) (2)                                  | \$445,722              | \$ 5,962           | 5.31                     | % \$464,838            | \$ 6,735           | 5.75                     | % |
| Taxable investment securities (1)              | 176,773                | 882                | 1.98                     | 161,874                | 1,007              | 2.47                     |   |
| Tax-exempt investment securities (1) (2)       | 35,670                 | 410                | 4.56                     | 32,275                 | 408                | 5.02                     |   |
| Other interest-earning assets                  | 658                    | 11                 | 6.63                     | 883                    | 12                 | 5.84                     |   |
| Total interest-earning assets                  | 658,823                | 7,265              | 4.37                     | 659,870                | 8,162              | 4.91                     |   |
| Non-interest-earning assets:                   |                        |                    |                          |                        |                    |                          |   |
| Allowance for loan losses                      | (12,351 )              |                    |                          | (11,630 )              |                    |                          |   |
| Other assets                                   | 55,923                 |                    |                          | 58,265                 |                    |                          |   |
| Total assets                                   | \$702,395              |                    |                          | \$706,505              |                    |                          |   |
| Liabilities and Stockholders' Equity           |                        |                    |                          |                        |                    |                          |   |
| Interest-bearing liabilities:                  |                        |                    |                          |                        |                    |                          |   |
| Interest-bearing demand deposits               | \$243,105              | \$ 236             | 0.39                     | % \$249,030            | \$ 426             | 0.68                     | % |
| Savings deposits                               | 64,532                 | 23                 | 0.14                     | 53,283                 | 35                 | 0.26                     |   |
| Time deposits                                  | 161,551                | 543                | 1.33                     | 171,842                | 744                | 1.72                     |   |
| Repurchase agreements                          | 13,885                 | 179                | 5.11                     | 15,257                 | 186                | 4.81                     |   |
| FHLB-NY borrowing                              | 25,096                 | 151                | 2.39                     | 33,000                 | 214                | 2.57                     |   |
| Subordinated debenture                         | 7,217                  | 127                | 6.98                     | 7,217                  | 127                | 6.98                     |   |
| Total interest-bearing liabilities             | 515,386                | 1,259              | 0.97                     | 529,629                | 1,732              | 1.30                     |   |
| Non-interest-bearing liabilities:              |                        |                    |                          |                        |                    |                          |   |
| Demand deposits                                | 125,443                |                    |                          | 115,313                |                    |                          |   |
| Other liabilities                              | 3,105                  |                    |                          | 5,252                  |                    |                          |   |
| Stockholders' equity                           | 58,461                 |                    |                          | 56,311                 |                    |                          |   |
| Total liabilities and stockholders' equity     | \$702,395              |                    |                          | \$706,505              |                    |                          |   |
| Net interest income (taxable equivalent basis) |                        | 6,006              |                          |                        | 6,430              |                          |   |
| Tax Equivalent adjustment                      |                        | (145 )             |                          |                        | (144 )             |                          |   |
| Net interest income                            |                        | \$ 5,861           |                          |                        | \$ 6,286           |                          |   |
| Net interest spread (taxable equivalent basis) |                        |                    | 3.40                     | %                      |                    | 3.61                     | % |

|                                                                        |        |        |
|------------------------------------------------------------------------|--------|--------|
| Net yield on interest-earning<br>assets (taxable equivalent basis) (3) | 3.62 % | 3.87 % |
|------------------------------------------------------------------------|--------|--------|

(1) For purpose of these calculations, nonaccruing loans are included in the average balance. Loans and total interest-earning assets are net of unearned income. Securities are included at amortized cost.

(2) The tax equivalent adjustments are based on a marginal tax rate of 34%.

(3) Net interest income (taxable equivalent basis) divided by average interest-earning assets.

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## Analysis of Net Interest Income (Unaudited)

For the Nine Months Ended September 30,

|                                                | 2012                   |                    |                          |   | 2011                   |                    |                          |   |
|------------------------------------------------|------------------------|--------------------|--------------------------|---|------------------------|--------------------|--------------------------|---|
|                                                | Average                | Interest           | Average                  |   | Average                | Interest           | Average                  |   |
|                                                | Balance                | Income/<br>Expense | Rates<br>Earned/<br>Paid | % | Balance                | Income/<br>Expense | Rates<br>Earned/<br>Paid |   |
|                                                | (Dollars in thousands) |                    |                          |   | (Dollars in thousands) |                    |                          |   |
| Assets                                         |                        |                    |                          |   |                        |                    |                          |   |
| Interest-earning assets:                       |                        |                    |                          |   |                        |                    |                          |   |
| Loans (1) (2)                                  | \$452,664              | \$18,328           | 5.39                     | % | \$461,718              | \$19,863           | 5.75                     | % |
| Taxable investment securities (1)              | 176,088                | 2,816              | 2.13                     |   | 159,074                | 3,152              | 2.65                     |   |
| Tax-exempt investment securities (1) (2)       | 34,030                 | 1,210              | 4.74                     |   | 31,732                 | 1,209              | 5.09                     |   |
| Other interest-earning assets                  | 998                    | 28                 | 3.87                     |   | 782                    | 29                 | 4.96                     |   |
| Total interest-earning assets                  | 663,780                | 22,382             | 4.49                     |   | 653,306                | 24,253             | 4.96                     |   |
| Non-interest-earning assets:                   |                        |                    |                          |   |                        |                    |                          |   |
| Allowance for loan losses                      | (12,574 )              |                    |                          |   | (10,237 )              |                    |                          |   |
| Other assets                                   | 54,286                 |                    |                          |   | 53,696                 |                    |                          |   |
| Total assets                                   | \$705,492              |                    |                          |   | \$696,765              |                    |                          |   |
| Liabilities and Stockholders' Equity           |                        |                    |                          |   |                        |                    |                          |   |
| Interest-bearing liabilities:                  |                        |                    |                          |   |                        |                    |                          |   |
| Interest-bearing demand deposits               | \$248,095              | \$847              | 0.45                     | % | \$248,906              | \$1,385            | 0.74                     | % |
| Savings deposits                               | 61,674                 | 84                 | 0.18                     |   | 51,323                 | 100                | 0.26                     |   |
| Time deposits                                  | 163,954                | 1,748              | 1.42                     |   | 173,549                | 2,289              | 1.76                     |   |
| Repurchase agreements                          | 14,188                 | 543                | 5.10                     |   | 15,445                 | 551                | 4.76                     |   |
| FHLB-NY borrowing                              | 27,428                 | 480                | 2.33                     |   | 33,748                 | 668                | 2.65                     |   |
| Subordinated debenture                         | 7,217                  | 379                | 7.00                     |   | 7,217                  | 377                | 6.98                     |   |
| Total interest-bearing liabilities             | 522,556                | 4,081              | 1.04                     |   | 530,188                | 5,370              | 1.35                     |   |
| Non-interest-bearing liabilities:              |                        |                    |                          |   |                        |                    |                          |   |
| Demand deposits                                | 121,320                |                    |                          |   | 108,850                |                    |                          |   |
| Other liabilities                              | 3,027                  |                    |                          |   | 3,634                  |                    |                          |   |
| Stockholders' equity                           | 58,589                 |                    |                          |   | 54,093                 |                    |                          |   |
| Total liabilities and stockholders' equity     | \$705,492              |                    |                          |   | \$696,765              |                    |                          |   |
| Net interest income (taxable equivalent basis) |                        |                    |                          |   |                        |                    |                          |   |
|                                                |                        | 18,301             |                          |   |                        | 18,883             |                          |   |
| Tax Equivalent adjustment                      |                        | (429 )             |                          |   |                        | (427 )             |                          |   |
| Net interest income                            |                        | \$17,872           |                          |   |                        | \$18,456           |                          |   |
| Net interest spread (taxable equivalent basis) |                        |                    |                          |   |                        |                    |                          |   |
|                                                |                        |                    | 3.45                     | % |                        |                    | 3.61                     | % |

|                                                                     |        |        |
|---------------------------------------------------------------------|--------|--------|
| Net yield on interest-earning assets (taxable equivalent basis) (3) | 3.67 % | 3.86 % |
|---------------------------------------------------------------------|--------|--------|

(1) For purpose of these calculations, nonaccruing loans are included in the average balance. Loans and total interest-earning assets are net of unearned income. Securities are included at amortized cost.

(2) The tax equivalent adjustments are based on a marginal tax rate of 34%.

(3) Net interest income (taxable equivalent basis) divided by average interest-earning assets.

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For the three months ended September 30, 2012, total interest income, on a tax equivalent basis, decreased \$897,000 to \$7.3 million, or 11.0%, when compared to the same prior year period. The decrease was due to a decrease in yields on interest-earning assets. Total interest income on a tax equivalent basis decreased \$1.9 million to \$22.4 million for the nine months ended September 30, 2012, or 7.7%, compared to the same period for 2011. The decrease in the current nine month period is due to a decrease in the overall yield on interest-earning assets, partially offset by an increase in the average interest-earning assets. The average rate earned on interest-earning assets was 4.37% and 4.49% for the three and nine months ended September 30, 2012, respectively, compared to an average rate of 4.91 and 4.96% for the three and nine months ended September 30, 2011, respectively. The decline in the asset yield reflects the effect of a prolonged low interest rate environment as well as the impact of nonaccrual loans. Average interest-earning assets decreased \$1.0 million but increased \$10.5 million for the three and nine months ended September 30, 2012, respectively, compared to the same prior year periods. When compared to the prior year period, the change in average interest-earning assets for the nine months ended September 30, 2012 reflects an increase in average investment securities of \$19.3 million partially offset by a decrease of \$9.1 million in average loans.

Interest paid on deposits and borrowed money decreased \$473,000 and \$1.3 million for the three and nine months ended September 30, 2012, respectively, compared to the same periods for 2011. The decline is due to general decreases in rates paid on deposits and borrowings coupled with decreases in average interest-bearing liabilities. For the three months ended September 30, 2012, the total cost for interest-bearing liabilities declined to 0.97% representing a 33 basis point decline when compared to the same prior year period. The cost for deposits and borrowed money decreased 31 basis points from 1.35% for the nine month period ended September 30, 2011 to 1.04% for the comparable period in 2012. The average balance of total interest-bearing deposits and borrowings decreased \$14.2 million and \$7.6 million for the three months and nine months ended September 30, 2012, respectively, from the comparable 2011 periods.

## Provision for Loan Losses

The Corporation maintains an allowance for loan losses at a level considered by management to be adequate to cover the probable incurred losses associated with its loan portfolio. On an ongoing basis, management analyzes the adequacy of this allowance by considering the nature and volume of the Corporation's loan activity, financial condition of the borrower, fair market value of the underlying collateral, and changes in general market conditions. Additions to the allowance for loan losses are charged to operations in the appropriate period. Actual loan losses, net of recoveries, serve to reduce the allowance. The appropriate level of the allowance for loan losses is based on estimates, and ultimate losses may vary from current estimates.

The loan loss provision totaled \$2.000 million and \$6.665 million for the three and nine months ended September 30, 2012, respectively, compared to \$2.330 million and \$5.920 million for the three and nine months ended September 30, 2011, respectively. Nonaccrual loans of \$25.0 million at September 30, 2012 reflected a decrease from \$27.7 million of nonaccrual loans at December 31, 2011. The allowance for loan losses related to the impaired loans increased from \$3.1 million at December 31, 2011 to \$3.6 million at September 30, 2012. During the first nine months of 2012, the Corporation charged off \$5.9 million of loan balances and recovered \$224,000 in previously charged off loans compared to \$2.1 million and \$33,000, respectively, during the same period in 2011.

The current period loan loss provision primarily is indicative of continuing economic conditions that have contributed to an increase in loan delinquencies and the softness in the real estate market. The Corporation monitors its loan portfolio and intends to continue to provide for loan loss reserves based on its ongoing periodic review of the loan portfolio and general market conditions.

See “Asset Quality” section below for a summary of the allowance for loan losses and nonperforming assets.

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Noninterest Income

Noninterest income was \$1.7 million and \$4.2 million for the three and nine months ended September 30, 2012, respectively, compared to \$1.4 million and \$3.4 million for the comparable prior year periods, respectively. The increase is primarily due to higher gains on calls and sales of securities for the current year periods. Current year noninterest income includes gains on calls and sales of securities of \$891,000 and \$1.3 million for the three and nine months ended September 30, 2012, respectively, greater than those realized for the three and nine months ended September 30, 2011 of \$454,000 and \$475,000, respectively. The gain for the three months ended September reflects a transaction executed to lower the Company's risk exposure to rising interest rates and delever the balance sheet through the partial repayment of a higher costing wholesale repurchase agreement. A resulting gain was partially offset by a prepayment penalty discussed below.

Noninterest Expense

Noninterest expenses for the three and nine months ended September 30, 2012 was \$5.2 million and \$14.4 million, respectively, compared to \$4.6 million and \$13.8 million in the comparable prior year periods. Included in noninterest expense for the current year periods is \$691,000 related to a prepayment premium resulting from the repayment of \$7 million of a wholesale repurchase agreement.

Income Tax Expense

Income tax expense totaled \$46,000 and \$193,000 for the three and nine months ended September 30, 2012, respectively, compared to \$113,000 and \$432,000 for the same prior year periods. The effective tax rate for the three and nine months ended September 30, 2012 of 12.3% and 19.8%, respectively, reflects a decrease in our overall projected effective tax rate as a result of our tax exempt income representing a larger percentage of pretax income due to lower projected earnings. Likewise, the effective tax rate for the three and nine months ended September 30, 2011 was 16.4% and 20.87%, respectively.

Asset Quality

The Corporation's principal earning asset is its loan portfolio. Inherent in the lending function is the risk of deterioration in the borrowers' ability to repay loans under existing loan agreements. To address this risk, reserves are maintained to absorb probable incurred loan losses. In determining the adequacy of the allowance for loan losses, management of the Corporation considers the risks inherent in its loan portfolio and changes in the nature and volume

of its loan activities, along with general economic and real estate market conditions. Although management attempts to establish a reserve sufficient to offset probable incurred losses in the portfolio, changes in economic conditions, regulatory policies and borrowers' performance could require future changes to the allowance.

Risk elements include nonaccrual loans, past due and restructured loans, potential problem loans, loan concentrations and other real estate owned. The following table shows the composition of nonperforming assets at the end of the last four quarters:

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|                                                  | September<br>30,<br>2012 | June 30,<br>2012 | March 31,<br>2012 | December 31,<br>2011 |  |  |   |
|--------------------------------------------------|--------------------------|------------------|-------------------|----------------------|--|--|---|
|                                                  | (Dollars in thousands)   |                  |                   |                      |  |  |   |
| Nonaccrual loans (1)                             | \$24,960                 | \$29,541         | \$ 26,823         | \$ 27,736            |  |  |   |
| Loans past due 90 days or more and accruing (2)  | 75                       | 200              | —                 | —                    |  |  |   |
| Total nonperforming loans                        | 25,035                   | 29,741           | 26,823            | 27,736               |  |  |   |
| Other real estate owned                          | 2,985                    | 1,991            | 3,840             | 5,288                |  |  |   |
| Total nonperforming assets                       | \$28,020                 | \$31,732         | \$ 30,663         | \$ 33,024            |  |  |   |
| Performing restructured loans (3)                | \$7,176                  | \$3,716          | \$ 5,847          | \$ 5,979             |  |  |   |
| Allowance for loan losses                        | \$12,598                 | \$11,934         | \$ 13,097         | \$ 11,604            |  |  |   |
| Nonperforming loans to total gross loans         | 5.72                     | % 6.68           | % 5.91            | % 6.08               |  |  | % |
| Nonperforming assets to total assets             | 4.10                     | % 4.53           | % 4.31            | % 4.66               |  |  | % |
| Allowance for loan losses to total gross loans   | 2.88                     | % 2.68           | % 2.89            | % 2.54               |  |  | % |
| Allowance for loan losses to nonperforming loans | 50.32                    | % 40.13          | % 48.83           | % 41.84              |  |  | % |

(1) Generally represents loans as to which the payment of principal or interest is in arrears for a period of more than 90 days. Interest previously accrued on these loans and not yet paid is reversed and charged against income during the current period. Interest earned thereafter is only included in income to the extent that it is received in cash.

(2) Represents loans as to which payment of principal or interest is contractually past due 90 days or more but which are currently accruing income at the contractually stated rates. A determination is made to continue accruing income on those loans which are sufficiently collateralized and on which management believes all interest and principal owed will be collected.

(3) Any restructured loans that are on nonaccrual status are only reported in nonaccrual loans and not reflected in restructured loans.

A loan is generally placed on nonaccrual when, based on current information and events, it is probable that the Corporation will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. The identification of nonaccrual loans reflects careful monitoring of the loan portfolio. The Corporation is focused on resolving the nonperforming loans and mitigating future losses in the portfolio. All delinquent loans continue to be reviewed by management.

At September 30, 2012, the nonaccrual loans were comprised of 59 loans, primarily commercial real estate loans, commercial loans and construction loans. While the Corporation maintains strong underwriting requirements, the amount of nonaccrual loans is reflective of the prolonged weakened economic conditions and the corresponding effects it has had on our commercial borrowers and the current real estate environment. Certain loans, including restructured loans, are current, but in accordance with applicable guidance and cautious review, management has continued to keep these loans on nonaccrual.

Since December 31, 2011, nonaccrual loans have decreased \$2.8 million to \$25.0 million at the end of the most recent quarter. Included in nonaccrual loans at September 30, 2012 is one loan for \$3.0 million. During the second quarter of 2012, management placed the loan on nonaccrual based on developments relating to the borrower which have impacted the borrower's repayment ability. The increase in nonaccruals due to this loan was offset by payments being received on other nonaccrual loans, payoffs of loans, certain loans transferring to OREO and loans returning to an accrual status. The ratio of allowance for loan losses to nonperforming loans increased to 50.32% at September 30, 2012 from 41.84% at December 31, 2011. The ratio of allowance for loan losses to nonperforming loans is reflective of detailed analysis and the probable incurred losses we have identified with these nonperforming loans. This metric reflects the effect of the increase in nonaccrual loans partially offset by an increase in the allowance for loan losses.

Evaluation of all nonperforming loans includes the updating of appraisals and specific evaluation of such loans to determine estimated cash flows from business and/or collateral. We have assessed these loans for collectability and considered, among other things, the borrower's ability to repay, the value of the underlying collateral, and other market conditions to ensure the allowance for loan losses is adequate to absorb probable incurred losses. The majority of our nonperforming loans are secured by real estate collateral. While our nonperforming loans have remained elevated, we have recorded appropriate chargeoffs and the underlying collateral coverage for a considerable portion of the nonperforming loans currently supports the significant collection of our remaining principal.



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For loans not included in nonperforming loans, at September 30, 2012, the level of loans past due 30-89 days was \$2.0 million compared to \$1.0 million at December 31, 2011. We will continue to monitor delinquencies for early identification of new problem loans. While not comprising a significantly large portion of the loan portfolio, a large number of problem loans are commercial construction loans which have been affected by the struggling construction industry. As such, the entire commercial construction portfolio is being actively monitored.

The Corporation maintains an allowance for loan losses at a level considered by management to be adequate to cover the probable incurred losses associated with its loan portfolio. The Corporation's policy with respect to the methodology for the determination of the allowance for loan losses involves a high degree of complexity and requires management to make difficult and subjective judgments.

The adequacy of the allowance for loan losses is based upon management's evaluation of the known and inherent risks in the portfolio, consideration to the size and composition of the loan portfolio, actual loan loss experience, the level of delinquencies, detailed analysis of individual loans for which full collectability may not be assured, the existence and estimated net realizable value of any underlying collateral and guarantees securing the loans, and current economic and market conditions.

In establishing the allowance for loan losses, the Corporation utilizes a two-tier approach by (1) identifying problem loans and allocating specific loss allowances on such loans and (2) establishing a general valuation allowance on the remainder of its loan portfolio. The Corporation maintains a loan review system that allows for a periodic review of its loan portfolio and the identification of potential problem loans. Such a system takes into consideration, among other things, delinquency status, size of loans, type of collateral and financial condition of the borrowers.

Allocations of specific loan loss allowances are established for identified loans based on a review of various information including appraisals of underlying collateral. Appraisals are performed by independent licensed appraisers to determine the value of impaired, collateral-dependent loans. Appraisals are periodically updated to ascertain any further decline in value. General loan loss allowances are based upon a combination of factors including, but not limited to, actual loss experience, composition of the loan portfolio, current economic conditions and management's judgment.

Primarily as a result of the continuing higher level of nonperforming loans, the Corporation continues to record elevated levels of provision for loan losses. For the three and nine months ended September 30, 2012, the provision for loan losses was \$2.000 million and \$6.665 million, respectively, compared to \$2.330 million and \$5.920 million for the three and nine months ended September 30, 2011, respectively. The total allowance for loan losses increased to 2.88% of total loans from a comparable ratio of 2.54% at December 31, 2011. The increase in the ratio includes the recording of the additional provision for loan losses offset by the impact of net chargeoffs.

When it is believed that some portion or all of a loan balance will not be collected, that amount is charged off as a loss against the allowance for loan losses. For the nine months ended September 30, 2012, net chargeoffs were \$5.671 million compared to \$2.021 for the nine months ended September 30, 2011. While regular monthly payments continue to be made on many of the nonaccrual loans, certain chargeoffs result, nevertheless, from the borrowers' inability to provide adequate documentation evidencing their ability to continue to service their debt. Therefore, consideration has been given to any underlying collateral and appropriate chargeoffs recorded based, in general, on the deficiency of such collateral. In general, these chargeoffs reflect partial writedowns on nonaccrual loans due to the initial and ongoing evaluations of market values of the underlying real estate collateral in accordance with Accounting Standards Codification ("ASC") 310-40. In addition, the current year reflects an increased level of chargeoffs of previously established reserves that were based on analysis of the discounted cash flows for non-real estate collateral dependent loans. Management believes the chargeoff of these reserves provides a clearer indication of the value of nonaccrual loans. The chargeoff of reserves increases the average historical chargeoff experience, thereby resulting in an increase in Corporation's level of general reserves on performing loans. In addition to our actions of recording partial and full chargeoffs on loans, we continue to aggressively pursue collection, including legal action.

At September 30, 2012 and December 31, 2011, the Corporation had \$14.6 million and \$15.1 million, respectively, of loans whose terms have been modified in troubled debt restructurings. Of these loans, \$7.2 million and \$6.0 million were performing in accordance with their new terms at September 30, 2012 and December 31, 2011, respectively. The remaining troubled debt restructures are reported as nonaccrual loans. Specific reserves of \$3.3 million and \$1.2 million were allocated for the troubled debt restructurings at September 30, 2012 and December 31, 2011, respectively. As of September 30, 2012 and December 31, 2011, the Corporation had committed \$377,000 and \$416,000, respectively, of additional funds to a single customer with an outstanding construction loan that is classified as a troubled debt restructuring.

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Included in performing restructured loans at December 31, 2011 is a loan for \$2.3 million for which the estate of our borrower was provided with a forbearance to allow time to market for sale the underlying commercial real estate collateral. The property was sold in 2012 and the Corporation collected all outstanding principal and accrued interest owed under the loan.

The balance in performing restructured loans also includes two loans to a related borrower for \$1.1 million at both September 30, 2012 and December 31, 2011. While these loans are current under their restructured terms, because of the below market rate of interest, these loans will continue to be reflected as restructured loans in accordance with accounting practices.

As of September 30, 2012, there were \$32.0 million of other loans not included in the preceding risk elements table, compared to \$36.1 million at December 31, 2011, where credit conditions of borrowers caused management to have concerns about the possibility of the borrowers not complying with the present terms and conditions of repayment and which may result in disclosure of such loans as nonperforming loans at a future date. These loans have been considered by management in conjunction with the analysis of the adequacy of the allowance for loan losses.

The Corporation's lending activities are concentrated in loans secured by real estate located in northern New Jersey. Accordingly, the collectability of a substantial portion of the Corporation's loan portfolio is susceptible to changes in real estate market conditions in northern New Jersey.

Capital Adequacy

The Corporation is subject to capital adequacy guidelines promulgated by the Board of Governors of the Federal Reserve System ("FRB"). The Bank is subject to similar capital adequacy requirements imposed by the Federal Deposit Insurance Corporation. The FRB has issued regulations to define the adequacy of capital based upon the sensitivity of assets and off-balance sheet exposures to risk factors. Four categories of risk weights (0%, 20%, 50%, and 100%) were established to be applied to different types of balance sheet assets and off-balance sheet exposures. The aggregate of the risk-weighted items (risk-based assets) is the denominator of the ratio; the numerator of the ratio is risk-based capital. Under the regulations, risk-based capital has been classified into two categories. Tier 1 capital includes common and qualifying perpetual preferred shareholders' equity less goodwill. Tier 2 capital includes mandatory convertible debt, allowance for loan losses, subject to certain limitations, and certain subordinated and term debt securities. Total qualifying capital consists of Tier 1 capital and Tier 2 capital; however, the amount of Tier 2 capital may not exceed the amount of Tier 1 capital. At September 30, 2012, the minimum risk-based capital requirements to be considered adequately capitalized were 4% for Tier 1 capital and 8% for total capital.

Federal banking regulators have also adopted leverage capital guidelines to supplement the risk-based measures. The leverage ratio is determined by dividing Tier 1 capital as defined under the risk-based guidelines by average total assets (non risk-adjusted) for the preceding quarter. At September 30, 2012 the minimum leverage ratio requirement

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to be considered well capitalized was 4%. The following table summarizes the capital ratios for the Corporation and the Bank at September 30, 2012.

|                           | Actual  | Required for<br>Capital<br>Adequacy<br>Purposes | To Be Well<br>Capitalized<br>Under Prompt<br>Corrective<br>Action<br>Regulations |       |   |
|---------------------------|---------|-------------------------------------------------|----------------------------------------------------------------------------------|-------|---|
| <b>Leverage ratio</b>     |         |                                                 |                                                                                  |       |   |
| Corporation               | 9.03 %  | 4.00                                            | %                                                                                | N/A   |   |
| Bank                      | 8.88 %  | 4.00                                            | %                                                                                | 5.00  | % |
| <b>Risk-based capital</b> |         |                                                 |                                                                                  |       |   |
| <b>Tier I</b>             |         |                                                 |                                                                                  |       |   |
| Corporation               | 13.68 % | 4.00                                            | %                                                                                | N/A   |   |
| Bank                      | 13.44 % | 4.00                                            | %                                                                                | 6.00  | % |
| <b>Total</b>              |         |                                                 |                                                                                  |       |   |
| Corporation               | 14.95 % | 8.00                                            | %                                                                                | N/A   |   |
| Bank                      | 14.70 % | 8.00                                            | %                                                                                | 10.00 | % |

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**Liquidity and Capital Resources**

The Corporation's primary sources of funds are deposits, amortization and prepayments of loans and mortgage-backed securities, maturities of investment securities and funds provided from operations. While scheduled loan and mortgage-backed securities amortization and maturities of investment securities are a relatively predictable source of funds, deposit flow and prepayments on loans and mortgage-backed securities are greatly influenced by market interest rates, economic conditions and competition. The Corporation's liquidity, represented by cash and cash equivalents, is a product of its operating, investing and financing activities.

The primary source of cash from operating activities is net income. Liquidity management is both a daily and long-term function of business management. Excess liquidity is generally invested in interest-earning cash accounts or short-term investments, such as federal funds sold.

Cash and cash equivalents increased \$3.7 million during the first nine months of 2012. Net operating and investing activities provided \$10.8 million and \$19.2 million, respectively, while financing activities used \$26.3 million.

We anticipate that the Corporation will have sufficient funds available to meet its current contractual commitments. Should we need temporary funding, the Corporation has the ability to borrow overnight with the FHLB-NY. The overall borrowing capacity is contingent on available collateral to secure borrowings and the ability to purchase additional activity-based capital stock of the FHLB-NY. In addition, the Corporation has available overnight variable repricing lines of credit with other correspondent banks totaling \$16.0 million on an unsecured basis.

With respect to the payment of dividends on common stock, the Corporation has historically paid a quarterly cash dividend, however management recognizes that the payment of future dividends could be impacted by losses or reduced earnings and the Corporation cannot assure the payment of future dividends. In addition, due to the Corporation's participation in the SBLF program, the Corporation may only declare and pay dividends on its common stock (or any other equity security junior to the Series B Preferred Stock issued in connection with the participation in the SBLF program) if it has declared and paid dividends on the Series B Preferred Stock for the current dividend period and, if after payment of such dividend, the dollar amount of the Corporation's Tier 1 Capital would be at least 90% of the Tier 1 Capital at the date of entering into the SBLF program excluding any subsequent chargeoffs and any redemption of the Series B Preferred shares.

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**ITEM 3. Quantitative and Qualitative Disclosures about Market Risk**

Not applicable to smaller reporting companies.

**ITEM 4. Controls and Procedures**

**Evaluation of internal controls and procedures**

Based on their evaluation as of the end of the period covered by this Quarterly Report on Form 10-Q, our principal executive officer and principal financial officer have concluded that our internal disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934 (the “Exchange Act”)) are effective to ensure that information required to be disclosed by us in reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission’s rules and forms.

**Changes in Internal Controls over Financial Reporting**

Pursuant to Rule 13a-15(d) under the Exchange Act, our management, with the participation of our principal executive officer and principal financial officer, has evaluated our internal controls over financial reporting and based upon such evaluation concluded that there were no changes in our internal control over financial reporting (as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the quarter ended September 30, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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**Part II -- Other Information**

**Item 6. Exhibits**

See Exhibit Index following this report.

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**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

Stewardship Financial Corporation

Date: November 9, 2012 By: /s/ Paul Van Ostenbridge  
Paul Van Ostenbridge  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: November 9, 2012 By: /s/ Claire M. Chadwick  
Claire M. Chadwick  
Senior Vice President and Chief Financial Officer  
(Principal Financial and Accounting Officer)



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**EXHIBIT INDEX**

Exhibit

Number Description of Exhibits

- |      |                                                                                                                                                                                                                                                                                                                           |
|------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 31.1 | Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002                                                                                                                                                                                                                        |
| 31.2 | Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002                                                                                                                                                                                                                        |
| 32.1 | Certification of Chief Executive Officer and Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002                                                                                                                                                                                            |
|      | The following material from Stewardship Financial Corporation's Quarterly Report on Form 10-Q for the quarter ended September 30, 2012, formatted in XBRL (Extensible Business Reporting Language): (i)                                                                                                                   |
| 101  | Consolidated Statements of Financial Condition, (ii) Consolidated Statements of Income, (iii) Consolidated Statement of Changes in Stockholders' Equity, (iv) Consolidated Statements of Comprehensive Income, (v) Consolidated Statements of Cash Flows and (vi) Notes to Consolidated Financial Statements <sup>1</sup> |

<sup>1</sup> This exhibit shall not be deemed "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, or otherwise subject to the liability of that section, nor shall it be deemed incorporated by reference into any filing under the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended, whether made before or after the date hereof and irrespective of any general incorporation language in any filing, except to the extent the Corporation specifically incorporates it by reference.