

STEWARDSHIP FINANCIAL CORP  
Form 10-Q  
August 11, 2014

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

¼ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2014

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  
(Registrant's telephone number, including area code)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  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 the definitions 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 August 8, 2014 was 6,026,666.

**Stewardship Financial Corporation**

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Stewardship Financial Corporation and Subsidiary

Consolidated Statements of Financial Condition

	June 31, 2014 (Unaudited)	December 31, 2013
Assets		
Cash and due from banks	\$ 14,397,000	\$ 17,024,000
Other interest-earning assets	233,000	381,000
Cash and cash equivalents	14,630,000	17,405,000
Securities available for sale	144,459,000	168,411,000
Securities held to maturity; estimated fair value of \$55,288,000 (at June 30, 2014) and \$27,221,000 (at December 31, 2013)	54,225,000	25,964,000
FHLB-NY stock, at cost	2,429,000	2,133,000
Loans held for sale	259,000	2,800,000
Loans, net of allowance for loan losses of \$9,825,000 (at June 30, 2014) and \$9,915,000 (at December 31, 2013)	423,413,000	424,262,000
Premises and equipment, net	6,490,000	5,739,000
Accrued interest receivable	2,019,000	2,066,000
Other real estate owned, net	1,225,000	451,000
Bank owned life insurance	13,506,000	13,303,000
Other assets	8,867,000	10,974,000
Total assets	\$ 671,522,000	\$ 673,508,000
Liabilities and shareholders' equity		
Liabilities		
Deposits:		
Noninterest-bearing	\$ 143,711,000	\$ 133,565,000
Interest-bearing	422,669,000	444,026,000
Total deposits	566,380,000	577,591,000
Federal Home Loan Bank of New York advances	31,000,000	25,000,000
Securities sold under agreements to repurchase	7,601,000	7,300,000
Subordinated debentures	7,217,000	7,217,000
Accrued interest payable	332,000	401,000
Accrued expenses and other liabilities	1,997,000	2,220,000

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Total liabilities	614,527,000	619,729,000
Commitments and contingencies	—	—
Shareholders' equity		
Preferred stock, no par value; 2,500,000 shares authorized; 15,000 shares issued and outstanding at June 30, 2014 and December 31, 2013.		
Liquidation preference of \$15,000,000	14,979,000	14,974,000
Common stock, no par value; 10,000,000 shares authorized; 6,022,794 and 5,943,767 shares issued and outstanding at June 30, 2014 and December 31, 2013, respectively	41,074,000	40,690,000
Retained earnings	2,450,000	1,905,000
Accumulated other comprehensive loss, net	(1,508,000 )	(3,790,000 )
Total shareholders' equity	56,995,000	53,779,000
Total liabilities and shareholders' equity	\$671,522,000	\$673,508,000

See notes to unaudited consolidated financial statements.

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## Stewardship Financial Corporation and Subsidiary

## Consolidated Statements of Income

(Unaudited)

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2014	2013	2014	2013
Interest income:				
Loans	\$5,193,000	\$5,680,000	\$10,353,000	\$11,604,000
Securities held to maturity				
Taxable	116,000	75,000	181,000	151,000
Non-taxable	173,000	195,000	347,000	391,000
Securities available for sale				
Taxable	669,000	578,000	1,375,000	1,144,000
Non-taxable	6,000	77,000	12,000	154,000
FHLB dividends	23,000	23,000	49,000	48,000
Other interest-earning assets	6,000	8,000	14,000	14,000
Total interest income	6,186,000	6,636,000	12,331,000	13,506,000
Interest expense:				
Deposits	443,000	592,000	919,000	1,233,000
Borrowed money	367,000	366,000	730,000	729,000
Total interest expense	810,000	958,000	1,649,000	1,962,000
Net interest income before provision for loan losses	5,376,000	5,678,000	10,682,000	11,544,000
Provision for loan losses	—	850,000	—	2,450,000
Net interest income after provision for loan losses	5,376,000	4,828,000	10,682,000	9,094,000
Noninterest income:				
Fees and service charges	504,000	492,000	925,000	948,000
Bank owned life insurance	106,000	77,000	202,000	153,000
Gain on calls and sales of securities	—	—	—	2,000
Gain on sales of mortgage loans	2,000	298,000	14,000	460,000
Loss on sale of loans	—	—	(241,000)	—
Gain on sale of other real estate owned	54,000	—	54,000	126,000
Gain on life insurance proceeds	—	—	—	537,000
Miscellaneous	141,000	128,000	252,000	243,000
Total noninterest income	807,000	995,000	1,206,000	2,469,000
Noninterest expenses:				
Salaries and employee benefits	2,557,000	2,711,000	5,235,000	5,407,000
Occupancy, net	520,000	503,000	1,075,000	1,020,000
Equipment	175,000	199,000	363,000	383,000
Data processing	435,000	332,000	822,000	660,000
Advertising	211,000	140,000	341,000	251,000

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FDIC insurance premium	133,000	276,000	344,000	426,000
Charitable contributions	45,000	60,000	90,000	120,000
Miscellaneous	1,030,000	910,000	1,930,000	1,796,000
Total noninterest expenses	5,106,000	5,131,000	10,200,000	10,063,000
Income before income tax expense	1,077,000	692,000	1,688,000	1,500,000
Income tax expense	351,000	231,000	456,000	217,000
Net income	726,000	461,000	1,232,000	1,283,000
Dividends on preferred stock	171,000	127,000	342,000	293,000
Net income available to common shareholders	\$555,000	\$334,000	\$890,000	\$990,000
Basic and diluted earnings per common share	\$0.09	\$0.06	\$0.15	\$0.17
Weighted average number of basic and diluted common shares outstanding	5,999,897	5,934,549	5,978,511	5,932,774

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		Six Months Ended	
	June 30,	2013	June 30,	2013
	2014		2014	
Net income	\$726,000	\$461,000	\$1,232,000	\$1,283,000
Other comprehensive income (loss), net of tax:				
Change in unrealized holding gains (losses) on securities available for sale	1,621,000	(2,729,000)	2,660,000	(3,068,000)
Loss on securities reclassified from available for sale to held to maturity	(457,000 )	—	(457,000 )	—
Accretion of loss on securities reclassified to held to maturity	11,000	—	11,000	—
Reclassification adjustment for gains in net income	—	—	—	(1,000 )
Change in fair value of interest rate swap	33,000	59,000	68,000	98,000
Total other comprehensive income (loss)	1,208,000	(2,670,000)	2,282,000	(2,971,000)
Total comprehensive income (loss)	\$1,934,000	\$(2,209,000)	\$3,514,000	\$(1,688,000)

See notes to unaudited consolidated financial statements.

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## Stewardship Financial Corporation and Subsidiary

## Consolidated Statement of Changes in Shareholders' Equity

(Unaudited)

## Six Months Ended June 30, 2014

	Preferred Stock	Common Stock Shares	Common Stock Amount	Retained Earnings	Accumulated Other Comprehensive Income, Net	Total
Balance -- December 31, 2013	\$ 14,974,000	5,943,767	\$ 40,690,000	\$ 1,905,000	\$(3,790,000)	\$ 53,779,000
Cash dividends paid on common stock	—	—	—	(119,000 )	—	(119,000)
Payment of discount on dividend reinvestment plan	—	—	(1,000 )	—	—	(1,000)
Cash dividends declared on preferred stock	—	—	—	(342,000 )	—	(342,000)
Common stock issued under dividend reinvestment plan	—	3,299	15,000	—	—	15,000
Common stock issued under stock plans	—	26,067	121,000	—	—	121,000
Issuance of restricted stock	—	49,661	249,000	(249,000 )	—	—
Amortization of restricted stock	—	—	—	28,000	—	28,000
Amortization of issuance costs	5,000	—	—	(5,000 )	—	—
Net income	—	—	—	1,232,000	—	1,232,000
Other comprehensive income	—	—	—	—	2,282,000	2,282,000
Balance -- June 30, 2014	\$ 14,979,000	6,022,794	\$ 41,074,000	\$ 2,450,000	\$(1,508,000)	\$ 56,995,000

## Six Months Ended June 30, 2013

	Preferred Stock	Common Stock Shares	Common Stock Amount	Retained Earnings	Accumulated Other Comprehensive Income, Net	Total
Balance -- December 31, 2012	\$ 14,964,000	5,924,865	\$ 40,606,000	\$ 316,000	\$ 460,000	\$ 56,346,000
Cash dividends paid on common stock	—	—	—	(119,000 )	—	(119,000)
Payment of discount on dividend reinvestment plan	—	—	(1,000 )	—	—	(1,000)
Cash dividends accrued on preferred stock	—	—	—	(293,000 )	—	(293,000)
Common stock issued under stock plans	—	11,189	47,000	—	—	47,000
Amortization of issuance costs	5,000	—	—	(5,000 )	—	—
Net income	—	—	—	1,283,000	—	1,283,000
Other comprehensive loss	—	—	—	—	(2,971,000)	(2,971,000)

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Balance -- June 30, 2013	\$14,969,000	5,936,054	\$40,652,000	\$1,182,000	\$(2,511,000)	\$54,292,000
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See notes to unaudited consolidated financial statements.

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## Stewardship Financial Corporation and Subsidiary

## Consolidated Statements of Cash Flows

(Unaudited)

	Six Months Ended	
	June 30,	
	2014	2013
Cash flows from operating activities:		
Net income	\$1,232,000	\$1,283,000
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization of premises and equipment	221,000	217,000
Amortization of premiums and accretion of discounts, net	478,000	700,000
Amortization of restricted stock	28,000	—
Accretion (amortization) of deferred loan fees	(4,000 )	22,000
Provision for loan losses	—	2,450,000
Originations of mortgage loans held for sale	(1,137,000 )	(27,614,000)
Proceeds from sale of mortgage loans	892,000	26,804,000
Proceeds from sale of loans	2,559,000	—
Gain on sales of mortgage loans	(14,000 )	(460,000 )
Loss on sale of loans	241,000	—
Gain on sales and calls of securities	—	(2,000 )
Gain on sale of other real estate owned	(54,000 )	(126,000 )
Deferred income tax expense (benefit)	31,000	(63,000 )
Decrease in accrued interest receivable	47,000	71,000
Decrease in accrued interest payable	(69,000 )	(115,000 )
Earnings on bank owned life insurance	(202,000 )	(153,000 )
Gain on life insurance proceeds	—	(537,000 )
Decrease in other assets	719,000	2,428,000
Increase (decrease) in other liabilities	(154,000 )	266,000
Net cash provided by operating activities	4,814,000	5,171,000
Cash flows from investing activities:		
Purchase of securities available-for-sale	(6,259,000 )	(35,436,000)
Proceeds from maturities and principal repayments on securities available-for-sale	9,361,000	16,297,000
Proceeds from sales and calls on securities available-for-sale	—	6,500,000
Purchase of securities held to maturity	(6,258,000 )	—
Proceeds from maturities and principal repayments on securities held to maturity	1,988,000	1,300,000
Proceeds from calls on securities held to maturity	—	250,000
Sale (purchase) of FHLB-NY stock	(296,000 )	80,000
Net increase in loans	(511,000 )	(4,342,000 )
Proceeds from sale of other real estate owned	594,000	461,000
Life insurance proceeds	—	1,055,000
Additions to premises and equipment	(972,000 )	(110,000 )

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Net cash used in investing activities	(2,353,000 )	(13,945,000)
Cash flows from financing activities:		
Net increase in noninterest-bearing deposits	10,146,000	21,102,000
Net decrease in interest-bearing deposits	(21,357,000)	(18,657,000)
Net increase in borrowings	6,000,000	—
Net increase in securities sold under agreements to repurchase	301,000	1,000
Cash dividends paid on common stock	(119,000 )	(119,000 )
Cash dividends paid on preferred stock	(342,000 )	(293,000 )
Payment of discount on dividend reinvestment plan	(1,000 )	(1,000 )
Issuance of common stock	136,000	47,000
Net cash provided by (used in) financing activities	(5,236,000 )	2,080,000
Net decrease in cash and cash equivalents	(2,775,000 )	(6,694,000 )
Cash and cash equivalents - beginning	17,405,000	21,016,000
Cash and cash equivalents - ending	\$14,630,000	\$14,322,000

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Stewardship Financial Corporation and Subsidiary

Consolidated Statements of Cash Flows (continued)

(Unaudited)

	Six Months Ended June 30,	
	2014	2013
Supplemental disclosures of cash flow information:		
Cash paid during the period for interest	\$1,718,000	\$2,077,000
Cash paid during the period for income taxes	58,000	68,000
Reclassification of securities available-for-sale to held to maturity	24,022,000	—
Transfers from loans to other real estate owned	1,364,000	349,000

See notes to unaudited consolidated financial statements.

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**Stewardship Financial Corporation and Subsidiary**

**Notes to Consolidated Financial Statements**

**June 30, 2014**

**(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 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, 2013, filed with the SEC on March 26, 2014 (the “2013 Annual Report”).

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 six months ended June 30, 2014 are not necessarily indicative of the results which may be expected for the entire year.

**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 consolidated financial statements, management is required to make estimates and assumptions, based on available information, that affect the amounts reported in the consolidated financial statements and disclosures provided. Actual results could differ significantly from those estimates.

### **Material estimates**

Material estimates that are particularly susceptible to significant changes relate to the determination of the allowance for loan losses. Management believes that the allowance for loan losses is adequate. While management uses available information to recognize 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.

### **Adoption of New Accounting Standards**

In July 2013, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2013-11, “Income Taxes, Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists”. This ASU requires that an unrecognized tax benefit, or a portion thereof, should be presented in the consolidated financial statements as a reduction to a deferred tax asset for a net operating loss carryforward, a similar tax loss, or a tax credit carryforward. This ASU applies to all entities that have unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists at the reporting date. The standard is effective for reporting periods, including interim periods, beginning after December 15, 2013. The adoption of the standard did not have a material effect on the Corporation’s consolidated financial statements.

In January 2014, the FASB issued ASU 2014-04, “Receivables – Troubled Debt Restructurings by Creditors (Subtopic 310-40) Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure,” This ASU applies to all creditors who obtain physical possession of residential real estate property collateralizing a consumer mortgage loan in satisfaction of a receivable. The amendments in this update clarify when an in substance repossession or foreclosure occurs and requires disclosure of both (1) the amount of foreclosed residential real estate property held by a creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in ASU 2014-04 are effective for fiscal years, including interim periods, beginning after December 15, 2014. The adoption of the amendments in this standard are not expected to have a material impact on the Corporation’s consolidated financial statements.

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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:

	June 30, 2014			
	Amortized Cost	Gross Unrealized Gains	Losses	Fair Value
U.S. government-sponsored agencies Obligations of state and political subdivisions	\$32,543,000	\$57,000	\$865,000	\$31,735,000
Mortgage-backed securities - residential	1,425,000	2,000	19,000	1,408,000
Asset-backed securities (a)	95,305,000	723,000	1,132,000	94,896,000
Corporate debt	9,873,000	48,000	2,000	9,919,000
	2,996,000	6,000	26,000	2,976,000
Total debt securities	142,142,000	836,000	2,044,000	140,934,000
Other equity investments	3,604,000	—	79,000	3,525,000
	\$145,746,000	\$836,000	\$2,123,000	\$144,459,000

	December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Losses	Fair Value
U.S. government-sponsored agencies Obligations of state and political subdivisions	\$41,066,000	\$15,000	\$2,389,000	\$38,692,000
Mortgage-backed securities - residential	1,429,000	—	71,000	1,358,000
Asset-backed securities (a)	115,134,000	244,000	3,143,000	112,235,000
Corporate debt	9,874,000	11,000	49,000	9,836,000
	2,995,000	5,000	115,000	2,885,000
Total debt securities	170,498,000	275,000	5,767,000	165,006,000
Other equity investments	3,543,000	—	138,000	3,405,000
	\$174,041,000	\$275,000	\$5,905,000	\$168,411,000

(a) Collateralized by student loans

There were no cash proceeds realized from sales and calls of securities available-for-sale for the three and six months ended June 30, 2014. Cash proceeds realized from sales and calls of securities available-for-sale for the three and six

months ended June 30, 2013 were \$4,000,000 and \$6,500,000, respectively. There were no gross gains and no gross losses realized on sales or calls during the three and six months ended June 30, 2014 or June 30, 2013. Gross gains realized on calls and sales during the six months ended June 30, 2013 totaled \$2,000. There were no gross losses realized on calls and sales during the three and six months ended June 30, 2013.

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

	June 30, 2014					
	Amortized Cost	Net Unrealized Loss (1)	Carrying Value	Gross Gains	Unrecognized Losses	Fair Value
U.S. government-sponsored agencies	\$ 12,270,000	\$ 350,000	\$ 11,920,000	\$ 46,000	\$ 29,000	\$ 11,937,000
Obligations of state and political subdivisions	19,354,000	—	19,354,000	743,000	—	20,097,000
Mortgage-backed securities - residential	23,325,000	374,000	22,951,000	397,000	94,000	23,254,000
	\$ 54,949,000	\$ 724,000	\$ 54,225,000	\$ 1,186,000	\$ 123,000	\$ 55,288,000

  

	December 31, 2013					
	Amortized Cost	Net Unrealized Loss	Carrying Value	Gross Gains	Unrecognized Losses	Fair Value
U.S. government-sponsored agencies	\$ 258,000	\$ —	\$ 258,000	\$ 31,000	\$ —	\$ 289,000
Obligations of state and political subdivisions	20,642,000	—	20,642,000	838,000	—	21,480,000
Mortgage-backed securities - residential	5,064,000	—	5,064,000	388,000	—	5,452,000
	\$ 25,964,000	\$ —	\$ 25,964,000	\$ 1,257,000	\$ —	\$ 27,221,000

(1) Net unrealized losses of held-to-maturity securities represents the net loss on previously designated available-for-sale securities transferred to held to maturity securities at fair value which is being amortized through accumulated other comprehensive income over the remaining life of the securities.

There were no cash proceeds realized from calls of securities held to maturity for the three and six months ended June 30, 2014. While there were no cash proceeds realized from calls of securities held to maturity for the three months ended June 30, 2013, cash proceeds realized from calls of securities held to maturity for the six months ended June 30, 2013 were \$250,000. There were no gross gains and no gross losses realized on calls during the three and six months ended June 30, 2014 or 2013.

Mortgage-backed securities are a type of asset-backed security secured by a mortgage or collection of mortgages, purchased by government agencies such as the Government National Mortgage Association and government sponsored agencies such as the Federal National Mortgage Association ("FNMA") and the Federal Home Loan Mortgage Corporation, which then issue securities that represent claims on the principal and interest payments made by borrowers on the loans in the pool.

The changes in available-for-sale and held to maturity securities for the period ending June 30, 2014 is primarily attributed to a \$24.0 million transfer of previously-designated available-for-sale securities to a held to maturity designation at fair value. In accordance with Accounting Standards Codification 320, *Investment – Debt and Equity Securities*, the Corporation is required at each balance sheet due date to reassess the classification of each security held. The reclassification for the period ended June 30, 2014 is permitted as the Company has appropriately determined the ability and intent to hold these securities as an investment until maturity or call. The securities were transferred to the held to maturity portfolio to protect our tangible common equity against rising rates and to appropriately align the mix of securities within held to maturity and available-for-sale. The securities transferred had a net loss of \$742,000 that is reflected in accumulated other comprehensive loss on the consolidated statement of financial condition, net of subsequent amortization, which is being recognized over the life of the securities.

Issuers may have the right to call or prepay obligations with or without call or prepayment penalties. This might cause actual maturities to differ from the contractual maturities.

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The following table presents the amortized cost and fair value of the debt 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 and asset-backed securities, are shown separately.

	June 30, 2014	
	Amortized Cost	Fair Value
Available-for-sale		
Within one year	\$—	\$—
After one year, but within five years	6,011,000	5,988,000
After five years, but within ten years	18,449,000	18,076,000
After ten years	12,504,000	12,055,000
Mortgage-backed securities - residential	95,305,000	94,896,000
Asset-backed securities	9,873,000	9,919,000
Total	\$142,142,000	\$140,934,000
Held to maturity		
Within one year	\$6,232,000	\$6,289,000
After one year, but within five years	9,560,000	10,044,000
After five years, but within ten years	9,520,000	9,745,000
After ten years	5,962,000	5,956,000
Mortgage-backed securities - residential	22,951,000	23,254,000
Total	\$54,225,000	\$55,288,000

The following tables summarize the fair value and unrealized losses in the available-for-sale securities portfolio of those investment securities which reported an unrealized loss at June 30, 2014 and December 31, 2013, and if the unrealized loss position was continuous for the twelve months prior to June 30, 2014 and December 31, 2013.

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## Available-for-Sale

June 30, 2014	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. government-sponsored agencies	\$1,023,000	\$(3,000)	\$23,737,000	\$(862,000)	\$24,760,000	\$(865,000)
Obligations of state and political subdivisions	—	—	998,000	(19,000)	998,000	(19,000)
Mortgage-backed securities - residential	6,891,000	(48,000)	37,034,000	(1,084,000)	43,925,000	(1,132,000)
Asset-backed securities	—	—	3,040,000	(2,000)	3,040,000	(2,000)
Corporate debt	—	—	1,474,000	(26,000)	1,474,000	(26,000)
Other equity investments	—	—	3,465,000	(79,000)	3,465,000	(79,000)
Total temporarily impaired securities	\$7,914,000	\$(51,000)	\$69,748,000	\$(2,072,000)	\$77,662,000	\$(2,123,000)

December 31, 2013	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. government-sponsored agencies	\$24,517,000	\$(1,531,000)	\$8,987,000	\$(858,000)	\$33,504,000	\$(2,389,000)
Obligations of state and political subdivisions	949,000	(43,000)	409,000	(28,000)	1,358,000	(71,000)
Mortgage-backed securities - residential	75,183,000	(2,304,000)	13,334,000	(839,000)	88,517,000	(3,143,000)
Asset-backed securities	8,791,000	(49,000)	—	—	8,791,000	(49,000)
Corporate debt	2,385,000	(115,000)	—	—	2,385,000	(115,000)
Other equity investments	3,346,000	(138,000)	—	—	3,346,000	(138,000)
Total temporarily impaired securities	\$115,171,000	\$(4,180,000)	\$22,730,000	\$(1,725,000)	\$137,901,000	\$(5,905,000)

## Held to Maturity

June 30, 2014	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. government-sponsored agencies	\$9,621,000	\$(29,000)	\$ —	\$ —	\$9,621,000	\$(29,000)
Obligations of state and political subdivisions	—	—	—	—	—	—
Mortgage-backed						

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securities - residential	12,758,000	(94,000 )	—	—	12,758,000	(94,000 )
Total temporarily impaired securities	\$22,379,000	\$(123,000 )	\$ —	\$ —	\$22,379,000	\$(123,000 )

December 31, 2013	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. government- sponsored agencies	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Obligations of state and political subdivisions	—	—	—	—	—	—
Mortgage-backed securities - residential	—	—	—	—	—	—
Total temporarily impaired securities	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —

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*Other-Than-Temporary-Impairment*

At June 30, 2014, there were twenty-four U.S. government-sponsored agency securities, two obligations of state and political subdivisions securities, thirty-two mortgage-backed securities, one asset-backed security, two corporate debt securities, and an other equity investments security in a continuous loss position for 12 months or longer. Management has assessed the securities that were in an unrealized loss position at June 30, 2014 and December 31, 2013 and has determined that any decline in fair value below amortized cost primarily relate to changes in interest rates and market spreads and was temporary.

In making this determination management considered the following factors in estimating the cash flows expected to be collected from the security: the period of time the securities were in an unrealized loss position; the percentage decline in comparison to the securities' amortized cost; any adverse conditions specifically related to the security, an industry or a geographic area; the rating or changes to the rating by a credit rating agency; the financial condition of the issuer and guarantor and any recoveries or additional declines in fair value subsequent to the balance sheet date. Management expects to collect all amounts contractually due and none of the debt securities can be prepaid at less than the par values.

Management does not intend to sell these securities in an unrealized loss position and it is not more likely than not that we will be required to sell these securities before the recovery of their amortized cost bases, which may be at maturity.

Index**Note 3. Loans and Allowance for Loan Losses**

At June 30, 2014 and December 31, 2013, respectively, the loan portfolio consisted of the following:

	June 30, 2014	December 31, 2013
Commercial:		
Secured by real estate	\$49,651,000	\$46,162,000
Other	21,551,000	27,728,000
Commercial real estate	259,339,000	253,035,000
Commercial construction	3,652,000	3,445,000
Residential real estate	72,798,000	77,540,000
Consumer:		
Secured by real estate	25,650,000	25,458,000
Other	501,000	534,000
Other	56,000	107,000
Total gross loans	433,198,000	434,009,000
Less: Deferred loan fees, net of costs	(40,000 )	(168,000 )
Allowance for loan losses	9,825,000	9,915,000
	9,785,000	9,747,000
Loans, net	\$423,413,000	\$424,262,000

At June 30, 2014 and December 31, 2013, loan participations sold by the Corporation to other lending institutions totaled approximately \$12,082,000 and \$12,725,000, respectively. These amounts are not included in the totals presented above.

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

	For the three months ended June 30, 2014				
	Balance, beginning of period	Provision charged to operations	Loans charged off	Recoveries of loans charged off	Balance, end of period
Commercial	\$3,126,000	\$ (94,000 )	\$ (2,000 )	\$ 38,000	\$3,068,000
Commercial real estate	5,413,000	36,000	(63,000 )	62,000	5,448,000
Commercial construction	135,000	(15,000 )	—	—	120,000
Residential real estate	473,000	(21,000 )	—	—	452,000
Consumer	253,000	8,000	(2,000 )	—	259,000

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Other loans	1,000	(1,000	)	—	—	—
Unallocated	391,000	87,000		—	—	478,000
Total	\$9,792,000	\$ —		\$ (67,000	) \$ 100,000	\$9,825,000

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For the six months ended June 30, 2014

	Balance, beginning of period	Provision charged to operations	Loans charged off	Recoveries of loans charged off	Balance, end of period
Commercial	\$3,373,000	\$ (250,000 )	\$ (183,000 )	\$ 128,000	\$3,068,000
Commercial real estate	5,665,000	(195,000 )	(87,000 )	65,000	5,448,000
Commercial construction	117,000	3,000	—	—	120,000
Residential real estate	460,000	—	(8,000 )	—	452,000
Consumer	288,000	(24,000 )	(5,000 )	—	259,000
Other loans	3,000	(3,000 )	—	—	—
Unallocated	9,000	469,000	—	—	478,000
Total	\$9,915,000	\$ —	\$ (283,000 )	\$ 193,000	\$9,825,000

For the three months ended June 30, 2013

	Balance, beginning of period	Provision charged to operations	Loans charged off	Recoveries of loans charged off	Balance, end of period
Commercial	\$5,285,000	\$ (1,082,000 )	\$ (261,000 )	\$ 43,000	\$3,985,000
Commercial real estate	5,549,000	1,452,000	(1,403,000)	—	5,598,000
Commercial construction	20,000	261,000	—	23,000	304,000
Residential real estate	334,000	100,000	—	—	434,000
Consumer	290,000	99,000	—	21,000	410,000
Other loans	1,000	—	—	—	1,000
Unallocated	33,000	20,000	—	2,000	55,000
Total	\$11,512,000	\$ 850,000	\$ (1,664,000)	\$ 89,000	\$10,787,000

For the six months ended June 30, 2013

	Balance, beginning of period	Provision charged to operations	Loans charged off	Recoveries of loans charged off	Balance, end of period
Commercial	\$4,832,000	\$ (277,000 )	\$ (648,000 )	\$ 78,000	\$3,985,000
Commercial real estate	4,936,000	2,421,000	(1,759,000)	—	5,598,000
Commercial construction	169,000	133,000	(24,000 )	26,000	304,000
Residential real estate	308,000	126,000	—	—	434,000
Consumer	352,000	41,000	(3,000 )	20,000	410,000
Other loans	3,000	(4,000 )	—	2,000	1,000
Unallocated	41,000	10,000	—	4,000	55,000
Total	\$10,641,000	\$ 2,450,000	\$ (2,434,000)	\$ 130,000	\$10,787,000

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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 June 30, 2014 and December 31, 2013.

	June 30, 2014							Unallocated	Total
	Commercial	Commercial Real Estate	Commercial Construction	Residential Real Estate	Consumer	Other Loans			
Allowance for loan losses:									
Ending allowance balance attributable to loans									
Individually evaluated for impairment	\$ 142,000	\$ 59,000	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 201,000
Collectively evaluated for impairment	2,926,000	5,389,000	120,000	452,000	259,000	—	478,000	9,624,000	
Total ending allowance balance	\$ 3,068,000	\$ 5,448,000	\$ 120,000	\$ 452,000	\$ 259,000	\$ —	\$ 478,000	\$ 9,825,000	
Loans:									
Loans individually evaluated for impairment	\$ 6,721,000	\$ 10,450,000	\$ 1,431,000	\$ 728,000	\$ 606,000	\$ —	\$ —	\$ 19,936,000	
Loans collectively evaluated for impairment	64,481,000	248,889,000	2,221,000	72,070,000	25,545,000	56,000	—	413,262,000	
Total ending loan balance	\$ 71,202,000	\$ 259,339,000	\$ 3,652,000	\$ 72,798,000	\$ 26,151,000	\$ 56,000	\$ —	\$ 433,190,000	

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	December 31, 2013							Total
	Commercial Commercial	Commercial Real Estate	Commercial Construction	Residential Real Estate	Consumer	Other Loans	Unallocated	
Allowance for loan losses:								
Ending allowance balance attributable to loans								
Individually evaluated for impairment	\$ 300,000	\$ 72,000	\$ —	\$ —	\$ —	\$ —	\$ —	\$ 372,000
Collectively evaluated for impairment	3,073,000	5,593,000	117,000	460,000	288,000	3,000	9,000	9,543,000
Total ending allowance balance	\$ 3,373,000	\$ 5,665,000	\$ 117,000	\$ 460,000	\$ 288,000	\$ 3,000	\$ 9,000	\$ 9,915,000
Loans:								
Loans individually evaluated for impairment	\$ 7,261,000	\$ 12,821,000	\$ 1,196,000	\$ 755,000	\$ 617,000	\$ —	\$ —	\$ 22,650,000
Loans collectively evaluated for impairment	66,629,000	240,214,000	2,249,000	76,785,000	25,375,000	107,000	—	411,359,000
Total ending loan balance	\$ 73,890,000	\$ 253,035,000	\$ 3,445,000	\$ 77,540,000	\$ 25,992,000	\$ 107,000	\$ —	\$ 434,009,000

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

	June 31, 2014	December 31, 2013
Commercial:		
Secured by real estate	\$ 1,905,000	\$ 2,182,000
Other	—	73,000
Commercial real estate	1,635,000	6,592,000
Residential real estate	729,000	755,000
Consumer:		
Secured by real estate	606,000	617,000

Total nonaccrual loans \$4,875,000 \$ 10,219,000

At December 31, 2013, there was one relationship, which included four nonaccrual commercial real estate loans totaling \$2.8 million, which was classified as held for sale and included in the table above. The \$2.8 million was sold and there were no nonaccrual loans classified as held for sale at June 30, 2014.

At June 30, 2014 and December 31, 2013, there were no loans that were past due 90 days and still accruing.

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The following table presents loans individually evaluated for impairment by class of loan at and for the periods indicated:

	At and for the six months ended June 30, 2014				
	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial:					
Secured by real estate	\$6,552,000	\$5,533,000		\$5,633,000	\$ 118,000
Other	73,000	65,000		69,000	—
Commercial real estate	10,263,000	8,106,000		8,959,000	140,000
Commercial construction	1,845,000	1,431,000		653,000	42,000
Residential real estate	820,000	728,000		739,000	—
Consumer:					
Secured by real estate	623,000	606,000		612,000	—
With an allowance recorded:					
Commercial:					
Secured by real estate	400,000	400,000	\$ 133,000	454,000	7,000
Other	727,000	723,000	9,000	775,000	24,000
Commercial real estate	2,353,000	2,344,000	59,000	2,368,000	62,000
Commercial construction	—	—	—	700,000	—
	\$23,656,000	\$19,936,000	\$ 201,000	\$20,962,000	\$ 393,000

During the six months ended June 30, 2014, no interest income was recognized on a cash basis.

	At and for the year ended December 31, 2013				
	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial:					
Secured by real estate	\$7,204,000	\$5,756,000		\$6,286,000	\$ 239,000
Other	80,000	73,000		98,000	1,000
Commercial real estate	12,920,000	10,474,000		9,952,000	118,000
Commercial construction	567,000	528,000		2,753,000	52,000
Residential real estate	826,000	755,000		529,000	—
Consumer:					
Secured by real estate	630,000	617,000		730,000	—
With an allowance recorded:					

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Commercial:					
Secured by real estate	686,000	559,000	\$ 269,000	900,000	28,000
Other	877,000	873,000	31,000	1,067,000	52,000
Commercial real estate	2,356,000	2,347,000	72,000	3,174,000	47,000
Commercial construction	1,043,000	668,000	—	430,000	43,000
Residential real estate	—	—	—	36,000	—
Consumer:					
Secured by real estate	—	—	—	68,000	—
	\$27,189,000	\$22,650,000	\$ 372,000	\$26,023,000	\$ 580,000

During the year ended December 31, 2013, no interest income was recognized on a cash basis.

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The following table presents the aging of the recorded investment in past due loans by class of loans as of June 30, 2014 and December 31, 2013. Nonaccrual loans are included in the disclosure by payment status.

	June 30, 2014					
	30-59 Days Past Due	60-89 Days Past Due	Greater than		Loans	
			90 Days Past Due	Total Past Due	Not Past Due	Total
Commercial:						
Secured by real estate	\$—	\$ —	\$ 1,023,000	\$ 1,023,000	\$ 48,628,000	\$ 49,651,000
Other	—	—	—	—	21,551,000	21,551,000
Commercial real estate	—	—	1,281,000	1,281,000	258,058,000	259,339,000
Commercial construction	—	—	—	—	3,652,000	3,652,000
Residential real estate	—	—	404,000	404,000	72,394,000	72,798,000
Consumer:						
Secured by real estate	27,000	—	479,000	506,000	25,144,000	25,650,000
Other	—	—	—	—	501,000	501,000
Other	—	—	—	—	56,000	56,000
Total	\$27,000	\$ —	\$ 3,187,000	\$ 3,214,000	\$ 429,984,000	\$ 433,198,000
	December 31, 2013					
	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days Past Due	Total Past Due	Loans Not Past Due	Total
Commercial:						
Secured by real estate	\$ 866,000	\$ —	\$ 499,000	\$ 1,365,000	\$ 44,797,000	\$ 46,162,000
Other	—	—	—	—	27,728,000	27,728,000
Commercial real estate	1,043,000	—	5,100,000	6,143,000	246,892,000	253,035,000
Commercial construction	—	—	—	—	3,445,000	3,445,000
Residential real estate	—	—	523,000	523,000	77,017,000	77,540,000
Consumer:						
Secured by real estate	—	—	479,000	479,000	24,979,000	25,458,000
Other	—	3,000	—	3,000	531,000	534,000
Other	—	—	—	—	107,000	107,000
Total	\$ 1,909,000	\$ 3,000	\$ 6,601,000	\$ 8,513,000	\$ 425,496,000	\$ 434,009,000

**Troubled Debt Restructurings**

At June 30, 2014 and December 31, 2013, the Corporation had \$16.2 million and \$16.6 million, respectively, of loans whose terms have been modified in troubled debt restructurings. Of these loans, \$15.1 million and \$15.2 million were performing in accordance with their new terms at June 30, 2014 and December 31, 2013, respectively. The remaining troubled debt restructurings are reported as nonaccrual loans. Specific reserves of \$142,000 and \$281,000 have been allocated for the troubled debt restructurings at June 30, 2014 and December 31, 2013, respectively. As of June 30, 2014 and December 31, 2013, the Corporation has committed \$21,000 and \$257,000, respectively, of additional funds to a single customer with an outstanding construction loan that is classified as a troubled debt restructuring.

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.

There were no new loans classified as a troubled debt restructuring during the three and six months ended June 30, 2014. During the three and six months ended June 30, 2013, one loan was modified as troubled debt restructuring. The modification of the terms of this loan represented a term out of a remaining balance on a matured loan. The following table presents loans by class that were modified as troubled debt restructurings that occurred during the three and six months ended June 30, 2013:

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	For the three months ended June 30, 2013			For the six months ended June 30, 2013		
	Pre- Modification of Recorded Loans Investment	Post- Modification Recorded Investment	Number of Loans	Pre- Modification of Recorded Loans Investment	Post- Modification Recorded Investment	Number of Loans
Commercial:						
Other	1	\$ 17,000		1	\$ 17,000	
Total	1	\$ 17,000		1	\$ 17,000	

For the three and six months ended June 30, 2013, the troubled debt restructuring described above resulted in no change to the allowance for loan losses. There were no charge-offs during the three and six months ended June 30, 2013 related to this troubled debt restructuring.

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 for which there was a payment default within twelve months following the modification.

**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 borrower 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 has all of the 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 known 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.

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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 June 30, 2014 and December 31, 2013, and based on the most recent analysis performed at those times, the risk category of loans by class is as follows:

	June 30, 2014					
	Pass	Special Mention	Substandard	Doubtful	Loss	Total
Commercial:						
Secured by real estate	\$41,854,000	\$4,825,000	\$2,972,000	\$ —	\$ —	\$49,651,000
Other	19,983,000	1,128,000	440,000	—	—	21,551,000
Commercial real estate	245,773,000	11,931,000	1,635,000	—	—	259,339,000
Commercial construction	2,162,000	1,490,000	—	—	—	3,652,000
Total	\$309,772,000	\$19,374,000	\$5,047,000	\$ —	\$ —	\$334,193,000

	December 31, 2013					
	Pass	Special Mention	Substandard	Doubtful	Loss	Total
Commercial:						
Secured by real estate	\$39,114,000	\$3,387,000	\$3,661,000	\$ —	\$ —	\$46,162,000
Other	25,604,000	1,325,000	799,000	—	—	27,728,000
Commercial real estate	241,488,000	7,326,000	4,221,000	—	—	253,035,000
Commercial construction	2,164,000	1,281,000	—	—	—	3,445,000
Total	\$308,370,000	\$13,319,000	\$8,681,000	\$ —	\$ —	\$330,370,000

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 also 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 June 30, 2014 and December 31, 2013.

	June 30, 2014		
	Current	Past Due and Nonaccrual	Total
Residential real estate	\$72,394,000	\$ 404,000	\$72,798,000
Consumer:			
Secured by real estate	25,171,000	479,000	25,650,000
Other	501,000	—	501,000
Total	\$98,066,000	\$ 883,000	\$98,949,000

December 31, 2013

	Current	Past Due and Nonaccrual	Total
Residential real estate	\$77,017,000	\$ 523,000	\$77,540,000
Consumer:			
Secured by real estate	24,979,000	479,000	25,458,000
Other	534,000	—	534,000
Total	\$102,530,000	\$ 1,002,000	\$103,532,000

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**Note 4. 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 of investment securities 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). As the Corporation is responsible for the determination of fair value, it performs quarterly analyses on the prices received from the pricing service to determine whether the prices are reasonable estimates of fair value. Specifically, the Corporation compares the prices received from the pricing service to a secondary pricing source. The Corporation's internal price verification procedures have not historically resulted in adjustment in the prices obtained from the pricing service.

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 and other real estate owned ("OREO") 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 or OREO 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. OREO is initially recorded at fair value less estimated selling costs. For collateral dependent loans and OREO, 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 OREO are performed by licensed appraisers whose qualifications and licenses have been reviewed and verified by the Corporation. The Corporation utilizes a third party to order appraisals and, once received, 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 the 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 Value At June 30, 2014	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)
Assets:				
Available for sale securities				
U.S. government - sponsored agencies	\$31,735,000	\$—	\$31,735,000	\$ —
Obligations of state and political subdivisions	1,408,000	—	1,408,000	—
Mortgage-backed securities - residential	94,896,000	—	94,896,000	—
Asset-backed securities	9,919,000	—	9,919,000	—
Corporate debt	2,976,000	—	2,976,000	—
Other equity investments	3,525,000	3,465,000	60,000	—
Total available for sale securities	\$144,459,000	\$3,465,000	\$140,994,000	\$ —
Liabilities:				
Interest rate swap	\$445,000	\$—	\$445,000	\$ —

## At December 31, 2013

Assets:				
Available for sale securities				
U.S. government - sponsored agencies	\$38,692,000	\$—	\$38,692,000	\$—
Obligations of state and political subdivisions	1,358,000	—	1,358,000	—
Mortgage-backed securities - residential	112,235,000	—	112,235,000	—
Asset-backed securities	9,836,000	—	9,836,000	—
Corporate debt	2,885,000	—	2,885,000	—
Other equity investments	3,405,000	3,345,000	60,000	—

Total available for sale securities	\$ 168,411,000	\$ 3,345,000	\$ 165,066,000	\$—
Liabilities:				
Interest rate swap	\$ 559,000	\$—	\$ 559,000	\$—

There were no transfers of assets between Level 1 and Level 2 during the six months ended June 30, 2014 or during the year ended December 31, 2013. There were no changes to the valuation techniques for fair value measurements as of June 30, 2014 and December 31, 2013.

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 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)
At June 30, 2014				
Assets:				
Impaired loans				
Commercial:				
Secured by real estate	\$488,000	\$ —	\$ —	\$ 488,000
Commercial real estate	169,000	—	—	169,000
Residential real estate	404,000	—	—	404,000
Other Real Estate Owned	927,000	—	—	927,000
	\$1,988,000	\$ —	\$ —	\$ 1,988,000

At December 31, 2013

Assets:				
Impaired loans				
Commercial:				
Secured by real estate	\$5,861,000	\$—	\$—	\$5,861,000
Commercial real estate	8,483,000	—	—	8,483,000
Commercial construction	1,196,000	—	—	1,196,000
Residential real estate	755,000	—	—	755,000
Consumer				
Secured by real estate	617,000	—	—	617,000
Other Real Estate Owned	451,000	—	—	451,000
	\$17,363,000	\$—	\$—	\$17,363,000

Collateral-dependent impaired loans measured for impairment using the fair value of the collateral had a recorded investment of \$1,119,000, with a valuation allowance of \$58,000, resulting in an increase of the allocation for loan

losses of \$26,000 for the six months ended June 30, 2014.

Collateral-dependent impaired loans measured for impairment using the fair value of the collateral had a recorded investment of \$17,180,000, with a valuation allowance of \$268,000, resulting in an increase of the provision for loan losses of \$3,975,000 for the year ended December 31, 2013.

OREO had a recorded investment value of \$1,005,000 with a \$78,000 valuation allowance at June 30, 2014. At December 31, 2013, OREO had a recorded investment of \$480,000 with a \$29,000 valuation allowance. Additional valuation allowances of \$78,000 were recorded during the six months ended June 30, 2014. No additional valuation allowances were recorded during the six months ended June 30, 2013.

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For the Level 3 assets measured at fair value on a non-recurring basis at June 30, 2014 and December 31, 2013, the significant unobservable inputs used in the fair value measurements were as follows:

June 30, 2014

Assets	Fair Value	Valuation Technique	Unobservable Inputs	Range
Impaired loans	\$15,451,000	Comparable real estate sales and / or the income approach.	Adjustments for differences between comparable sales and income data available.	5% - 10%
			Estimated selling costs.	7%
Other real estate owned	\$1,225,000	Comparable real estate sales and / or the income approach.	Adjustments for differences between comparable sales and income data available.	0% - 8%
			Estimated selling costs.	7%

December 31, 2013

Assets	Fair Value	Valuation Technique	Unobservable Inputs	Range
Impaired loans	\$16,912,000	Comparable real estate sales and / or the income approach.	Adjustments for differences between comparable sales and income data available.	1% - 25%
			Estimated selling costs.	7%
Other real estate owned	\$451,000	Comparable real estate sales and / or the income approach.	Adjustments for differences between comparable sales and income data available.	5% - 8%
			Estimated selling costs.	7%

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

	Carrying Value At June 30, 2014	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	\$ 14,630,000	\$ 14,630,000	\$—	\$—
Securities available for sale	144,459,000	3,465,000	140,994,000	—
Securities held to maturity	54,225,000	—	55,288,000	—
Mortgage loans held for sale	259,000	—	—	259,000
Loans, net	423,413,000	—	—	433,271,000
Accrued interest receivable	2,019,000	—	742,000	1,277,000
Financial liabilities:				
Deposits	566,380,000	439,505,000	127,129,000	—
FHLB-NY advances	31,000,000	—	31,484,000	—
Securities sold under agreements to repurchase	7,601,000	—	7,668,000	—
Subordinated debentures	7,217,000	—	—	7,190,000
Accrued interest payable	332,000	1,000	313,000	18,000
Interest rate swap	445,000	—	445,000	—

	Carrying Value At December 31, 2013	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	\$ 17,405,000	\$ 17,405,000	\$—	\$—
Securities available for sale	168,411,000	3,345,000	165,066,000	—
Securities held to maturity	25,964,000	—	27,221,000	—
Loans held for sale	2,800,000	—	—	2,800,000
Loans, net	424,262,000	—	—	434,126,000
Accrued interest receivable	2,066,000	—	735,000	1,331,000

## Financial liabilities:

Deposits	577,591,000	441,790,000	136,268,000	—
FHLB-NY advances	25,000,000	—	25,404,000	—
Securities sold under				
agreements to repurchase	7,300,000	—	7,525,000	—
Subordinated debentures	7,217,000	—	—	7,213,000
Accrued interest payable	401,000	1,000	380,000	20,000
Interest rate swap	559,000	—	559,000	—

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

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

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

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**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 held for sale** – Loans in this category include loans that have been committed for sale to third party investors at the current carrying amount resulting in a Level 2 classification. In addition, the amount at December 31, 2013 represents the estimated fair value of a group of nonperforming loans to a single borrower that are being marketed for sale. The estimated fair value is based on the fair value of the note resulting in a Level 3 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 market discount rates which reflect the credit and interest rate risk inherent in the loans resulting in a Level 3 classification. Fair values estimated in this manner do not fully incorporate an exit-price approach to fair value, but instead are based on a comparison to current market rates for comparable loans.

**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 certificates of deposit is based on the discounted value of cash flows resulting in a Level 2 classification. The discount rate is estimated using market discount rates which reflect interest rate risk inherent in the certificates of deposit. Fair values estimated in this manner do not fully incorporate an exit-price approach to fair value, but instead are based on a comparison to current market rates for comparable deposits.

**FHLB-NY advances** – With respect to FHLB-NY borrowings, 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 and credit 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 debentures** – The fair value of the debentures is based on the discounted value of the cash flows. The discount rate is estimated using market rates which reflect the interest rate and credit risk inherent in the debentures resulting in a Level 3 classification.

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

**Interest rate swap** – The fair value of derivatives are based on valuation models using observable market data as of the measurement date (Level 2).

**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. At June 30, 2014 and December 31, 2013 the fair value of such commitments were not material.

### **Limitations**

The preceding fair value estimates were made at June 30, 2014 and December 31, 2013 based on pertinent market data and relevant information concerning 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.

Since these fair value approximations were made solely for on- and off-balance sheet financial instruments at June 30, 2014 and December 31, 2013, 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.

Index**Note 5. Earnings Per Share**

Basic earnings per share is calculated by dividing net income available to common shareholders by the weighted average 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 June 30,		Six Months Ended June 30,	
	2014	2013	2014	2013
Net income	\$726,000	\$461,000	\$1,232,000	\$1,283,000
Dividends on preferred stock	171,000	127,000	342,000	293,000
Net income available to common stockholders	\$555,000	\$334,000	\$890,000	\$990,000
Weighted average common shares outstanding - basic	5,999,897	5,934,549	5,978,511	5,932,774
Effect of dilutive securities - stock options	N/A	N/A	N/A	N/A
Weighted average common shares outstanding - diluted	5,999,897	5,934,549	5,978,511	5,932,774
Basic earnings per common share	\$0.09	\$0.06	\$0.15	\$0.17
Diluted earnings per common share	\$0.09	\$0.06	\$0.15	\$0.17

There were no stock options to purchase shares of common stock for the three and six months ended June 30, 2014. For the three and six months ended June 30, 2013, stock options to purchase 6,754 shares of common stock were not considered in computing diluted earnings per share of common stock because they were antidilutive.

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**Note 6. 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, pursuant to a Securities Purchase Agreement between the Corporation and the Secretary of the Treasury, 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.

The terms of the 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 could 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%. During 2013, the dividend quarterly rate ranged between 3.38% and 4.56%, and fixed at 4.56% beginning with the quarter ended December 31, 2013. 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 Shares) 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.

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 Series B Preferred Shares 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.

Index**Note 7. Accumulated Other Comprehensive Income**

The components of comprehensive income (loss), both gross and net of tax, are presented for the periods below:

	Three Months Ended June 30, 2014			June 30, 2013		
	Gross	Tax Effect	Net	Gross	Tax Effect	Net
Net income	\$1,077,000	\$(351,000 )	\$726,000	\$692,000	\$(231,000 )	\$461,000
Other comprehensive (loss) income:						
Change in unrealized holding gains (losses) on securities available for sale	2,645,000	(1,024,000)	1,621,000	(4,465,000)	1,736,000	(2,729,000)
Loss on securities reclassified from available for sale to held to maturity	(742,000 )	285,000	(457,000 )	—	—	—
Accretion of loss on securities reclassified to held to maturity	18,000	(7,000 )	11,000	—	—	—
Change in fair value of interest rate swap	56,000	(23,000 )	33,000	99,000	(40,000 )	59,000
Total other comprehensive income (loss)	1,977,000	(769,000 )	1,208,000	(4,366,000)	1,696,000	(2,670,000)
Total comprehensive income (loss)	\$3,054,000	\$(1,120,000)	\$1,934,000	\$(3,674,000)	\$1,465,000	\$(2,209,000)

	Six Months Ended June 30, 2014			June 30, 2013		
	Gross	Tax Effect	Net	Gross	Tax Effect	Net
Net income	\$1,688,000	\$(456,000 )	\$1,232,000	\$1,500,000	\$(217,000 )	\$1,283,000
Other comprehensive (loss) income:						
Change in unrealized holding gains (losses) on securities available for sale	4,343,000	(1,683,000)	2,660,000	(5,013,000)	1,945,000	(3,068,000)
Reclassification adjustment for gains in net income	—	—	—	(2,000 )	1,000	(1,000 )
Loss on securities reclassified						

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from available for sale to held to maturity	(742,000 )	285,000	(457,000 )	—	—	—
Accretion of loss on securities reclassified to held to maturity	18,000	(7,000 )	11,000	—	—	—
Change in fair value of interest rate swap	114,000	(46,000 )	68,000	164,000	(66,000 )	98,000
Total other comprehensive income (loss)	3,733,000	(1,451,000)	2,282,000	(4,851,000)	1,880,000	(2,971,000)
Total comprehensive income (loss)	\$5,421,000	\$(1,907,000)	\$3,514,000	\$(3,351,000)	\$1,663,000	\$(1,688,000)

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The following table presents the after-tax changes in the balances of each component of accumulated other comprehensive income for the six months ended June 30, 2014 and 2013.

	Six Months Ended June, 2014			Total
	Components of Accumulated Other Comprehensive Income (Loss)			
	Unrealized Gains and Losses on Available for Sale (AFS) Securities	Loss on securities reclassified from available for sale to held to maturity	Unrealized Gains and Losses on Derivatives	Other
Balance at December 31, 2013	\$ (3,455,000)	\$ —	\$ (335,000)	) \$ (3,790,000 )
Other comprehensive income (loss) before reclassifications	2,660,000	(446,000 )	68,000	2,282,000
Other comprehensive income (loss), net	2,660,000	(446,000 )	68,000	2,282,000
Balance at June 30, 2014	\$ (795,000 )	\$ (446,000 )	\$ (267,000 )	) \$ (1,508,000 )

	Six Months Ended June 30, 2013			Total
	Components of Accumulated Other Comprehensive Income (Loss)			
	Unrealized Gains and Losses on Available for Sale (AFS) Securities	Loss on securities reclassified from available for sale to held to maturity	Unrealized Gains and Losses on Derivatives	Other
Balance at December 31, 2013	\$ 947,000	\$ —	\$ (487,000)	) \$ 460,000
Other comprehensive income (loss) before reclassifications	(3,068,000)	—	98,000	(2,970,000 )
Amounts reclassified from other comprehensive income (loss)	(1,000 )	—	—	(1,000 )
Other comprehensive income (loss), net	(3,069,000)	—	98,000	(2,971,000 )
Balance at June 30, 2013	\$ (2,122,000)	\$ —	\$ (389,000)	) \$ (2,511,000 )

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The following table presents amounts reclassified from each component of accumulated other comprehensive income on a gross and net of tax basis for the six months ended June 30, 2014 and 2013.

Components of Accumulated Other Comprehensive Income (Loss)	Six Months Ended		Income Statement Line Item
	June 30, 2014	2013	
Unrealized gains on AFS securities before tax	\$ —	\$ 2,000	Gains on securities transactions, net )
Tax effect	—	(1,000)	
Total net of tax	—	1,000	
Total reclassifications, net of tax	\$ —	\$ 1,000	

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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 the Corporation and its consolidated subsidiary, Atlantic Stewardship Bank, depending on the context.

**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, 2013 included in the Corporation’s 2013 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 accounting policy and its application are periodically reviewed with the Audit Committee and the Board of Directors.

**Allowance for Loan Losses.** 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 loan 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.

**Deferred Income Taxes.** The Corporation records income taxes in accordance with ASC 740, "Income Taxes," as amended, using the asset and liability method. Accordingly, deferred tax assets and liabilities: (i) are recognized for the expected future tax consequences of events that have been recognized in the financial statements or tax returns; (ii) are attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases; and (iii) are measured using enacted tax rates expected to apply in the years when those temporary differences are expected to be recovered or settled. Where applicable, deferred tax assets are reduced by a valuation allowance for any portions determined not likely to be realized. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income tax expense in the period of enactment. The valuation allowance is adjusted, by a charge or credit to income tax expense, as changes in facts and circumstances warrant.

### **Financial Condition**

Total assets decreased just \$2.0 million to \$671.5 million at June 30, 2014 from \$673.5 million at December 31, 2013. Cash and cash equivalents decreased \$2.8 million to \$14.6 million at June 30, 2014 from \$17.4 million at December 31, 2013. During the second quarter of 2014, the Corporation reclassified \$24.0 million of securities available-for-sale to securities held to maturity as the Corporation has the intent and ability to hold these securities until maturity. The securities were transferred to the held to maturity portfolio to protect our tangible common equity against rising rates and to appropriately align the mix of securities within held to maturity and available-for-sale. After the reclassification, the balance in securities available-for-sale was relatively unchanged while securities held to maturity increased \$4.2 million to \$54.2 million. In late 2013, the Corporation sold \$12.0 million of obligations of state and political subdivisions from the available-for-sale portfolio. The transaction lowered the impact of tax-free income on the portfolio and helped fund the purchase of loan participations. Net loans were relatively unchanged, decreasing just \$849,000 to \$423.4 million at June 30, 2014 compared to \$424.3 million at December 31, 2013. New loans originated during the first six months of fiscal year 2014 were offset by decreases due to regular principal payments and payoffs. Loans held for sale totaled \$259,000 at June 30, 2014, a decrease of \$2,541,000 from \$2.8 million at December 31, 2013. The \$2.8 million represented the fair value of a small group of nonperforming loans that, at December 31, 2013, the Corporation had categorized as held for sale at the lower of cost or fair value of the underlying collateral, less cost to sell. This loan group was sold during the six months ended June 30, 2014 and resulted in a net loss to the Corporation of \$241,000, reflecting further declines in fair value. Other real estate owned (OREO) increased \$774,000 to \$1.2 million at June 30, 2014 compared to \$451,000 at December 31, 2013 reflecting the foreclosure or deed-in-lieu of foreclosure on several properties partially offset by the sale of two OREO properties.

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Deposits totaled \$566.4 million at June 30, 2014, a decrease of \$11.2 million from \$577.6 million at December 31, 2013. The net decline in deposits consisted of a \$21.3 million decrease in interest-bearing accounts partially offset by a \$10.1 million increase in noninterest-bearing accounts.

## Results of Operations

### General

The Corporation reported net income of \$727,000, or \$0.09 diluted earnings per common share for the three months ended June 30, 2014, compared to net income of \$461,000, or \$0.06 diluted earnings per common share for the three months ended June 30, 2013. For the six months ended June 30, 2014, the Corporation reported net income of \$1.2 million, or \$0.15 diluted earnings per common share compared to net income of \$1.3 million, or \$0.17 per diluted common share, for the comparable prior year period.

### Net Interest Income

Net interest income, on a tax equivalent basis, for the three and six months ended June 30, 2014 was \$5.5 million and \$10.9 million, respectively, compared to \$5.8 million and \$11.8 million recorded in the prior year periods. The net interest rate spread and net yield on interest-earning assets for the three months ended June 30, 2014 were 3.32% and 3.51%, respectively, compared to 3.36% and 3.55% for the three months ended June 30, 2013. For the six months ended June 30, 2014, the net interest rate spread and net yield on interest-earning assets were 3.28% and 3.45%, respectively, compared to 3.46% and 3.66% for the six months ended June 30, 2013. The net interest rate spread and net yield on interest-earning assets for the current year periods reflect a decline in loan interest rates and an increase in yields on securities as well as a decline in the interest rates on deposits. The increase in yields on securities partially reflects the above noted sale of lower yielding obligations of state and political subdivisions. In addition, due to a slowdown in mortgage refinance activity, a reduction in premium amortization contributed to an increase in the yields on securities. 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 primarily reflect lower yields on loans reflective of the historically low market rates in the current environment partially offset by increased yields on investment securities.

The following table reflects the components of the Corporation's net interest income for the three and six months ended June 30, 2014 and 2013 including: (1) average assets, liabilities and shareholders' 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 June 30,

	2014			2013			
	Average	Interest	Average	Average	Interest	Average	
	Balance	Income/ Expense	Rates Earned/ Paid	Balance	Income/ Expense	Rates Earned/ Paid	
	(Dollars in thousands)			(Dollars in thousands)			
Assets							
Interest-earning assets:							
Loans (1) (2)	\$424,245	\$ 5,204	4.97	% \$448,182	\$ 5,691	5.09	%
Taxable investment securities (1)	180,124	807	1.82	172,296	676	1.57	
Tax-exempt investment securities (1) (2)	20,880	267	5.19	36,666	406	4.44	
Other interest-earning assets	7,747	6	0.37	391	8	8.21	
Total interest-earning assets	632,996	6,284	4.03	657,535	6,781	4.14	
Non-interest-earning assets:							
Allowance for loan losses	(9,846 )			(11,937 )			
Other assets	43,492			48,871			
Total assets	\$666,642			\$694,469			
Liabilities and Stockholders' Equity							
Interest-bearing liabilities:							
Interest-bearing demand deposits	\$217,825	\$ 155	0.29	% \$234,231	\$ 189	0.32	%
Savings deposits	78,960	21	0.11	72,323	20	0.11	
Time deposits	129,077	266	0.84	147,155	383	1.04	
Repurchase agreements	7,601	91	4.86	7,344	91	4.97	
FHLB-NY borrowing	25,891	151	2.35	25,140	150	2.39	
Subordinated debenture	7,217	126	7.08	7,217	125	7.00	
Total interest-bearing liabilities	466,571	810	0.70	493,410	958	0.78	
Non-interest-bearing liabilities:							
Demand deposits	141,758			140,978			
Other liabilities	2,180			3,413			
Stockholders' equity	56,133			56,668			
Total liabilities and stockholders' equity	\$666,642			\$694,469			
Net interest income (taxable equivalent basis)		5,474			5,823		
Tax equivalent adjustment		(98 )			(145 )		
Net interest income		\$ 5,376			\$ 5,678		
Net interest spread (taxable equivalent basis)			3.33	%		3.36	%

Net yield on interest-earning assets (taxable equivalent basis) (3)	3.51 %	3.55 %
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(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 Six Months Ended June 30,

	2014				2013			
	Average	Interest	Average		Average	Interest	Average	
	Balance	Income/	Rates		Balance	Income/	Rates	
	(Dollars in thousands)	Expense	Earned/		(Dollars in thousands)	Expense	Earned/	
			Paid				Paid	
<b>Assets</b>								
Interest-earning assets:								
Loans (1) (2)	\$427,566	\$10,374	4.89	%	\$445,366	\$11,625	5.26	%
Taxable investment securities (1)	177,595	1,604	1.82		170,419	1,343	1.59	
Tax-exempt investment securities (1) (2)	21,150	538	5.13		36,571	813	4.48	
Other interest-earning assets	8,840	14	0.32		416	14	6.79	
Total interest-earning assets	635,151	12,530	3.98		652,772	13,795	4.26	
Non-interest-earning assets:								
Allowance for loan losses	(10,009)				(11,508)			
Other assets	43,099				48,137			
Total assets	\$668,241				\$689,401			
<b>Liabilities and Stockholders' Equity</b>								
Interest-bearing liabilities:								
Interest-bearing demand deposits	\$222,966	\$316	0.29	%	\$236,548	\$374	0.32	%
Savings deposits	79,070	42	0.11		70,654	38	0.11	
Time deposits	130,708	560	0.87		148,138	821	1.12	
Repurchase agreements	7,556	182	4.86		7,344	181	5.00	
FHLB-NY borrowing	25,730	299	2.34		25,277	298	2.38	
Subordinated debenture	7,217	250	6.99		7,217	250	6.99	
Total interest-bearing liabilities	473,247	1,649	0.70		495,178	1,962	0.80	
Non-interest-bearing liabilities:								
Demand deposits	137,172				134,596			
Other liabilities	2,350				2,977			
Stockholders' equity	55,472				56,650			
Total liabilities and stockholders' equity	\$668,241				\$689,401			
Net interest income (taxable equivalent basis)		10,881				11,833		
Tax equivalent adjustment		(199)				(289)		
Net interest income		\$10,682				\$11,544		
Net interest spread (taxable equivalent basis)			3.28	%			3.46	%

Net yield on interest-earning assets (taxable equivalent basis) (3)	3.45 %	3.66 %
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(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 June 30, 2014, total interest income, on a tax equivalent basis, decreased \$496,000 to \$6.3 million, or 7.3%, when compared to the same prior year period. The decrease was due to both a decrease in the average balance of interest-earning assets and a decrease in yields on interest-earning assets. Total interest income on a tax equivalent basis decreased \$1.3 million to \$12.5 million for the six months ended June 30, 2014, or 9.2%, compared to the same period for 2013. Consistent with the three month period, the decrease in the current six month period is due to a decrease in the overall yield on interest-earning assets and a decrease in the average interest-earning assets. The average rate earned on interest-earning assets was 4.03% and 3.98% for the three and six months ended June 30, 2014, respectively, compared to an average rate of 4.14% and 4.26% for the three and six months ended June 30, 2013. The decline in the asset yield reflects the effect of a prolonged low interest rate environment. Average interest-earning assets decreased \$24.5 million and \$17.6 million for the three and six months ended June 30, 2014 compared to the prior year periods. The change in average interest-earning assets primarily reflects a decrease from the comparable prior year period in average loans, which decreased \$23.9 million and \$17.8 million for the three and six months ended June 30, 2014, respectively.

Interest paid on deposits and borrowed money decreased \$148,000 and \$313,000 for the three and six months ended June 30, 2014, respectively, compared to the same periods for 2013. 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 June 30, 2014, the total cost for interest-bearing liabilities declined to 0.70% representing an 8 basis point decline when compared to the same prior year period. The cost for deposits and borrowed money decreased 10 basis points from 0.80% for the six month period ended June 30, 2013 to 0.70% for the comparable period in 2014. The average balance of total interest-bearing deposits and borrowings decreased \$26.8 million and \$21.9 million for the three and six months ended June 30, 2014, respectively, from the comparable 2013 period. Average interest-bearing deposits decreased \$27.8 million and \$22.6 million for the three and six months ended June 30, 2014, respectively, when compared to the same prior year 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 value of 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, reduce the allowance. The appropriate level of the allowance for loan losses is based on estimates, and ultimate losses may vary from current estimates.

For the three and six months ended June 30, 2014, the Corporation recorded no provision for loan losses compared to \$850,000 and \$2.5 million for the three and six months ended June 30, 2013, respectively. The lack of a provision for loan losses in the current year periods is partially reflective of improvement in the Corporation's credit quality metrics. Nonperforming loans of \$4.9 million at June 30, 2014, or 1.13% of total gross loans, reflected a significant decrease from \$10.2 million of nonperforming loans, or 2.34% of total gross loans, at December 31, 2013.

The allowance for loan losses was \$9.8 million, or 2.27% of total gross loans, as of June 30, 2014 compared to \$9.9 million or 2.28% of total gross loans as of December 31, 2013. The allowance for loan losses related to impaired loans decreased from \$372,000 at December 31, 2013 to \$201,000 at June 30, 2014. During the six months ended June 30, 2014, the Corporation charged off \$283,000 of loan balances and recovered \$193,000 in previously charged off loans compared to \$2.4 million and \$130,000, respectively, during the same period in 2013.

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, charge-off activity and general market conditions. There can be no assurances that the current level of no provision will continue in the future

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

#### Noninterest Income

Noninterest income was \$807,000 and \$1.2 million for the three and six months ended June 30, 2014, respectively, compared to \$995,000 and \$2.5 million for the prior year periods. For both the three and six months ended June 30, 2014, noninterest income included \$54,000 of gains on sales of other real estate owned while there were no such gains for the three months ended June 30, 2013 and \$126,000 of gains on sales of other real estate owned for the six months ended June 30, 2013. Gains on sales of mortgage loans totaled \$2,000 and \$14,000 for the three and six months ended June 30, 2014, respectively, a decrease from \$298,000 and \$460,000 for the three and months ended June 30, 2013. The decline is reflective of a rise in mortgage rates which reduced application volume. The six months ended June 30, 2014 includes a \$241,000 loss from the sale of nonperforming loans. For the prior year six months ended June 30, 2013, there was a \$537,000 payment received as a result of an insurance death benefit.

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Noninterest expenses for the three and six months ended June 30, 2014 was \$5.1 million and \$10.2 million, respectively, compared to \$5.1 million and \$10.1 million in the comparable prior year periods. An increase in data processing expense is reflective of costs associated with the outsourcing / migration of the Corporation's information technology environment / network, including disaster recovery / business continuity planning, to a third party / hosted environment.

Income Tax Expense

Income tax expense totaled \$351,000 and \$456,000 for the three and six months ended June 30, 2014, respectively, representing effective tax rates of 32.6% and 27.0%. For the three and six months ended June 30, 2013, income tax expense totaled \$231,000 and \$217,000, respectively, equating to effective tax rates of 33.4% and 20.7%. The 2014 tax expense includes the impact of tax exempt income. The tax expense for 2013 reflects a decrease in our overall projected effective tax rate as a result of our tax exempt income, including the gain on life insurance proceeds, representing a larger percentage of pretax income.

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. The Corporation manages this risk by maintaining reserves to absorb probable incurred loan losses. In determining the adequacy of the allowance for loan losses, management 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 endeavors 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 each of the last four quarters:

June 30, 2014	March 31, 2014	December 31, 2013	September 30, 2013
(Dollars in thousands)			

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Nonaccrual loans (1)	\$4,875	\$ 5,073	\$ 10,219	\$ 15,269
Loans past due 90 days or more and accruing (2)	—	—	—	—
Total nonperforming loans	4,875	5,073	10,219	15,269
Other real estate owned	1,225	1,789	451	470
Total nonperforming assets	\$6,100	\$ 6,862	\$ 10,670	\$ 15,739
Performing restructured loans (3)	\$15,061	\$ 15,228	\$ 15,231	\$ 10,986
Allowance for loan losses	\$9,825	\$ 9,792	\$ 9,915	\$ 10,704
Nonperforming loans to total gross loans (4)	1.13 %	1.20 %	2.34 %	3.48 %
Nonperforming assets to total assets	0.91 %	1.02 %	1.58 %	2.28 %
Allowance for loan losses to total gross loans	2.27 %	2.31 %	2.28 %	2.44 %
Allowance for loan losses to nonperforming loans	201.54 %	193.02 %	97.03 %	70.10 %

(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.

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

(4) Gross loans includes \$2.8 million of loans held for sale at December 31, 2013.

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 nonperforming loans and mitigating future losses in the portfolio. All delinquent loans continue to be reviewed by management.

At June 30, 2014, the nonaccrual loans were comprised of 57 loans, primarily commercial real estate loans, commercial loans and construction loans. While the Corporation maintains strong underwriting requirements, the number and amount of nonaccrual loans is a reflection 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 other weakness concerns, management has continued to keep these loans on nonaccrual status.

During the six months ended June 30, 2014, nonaccrual loans have decreased over 50% since December 31, 2013 to \$4.9 million. The decrease reflects payments received, payoffs, charge-offs and loans returned to an accrual status partially offset by a small number of new nonaccrual loans. The ratio of allowance for loan losses to nonperforming loans increased to 201.54% at June 30, 2014 from 97.03% at December 31, 2013. The ratio of allowance for loan losses to nonperforming loans is reflective of a detailed analysis and the probable losses to be incurred that we have identified with these nonperforming loans. This metric reflects both the effect of a slight increase in the allowance for loan losses, due primarily from net recoveries, and the decrease in nonaccrual loans.

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 losses to be incurred. The majority of our nonperforming loans are secured by real estate collateral. While we have continued to record appropriate charge-offs, the existing underlying collateral coverage for a considerable portion of the nonperforming loans currently supports collection of a significant portion of our remaining principal.

For loans not included in nonperforming loans, at June 30, 2014, the level of loans past due 30-89 days was only \$27,000 compared to \$1.9 million at December 31, 2013. 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 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 losses to be incurred 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 loan loss 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 early 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.

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For the six months ended June 30, 2014, no provision for loan losses was recorded compared to \$2.5 million for the six months ended June 30, 2013. The total allowance for loan losses of 2.27% of total loans was comparable to a ratio of 2.28% at December 31, 2013.

When management expects 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 three months ended June 30, 2014 the Corporation recorded a net recovery of \$33,000 compared to a net charge-off of \$90,000 for the six months ended June 30, 2014. For the prior year three and six months ended June 30, 2013, net charge-offs were \$1.6 million and \$2.3 million, respectively. These net charge-offs reflect partial writedowns or full charge-offs 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. Regardless of our actions of recording partial and full charge-offs on loans, we continue to aggressively pursue collection, including legal action.

While regular monthly payments continue to be made on many of the nonaccrual loans, certain charge-offs 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 charge-offs recorded based, in general, on the deficiency of such collateral. In general, the charge-offs reflect partial writedowns and full charge-offs on nonaccrual loans due to the initial evaluation of market values of the underlying real estate collateral in accordance with ASC 310-40. Management believes the charge-off of these reserves provides a clearer indication of the value of nonaccrual loans.

At June 30, 2014 and December 31, 2013, the Corporation had \$16.2 million and \$16.6 million, respectively, of loans whose terms have been modified in troubled debt restructurings. Of these loans, \$15.1 million and \$15.2 million were performing in accordance with their new terms at June 30, 2014 and December 31, 2013, respectively. The remaining troubled debt restructurings are reported as nonaccrual loans. Specific reserves of \$142,000 and \$281,000 have been allocated for the troubled debt restructurings at June 30, 2014 and December 31, 2013, respectively. As of June 30, 2014 and December 31, 2013, the Corporation has committed \$21,000 and \$257,000, respectively, of additional funds to a single customer with an outstanding construction loan that is classified as a troubled debt restructuring.

As of June 30, 2014, there were \$13.4 million of other loans not included in the preceding table where credit conditions of borrowers, including real estate tax delinquencies, 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 consists of common and qualifying perpetual preferred shareholders’ equity less goodwill and other intangibles. Tier 2 capital consists of (a) the allowance for loan losses of up to 1.25% of risk-weighted assets, (b) the excess of qualifying preferred stock, (c) hybrid capital instruments, (d) debt, (e) mandatory convertible securities and (f) qualifying subordinated debt. Total qualifying capital consists of Tier 1 capital and Tier 2 capital less reciprocal holdings of other banking organizations’ capital instruments, investments in unconsolidated subsidiaries and any other deductions as determined by the FRB (determined on a case-by-case basis or as a matter of policy after formal rule-making). However, the amount of Tier 2 capital may not exceed the amount of Tier 1 capital. At June 30, 2014, 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 under which a bank holding company must maintain a minimum level of Tier 1 capital to average total consolidated assets of at least 3% (in the case of a bank holding company that has the highest regulatory examination rating and is not contemplating significant growth or expansion) is determined by dividing Tier 1 capital as defined under the risk-based guidelines by average total assets (non-risk-adjusted) for the preceding three months. At June 30, 2014 the minimum leverage ratio requirement to be considered well capitalized was 4%. The following table summarizes the capital ratios for the Corporation and the Bank at June 30, 2014.

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	Actual	Required for Capital Adequacy Purposes	To Be Well Capitalized Under Prompt Corrective Action Regulations		
Leverage ratio					
Corporation	9.35 %	4.00	%	N/A	
Bank	9.11 %	4.00	%	5.00	%
Risk-based capital					
Tier I					
Corporation	13.64 %	4.00	%	N/A	
Bank	13.28 %	4.00	%	6.00	%
Total					
Corporation	14.90 %	8.00	%	N/A	
Bank	14.54 %	8.00	%	10.00	%

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 decreased \$2.8 million during the first six months of 2014. Net operating activities provided \$4.8 million while investing and financing activities used \$2.4 million and \$5.2 million, respectively.

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 Federal Home Loan Bank-NY ("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. The Corporation may also borrow from the Discount Window of the Federal Reserve Bank of New York based on the market value of collateral pledged. In addition, the Corporation has available overnight variable repricing lines of credit with other correspondent banks

totaling \$21.0 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 its participation in the United States Treasury's Small Business Lending Fund (the "SBLF") program, pursuant to which the Corporation issued 15,000 shares of Senior Non-Cumulative Perpetual Preferred Stock, Series B (the "Series B Preferred Shares") to the Treasury for a purchase price of \$15.0 million in cash, the Corporation may only declare and pay dividends on its common stock (or any other equity security 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 at the date of entering into the SBLF program excluding any subsequent charge-offs and any redemption of the Series B Preferred Shares. On July 16, 2014, the Corporation announced that its Board of Directors had declared a \$0.01 per share cash dividend payable on its common stock to shareholders of record as of August 1, 2014. The dividend is to be paid on August 15, 2014.

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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 June 30, 2014 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: August 11, 2014 By: /s/ Paul Van Ostenbridge  
Paul Van Ostenbridge  
President and Chief Executive Officer  
(Principal Executive Officer)

Date: August 11, 2014 By: /s/ Claire M. Chadwick  
Claire M. Chadwick  
Executive 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
101	The following material from Stewardship Financial Corporation's Quarterly Report on Form 10-Q for the quarter ended June 30, 2014, formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Statements of Financial Condition, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Comprehensive Income, (iv) Consolidated Statement of Changes in Shareholders' Equity, (v) Consolidated Statements of Cash Flows and (vi) Notes to Consolidated Financial Statements, tagged as blocks of text <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.