

SI Financial Group, Inc.  
Form 10-Q  
May 09, 2012

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-Q

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

For the Quarterly Period Ended March 31, 2012  
OR

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

For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 0-54241

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

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

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  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 (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  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 definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer

Accelerated Filer

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Non-Accelerated Filer

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

As of May 4, 2012, there were 10,575,776 shares of the registrant's common stock outstanding.

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements.

## SI FINANCIAL GROUP, INC.

## CONSOLIDATED BALANCE SHEETS

(In Thousands, Except Share Amounts / Unaudited)

|  | March 31,<br>2012 | December 31,<br>2011 |
|--|-------------------|----------------------|
| <b>ASSETS:</b>   |                   |                      |
| Cash and due from banks:   |                   |                      |
| Noninterest-bearing  | \$13,911          | \$13,980             |
| Interest-bearing   | 43,877            | 34,432               |
| Total cash and cash equivalents  | 57,788            | 48,412               |
| Available for sale securities, at fair value   | 232,519           | 230,814              |
| Loans held for sale  | 1,645             | 5,558                |
| Loans receivable (net of allowance for loan losses of \$5,378 at March 31, 2012 and \$4,970 at December 31, 2011)  | 632,198           | 618,626              |
| Federal Home Loan Bank stock, at cost  | 8,078             | 8,388                |
| Bank-owned life insurance  | 9,085             | 9,012                |
| Premises and equipment, net  | 11,789            | 12,651               |
| Goodwill and other intangibles   | 3,459             | 4,105                |
| Accrued interest receivable  | 3,473             | 3,539                |
| Deferred tax asset, net  | 4,199             | 4,614                |
| Other real estate owned, net   | 384               | 976                  |
| Prepaid FDIC deposit insurance assessment  | 1,774             | 1,974                |
| Other assets   | 7,641             | 6,378                |
| Total assets   | \$974,032         | \$955,047            |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY:</b>   |                   |                      |
| Liabilities:   |                   |                      |
| Deposits:  |                   |                      |
| Noninterest-bearing  | \$88,079          | \$85,958             |
| Interest-bearing   | 633,108           | 615,968              |
| Total deposits   | 721,187           | 701,926              |
| Mortgagors' and investors' escrow accounts   | 1,750             | 3,291                |
| Federal Home Loan Bank advances  | 100,069           | 100,069              |
| Junior subordinated debt owed to unconsolidated trust  | 8,248             | 8,248                |
| Accrued expenses and other liabilities   | 11,197            | 10,996               |
| Total liabilities  | 842,451           | 824,530              |
| Shareholders' Equity:  |                   |                      |
| Preferred stock (\$.01 par value; 1,000,000 shares authorized; none issued)  | —                 | —                    |
| Common stock (\$.01 par value; 35,000,000 shares authorized; 10,576,849 shares issued; 10,575,776 and 10,576,302 shares outstanding at March 31, 2012 and December 31, 2011, respectively) | 106               | 106                  |
| Additional paid-in-capital   | 94,649            | 94,612               |
| Unallocated common shares held by ESOP   | (5,448            | ) (5,568             |
| Unearned restricted shares   | (35               | ) (38                |

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|  |           |           |   |
|--|-----------|-----------|---|
| Retained earnings  | 42,188    | 42,085    |   |
| Accumulated other comprehensive income (loss)  | 132       | (675      | ) |
| Treasury stock, at cost (1,073 and 547 shares at March 31, 2012 and December 31, 2011, respectively) | (11       | ) (5      | ) |
| Total shareholders' equity   | 131,581   | 130,517   |   |
| Total liabilities and shareholders' equity   | \$974,032 | \$955,047 |   |

See accompanying notes to unaudited interim consolidated financial statements.

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

|   | Three Months Ended<br>March 31, |         |   |
|---|---------------------------------|---------|---|
|   | 2012                            | 2011    |   |
| Interest and dividend income:                                       |                                 |         |   |
| Loans, including fees   | \$7,635                         | \$7,908 |   |
| Securities:   |                                 |         |   |
| Taxable interest  | 1,557                           | 1,561   |   |
| Tax-exempt interest   | 1                               | 1       |   |
| Dividends   | 16                              | 20      |   |
| Other   | 12                              | 30      |   |
| Total interest and dividend income                                  | 9,221                           | 9,520   |   |
| Interest expense:   |                                 |         |   |
| Deposits  | 1,595                           | 1,897   |   |
| Federal Home Loan Bank advances                                     | 849                             | 1,012   |   |
| Subordinated debt   | 107                             | 83      |   |
| Total interest expense  | 2,551                           | 2,992   |   |
| Net interest income   | 6,670                           | 6,528   |   |
| Provision for loan losses   | 484                             | 210     |   |
| Net interest income after provision for loan losses                 | 6,186                           | 6,318   |   |
| Noninterest income:   |                                 |         |   |
| Total other-than-temporary impairment losses on securities          | (409                            | ) —     |   |
| Portion of losses recognized in other comprehensive income          | 373                             | —       |   |
| Net impairment losses recognized in earnings                        | (36                             | ) —     |   |
| Service fees  | 1,210                           | 1,180   |   |
| Wealth management fees  | 1,067                           | 1,066   |   |
| Increase in cash surrender value of bank-owned life insurance       | 72                              | 72      |   |
| Net gain on sale of securities                                      | 317                             | 35      |   |
| Mortgage banking  | 279                             | 169     |   |
| Net (loss) gain in fair value on trading securities and derivatives | (49                             | ) 27    |   |
| Net loss on disposal of equipment                                   | —                               | (7      | ) |
| Net loss on disposal of SI Trust Servicing operations               | (486                            | ) —     |   |
| Other   | 387                             | 107     |   |
| Total noninterest income  | 2,761                           | 2,649   |   |
| Noninterest expenses:   |                                 |         |   |
| Salaries and employee benefits                                      | 4,238                           | 4,144   |   |
| Occupancy and equipment   | 1,486                           | 1,535   |   |
| Computer and electronic banking services                            | 993                             | 956     |   |
| Outside professional services                                       | 364                             | 267     |   |
| Marketing and advertising   | 152                             | 160     |   |
| Supplies  | 137                             | 135     |   |

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|   |        |        |
|---|--------|--------|
| FDIC deposit insurance and regulatory assessments | 272    | 305    |
| Contribution to SI Financial Group Foundation     | —      | 500    |
| Other   | 708    | 711    |
| Total noninterest expenses                        | 8,350  | 8,713  |
| Income before income tax provision                | 597    | 254    |
| Income tax provision                              | 194    | 45     |
| Net income  | \$403  | \$209  |
| Earnings per share:                               |        |        |
| Basic   | \$0.04 | \$0.02 |
| Diluted   | \$0.04 | \$0.02 |

See accompanying notes to unaudited interim consolidated financial statements.



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

|  | Three Months Ended<br>March 31, |       |
|--|---------------------------------|-------|
|  | 2012                            | 2011  |
| Net Income   | \$403                           | \$209 |
| Other comprehensive income, net of tax:                                |                                 |       |
| Net unrealized gain on available for sale securities:                  |                                 |       |
| Net unrealized holding gain on available for sale securities           | 627                             | 499   |
| Less: reclassification adjustment for gains recognized in net income   | (209                            | ) (23 |
| Plus: credit portion of OTTI losses recognized in net income           | 24                              | —     |
| Plus: noncredit portion of OTTI gains on available for sale securities | 360                             | 80    |
| Net unrealized holding gains on available for sale securities          | 802                             | 556   |
| Net unrealized gain on interest-rate swap derivative                   | 5                               | 49    |
| Other comprehensive income   | 807                             | 605   |
| Comprehensive income   | \$1,210                         | \$814 |

See accompanying notes to unaudited interim consolidated financial statements.

## SI FINANCIAL GROUP, INC.

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY

FOR THE THREE MONTHS ENDED MARCH 31, 2012

(In Thousands, Except Share Amounts / Unaudited)

|  | Common Stock |         | Additional<br>Paid-in<br>Capital | Unallocated<br>Common<br>Shares<br>Held<br>by ESOP |          | Unearned<br>Restricted<br>Shares | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income<br>(Loss) |            | Treasury<br>Stock | Total<br>Shareholders'<br>Equity |
|--|--------------|---------|----------------------------------|--|----------|----------------------------------|----------------------|---|------------|-------------------|----------------------------------|
|  | Shares       | Dollars |                                  |  |          |                                  |                      |   |            |                   |                                  |
| Balance at<br>December 31,<br>2011                 | 10,576,849   | \$ 106  | \$ 94,612                        | \$ (5,568 )  | \$ (38 ) | \$ 42,085                        | \$ (675 )            | \$ (5 )   | \$ 130,517 |                   |                                  |
| Net income   | —            | —       | —                                | —  | —        | 403                              | —                    | —   | 403        |                   |                                  |
| Other<br>comprehensive<br>income                   | —            | —       | —                                | —  | —        | —                                | 807                  | —   | 807        |                   |                                  |
| Cash dividends<br>declared (\$.03<br>per share)    | —            | —       | —                                | —  | —        | (300 )                           | —                    | —   | (300 )     |                   |                                  |
| Equity<br>incentive plan<br>compensation           | —            | —       | 26                               | —  | 3        | —                                | —                    | —   | 29         |                   |                                  |
| Allocation of<br>12,159 ESOP<br>shares             | —            | —       | 8                                | 120  | —        | —                                | —                    | —   | 128        |                   |                                  |
| Tax benefit<br>from<br>share-based<br>compensation | —            | —       | 3                                | —  | —        | —                                | —                    | —   | 3          |                   |                                  |
| Treasury stock<br>purchased (526<br>shares)        | —            | —       | —                                | —  | —        | —                                | —                    | (6 )  | (6 )       |                   |                                  |
| Balance at<br>March 31, 2012                       | 10,576,849   | \$ 106  | \$ 94,649                        | \$ (5,448 )  | \$ (35 ) | \$ 42,188                        | \$ 132               | \$ (11 )  | \$ 131,581 |                   |                                  |

See accompanying notes to unaudited interim consolidated financial statements.

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

|   | Three Months Ended<br>March 31, |           |
|---|---------------------------------|-----------|
|   | 2012                            | 2011      |
| Cash flows from operating activities:   |                                 |           |
| Net income  | \$403                           | \$209     |
| Adjustments to reconcile net income to net cash provided by operating activities:     |                                 |           |
| Provision for loan losses   | 484                             | 210       |
| Employee stock ownership plan expense   | 128                             | 114       |
| Equity incentive plan expense   | 29                              | 20        |
| Excess tax benefit from share-based compensation                                      | (3                              | ) (2      |
| Amortization of investment premiums and discounts, net                                | 325                             | 103       |
| Amortization of loan premiums and discounts, net                                      | 206                             | 204       |
| Depreciation and amortization of premises and equipment                               | 501                             | 461       |
| Amortization of core deposit intangible   | 3                               | 5         |
| Net gain on sale of securities  | (317                            | ) (35     |
| Net loss (gain) on trading securities and derivatives                                 | 49                              | (27       |
| Loans originated for sale   | (7,002                          | ) (14,249 |
| Proceeds from sale of loans held for sale   | 11,049                          | 19,785    |
| Net loss on disposal of SI Trust Servicing operations                                 | 486                             | —         |
| Net gain on sale of loans held for sale   | (218                            | ) (124    |
| Net loss on disposal of equipment   | —                               | 7         |
| Net loss on sales or write-downs of other real estate owned                           | 11                              | 62        |
| Increase in cash surrender value of bank-owned life insurance                         | (72                             | ) (72     |
| Gain on bank-owned life insurance proceeds  | —                               | (120      |
| Other-than-temporary impairment losses on securities                                  | 36                              | —         |
| Change in operating assets and liabilities:   |                                 |           |
| Accrued interest receivable   | 66                              | (244      |
| Other assets  | (99                             | ) 1,134   |
| Accrued expenses and other liabilities  | 136                             | (608      |
| Net cash provided by operating activities   | 6,201                           | 6,833     |
| Cash flows from investing activities:   |                                 |           |
| Purchases of available for sale securities  | (27,712                         | ) (47,374 |
| Proceeds from sales of available for sale securities                                  | 9,336                           | 1,065     |
| Proceeds from maturities of and principal repayments on available for sale securities | 18,150                          | 9,917     |
| Net (increase) decrease in loans  | (14,381                         | ) 14,633  |
| Purchases of loans  | —                               | (17,419   |
| Proceeds from sale of other real estate owned   | 700                             | 473       |
| Purchases of premises and equipment   | (335                            | ) (866    |
| Proceeds from bank-owned life insurance   | —                               | 600       |
| Net cash used in investing activities   | (14,242                         | ) (38,971 |
| Cash flows from financing activities:   |                                 |           |
| Net increase in deposits  | 19,261                          | 10,660    |
| Net decrease in mortgagors' and investors' escrow accounts                            | (1,541                          | ) (1,634  |
| Proceeds from Federal Home Loan Bank advances   | —                               | 14,000    |

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|   |        |         |   |
|---|--------|---------|---|
| Repayments of Federal Home Loan Bank advances         | —      | (19,000 | ) |
| Net proceeds from common stock offering               | —      | 2,769   |   |
| Excess tax benefit from share-based compensation      | 3      | 2       |   |
| Purchase of shares by ESOP pursuant to reorganization | —      | (3,141  | ) |
| Cash dividends on common stock                        | (300   | ) (298  | ) |
| Treasury stock purchased                              | (6     | ) (5    | ) |
| Net cash provided by financing activities             | 17,417 | 3,353   |   |

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

|   | Three Months Ended |           |
|---|--------------------|-----------|
|   | March 31,          |           |
|   | 2012               | 2011      |
| Net change in cash and cash equivalents                         | 9,376              | (28,785 ) |
| Cash and cash equivalents at beginning of period                | 48,412             | 78,321    |
| Cash and cash equivalents at end of period                      | \$57,788           | \$49,536  |
| Supplemental cash flow information:                             |                    |           |
| Interest paid   | \$2,513            | \$3,009   |
| Income taxes paid, net  | 13                 | —         |
| Transfer of stock offering escrow for issuance of common shares | —                  | 47,556    |
| Transfer of loans to other real estate owned                    | 119                | 80        |

See accompanying notes to unaudited interim consolidated financial statements.

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2012 AND 2011 AND DECEMBER 31, 2011

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

Nature of Business

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

Effective January 12, 2011, the Company completed its public stock offering and the concurrent conversion of the Bank from the mutual holding company form of organization to the stock form of organization (the "Conversion"). A total of 6,544,493 shares of common stock were sold in the subscription and community offerings at \$8.00 per share, including 392,670 shares purchased by the Savings Institute Bank and Trust Company Employee Stock Ownership Plan (the "ESOP"). Additional shares totaling 4,032,356 were issued in exchange for shares of the former SI Financial Group, Inc. at an exchange ratio of 0.8981. Shares outstanding after the stock offering and the exchange totaled 10,576,849. Proceeds received from the stock offering totaled \$50.3 million, net of costs of \$2.0 million. Earnings per share and the weighted average common shares outstanding reflect the conversion exchange ratio.

Principles of Consolidation

The accompanying consolidated financial statements include the accounts of the Company, its wholly-owned subsidiary, the Bank, and the Bank's wholly-owned subsidiaries, 803 Financial Corp., SI Mortgage Company and SI Realty Company, Inc. All significant intercompany accounts and transactions have been eliminated.

Basis of Financial Statement Presentation

The interim consolidated financial statements and related notes have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information, with the instructions to Form 10-Q and Rule 8-03 of Regulation S-X of the Securities and Exchange Commission ("SEC") and general practices within the banking industry. Accordingly, certain information and footnote disclosures required by GAAP for complete financial statements have been omitted. Information in the accompanying interim consolidated financial statements and notes to the financial statements of the Company as of March 31, 2012 and for the three months ended March 31, 2012 and 2011 is unaudited. These unaudited interim consolidated financial statements and related notes should be read in conjunction with the audited financial statements of the Company and the accompanying notes for the year ended December 31, 2011 contained in the Company's Form 10-K.

In the opinion of management, the accompanying unaudited interim consolidated financial statements reflect all of the adjustments, consisting only of normal and recurring adjustments, necessary for a fair presentation of the financial condition, results of operations and cash flows as of and for the period covered herein. The results of operations for the three months ended March 31, 2012 are not necessarily indicative of the operating results for the year ending December 31, 2012.

In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosures of contingent assets and liabilities, as of the date of the balance sheets and reported amounts of revenues and expenses for the periods presented. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2012 AND 2011 AND DECEMBER 31, 2011

in the near term relate to the determination of the allowance for loan losses, other-than-temporary impairment (“OTTI”) of securities, deferred income taxes and the valuation of intangible assets.

Reclassifications

Certain amounts in the Company’s 2011 consolidated financial statements have been reclassified to conform to the 2012 presentation. Such reclassifications had no effect on net income.

Loans Receivable

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

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

The Company periodically may agree to modify the contractual terms of loans. When a loan is modified and concessions have been made to the original contractual terms, such as reductions of interest rates or deferral of interest or principal payments due to the borrower’s financial condition, the modification is considered a troubled debt restructuring (“TDR”). All TDRs are initially classified as impaired.

Management considers all nonaccrual loans and TDRs to be impaired. In most cases, loan payments less than 90 days past due are considered minor collection delays and the related loans are generally not considered impaired.

Allowance for Loan Losses

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

Management's judgment in determining the adequacy of the allowance is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. The allowance for loan losses is evaluated on a monthly basis by management and is based on the evaluation of the known and inherent risk characteristics and size and composition of the loan portfolio, the assessment of current economic and real estate



market conditions, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, historical loan loss experience, the level of nonperforming loans, delinquencies, classified assets and loan charge-offs and evaluations of loans and other relevant factors.

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2012 AND 2011 AND DECEMBER 31, 2011

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

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

General valuation allowance. The general component represents a valuation allowance on the remainder of the loan portfolio, after excluding impaired loans. For this portion of the allowance, loans are segregated by category and assigned an allowance percentage based on historical loan loss experience adjusted for qualitative factors stratified by the following loan segments: residential one- to four-family, multi-family and commercial real estate, construction, commercial business and consumer. Management uses a rolling average of historical losses based on the time frame appropriate to capture relevant loss data for each loan segment. This historical loss factor is adjusted for the following qualitative factors: levels/trends in delinquencies; level of loan charge-offs and nonperforming loans; trends in terms of volume, nature and terms of loans; effects of changes in risk selection, underwriting standards and other changes in lending policies, procedures and practices; experience/ability and depth of lending management and staff and national and local economic trends and conditions.

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

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

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

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

Commercial Business – Loans in this segment are made to businesses and are generally secured by assets of the business. Repayment is expected from the cash flows of the business. A weakened economy and reduced viability of the industry in which the customer operates will have a negative impact on the credit quality in this segment. To a

lesser extent, the Bank finances capital improvements for condominium associations which are secured by the assigned rights to levy special assessments.

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Consumer – Loans in this segment primarily include home equity lines of credit (representing both first and second liens) and indirect automobile loans and, to a lesser extent, loans secured by marketable securities, passbook or certificate accounts, motorcycles, automobiles and recreational vehicles, as well as unsecured loans. Consumer loan collections depend on the borrower's continuing financial stability, and therefore are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy.

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

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

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

**Interest and Fees on Loans**

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

Loan origination fees and direct loan origination costs are deferred, and the net amount is recognized as an adjustment of the related loan's yield utilizing the interest method over the contractual life of the loan.

**Recent Accounting Pronouncements**

Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements – In May 2011, the Financial Accounting Standards Board ("FASB") amended its standard related to fair value measurement and disclosure requirements in accordance with GAAP and International Financial Reporting Standards. The amendments (1)

change the wording used to describe many of the requirements in GAAP for measuring fair value and for disclosing information about fair value measurement, (2) clarify the intent of the application of existing fair value measurement requirements and (3) change the requirements for measuring fair value and for disclosing information about fair value. The amendments are not intended to change the application of existing requirements for fair value measurement. The amendments should be applied prospectively effective during the first interim and annual periods beginning after December 15, 2011. The adoption of these amendments did not

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have a material impact on the Company's consolidated financial statements.

**Presentation of Comprehensive Income** – In June 2011, the FASB amended its standard related to the presentation of comprehensive income. Under this amendment, an entity will have the option to present the total of comprehensive income, the components of net income and the components of other comprehensive income in a single continuous statement or in two separate but consecutive statements. The Company adopted this amendment as of December 31, 2011 with the presentation of separate consolidated statements of comprehensive income.

**Testing of Goodwill for Impairment** – In September 2011, the FASB amended its standard related to how entities test goodwill for impairment. Under this amendment, an entity is now permitted to first assess qualitative factors to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount as a basis for determining whether it is necessary to perform the two-step goodwill impairment test. If after assessing the totality of events and circumstances, an entity determines it is not more likely than not that the fair value of the reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. Under this amendment, an entity is no longer permitted to carry forward its detailed calculation of a reporting unit's fair value from a prior year. The amendments in this update are effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011. The Company adopted this amendment as of December 31, 2011 and it did not have a material impact on the Company's consolidated financial statements.

**Disclosures about Offsetting Assets and Liabilities** – In December 2011, the FASB amended its standard related to disclosure requirements for offsetting assets and liabilities. Under this amendment, an entity will be required to disclose both gross and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting arrangement. This scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements, and securities borrowing and securities lending arrangements. The amendments in this update are effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures required by these amendments retrospectively for all comparative periods presented. The adoption of this amendment is not expected to have a material impact on the Company's consolidated financial statements.

**NOTE 2. EARNINGS PER SHARE**

Basic earnings per share is calculated by dividing the net income available to common shareholders by the weighted average number of common shares outstanding during the period. Unvested restricted shares are considered outstanding in the computation of basic earnings per share since the shares participate in dividends and the rights to the dividends are non-forfeitable. Diluted earnings per share is computed in a manner similar to basic earnings per share except that the weighted average number of common shares outstanding is increased to include the incremental common shares (as computed using the treasury stock method) that would have been outstanding if all potentially dilutive common stock equivalents were issued during the period. The Company's common stock equivalents relate solely to stock options. Treasury shares and unallocated common shares held by the Bank's ESOP are not deemed outstanding for earnings per share calculations.

Anti-dilutive shares are common stock equivalents with weighted average exercise prices in excess of the weighted average market value for the periods presented, and are not considered in diluted earnings per share calculations. The

Company had 343,807 and 416,677 anti-dilutive common shares outstanding for the three months ended March 31, 2012 and 2011, respectively.

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The computation of earnings per share is as follows:

|   | Three Months Ended                   |            |
|---|--------------------------------------|------------|
|   | March 31,                            |            |
|   | 2012                                 | 2011       |
|   | (In Thousands, Except Share Amounts) |            |
| Net income                                  | \$403                                | \$209      |
| Weighted average common shares outstanding: |                                      |            |
| Basic                                       | 9,971,292                            | 10,114,324 |
| Effect of dilutive stock options            | 27,023                               | 18,751     |
| Diluted                                     | 9,998,315                            | 10,133,075 |
| Earnings per share:                         |                                      |            |
| Basic                                       | \$0.04                               | \$0.02     |
| Diluted                                     | \$0.04                               | \$0.02     |

## NOTE 3. SECURITIES

Available for sale securities:

The amortized cost, gross unrealized gains and losses and approximate fair values of available for sale securities at March 31, 2012 and December 31, 2011 are as follows:

|   | March 31, 2012      |            |            |             |
|---|---------------------|------------|------------|-------------|
|   | Amortized           | Gross      | Gross      | Fair        |
|   | Cost <sup>(1)</sup> | Unrealized | Unrealized | Value       |
|   | (In Thousands)      |            |            |             |
| Debt securities:                                |                     |            |            |             |
| U.S. Government and agency obligations          | \$81,230            | \$802      | \$(40)     | ) \$81,992  |
| Government-sponsored enterprises                | 26,335              | 450        | (5)        | ) 26,780    |
| Mortgage-backed securities: <sup>(2)</sup>      |                     |            |            |             |
| Agency - residential                            | 90,009              | 2,871      | (183)      | ) 92,697    |
| Non-agency - residential                        | 7,052               | 46         | (429)      | ) 6,669     |
| Non-agency - HELOC                              | 2,964               | —          | (511)      | ) 2,453     |
| Corporate debt securities                       | 11,574              | 254        | (165)      | ) 11,663    |
| Collateralized debt obligations                 | 6,206               | —          | (2,728)    | ) 3,478     |
| Obligations of state and political subdivisions | 6,318               | 289        | —          | ) 6,607     |
| Tax-exempt securities                           | 70                  | 1          | —          | ) 71        |
| Foreign government securities                   | 75                  | —          | —          | ) 75        |
| Total debt securities                           | 231,833             | 4,713      | (4,061)    | ) 232,485   |
| Equity securities:                              |                     |            |            |             |
| Equity securities - financial services          | 33                  | 1          | —          | ) 34        |
| Total available for sale securities             | \$231,866           | \$4,714    | \$(4,061)  | ) \$232,519 |



(1) Net of OTTI write-downs recognized in earnings.

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

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|   | December 31, 2011                |                              |                               |               |
|---|----------------------------------|------------------------------|-------------------------------|---------------|
|   | Amortized<br>Cost <sup>(1)</sup> | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|   | (In Thousands)                   |                              |                               |               |
| Debt securities:                                |                                  |                              |                               |               |
| U.S. Government and agency obligations          | \$88,917                         | \$770                        | \$(100)                       | ) \$89,587    |
| Government-sponsored enterprises                | 17,204                           | 462                          | —                             | ) 17,666      |
| Mortgage-backed securities: <sup>(2)</sup>      |                                  |                              |                               |               |
| Agency - residential                            | 85,552                           | 3,070                        | (178)                         | ) 88,444      |
| Non-agency - residential                        | 7,766                            | 21                           | (899)                         | ) 6,888       |
| Non-agency - HELOC                              | 3,097                            | —                            | (559)                         | ) 2,538       |
| Corporate debt securities                       | 14,094                           | 240                          | (287)                         | ) 14,047      |
| Collateralized debt obligations                 | 6,275                            | —                            | (3,358)                       | ) 2,917       |
| Obligations of state and political subdivisions | 6,488                            | 278                          | —                             | ) 6,766       |
| Tax-exempt securities                           | 70                               | 1                            | —                             | ) 71          |
| Foreign government securities                   | 75                               | —                            | —                             | ) 75          |
| Total debt securities                           | 229,538                          | 4,842                        | (5,381)                       | ) 228,999     |
| Equity securities:                              |                                  |                              |                               |               |
| Equity securities - financial services          | 228                              | 1                            | (24)                          | ) 205         |
| Equity securities - other                       | 1,609                            | 96                           | (95)                          | ) 1,610       |
| Total equity securities                         | 1,837                            | 97                           | (119)                         | ) 1,815       |
| Total available for sale securities             | \$231,375                        | \$4,939                      | \$(5,500)                     | ) \$230,814   |

(1) Net of OTTI write-downs recognized in earnings.

(2) Agency securities refer to debt obligations issued or guaranteed by government corporations or government-sponsored enterprises ("GSEs"). Non-agency securities, or private-label securities, are the sole obligation of their issuer and are not guaranteed by one of the GSEs or the U.S. Government.

The amortized cost and fair value of debt securities by contractual maturities at March 31, 2012 are presented below. Actual maturities of mortgage-backed securities ("MBS") may differ from contractual maturities because the mortgages underlying the securities may be called or repaid without any penalties. Because mortgage-backed securities are not due at a single maturity date, they are not included in the maturity categories in the following maturity summary.

|                             | Amortized<br>Cost<br>(In Thousands) | Fair<br>Value |
|-----------------------------|-------------------------------------|---------------|
| Within 1 year               | \$3,824                             | \$3,874       |
| After 1 but within 5 years  | 35,498                              | 36,118        |
| After 5 but within 10 years | 12,484                              | 12,548        |
| After 10 years              | 80,002                              | 78,126        |
|                             | 131,808                             | 130,666       |
| Mortgage-backed securities  | 100,025                             | 101,819       |

|                       |           |           |
|-----------------------|-----------|-----------|
| Total debt securities | \$231,833 | \$232,485 |
|-----------------------|-----------|-----------|

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The following is a summary of realized gains and losses on the sale of securities for the three months ended March 31, 2012 and 2011:

|                                | Three Months Ended March 31, |      |
|--------------------------------|------------------------------|------|
|                                | 2012                         | 2011 |
|                                | (In Thousands)               |      |
| Gross gains on sales           | \$370                        | \$35 |
| Gross losses on sales          | (53                          | ) —  |
| Net gain on sale of securities | \$317                        | \$35 |

Proceeds from the sale of available for sale securities were \$9.3 million and \$1.1 million for the three months ended March 31, 2012 and 2011, respectively.

The following tables present information pertaining to securities with gross unrealized losses at March 31, 2012 and December 31, 2011, aggregated by investment category and length of time the individual securities have been in a continuous unrealized loss position.

| March 31, 2012:                        | Less Than 12 Months |                   | 12 Months Or More |                   | Total      |                   |
|--|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|  | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
|  | (In Thousands)      |                   |                   |                   |            |                   |
| U.S. Government and agency obligations | \$7,807             | \$33              | \$3,829           | \$7               | \$11,636   | \$40              |
| Government sponsored enterprises       | 5,935               | 5                 | —                 | —                 | 5,935      | 5                 |
| Mortgage-backed securities:            |                     |                   |                   |                   |            |                   |
| Agency - residential                   | 18,298              | 146               | 1,005             | 37                | 19,303     | 183               |
| Non-agency - residential               | —                   | —                 | 5,597             | 429               | 5,597      | 429               |
| Non-agency - HELOC                     | —                   | —                 | 2,453             | 511               | 2,453      | 511               |
| Corporate debt securities              | 2,783               | 146               | 981               | 19                | 3,764      | 165               |
| Collateralized debt obligations        | —                   | —                 | 3,478             | 2,728             | 3,478      | 2,728             |
| Total                                  | \$34,823            | \$330             | \$17,343          | \$3,731           | \$52,166   | \$4,061           |
|  |                     |                   |                   |                   |            |                   |
| December 31, 2011:                     | Less Than 12 Months |                   | 12 Months Or More |                   | Total      |                   |
|  | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
|  | (In Thousands)      |                   |                   |                   |            |                   |
| U.S. Government and agency obligations | \$32,390            | \$94              | \$415             | \$6               | \$32,805   | \$100             |
| Mortgage-backed securities:            |                     |                   |                   |                   |            |                   |
| Agency - residential                   | 8,241               | 111               | 1,969             | 67                | 10,210     | 178               |
| Non-agency - residential               | —                   | —                 | 5,305             | 899               | 5,305      | 899               |
| Non-agency - HELOC                     | —                   | —                 | 2,538             | 559               | 2,538      | 559               |
| Corporate debt securities              | 3,482               | 234               | 946               | 53                | 4,428      | 287               |
| Collateralized debt obligations        | —                   | —                 | 2,917             | 3,358             | 2,917      | 3,358             |
| Equity securities - financial services | 169                 | 24                | —                 | —                 | 169        | 24                |

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|                         |          |       |          |         |          |         |
|-------------------------|----------|-------|----------|---------|----------|---------|
| Equity services - other | 708      | 95    | —        | —       | 708      | 95      |
| Total                   | \$44,990 | \$558 | \$14,090 | \$4,942 | \$59,080 | \$5,500 |

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For debt securities with OTTI losses, the Company estimated the portion of loss attributable to credit using a discounted cash flow model in accordance with applicable guidance. Significant inputs for the non-agency mortgage-backed securities included the estimated cash flows of the underlying collateral based on key assumptions, such as default rate, loss severity and prepayment rate. Assumptions used can vary widely from loan to loan, and are influenced by such factors as loan interest rate, geographical location of the borrower, borrower characteristics and collateral type. Significant inputs for the collateralized debt obligations included estimated cash flows and prospective deferrals, defaults and recoveries based on the underlying seniority status and subordination structure of the pooled trust preferred debt tranche at the time of measurement. Prospective deferral, default and recovery estimates affecting projected cash flows were based on an analysis of the underlying financial condition of the individual issuers, with consideration of the account's capital adequacy, credit quality, lending concentrations and other factors. All cash flow estimates were based on the securities' tranche structure and contractual rate and maturity terms. The Company utilized the services of an independent third-party valuation firm to obtain information about the structure in order to determine how the underlying collateral cash flows will be distributed to each security issued from the structure. The present value of the expected cash flows was compared to the Company's holdings to determine the credit-related impairment loss, if any.

To the extent that continued changes in interest rates, credit movements and other factors that influence fair value of investments occur, the Company may be required to record additional impairment charges for OTTI in future periods.

At March 31, 2012, twenty-eight debt securities with gross unrealized losses had aggregate depreciation of 7.22% of the Company's amortized cost basis. The majority of the unrealized losses related to the Company's collateralized debt obligations and non-agency mortgage-backed securities. The Company recognized net impairment losses on securities of \$36,000 for the three months ended March 31, 2012 and did not recognize net impairment losses on securities for the three months ended March 31, 2011. The following summarizes, by security type, the basis for management's determination during the preparation of the financial statements of whether the applicable investments within the Company's securities portfolio were other-than-temporarily impaired at March 31, 2012.

**Debt Securities:**

**U.S. Government and Agency Obligations and Government-Sponsored Enterprises.** The unrealized losses on the Company's U.S. Government and agency obligations and government-sponsored enterprises related primarily to a widening of the rate spread to comparable treasury securities. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell the securities before their anticipated recovery, which may be maturity, the Company did not consider these securities to be other-than-temporarily impaired at March 31, 2012.

**Mortgage-backed Securities - Agency - Residential.** The unrealized losses on the Company's agency-residential mortgage-backed securities were caused by increases in the rate spread to comparable treasury securities. The Company does not expect these securities to settle at a price less than the amortized cost basis of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before the recovery of their amortized cost basis, which may be at maturity, the Company did not consider these investments to be other-than-temporarily impaired at March 31, 2012.

Mortgage-backed Securities - Non-agency - Residential. Despite significant improvement in the market, these securities continue to trade well below historic levels, particularly those backed by jumbo or hybrid loan collateral. In particular, four non-agency mortgage-backed securities displayed market pricing significantly below

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book value or were rated below investment grade at March 31, 2012. At March 31, 2012, management evaluated credit rating details for the tranche, as well as credit information on subordinate tranches, potential future credit losses and loss analyses. Additionally, management reviewed reports prepared by an independent third party for certain non-agency mortgage-backed securities. The Company previously recorded OTTI losses on two of the non-agency mortgage-backed securities totaling \$1.1 million related to credit. The Company recorded additional impairment losses totaling \$36,000 on these two non-agency mortgage-backed securities as of March 31, 2012.

The following table details the Company's non-agency residential mortgage-backed security holdings that are rated below investment grade as of March 31, 2012:

| Security               | Class <sup>(1)</sup> | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Lowest Credit Rating <sup>(2)</sup> | Total Credit-Related OTTI <sup>(3)</sup> | Credit Support Coverage Ratios <sup>(4)</sup> |
|------------------------|----------------------|----------------|------------------------|-------------------------|------------|-------------------------------------|--|---|
| (Dollars in Thousands) |                      |                |                        |                         |            |                                     |  |   |
| MBS 1                  | SSNR, AS             | \$2,117        | \$—                    | \$(390)                 | \$1,727    | CCC                                 | \$110                                    | 0.78  |
| MBS 2                  | SSUP, AS             | —              | 18                     | —                       | 18         | D                                   | 1,071                                    | 0.00  |
| MBS 3                  | PT, AS               | 278            | —                      | —                       | 278        | CCC                                 | —  | 2.41  |
| MBS 4                  | CSTR                 | 3,632          | —                      | \$(39)                  | 3,593      | BB-                                 | —  | 12.00   |
|                        |                      | \$6,027        | \$18                   | \$(429)                 | \$5,616    |                                     | \$1,181                                  |   |

<sup>(1)</sup> Class definitions: PT – Pass Through, AS – Accelerated, SSNR – Super Senior, SSUP – Senior Support and CSTR – Collateral Strip Interest.

<sup>(2)</sup> The Company utilized credit ratings provided by Moody's, S&P and Fitch in its evaluation of issuers.

<sup>(3)</sup> The OTTI amounts provided in the table represent cumulative credit loss amounts through March 31, 2012.

<sup>(4)</sup> The credit support coverage ratio, which is the ratio that determines the multiple of credit support, is based on assumptions for the performance of loans within the delinquency pipeline. The assumptions used are: current collateral support/((60 day delinquencies x .60) + (90 day delinquencies x .70) + (foreclosures x 1.00) + (other real estate x 1.00)) x .40 for loss severity.

Mortgage-backed Securities - Non-agency - HELOC. The unrealized loss on the Company's non-agency - HELOC mortgage-backed security is related to one security whose market has been illiquid. This security is collateralized by home equity lines of credit secured by first and second liens and insured by Financial Security Assurance. At March 31, 2012, management evaluated credit rating details, collateral support and loss analyses. All of the unrealized losses on this security relate to factors other than credit. Because the Company does not intend to sell this security and it is not more likely than not that the Company will be required to sell this security before the recovery of its amortized cost basis, which may be at maturity, the Company did not record an impairment loss at March 31, 2012.

Corporate Debt Securities. Substantially all of the corporate debt securities are rated investment-grade, including those in an unrealized loss position. Various factors were considered in assessing whether the Company expects to recover the amortized cost of corporate debt securities including, but not limited to, the strength of issuer credit ratings, the financial condition of guarantors and the length of time and the extent to which a security's fair value has been less than its amortized cost. Of the \$165,000 in gross unrealized losses related to corporate debt securities, only \$19,000 related to securities that have been in an unrealized loss position for 12 months or more. Based on management's assessment, the Company expects to recover the entire amortized cost basis of all corporate debt



securities that were in an unrealized loss position as of March 31, 2012.

Collateralized Debt Obligations. The unrealized losses on the Company's collateralized debt obligations related to investments in pooled trust preferred securities ("PTPS"). The PTPS market has stabilized at depressed market values as a result of market saturation. Transactions for PTPS have been limited and have occurred primarily as a result of distressed or forced liquidation sales. The securities were widely held by hedge funds and European

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banks and used to offset interest rate exposure tied to LIBOR. As the positions have unwound, an excess supply of these securities have saturated the market.

Management evaluated current credit ratings, credit support and stress testing for future defaults related to the Company's PTPS. Management also reviewed analytics provided by the trustee and independent OTTI reviews and associated cash flow analyses performed by an independent third party. The unrealized losses on the Company's PTPS investments were caused by a lack of liquidity, credit downgrades and decreasing credit support. The increased number of bank and insurance company failures has decreased the level of credit support for these investments. A number of lower tranche income issues have foregone payments or have received payment in kind through increased principal allocations. However, the number of deferring securities has been decreasing and a number of reinstatements have occurred recently. Based on the existing credit profile of the remainder of the Company's PTPS investments, management does not believe that these investments will suffer from any further credit-related losses. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be at maturity, the Company did not record additional impairment losses at March 31, 2012.

The following table details the Company's collateralized debt obligations that are rated below investment grade as of March 31, 2012:

| Security               | Class | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Lowest Credit Rating <sup>(1)</sup> | Total Credit-Related OTTI <sup>(2)</sup> | % of Current Performing Collateral Coverage |
|------------------------|-------|----------------|------------------------|-------------------------|------------|-------------------------------------|--|---|
| (Dollars in Thousands) |       |                |                        |                         |            |                                     |  |   |
| CDO 1                  | B1    | \$1,000        | \$—                    | \$(772)                 | ) \$228    | CCC-                                | \$—                                      | 103.3                                       |
| CDO 2                  | B3    | 1,000          | —                      | (762)                   | ) 238      | CCC-                                | —  | 103.3                                       |
| CDO 3                  | A2    | 2,578          | —                      | (765)                   | ) 1,813    | CCC-                                | 62                                       | 114.7                                       |
| CDO 4                  | A1    | 1,628          | —                      | (429)                   | ) 1,199    | CCC                                 | —  | 149.1                                       |
|                        |       | \$6,206        | \$—                    | \$(2,728)               | ) \$3,478  |                                     | \$62                                     |   |

<sup>(1)</sup> The Company utilized credit ratings provided by Moody's, S&P and Fitch in its evaluation of issuers.

<sup>(2)</sup> The OTTI amounts provided in the table represent cumulative credit loss amounts through March 31, 2012.

The following table presents a roll-forward of the balance of credit losses on the Company's debt securities for which a portion of OTTI was recognized in other comprehensive income for the three months ended March 31, 2012 and 2011.

|   | Three Months Ended March 31, |         |
|---|------------------------------|---------|
|   | 2012                         | 2011    |
|   | (In Thousands)               |         |
| Balance at beginning of period  | \$1,207                      | \$1,093 |
| Additional credit losses for which OTTI losses were previously recognized | 36                           | —       |
| Balance at end of period  | \$1,243                      | \$1,093 |



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

The composition of the Company's loan portfolio at March 31, 2012 and December 31, 2011 is as follows:

|  | March 31, 2012 | December 31,<br>2011 |
|--|----------------|----------------------|
|  | (In Thousands) |                      |
| Real estate loans:                           |                |                      |
| Residential - 1 to 4 family                  | \$246,964      | \$247,426            |
| Multi-family and commercial                  | 172,518        | 158,384              |
| Construction                                 | 15,069         | 12,290               |
| Total real estate loans                      | 434,551        | 418,100              |
| Commercial business loans:                   |                |                      |
| SBA and USDA guaranteed                      | 124,054        | 127,359              |
| Other  | 41,672         | 40,442               |
| Total commercial business loans              | 165,726        | 167,801              |
| Consumer loans:                              |                |                      |
| Home equity                                  | 27,809         | 27,425               |
| Indirect automobile                          | 5,335          | 5,733                |
| Other  | 2,458          | 2,824                |
| Total consumer loans                         | 35,602         | 35,982               |
| Total loans                                  | 635,879        | 621,883              |
| Deferred loan origination costs, net of fees | 1,697          | 1,713                |
| Allowance for loan losses                    | (5,378         | ) (4,970             |
| Loans receivable, net                        | \$632,198      | \$618,626            |

## Allowance for Loan Losses

The following table summarizes the changes in the allowance for loan losses by portfolio segment for the three months ended March 31, 2012 and 2011:

| March 31, 2012                             | Residential -<br>1 to 4 Family | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total   |
|--|--------------------------------|-----------------------------------|--------------|------------------------|----------|---------|
|  | (In Thousands)                 |                                   |              |                        |          |         |
| Balance at beginning of period             | \$759                          | \$2,337                           | \$280        | \$1,148                | \$446    | \$4,970 |
| Provision for loan losses                  | 37                             | 340                               | 88           | (22                    | ) 41     | 484     |
| Loans charged-off                          | (63                            | ) —                               | —            | —                      | (19      | ) (82   |
| Recoveries of loans previously charged-off | 2                              | 1                                 | —            | 1                      | 2        | 6       |

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|                          |       |         |       |         |       |         |
|--------------------------|-------|---------|-------|---------|-------|---------|
| Balance at end of period | \$735 | \$2,678 | \$368 | \$1,127 | \$470 | \$5,378 |
|--------------------------|-------|---------|-------|---------|-------|---------|

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| March 31, 2011                             | Residential -<br>1 to 4 Family | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total   |
|--|--------------------------------|-----------------------------------|--------------|------------------------|----------|---------|
|  | (In Thousands)                 |                                   |              |                        |          |         |
| Balance at beginning of period             | \$915                          | \$2,700                           | \$64         | \$790                  | \$330    | \$4,799 |
| Provision for loan losses                  | 81                             | (70 )                             | 109          | (15 )                  | 105      | 210     |
| Loans charged-off                          | (289 )                         | (32 )                             | (83 )        | (31 )                  | (14 )    | (449 )  |
| Recoveries of loans previously charged-off | —                              | —                                 | —            | 3                      | —        | 3       |
| Balance at end of period                   | \$707                          | \$2,598                           | \$90         | \$747                  | \$421    | \$4,563 |

Further information pertaining to the allowance for loan losses at March 31, 2012 and December 31, 2011 is as follows:

| March 31, 2012   | Residential -<br>1 to 4 Family | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total     |
|--|--------------------------------|-----------------------------------|--------------|------------------------|----------|-----------|
|  | (In Thousands)                 |                                   |              |                        |          |           |
| Allowance for loans deemed to be impaired and individually evaluated     | \$11                           | \$237                             | \$—          | \$75                   | \$27     | \$350     |
| Allowance for loans not deemed to be impaired and collectively evaluated | 724                            | 2,441                             | 368          | 1,052                  | 443      | 5,028     |
| Total loan loss allowance  | \$735                          | \$2,678                           | \$368        | \$1,127                | \$470    | \$5,378   |
| Loans deemed to be impaired and individually evaluated                   | \$5,365                        | \$9,679                           | \$—          | \$625                  | \$316    | \$15,985  |
| Loans not deemed to be impaired and collectively evaluated               | 241,599                        | 162,839                           | 15,069       | 165,101                | 35,286   | 619,894   |
| Total loans  | \$246,964                      | \$172,518                         | \$15,069     | \$165,726              | \$35,602 | \$635,879 |
| December 31, 2011  | Residential -<br>1 to 4 Family | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total     |
|  | (In Thousands)                 |                                   |              |                        |          |           |
| Allowance for loans deemed to be impaired and individually evaluated     | \$33                           | \$107                             | \$—          | \$105                  | \$—      | \$245     |
| Allowance for loans not deemed to be impaired and collectively evaluated | 726                            | 2,230                             | 280          | 1,043                  | 446      | 4,725     |

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|  |           |           |          |           |          |           |
|--|-----------|-----------|----------|-----------|----------|-----------|
| Total loan loss allowance  | \$759     | \$2,337   | \$280    | \$1,148   | \$446    | \$4,970   |
| Loans deemed to be<br>impaired and individually<br>evaluated     | \$5,590   | \$8,650   | \$—      | \$654     | \$316    | \$15,210  |
| Loans not deemed to be<br>impaired and collectively<br>evaluated | 241,836   | 149,734   | 12,290   | 167,147   | 35,666   | 606,673   |
| Total loans  | \$247,426 | \$158,384 | \$12,290 | \$167,801 | \$35,982 | \$621,883 |

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## Past Due Loans

The following represents an aging of loans at March 31, 2012 and December 31, 2011:

| March 31, 2012              | 30-59<br>Days<br>Past Due | 60-89<br>Days<br>Past Due | 90 Days or<br>More<br>Past Due | Total 30<br>Days or<br>More<br>Past Due | Current   | Total<br>Loans |
|-----------------------------|---------------------------|---------------------------|--------------------------------|---|-----------|----------------|
|                             | (In Thousands)            |                           |                                |   |           |                |
| Real Estate:                |                           |                           |                                |   |           |                |
| Residential - 1 to 4 family | \$3,584                   | \$20                      | \$3,641                        | \$7,245                                 | \$239,719 | \$246,964      |
| Multi-family and commercial | 242                       | 1,412                     | 2,479                          | 4,133                                   | 168,385   | 172,518        |
| Construction                | —                         | —                         | —                              | —                                       | 15,069    | 15,069         |
| Commercial Business:        |                           |                           |                                |   |           |                |
| SBA and USDA guaranteed     | 2,542                     | 933                       | —                              | 3,475                                   | 120,579   | 124,054        |
| Other                       | —                         | —                         | 595                            | 595                                     | 41,077    | 41,672         |
| Consumer:                   |                           |                           |                                |   |           |                |
| Home equity                 | 163                       | 281                       | 269                            | 713                                     | 27,096    | 27,809         |
| Indirect automobile         | 11                        | —                         | —                              | 11                                      | 5,324     | 5,335          |
| Other                       | 6                         | —                         | —                              | 6                                       | 2,452     | 2,458          |
| Total                       | \$6,548                   | \$2,646                   | \$6,984                        | \$16,178                                | \$619,701 | \$635,879      |
| December 31, 2011           | 30-59<br>Days<br>Past Due | 60-89<br>Days<br>Past Due | 90 Days or<br>More<br>Past Due | Total 30<br>Days or<br>More<br>Past Due | Current   | Total<br>Loans |
|                             | (In Thousands)            |                           |                                |   |           |                |
| Real Estate:                |                           |                           |                                |   |           |                |
| Residential - 1 to 4 family | \$4,065                   | \$995                     | \$3,835                        | \$8,895                                 | \$238,531 | \$247,426      |
| Multi-family and commercial | 292                       | —                         | 1,703                          | 1,995                                   | 156,389   | 158,384        |
| Construction                | —                         | —                         | —                              | —                                       | 12,290    | 12,290         |
| Commercial Business:        |                           |                           |                                |   |           |                |
| SBA and USDA guaranteed     | 2,729                     | 327                       | —                              | 3,056                                   | 124,303   | 127,359        |
| Other                       | —                         | —                         | 623                            | 623                                     | 39,819    | 40,442         |
| Consumer:                   |                           |                           |                                |   |           |                |
| Home equity                 | —                         | —                         | 269                            | 269                                     | 27,156    | 27,425         |
| Indirect automobile         | —                         | —                         | —                              | —                                       | 5,733     | 5,733          |
| Other                       | 124                       | —                         | —                              | 124                                     | 2,700     | 2,824          |
| Total                       | \$7,210                   | \$1,322                   | \$6,430                        | \$14,962                                | \$606,921 | \$621,883      |

The Company did not have any loans that were past due 90 days or more and still accruing at March 31, 2012 and December 31, 2011.

The Company reviews and establishes, if necessary, an allowance for certain impaired loans for the amount by which the present value of expected cash flows (or observable market price of loan or fair value of the collateral if the loan is



collateral dependent) are lower than the carrying value of the loan. For the periods presented, the Company concluded that certain impaired loans required no valuation allowance as a result of management's measurement of impairment. No additional funds are committed to be advanced to those borrowers whose loans are impaired.

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## Impaired and Nonaccrual Loans

The following is a summary of impaired loans and nonaccrual loans at March 31, 2012 and December 31, 2011:

| March 31, 2012                                   | Impaired Loans      |                          |                   |                  |
|--|---------------------|--------------------------|-------------------|------------------|
|  | Recorded Investment | Unpaid Principal Balance | Related Allowance | Nonaccrual Loans |
|  | (In Thousands)      |                          |                   |                  |
| Impaired loans without valuation allowance:      |                     |                          |                   |                  |
| Real Estate:                                     |                     |                          |                   |                  |
| Residential - 1 to 4 family                      | \$5,188             | \$5,520                  | \$—               | \$5,188          |
| Multi-family and commercial                      | 4,717               | 5,175                    | —                 | 3,756            |
| Commercial business - Other                      | 30                  | 30                       | —                 | 30               |
| Consumer - Home equity                           | 132                 | 147                      | —                 | 132              |
| Total impaired loans without valuation allowance | 10,067              | 10,872                   | —                 | 9,106            |
| Impaired loans with valuation allowance:         |                     |                          |                   |                  |
| Real Estate:                                     |                     |                          |                   |                  |
| Residential - 1 to 4 family                      | 177                 | 177                      | 11                | 177              |
| Multi-family and commercial                      | 4,962               | 5,052                    | 237               | 1,318            |
| Commercial business - Other                      | 595                 | 595                      | 75                | 595              |
| Consumer - Home equity                           | 184                 | 184                      | 27                | 184              |
| Total impaired loans with valuation allowance    | 5,918               | 6,008                    | 350               | 2,274            |
| Total impaired loans                             | \$15,985            | \$16,880                 | \$350             | \$11,380         |
| December 31, 2011                                | Impaired Loans      |                          |                   |                  |
|  | Recorded Investment | Unpaid Principal Balance | Related Allowance | Nonaccrual Loans |
|  | (In Thousands)      |                          |                   |                  |
| Impaired loans without valuation allowance:      |                     |                          |                   |                  |
| Real Estate:                                     |                     |                          |                   |                  |
| Residential - 1 to 4 family                      | \$5,232             | \$5,536                  | \$—               | \$5,232          |
| Multi-family and commercial                      | 4,757               | 5,215                    | —                 | 3,795            |
| Commercial business - Other                      | 31                  | 31                       | —                 | 31               |
| Consumer - Home equity                           | 316                 | 331                      | —                 | 316              |
| Total impaired loans without valuation allowance | 10,336              | 11,113                   | —                 | 9,374            |
| Impaired loans with valuation allowance:         |                     |                          |                   |                  |
| Real Estate:                                     |                     |                          |                   |                  |
| Residential - 1 to 4 family                      | 358                 | 358                      | 33                | 358              |
| Multi-family and commercial                      | 3,893               | 3,983                    | 107               | 236              |
| Commercial business - other                      | 623                 | 623                      | 105               | 623              |
| Total impaired loans with valuation allowance    | 4,874               | 4,964                    | 245               | 1,217            |

|                      |          |          |       |          |
|----------------------|----------|----------|-------|----------|
| Total impaired loans | \$15,210 | \$16,077 | \$245 | \$10,591 |
|----------------------|----------|----------|-------|----------|

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Additional information related to impaired loans is as follows:

|                             | Three Months Ended March 31, 2012 |                            |  | Three Months Ended March 31, 2011 |                            |  |
|-----------------------------|-----------------------------------|----------------------------|--|-----------------------------------|----------------------------|--|
|                             | Average Recorded Investment       | Interest Income Recognized | Interest Income Recognized on Cash Basis | Average Recorded Investment       | Interest Income Recognized | Interest Income Recognized on Cash Basis |
|                             | (In Thousands)                    |                            |  |                                   |                            |  |
| Real Estate:                |                                   |                            |  |                                   |                            |  |
| Residential - 1 to 4 family | \$5,478                           | \$66                       | \$66                                     | \$3,449                           | \$13                       | \$—                                      |
| Multi-family and commercial | 9,164                             | 64                         | —  | 4,522                             | 73                         | —  |
| Construction                | —                                 | —                          | —  | 241                               | —                          | —  |
| Commercial business - Other | 640                               | —                          | —  | 168                               | —                          | —  |
| Consumer - Home equity      | 316                               | —                          | —  | —                                 | —                          | —  |
| Total                       | \$15,598                          | \$130                      | \$66                                     | \$8,380                           | \$86                       | \$—                                      |

## Credit Quality Information

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

- o Pass (Ratings 1-4): Loans in these categories are considered low to average risk.
- o Special Mention (Rating 5): Loans in this category are starting to show signs of potential weakness and are being closely monitored by management.
- o Substandard (Rating 6): Generally, a loan is considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligors and/or the collateral pledged. There is a distinct possibility that the Company will sustain some loss if the weakness is not corrected.
- o Doubtful (Rating 7): Loans classified as doubtful have all the weaknesses inherent in those classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, highly questionable and improbable.
- o Loss (Rating 8): Loans in this category are considered uncollectible and of such little value that their continuance as loans is not warranted.

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

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The following tables present the Company's loans by risk rating at March 31, 2012 and December 31, 2011:

| March 31, 2012                  | Not Rated      | Pass      | Special<br>Mention | Substandard | Doubtful | Loss | Total     |
|---------------------------------|----------------|-----------|--------------------|-------------|----------|------|-----------|
|                                 | (In Thousands) |           |                    |             |          |      |           |
| Real estate loans:              |                |           |                    |             |          |      |           |
| Residential - 1 to 4 family     | \$—            | \$240,673 | \$763              | \$5,528     | \$—      | \$—  | \$246,964 |
| Multi-family and commercial     | —              | 144,718   | 10,296             | 17,504      | —        | —    | 172,518   |
| Construction                    | —              | 14,611    | 242                | 216         | —        | —    | 15,069    |
| Total real estate loans         | —              | 400,002   | 11,301             | 23,248      | —        | —    | 434,551   |
| Commercial business loans:      |                |           |                    |             |          |      |           |
| SBA and USDA guaranteed         | 124,054        | —         | —                  | —           | —        | —    | 124,054   |
| Other                           | —              | 36,305    | 3,651              | 1,716       | —        | —    | 41,672    |
| Total commercial business loans | 124,054        | 36,305    | 3,651              | 1,716       | —        | —    | 165,726   |
| Consumer loans:                 |                |           |                    |             |          |      |           |
| Home equity                     | —              | 27,493    | —                  | 316         | —        | —    | 27,809    |
| Indirect automobile             | —              | 5,335     | —                  | —           | —        | —    | 5,335     |
| Other                           | —              | 2,458     | —                  | —           | —        | —    | 2,458     |
| Total consumer loans            | —              | 35,286    | —                  | 316         | —        | —    | 35,602    |
| Total                           | \$124,054      | \$471,593 | \$14,952           | \$25,280    | \$—      | \$—  | \$635,879 |
| December 31, 2011               | Not Rated      | Pass      | Special<br>Mention | Substandard | Doubtful | Loss | Total     |
|                                 | (In Thousands) |           |                    |             |          |      |           |
| Real estate loans:              |                |           |                    |             |          |      |           |
| Residential - 1 to 4 family     | \$—            | \$240,904 | \$769              | \$5,753     | \$—      | \$—  | \$247,426 |
| Multi-family and commercial     | —              | 135,859   | 8,699              | 13,826      | —        | —    | 158,384   |
| Construction                    | —              | 11,707    | 583                | —           | —        | —    | 12,290    |
| Total real estate loans         | —              | 388,470   | 10,051             | 19,579      | —        | —    | 418,100   |
| Commercial business loans:      |                |           |                    |             |          |      |           |
| SBA and USDA guaranteed         | 127,359        | —         | —                  | —           | —        | —    | 127,359   |
| Other                           | —              | 34,788    | 3,977              | 1,677       | —        | —    | 40,442    |
| Total commercial business loans | 127,359        | 34,788    | 3,977              | 1,677       | —        | —    | 167,801   |
| Consumer loans:                 |                |           |                    |             |          |      |           |
| Home equity                     | —              | 27,109    | —                  | 316         | —        | —    | 27,425    |
| Indirect automobile             | —              | 5,733     | —                  | —           | —        | —    | 5,733     |
| Other                           | —              | 2,824     | —                  | —           | —        | —    | 2,824     |
| Total consumer loans            | —              | 35,666    | —                  | 316         | —        | —    | 35,982    |
| Total                           | \$127,359      | \$458,924 | \$14,028           | \$21,572    | \$—      | \$—  | \$621,883 |



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## Troubled Debt Restructurings

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

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

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

There were no loans modified as TDRs during the three months ended March 31, 2012.

The following table provides, by type of modification, the recorded investment at March 31, 2012 of modified loans identified as TDRs.

|  | Recorded Investment<br>(In Thousands) |
|--|---------------------------------------|
| Interest Rate Adjustments                      | \$2,475                               |
| Principal Deferrals <sup>(1)</sup>             | 443                                   |
| Combination of Rate and Payment <sup>(2)</sup> | 2,124                                 |
| Total  | \$5,042                               |

<sup>(1)</sup> Terms of modifications include temporary interest-only payments with deferral of principal.

<sup>(2)</sup> Terms include combination of interest rate adjustments and interest-only payments with deferral of principal.

One commercial real estate loan with a recorded investment of \$437,000, which was modified as a TDR and included in the above table, was in payment default (defined as 30 days or more past due) during the three months ended March 31, 2012.

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## NOTE 5. PREMISES AND EQUIPMENT

Premises and equipment at March 31, 2012 and December 31, 2011 are summarized as follows:

|   | March 31, 2011 | December 31,<br>2011 |
|---|----------------|----------------------|
|   | (In Thousands) |                      |
| Land                                      | \$2,098        | \$2,098              |
| Buildings                                 | 6,663          | 6,660                |
| Leasehold improvements                    | 7,828          | 7,822                |
| Furniture and equipment                   | 10,665         | 12,272               |
| Construction in process                   | 134            | 20                   |
|   | 27,388         | 28,872               |
| Accumulated depreciation and amortization | (15,599        | ) (16,221            |
| Premises and equipment, net               | \$11,789       | \$12,651             |

Construction in process related to capital improvements at our disaster recovery site at March 31, 2012 and incidental branch improvements at December 31, 2011.

## NOTE 6. ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

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

Components of other comprehensive income for the three months ended March 31, 2012 are as follows:

|   | March 31, 2012       |                |                      |
|---|----------------------|----------------|----------------------|
|   | Before Tax<br>Amount | Tax<br>Effects | Net of Tax<br>Amount |
|   | (In Thousands)       |                |                      |
| Securities:   |                      |                |                      |
| Unrealized holding gains on available for sale securities               | \$950                | \$(323         | ) \$627              |
| Credit portion of OTTI losses recognized in net income                  | 36                   | (12            | ) 24                 |
| Noncredit portion of OTTI gains on available for sale securities        | 545                  | (185           | ) 360                |
| Reclassification adjustment for gains realized in net income            | (317                 | ) 108          | (209                 |
| Unrealized holding gains on available for sale securities, net of taxes | 1,214                | (412           | ) 802                |
| Derivative instrument:  |                      |                |                      |
| Change in fair value of effective cash flow hedging derivative          | 8                    | (3             | ) 5                  |
| Other comprehensive income  | \$1,222              | \$(415         | ) \$807              |



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

|   | March 31, 2012    |         |            |
|---|-------------------|---------|------------|
|   | Before Tax        | Tax     | Net of Tax |
|   | Amount            | Effects | Amount     |
|   | (In Thousands)    |         |            |
| Net unrealized gain on available for sale securities              | \$1,790           | \$(608) | ) \$1,182  |
| Noncredit portion of OTTI losses on available for sale securities | (1,137)           | ) 387   | (750)      |
| Net unrealized loss on effective cash flow hedging derivative     | (454)             | ) 154   | (300)      |
| Accumulated other comprehensive income                            | \$199             | \$(67)  | ) \$132    |
|   | December 31, 2011 |         |            |
|   | Before Tax        | Tax     | Net of Tax |
|   | Amount            | Effects | Amount     |
|   | (In Thousands)    |         |            |
| Net unrealized gain on available for sale securities              | \$1,121           | \$(381) | ) \$740    |
| Noncredit portion of OTTI losses on available for sale securities | (1,682)           | ) 572   | (1,110)    |
| Net unrealized loss on effective cash flow hedging derivative     | (462)             | ) 157   | (305)      |
| Accumulated other comprehensive loss                              | \$(1,023)         | ) \$348 | \$(675)    |

## NOTE 7. REGULATORY CAPITAL

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance sheet items, as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined) and of Tier I capital (as defined) to total assets (as defined). As of March 31, 2012 and December 31, 2011, the Bank met the conditions to be classified as "well capitalized" under the regulatory framework for prompt corrective action. There are no conditions or events since then that management believes have changed the Bank's regulatory category. As a savings and loan holding company regulated by the Federal Reserve Board (the "FRB"), the Company is not currently subject to any separate regulatory capital requirements. The Dodd-Frank Act, however, requires the FRB to promulgate consolidated capital requirements for depository institution holding companies that are no less stringent, quantitatively in terms of components of capital, than those applicable to institutions themselves. There is a five-year transition period before the capital requirements will apply to savings and loan holding companies.



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The Bank's actual capital amounts and ratios as of March 31, 2012 and December 31, 2011 were as follows:

|                                 | Actual                 |       | For Capital Adequacy Purposes |       | To Be Well Capitalized Under Prompt Corrective Action Provisions |       |   |
|---------------------------------|------------------------|-------|-------------------------------|-------|--|-------|---|
|                                 | Amount                 | Ratio | Amount                        | Ratio | Amount   | Ratio |   |
| March 31, 2012                  | (Dollars in Thousands) |       |                               |       |  |       |   |
| Total Risk-based Capital Ratio  | \$108,497              | 22.30 | % \$38,923                    | 8.00  | % \$48,653   | 10.00 | % |
| Tier I Risk-based Capital Ratio | 102,657                | 21.10 | 19,461                        | 4.00  | 29,192   | 6.00  |   |
| Tier I Capital Ratio            | 102,657                | 10.76 | 38,162                        | 4.00  | 47,703   | 5.00  |   |
| December 31, 2011               | (Dollars in Thousands) |       |                               |       |  |       |   |
| Total Risk-based Capital Ratio  | \$106,997              | 22.21 | % \$38,540                    | 8.00  | % \$48,175   | 10.00 | % |
| Tier I Risk-based Capital Ratio | 101,574                | 21.09 | 19,265                        | 4.00  | 28,897   | 6.00  |   |
| Tier I Capital Ratio            | 101,574                | 10.86 | 37,412                        | 4.00  | 46,765   | 5.00  |   |
| Tangible Equity Ratio           | 101,574                | 10.86 | 14,030                        | 1.50  | N/A  | N/A   |   |

## NOTE 8. FAIR VALUE OF ASSETS AND LIABILITIES

## Fair Value Hierarchy

The Company groups its assets and liabilities in three levels based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

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

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

Level 3: Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using unobservable inputs to pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

Determination of Fair Value

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. The fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are

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not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

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

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

• **Trading securities.** The Company held two securities designated as trading securities, which were sold during the second quarter of 2011. A discounted cash flow methodology was used to determine the fair value for these securities. Certain inputs to the fair value calculation are unobservable and management determined that since an orderly and active market for these securities did not exist, the securities met the definition of Level 3 securities.

• **Securities available for sale.** Included in the available for sale category are both debt and equity securities. The securities measured at fair value in Level 1 are based on quoted market prices in an active exchange market. Securities measured at fair value in Level 2 are based on pricing models that consider standard input factors such as observable market data, benchmark yields, interest rate volatilities, broker/dealer quotes, credit spreads and new issue data. The Company utilizes Interactive Data Corporation (“IDC”), a third-party, nationally-recognized pricing service to estimate fair value measurements for the majority of its portfolio. The pricing service evaluates each asset class based on relevant market information considering observable data but these prices do not represent binding quotes. The fair value prices on all investments are reviewed for reasonableness by management. Securities measured at fair value in Level 3 include collateralized debt obligations that are backed by trust preferred securities issued by banks, thrifts and insurance companies. Management determined that an orderly and active market for these securities and similar securities did not exist based on a significant reduction in trading volume and widening spreads relative to historical levels. The Company estimates future cash flows discounted using a rate management believes is representative of current market conditions. Factors in determining the discount rate include the current level of deferrals and/or defaults, changes in credit rating and the financial condition of the debtors within the underlying securities, broker quotes for securities with similar structure and credit risk, interest rate movements and pricing for new issuances.

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

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

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

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

Deposits. The fair value of demand deposits, negotiable orders of withdrawal, regular savings, certain money market deposits and mortgagors' and investors' escrow accounts is the amount payable on demand at the reporting date. The fair value of certificates of deposit and other time deposits is

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estimated using a discounted cash flow calculation that applies interest rates currently being offered for deposits of similar remaining maturities to a schedule of aggregated expected maturities on such deposits.

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

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

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

Forward loan sale commitments and derivative loan commitments. Forward loan sale commitments and derivative loan commitments are based on the fair values of the underlying mortgage loans, including the servicing rights, and the probability of such commitments being exercised. Significant management judgment and estimation is required in determining these fair value measurements.

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

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

The following table presents assets and liabilities measured at fair value on a recurring basis as of March 31, 2012 and December 31, 2011. The Company had no significant transfers into or out of Levels 1, 2 or 3 during the three months ended March 31, 2012.

|   | March 31, 2012 |           |         | Total     |
|---|----------------|-----------|---------|-----------|
|   | Level 1        | Level 2   | Level 3 |           |
|   | (In Thousands) |           |         |           |
| Assets:   |                |           |         |           |
| U.S. Government and agency obligations                        | \$1,043        | \$80,949  | \$—     | \$81,992  |
| Government-sponsored enterprises                              | —              | 26,780    | —       | 26,780    |
| Mortgage-backed securities                                    | —              | 101,819   | —       | 101,819   |
| Corporate debt securities                                     | —              | 11,663    | —       | 11,663    |
| Collateralized debt obligations                               | —              | —         | 3,478   | 3,478     |
| Obligations of state and political subdivisions               | —              | 6,607     | —       | 6,607     |
| Tax-exempt securities   | —              | 71        | —       | 71        |
| Foreign government securities                                 | —              | 75        | —       | 75        |
| Equity securities   | 34             | —         | —       | 34        |
| Forward loan sale commitments and derivative loan commitments | —              | —         | 11      | 11        |
| Total assets  | \$1,077        | \$227,964 | \$3,489 | \$232,530 |

Liabilities:

|   |     |       |      |       |
|---|-----|-------|------|-------|
| Forward loan sale commitments and derivative loan commitments | \$— | \$—   | \$15 | \$15  |
| Interest rate swap agreements                                 | —   | 507   | —    | 507   |
| Total liabilities   | \$— | \$507 | \$15 | \$522 |



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|   | December 31, 2011         |           |         | Total     |
|---|---------------------------|-----------|---------|-----------|
|   | Level 1<br>(In Thousands) | Level 2   | Level 3 |           |
| Assets:   |                           |           |         |           |
| U.S. Government and agency obligations                        | \$1,051                   | \$88,536  | \$—     | \$89,587  |
| Government-sponsored enterprises                              | —                         | 17,666    | —       | 17,666    |
| Mortgage-backed securities                                    | —                         | 97,870    | —       | 97,870    |
| Corporate debt securities                                     | —                         | 14,047    | —       | 14,047    |
| Collateralized debt obligations                               | —                         | —         | 2,917   | 2,917     |
| Obligations of state and political subdivisions               | —                         | 6,766     | —       | 6,766     |
| Tax-exempt securities   | —                         | 71        | —       | 71        |
| Foreign government securities                                 | —                         | 75        | —       | 75        |
| Equity securities   | 1,815                     | —         | —       | 1,815     |
| Forward loan sale commitments and derivative loan commitments | —                         | —         | 82      | 82        |
| Total assets  | \$2,866                   | \$225,031 | \$2,999 | \$230,896 |
| Liabilities:  |                           |           |         |           |
| Forward loan sale commitments and derivative loan commitments | \$—                       | \$—       | \$90    | \$90      |
| Interest rate swap agreement                                  | —                         | 462       | —       | 462       |
| Total liabilities   | \$—                       | \$462     | \$90    | \$552     |

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

|   | Assets<br>Collateralized<br>Debt<br>Obligations<br>(In Thousands) | Liabilities<br>Derivative Loan and<br>Forward Loan Sale<br>Commitments, Net |
|---|---|---|
| Balance at December 31, 2011                                  | \$2,917   | \$(8 )  |
| Change in fair value included in net income                   | —   | 4   |
| Increase in fair value included in other comprehensive income | 561   | —   |
| Balance at March 31, 2012                                     | \$3,478   | \$(4 )  |

## Assets Measured at Fair Value on a Nonrecurring Basis

The Company may also be required, from time to time, to measure certain other financial assets on a nonrecurring basis in accordance with generally accepted accounting principles. These adjustments to fair value usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets. The following table summarizes the fair value hierarchy used to determine each adjustment and the carrying value of the related individual assets as of March 31, 2012 and 2011. There were no liabilities measured at fair value on a nonrecurring basis at March 31, 2012 or 2011.

At March 31, 2012

Three Months Ended

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|                         | Level 1<br>(In Thousands) | Level 2 | Level 3 | March 31, 2012<br>Total Losses |
|-------------------------|---------------------------|---------|---------|--------------------------------|
| Impaired loans          | \$—                       | \$—     | \$2,630 | \$144                          |
| Other real estate owned | —                         | —       | 384     | —                              |
| Total assets            | \$—                       | \$—     | \$3,014 | \$144                          |

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|                         | At March 31, 2011         |         |         | Three Months Ended<br>March 31, 2011 |
|-------------------------|---------------------------|---------|---------|--------------------------------------|
|                         | Level 1<br>(In Thousands) | Level 2 | Level 3 | Total Losses                         |
| Impaired loans          | \$—                       | \$—     | \$904   | \$5                                  |
| Other real estate owned | —                         | —       | 830     | 25                                   |
| Total assets            | \$—                       | \$—     | \$1,734 | \$30                                 |

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

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

Summary of Fair Values of Financial Instruments

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

Management uses its best judgment in estimating the fair value of the Company's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates presented herein are not necessarily indicative of the amounts the Company could have realized in a sales transaction at March 31, 2012 and December 31, 2011. The estimated fair value amounts at March 31, 2012 and December 31, 2011 have been measured as of each respective date, and the estimated fair value amounts at December 31, 2011 have not been re-evaluated or updated for purposes of the consolidated financial statements subsequent to that date. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each period-end. The information presented should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only required for a limited portion of the Company's assets. Due to the wide range of valuation techniques and the degree of subjectivity used in making the estimate, comparisons between the Company's disclosures and those of other banks may not be meaningful.

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As of March 31, 2012 and December 31, 2011, the recorded carrying amounts and estimated fair values of the Company's financial instruments are as follows:

|   | March 31, 2012     |          |         |         |          |
|---|--------------------|----------|---------|---------|----------|
|   | Carrying<br>Amount | Level 1  | Level 2 | Level 3 | Total    |
| Financial Assets:                                     |                    |          |         |         |          |
| (In Thousands)  |                    |          |         |         |          |
| Cash and cash equivalents                             | \$57,788           | \$57,788 | \$—     | \$—     | \$57,788 |
| Available for sale securities                         | 232,519            | 1,077    | 227,964 | 3,478   | 232,519  |
| Federal Home Loan Bank stock                          | 8,078              | —        | —       | 8,078   | 8,078    |
| Loans held for sale                                   | 1,645              | —        | —       | 1,678   | 1,678    |
| Loans receivable, net                                 | 632,198            | —        | —       | 649,294 | 649,294  |
| Accrued interest receivable                           | 3,473              | —        | —       | 3,473   | 3,473    |
| Financial Liabilities:                                |                    |          |         |         |          |
| Deposits  | 721,187            | —        | —       | 723,340 | 723,340  |
| Mortgagors' and investors' escrow accounts            | 1,750              | —        | —       | 1,750   | 1,750    |
| Federal Home Loan Bank advances                       | 100,069            | —        | 105,592 | —       | 105,592  |
| Junior subordinated debt owed to unconsolidated trust | 8,248              | —        | 5,120   | —       | 5,120    |
| On-balance sheet derivative financial instruments:    |                    |          |         |         |          |
| Assets:   |                    |          |         |         |          |
| Derivative loan commitments                           | 11                 | —        | —       | 11      | 11       |
| Liabilities:  |                    |          |         |         |          |
| Derivative loan commitments                           | 6                  | —        | —       | 6       | 6        |
| Forward loan sale commitments                         | 9                  | —        | —       | 9       | 9        |
| Interest rate swap agreements                         | 507                | —        | 507     | —       | 507      |

|   | December 31, 2011  |          |         |         |          |
|---|--------------------|----------|---------|---------|----------|
|   | Carrying<br>Amount | Level 1  | Level 2 | Level 3 | Total    |
| Financial Assets:                                     |                    |          |         |         |          |
| (In Thousands)  |                    |          |         |         |          |
| Cash and cash equivalents                             | \$48,412           | \$48,412 | \$—     | \$—     | \$48,412 |
| Available for sale securities                         | 230,814            | 2,866    | 225,031 | 2,917   | 230,814  |
| Federal Home Loan Bank stock                          | 8,388              | —        | —       | 8,388   | 8,388    |
| Loans held for sale                                   | 5,558              | —        | —       | 5,652   | 5,652    |
| Loans receivable, net                                 | 618,626            | —        | —       | 629,142 | 629,142  |
| Accrued interest receivable                           | 3,539              | —        | —       | 3,539   | 3,539    |
| Financial Liabilities:                                |                    |          |         |         |          |
| Deposits  | 701,926            | —        | —       | 704,333 | 704,333  |
| Mortgagors' and investors' escrow accounts            | 3,291              | —        | —       | 3,291   | 3,291    |
| Federal Home Loan Bank advances                       | 100,069            | —        | 105,666 | —       | 105,666  |
| Junior subordinated debt owed to unconsolidated trust | 8,248              | —        | 4,399   | —       | 4,399    |
| On-balance sheet derivative financial instruments:    |                    |          |         |         |          |

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Assets:

|                               |    |   |   |    |    |
|-------------------------------|----|---|---|----|----|
| Derivative loan commitments   | 78 | — | — | 78 | 78 |
| Forward sale loan commitments | 4  | — | — | 4  | 4  |

Liabilities:

|                               |     |   |     |    |     |
|-------------------------------|-----|---|-----|----|-----|
| Forward sale loan commitments | 90  | — | —   | 90 | 90  |
| Interest rate swap agreement  | 462 | — | 462 | —  | 462 |

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Off-Balance Sheet Instruments

The Company assumes interest rate risk, which represents the risk that general interest rate levels will change, as a result of its normal operations. As a result, the fair values of the Company's financial instruments will change when interest rate levels change and that change may be either favorable or unfavorable to the Company. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed-rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities and attempts to minimize interest rate risk by adjusting terms of new loans and deposits and by investing in securities with terms that mitigate the Company's overall interest rate risk.

NOTE 9. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

Derivative Financial Instruments

The Company has stand-alone derivative financial instruments in the form of interest rate swap agreements, which derive their value from underlying interest rates. These transactions involve both credit and market risk. The notional amounts are amounts on which calculations, payments and the value of the derivative are based. Notional amounts do not represent direct credit exposures. Direct credit exposure is limited to the net difference between the calculated amounts to be received and paid, if any. Such difference, which represents the fair value of the derivative instruments, is reflected on the Company's balance sheets as other assets and other liabilities.

The Company is exposed to credit-related losses in the event of nonperformance by the counterparties to these agreements. The Company controls the credit risk of its financial contracts through credit approvals, limits and monitoring procedures and does not expect any counterparties to fail their obligations.

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

Derivative Instruments Designated As Hedging Instruments

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

At March 31, 2012 and December 31, 2011, information pertaining to the outstanding interest rate swap agreement used to hedge variable rate debt is as follows:

| March 31, 2012 | December 31, 2011 |
|----------------|-------------------|
|----------------|-------------------|

|  | (Dollars in Thousands) |         |   |
|--|------------------------|---------|---|
| Notional amount                                | \$8,000                | \$8,000 |   |
| Weighted average fixed pay rate                | 2.44                   | % 2.44  | % |
| Weighted average variable receive rate         | 0.47                   | % 0.55  | % |
| Weighted average maturity in years             | 3.7                    | 4.0     |   |
| Unrealized loss relating to interest rate swap | \$454                  | \$462   |   |

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At March 31, 2012 and December 31, 2011, the unrealized loss related to the above mentioned interest rate swap was recorded as a derivative liability. Changes in the fair value of an interest rate swap designated as a hedging instrument of the variability of cash flows associated with long-term debt are reported in other comprehensive income. These amounts are subsequently reclassified into interest expense as a yield adjustment in the same period in which the related interest on the long-term debt affects earnings.

Risk management results for the periods ended March 31, 2012 and December 31, 2011, related to the balance sheet hedging of long-term debt, indicate that the hedge was 100% effective and that there was no component of the derivative instrument's loss which was excluded from the assessment of hedge effectiveness.

The Company's derivative contract contains a provision establishing a collateral requirement (subject to minimum collateral posting thresholds) based on the Company's external credit rating. If the Company's junior subordinated debt rating was to fall below the level generally recognized as investment grade, the counterparty to such derivative contract could require additional collateral on the derivative transaction in a net liability position (after considering the effect of bilateral netting arrangements and posted collateral). The aggregate fair value of the derivative instrument, with such a credit-related contingent feature that was in a net liability position at March 31, 2012, was \$454,000 for which the Company had previously posted collateral of \$600,000 in the normal course of business.

Derivative Instruments Not Designated As Hedging Instruments

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

Interest Rate Swap Agreement - During the first quarter of 2012, management entered into an interest rate swap agreement, that does not meet the strict hedge accounting requirements of FASB's "Derivatives and Hedging" standard, to manage the Company's exposure to interest rate movements and other identified risks. Changes in fair value of this instrument are recorded as a component of noninterest income. At March 31, 2012, information pertaining to the Company's interest rate swap agreement not designated as a hedge is as follows:

|  | March 31, 2012         |   |
|--|------------------------|---|
|  | (Dollars in Thousands) |   |
| Notional amount                        | \$15,000               |   |
| Weighted average fixed pay rate        | 1.26                   | % |
| Weighted average variable receive rate | 0.58                   | % |
| Weighted average maturity in years     | 4.8                    |   |

The Company reported a loss in fair value on the interest rate swap not designated as a hedge of \$53,000 in noninterest income for the three months ended March 31, 2012.

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



inception of the rate lock.

Outstanding derivative loan commitments expose the Company to the risk that the price of the loans arising from exercise of the loan commitment might decline from inception of the rate lock to funding of the loan due to increases in mortgage interest rates. If interest rates increase, the value of these loan commitments decrease.

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Conversely, if interest rates decrease, the value of these loan commitments increase. The loss in fair value of such commitments, which totaled \$73,000, was recorded in noninterest income on the income statement for the three months ended March 31, 2012.

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

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

The Company expects that these forward loan sale commitments will experience changes in fair value opposite to the change in fair value of derivative loan commitments. The gain in fair value of such commitments, which totaled \$77,000, was recorded in noninterest income on the income statement for the three months ended March 31, 2012.

## Interest Rate Risk Management - Derivative Instruments

The following table presents the fair values of derivative instruments as well as their classification on the consolidated balance sheets at March 31, 2012 and December 31, 2011.

| Balance Sheet<br>Location<br>(In Thousands)        | March 31, 2012     |                         | December 31, 2011  |                         |          |
|--|--------------------|-------------------------|--------------------|-------------------------|----------|
|  | Notional<br>Amount | Estimated<br>Fair Value | Notional<br>Amount | Estimated<br>Fair Value |          |
| Derivative designated as hedging instrument:       |                    |                         |                    |                         |          |
| Interest rate swap                                 | Other Liability    | \$8,000                 | \$(454 )           | \$8,000                 | \$(462 ) |
| Derivatives not designated as hedging instruments: |                    |                         |                    |                         |          |
| Interest rate swap                                 | Other Liability    | 15,000                  | (53 )              | —                       | —        |
| Derivative loan commitments                        | Other Asset        | 7,319                   | 5                  | 9,074                   | 78       |
| Forward loan sale commitments                      | Other Liability    | 2,159                   | (9 )               | 9,108                   | (86 )    |

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

Management's discussion and analysis of financial condition and results of operations is intended to assist in understanding changes in the Company's financial condition as of March 31, 2012 and December 31, 2011 and the results of operations for the three months ended March 31, 2012 and 2011. The information contained in this section should be read in conjunction with the consolidated financial statements and notes thereto appearing in Part I, Item 1 of this document as well as with management's discussion and analysis of financial condition and results of operations and consolidated financial statements included in the Company's 2011 Annual Report on Form 10-K.

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

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

#### Critical Accounting Policies

The Company considers accounting policies involving significant judgments and assumptions by management that have, or could have, a material impact on the carrying value of certain assets or on income to be critical accounting policies. The Company considers the determination of allowance for loan losses, OTTI of securities, deferred income taxes and the impairment of long-lived assets to be its critical accounting policies. Additional information about the Company's accounting policies is included in the notes to the Company's consolidated financial statements contained in Part I, Item 1 of this document and in the Company's 2011 Annual Report on Form 10-K.

#### Impact of New Accounting Standards

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

Comparison of Financial Condition at March 31, 2012 and December 31, 2011

Assets:

Summary. Assets increased \$19.0 million, or 2.0%, to \$974.0 million at March 31, 2012 from \$955.0 million at December 31, 2011, principally due to increases of \$13.6 million in net loans receivable, \$9.4 million in cash and cash equivalents and \$1.7 million in available for sale securities, offset by a decrease of \$3.9 million in loans held for sale. Cash and cash equivalents increased due to the increase in deposits. Securities increased with the purchase of primarily mortgage-backed securities and government-sponsored enterprise securities.

Loans Receivable, Net. Net loans receivable increased \$13.6 million. Loan originations totaled \$48.7 million during the first three months of 2012, an increase of \$13.2 million compared to the same period in 2011. Changes in the loan portfolio consisted of the following:

Residential Loans. Residential mortgage loans comprised 38.8% of the total loan portfolio at March 31, 2012. Residential mortgage loans decreased \$462,000, or 0.2%, primarily due to prepayments and the sale of \$10.9 million of longer-term fixed-rate residential mortgage loans, offset by \$18.3 million in residential mortgage loan originations. Residential loan originations decreased \$6.8 million for the first three months of 2012 over the comparable period in 2011.

Commercial Loans. The commercial loan portfolio, which includes multi-family and commercial real estate and commercial business loans, represented 53.2% of total loans. Multi-family and commercial real estate loans increased \$14.1 million, or 8.9%, largely due to loan originations of \$22.8 million. Loan originations for commercial real estate loans increased \$15.4 million during the first three months of 2012 compared to the same period in 2011. Commercial business loans decreased \$2.1 million, or 1.2%, despite loan originations of \$5.6 million. Loan originations for commercial business loans increased \$5.3 million during the first three months of 2012, resulting from the addition of several new commercial lenders.

Construction Loans. Construction loans, which include both residential and commercial construction loans, increased \$2.8 million. The increase primarily related to one commercial construction loan that will convert to a permanent commercial real estate loan upon the completion of the construction project.

Consumer Loans. Consumer loans represent 5.6% of the Company's total loan portfolio. Consumer loans decreased \$380,000 during the first three months of 2012. Increases in home equity loans of \$384,000 were offset by decreases of \$398,000 and \$366,000 in indirect automobile and other consumer loans, respectively. Loan originations for consumer loans totaled \$2.1 million, representing a decrease of \$693,000 for the three months ended March 31, 2012 from the comparable period in 2011.

The allowance for loan losses totaled \$5.4 million at March 31, 2012 compared to \$5.0 million at December 31, 2011. The ratio of the allowance for loan losses to total loans increased from 0.80% at December 31, 2011 to 0.85% at March 31, 2012.

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

|   | March 31, 2012         | December 31,<br>2011 |       |
|---|------------------------|----------------------|-------|
|   | (Dollars in Thousands) |                      |       |
| Nonaccrual loans:   |                        |                      |       |
| Real estate loans   |                        |                      |       |
| Residential - 1 to 4 family   | \$5,365                | \$5,590              |       |
| Multi-family and commercial   | 5,074                  | 4,031                |       |
| Total real estate loans   | 10,439                 | 9,621                |       |
| Commercial business loans   | 625                    | 654                  |       |
| Consumer loans  |                        |                      |       |
| Home equity   | 316                    | 316                  |       |
| Total nonaccrual loans  | 11,380                 | 10,591               |       |
| Accruing loans past due 90 days or more                                     | —                      | —                    |       |
| Total nonperforming loans   | 11,380                 | 10,591               |       |
| Other real estate owned, net <sup>(1)</sup>                                 | 384                    | 976                  |       |
| Total nonperforming assets  | 11,764                 | 11,567               |       |
| Accruing troubled debt restructurings                                       | 4,605                  | 4,620                |       |
| Total nonperforming assets and troubled debt restructurings                 | \$16,369               | \$16,187             |       |
| Allowance for loan losses as a percent of nonperforming loans               | 47.26                  | %                    | 46.93 |
| Total nonperforming loans to total loans                                    | 1.79                   | %                    | 1.70  |
| Total nonperforming loans to total assets                                   | 1.17                   | %                    | 1.11  |
| Total nonperforming assets and troubled debt restructurings to total assets | 1.68                   | %                    | 1.69  |

<sup>(1)</sup> Other real estate owned balances are shown net of related write-downs or valuation allowance.

An increase in nonperforming multi-family and commercial real estate loans of \$1.0 million contributed to the higher balance of nonperforming loans at March 31, 2012. Nonperforming loans are expected to remain elevated in the short-term due to recent changes that extended the State of Connecticut's foreclosure process. The modification of loan terms, which may result in TDR classification, may be provided to borrowers when necessary to preserve the unpaid principal balance of certain loans.

Other real estate owned decreased \$592,000 from December 31, 2011 to March 31, 2012, primarily as a result of the sale of one commercial property and three residential properties with an aggregate carrying value of \$711,000. During the first three months of 2012, the Company acquired one residential property with a carrying value totaling \$119,000. At March 31, 2012, other real estate owned included two residential properties and one commercial property.

Troubled debt restructurings, which consisted of six commercial real estate loans, with modifications consisting of deferred principal payments, interest rate concessions or a combination of deferred principal payments and interest rate concessions, totaled \$5.0 million at March 31, 2012 compared to \$5.1 million at December 31, 2011. Of the total troubled debt restructurings, \$4.6 million were accruing in accordance with their restructured terms at March 31, 2012 and December 31, 2011. The Company anticipates that the borrowers will repay all contractual principal and interest in accordance with the terms of their restructured loan agreements.



**Liabilities:**

Summary. Liabilities increased \$17.9 million, or 2.2%, to \$842.5 million at March 31, 2012 compared to \$824.5 million at December 31, 2011. Deposits increased \$19.3 million, or 2.7%, which included increases in NOW and money market accounts of \$14.9 million, noninterest-bearing deposits of \$2.1 million and certificates of deposit of \$1.7 million. Deposit growth remained strong due to marketing and promotional initiatives and competitively-priced deposit products. Borrowings, including subordinated debentures, remained unchanged at \$108.3 million for March 31, 2012 and December 31, 2011.

**Equity:**

Summary. Shareholders' equity increased \$1.1 million from \$130.5 million at December 31, 2011 to \$131.6 million at March 31, 2012. The increase in shareholders' equity was attributable to an increase in net unrealized gains on available for sale securities aggregating \$802,000 (net of taxes) and earnings of \$403,000, offset by dividends of \$300,000.

Accumulated Other Comprehensive Income (Loss). Accumulated other comprehensive income (loss) is comprised of the unrealized gains and losses on available for sale securities and unrealized gains and losses on an interest rate swap, net of taxes. Net unrealized gains on available for sale securities, net of taxes, totaled \$432,000 at March 31, 2012 compared to net unrealized losses on available for sale securities, net of taxes, of \$370,000 at December 31, 2011. Unrealized gains on available for sale securities at March 31, 2012 resulted from an improvement in the market value of primarily the debt securities portfolio, which was recognized in accumulated other comprehensive income on the consolidated balance sheet and a component of comprehensive income on the consolidated statement of changes in shareholders' equity. The net unrealized loss on the interest rate swap, net of taxes, totaled \$300,000 and \$305,000 at March 31, 2012 and December 31, 2011, respectively.

**Results of Operations for the Three Months Ended March 31, 2012 and 2011**

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

Summary. The Company reported net income of \$403,000 for the three months ended March 31, 2012, an increase of \$194,000, compared to net income of \$209,000 for the three months ended March 31, 2011, primarily due to increases in net interest income and noninterest income and a decrease in noninterest expenses, offset by increases in the provision for loan losses and the income tax provision.

Interest and Dividend Income. Total interest and dividend income decreased \$299,000, or 3.1%, to \$9.2 million for the three months ended March 31, 2012, compared to the same period in 2011. The decrease in interest income was due to lower yields on interest-earning assets, offset by an increase in the average balance of loans and securities. The yield earned on interest-earning assets decreased 31 basis points to 4.06%, with the yield on investment securities contributing the largest decrease of 40 basis points to 2.63%. Average interest-earning assets increased \$29.5 million to \$912.7 million in 2012, mainly due to an increase in the average balance of securities of \$29.1 million

Interest Expense. For the three months ended March 31, 2012, interest expense decreased \$441,000, or 14.7%, to \$2.6 million compared to \$3.0 million for the same period in 2011, primarily due to lower rates paid on interest-bearing deposits and FHLB borrowings and a decrease in the average balance of FHLB borrowings, offset by an



increase in the average balance of NOW and money market deposits and an increase in the rate on subordinated debt. Average interest-bearing deposits increased \$23.7 million to \$625.9 million while the average rate decreased 26 basis points to 1.02%. An increase in the average balance of NOW and money market accounts totaling \$51.9 million was offset by decreases in the average balance of savings accounts and certificates of deposit totaling \$16.2 million and \$12.1 million, respectively, as certain customers shifted from savings accounts and certificates of deposit to NOW and money market accounts. The average balance of FHLB advances decreased \$13.4 million and the average rate decreased 21 basis points to 3.41%. Impacted by the interest rate swap, the average rate on subordinated debt increased 114 basis points to 5.22%. Average rates declined as a result of the sustained lower interest rate environment during 2012.

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

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|  | At or For the Three Months Ended March 31,<br>2012 |                         |                           | 2011               |                         |                           |   |  |
|--|--|-------------------------|---------------------------|--------------------|-------------------------|---------------------------|---|--|
|  | Average<br>Balance                                 | Interest &<br>Dividends | Average<br>Yield/<br>Rate | Average<br>Balance | Interest &<br>Dividends | Average<br>Yield/<br>Rate |   |  |
| (Dollars in Thousands)   |  |                         |                           |                    |                         |                           |   |  |
| Interest-earning assets:   |  |                         |                           |                    |                         |                           |   |  |
| Loans <sup>(1) (2)</sup>   | \$630,078  | \$7,635                 | 4.87                      | % \$614,448        | \$7,908                 | 5.22                      | % |  |
| Securities <sup>(3)</sup>  | 240,914  | 1,574                   | 2.63                      | 211,845            | 1,582                   | 3.03                      |   |  |
| Other interest-earning assets  | 41,676   | 12                      | 0.12                      | 56,909             | 30                      | 0.21                      |   |  |
| Total interest-earning assets  | 912,668  | 9,221                   | 4.06                      | 883,202            | 9,520                   | 4.37                      |   |  |
| Noninterest-earning assets   | 49,837   |                         |                           | 58,562             |                         |                           |   |  |
| Total assets   | \$962,505  |                         |                           | \$941,764          |                         |                           |   |  |
| Interest-bearing liabilities:  |  |                         |                           |                    |                         |                           |   |  |
| Deposits:  |  |                         |                           |                    |                         |                           |   |  |
| Interest-bearing demand  | \$44   | —                       | —                         | \$—                | —                       | —                         |   |  |
| NOW and money market   | 313,981  | 215                     | 0.28                      | 262,036            | 339                     | 0.52                      |   |  |
| Savings <sup>(4)</sup>   | 39,107   | 35                      | 0.36                      | 55,258             | 54                      | 0.40                      |   |  |
| Certificates of deposit <sup>(5)</sup>   | 272,802  | 1,345                   | 1.98                      | 284,930            | 1,504                   | 2.14                      |   |  |
| Total interest-bearing deposits  | 625,934  | 1,595                   | 1.02                      | 602,224            | 1,897                   | 1.28                      |   |  |
| Federal Home Loan Bank advances  | 100,069  | 849                     | 3.41                      | 113,447            | 1,012                   | 3.62                      |   |  |
| Subordinated debt  | 8,248  | 107                     | 5.22                      | 8,248              | 83                      | 4.08                      |   |  |
| Total interest-bearing liabilities   | 734,251  | 2,551                   | 1.40                      | 723,919            | 2,992                   | 1.68                      |   |  |
| Noninterest-bearing liabilities  | 96,278   |                         |                           | 87,236             |                         |                           |   |  |
| Total liabilities  | 830,529  |                         |                           | 811,155            |                         |                           |   |  |
| Total shareholders' equity   | 131,976  |                         |                           | 130,609            |                         |                           |   |  |
| Total liabilities and shareholders' equity   | \$962,505  |                         |                           | \$941,764          |                         |                           |   |  |
| Net interest-earning assets  | \$178,417  |                         |                           | \$159,283          |                         |                           |   |  |
| Tax equivalent net interest income <sup>(3)</sup>  |  | 6,670                   |                           |                    | 6,528                   |                           |   |  |
| Tax equivalent interest rate spread <sup>(6)</sup>   |  |                         | 2.66                      | %                  |                         | 2.69                      | % |  |
| Tax equivalent net interest margin as a percentage of interest-earning assets <sup>(7)</sup> |  |                         | 2.94                      | %                  |                         | 3.00                      | % |  |
| Average of interest-earning assets to average interest-bearing liabilities                   |  |                         | 124.30                    | %                  |                         | 122.00                    | % |  |
| Net interest income  |  | \$6,670                 |                           |                    | \$6,528                 |                           |   |  |

- (1) Amount is net of deferred loan origination fees and costs. Average balances include nonaccrual loans and loans held for sale and excludes the allowance for loan losses.
- (2) Loan fees are included in interest income and are immaterial.
- (3) Municipal securities income and net interest income are presented on a tax equivalent basis using a tax rate of 34%. The tax equivalent adjustment is deducted from tax equivalent net interest income to agree to the amounts reported in the statements of income.
- (4) Includes mortgagors' and investors' escrow accounts.
- (5) Includes brokered deposits.
- (6) Tax equivalent net interest rate spread represents the difference between the weighted average yield on interest-earning assets and the weighted average cost of interest-bearing liabilities.
- (7) Tax equivalent net interest margin represents tax equivalent net interest income divided by average interest-earning assets.

The following table sets forth the extent to which changes in interest rates and changes in volume of interest-earning assets and interest-bearing liabilities have on the Company's interest income and interest expense for the periods presented. The rate column shows the effects attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effects attributable to changes in volume (changes in volume multiplied by prior rate). The net column represents the sum of the rate and volume columns. For purposes of this table, changes attributable to both changes in rate and volume that cannot be segregated have been allocated proportionately based on the changes due to rate and the changes due to volume.

|                                    | Three Months Ended         |          |         |
|------------------------------------|----------------------------|----------|---------|
|                                    | March 31, 2012 and 2011    |          |         |
|                                    | Increase (Decrease) Due To |          | Net     |
|                                    | Rate                       | Volume   |         |
|                                    | (In Thousands)             |          |         |
| Interest-earning assets:           |                            |          |         |
| Interest and dividend income:      |                            |          |         |
| Loans <sup>(1)(2)</sup>            | \$ (460                    | ) \$ 187 | \$ (273 |
| Securities <sup>(3)</sup>          | (217                       | ) 209    | (8      |
| Other interest-earning assets      | (11                        | ) (7     | ) (18   |
| Total interest-earning assets      | (688                       | ) 389    | (299    |
| Interest-bearing liabilities:      |                            |          |         |
| Interest expense:                  |                            |          |         |
| Deposits <sup>(4)</sup>            | (288                       | ) (14    | ) (302  |
| Federal Home Loan Bank advances    | (53                        | ) (110   | ) (163  |
| Subordinated debt                  | 24                         | —        | 24      |
| Total interest-bearing liabilities | (317                       | ) (124   | ) (441  |
| Change in net interest income      | \$ (371                    | ) \$ 513 | \$ 142  |

<sup>(1)</sup> Amount is net of deferred loan origination fees and costs. Average balances include nonaccrual loans and loans held for sale.

<sup>(2)</sup> Loan fees are included in interest income and are immaterial.

<sup>(3)</sup> Municipal securities income and net interest income are presented on a tax equivalent basis using a tax rate of 34%. The tax equivalent adjustment is deducted from tax equivalent net interest income to agree to the amount reported in the statements of income.

<sup>(4)</sup> Includes mortgagors' and investors' escrow accounts.

**Provision for Loan Losses.** The provision for loan losses increased \$274,000 to \$484,000 for the three months ended March 31, 2012, compared to the same period in the prior year, primarily due to an increase in nonperforming loans for 2012, offset by a decrease in net loan charge-offs. At March 31, 2012, nonperforming loans totaled \$11.4 million, compared to \$6.5 million at March 31, 2011. An increase in nonperforming commercial and residential real estate loans of \$3.1 million and \$1.3 million, respectively, contributed to the higher balance of nonperforming loans at March 31, 2012. Net loan charge-offs were \$76,000 for the three months ended March 31, 2012 compared to \$446,000 for the three months ended March 31, 2011. For each period, loan charge-offs consisted primarily of residential mortgage loans. Specific loan loss allowances relating to impaired loans increased to \$350,000 at March 31, 2012, compared to \$259,000 at March 31, 2011.

Noninterest Income. The following table shows the components of noninterest income and the dollar and percentage changes for the periods presented.

|   | Three Months<br>Ended March 31, |         | Change  |          |   |
|---|---------------------------------|---------|---------|----------|---|
|   | 2012                            | 2011    | Dollars | Percent  |   |
|   | (Dollars in Thousands)          |         |         |          |   |
| Service fees  | \$1,210                         | \$1,180 | \$30    | 2.5      | % |
| Wealth management fees  | 1,067                           | 1,066   | 1       | 0.1      |   |
| Increase in cash surrender value of bank-owned life insurance       | 72                              | 72      | —       | —        |   |
| Net gain on sale of securities                                      | 317                             | 35      | 282     | 805.7    |   |
| Net impairment losses recognized in earnings                        | (36                             | ) —     | (36     | ) N/A    |   |
| Mortgage banking  | 279                             | 169     | 110     | 65.1     |   |
| Net (loss) gain in fair value on trading securities and derivatives | (49                             | ) 27    | (76     | ) (281.5 | ) |
| Net loss on disposal of equipment                                   | —                               | (7      | ) 7     | (100.0   | ) |
| Net loss on disposal of SI Trust Servicing operations               | (486                            | ) —     | (486    | ) N/A    |   |
| Other   | 387                             | 107     | 280     | 261.7    |   |
| Total noninterest income  | \$2,761                         | \$2,649 | \$112   | 4.2      | % |

The Company realized higher net gains on the sale of securities of \$282,000 for the three months ended March 31, 2012 compared to the same period in 2011. Fees related to mortgage banking activities increased \$110,000 due to higher proceeds received from residential mortgage loan sales. Service fees increased \$30,000 for the three months ended March 31, 2012, as a result of an increase in fees associated with higher electronic banking usage. During the first quarter of 2012, the Company reported a net loss of \$486,000 (pre-tax) on the sale of SI Trust Servicing, a third-party provider of trust outsourcing services for community banks. The Company recognized a loss of \$49,000 for the quarter ended March 31, 2012, compared to a net gain of \$6,000 for the quarter ended March 31, 2011, resulting from the change in fair value of certain derivative instruments. The Company recorded other-than-temporary impairment charges of \$36,000 on two mortgage-backed securities during the first quarter of 2012. The Company did not recognize other-than-temporary impairment charges on its securities portfolio during the first quarter of 2011. Contributing to the increase of \$280,000 in other noninterest income for 2012 was a realized investment gain of \$355,000 received from one of the Bank's small business investment company limited partnerships ("SBIC"). For 2011, other noninterest income was offset by impairment charges of \$72,000 to reduce the carrying value in the Bank's SBIC.

On February 13, 2012, the Bank entered into a definitive agreement with Reliance Integrated Solutions, LLC ("Reliance") in which Reliance acquired the assets and assumed certain liabilities of SI Trust Servicing. The transaction closed on April 1, 2012, with recognition of the transaction reported in the Company's consolidated financial statements at and for the period ended March 31, 2012. Included in the determination of the loss on the sale of SI Trust Servicing of \$486,000 was contingent consideration pertaining to client revenues for a period of four years. The Company will remeasure the contingent consideration at each reporting date during the contingency period with changes recognized in earnings.

Noninterest Expenses. The following table shows the components of noninterest expenses and the dollar and percentage changes for the periods presented.

|   | Three Months<br>Ended March 31, |         | Change  |         |    |
|---|---------------------------------|---------|---------|---------|----|
|   | 2012                            | 2011    | Dollars | Percent |    |
|   | (Dollars in Thousands)          |         |         |         |    |
| Salaries and employee benefits                    | \$4,238                         | \$4,144 | \$94    | 2.3     | %  |
| Occupancy and equipment                           | 1,486                           | 1,535   | (49)    | (3.2)   | )  |
| Computer and electronic banking services          | 993                             | 956     | 37      | 3.9     |    |
| Outside professional services                     | 364                             | 267     | 97      | 36.3    |    |
| Marketing and advertising                         | 152                             | 160     | (8)     | (5.0)   | )  |
| Supplies  | 137                             | 135     | 2       | 1.5     |    |
| FDIC deposit insurance and regulatory assessments | 272                             | 305     | (33)    | (10.8)  | )  |
| Contribution to SI Financial Group Foundation     | —                               | 500     | (500)   | (100.0) | )  |
| Other   | 708                             | 711     | (3)     | (0.4)   | )  |
| Total noninterest expenses                        | \$8,350                         | \$8,713 | \$(363) | (4.2)   | )% |

Noninterest expenses decreased \$363,000 for the three months ended March 31, 2012 compared to the same period in 2011, mainly due to a \$500,000 cash contribution expense to SI Financial Group Foundation in connection with the public stock offering and concurrent second-step conversion completed during the first quarter of 2011. SI Financial Group Foundation is a charitable foundation dedicated to providing assistance to charitable causes within the communities we serve. Occupancy and equipment expenses decreased primarily related to lower snow removal and utility costs during the first quarter of 2012 compared to 2011. The decreases in noninterest expenses were offset by increases in salaries and benefits of \$94,000 which were attributable to the addition of lending staff hired to build commercial loan relationships and outside professional services of \$97,000 related to higher legal fees associated with foreclosure activity. Foreclosure expenses, including legal fees associated with foreclosure actions, increased in 2012 as a result of the increase in nonperforming loans.

Income Tax Provision. The provision for income taxes increased \$149,000 for the three months ended March 31, 2012 compared to the same period in 2011. The effective tax rate for the three months ended March 31, 2012 and 2011 was 32.5% and 17.7%, respectively. The effective tax rate for the first three months of 2011 was reduced by a non-taxable gain on bank-owned life insurance proceeds received during the first quarter of 2011.

#### Liquidity and Capital Resources

Liquidity is the ability to meet current and future financial obligations of a short- and long-term nature. The Bank's primary sources of funds consist of proceeds from the recent stock offering, deposit inflows, loan sales and repayments, maturities and sales of securities and FHLB borrowings. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows, mortgage prepayments and loan and security sales are greatly influenced by general interest rates, economic conditions and competition.

The Bank's most liquid assets are cash and cash equivalents. The levels of these assets depend on the Bank's operating, financing, lending and investing activities during any given period. At March 31, 2012, cash and cash equivalents totaled \$57.8 million. Securities classified as available for sale, which provide additional sources of liquidity, totaled \$232.5 million at March 31, 2012. In addition, at March 31, 2012, the Bank had the ability to borrow \$154.4 million from the FHLB, which included overnight lines of credit of \$10.0 million. On that date, the Bank had FHLB advances outstanding of \$100.1 million and no overnight advances outstanding. Additionally, the Bank has the ability to access the Federal Reserve Bank's Discount Window on a collateralized basis and maintains a \$7.0 million

unsecured line of credit with a financial institution to access federal funds. The Bank believes that its liquid assets combined with the available line from the FHLB provide adequate liquidity to meet its current financial obligations.

The Bank's primary investing activities are the origination, purchase and sale of loans and the purchase and sale of securities. For the three months ended March 31, 2012, the Company originated \$48.7 million of loans and purchased \$27.7 million of securities. There were no loans purchased during the three months ended March 31, 2012. For the year ended December 31, 2011, the Company originated \$147.2 million of loans and purchased \$139.9 million of securities and \$47.0 million of loans.

Financing activities consist primarily of activity in deposit accounts and in borrowed funds. The increased liquidity needed to fund asset growth has been provided through increased deposits and through proceeds from the recently completed stock offering. The net increase in total deposits, including mortgagors' and investors' escrow accounts, was \$17.7 million for the three months ended March 31, 2012. Certificates of deposit due within one year of March 31, 2012 totaled \$104.3 million, or 14.5%, of total deposits. Management believes that the amount of deposits in shorter-term certificates of deposit reflects customers' hesitancy to invest their funds in longer-term certificates of deposit due to the uncertain interest rate environment. To compensate, the Bank has increased the duration of its borrowings with the FHLB and offered attractive rates on certain certificates of deposit in an effort to extend the maturity of its deposits. The Bank will be required to seek other sources of funds, including other certificates of deposit and lines of credit, if maturing certificates of deposit are not retained. Depending on market conditions, the Bank may be required to pay higher rates on such deposits or other borrowings than are currently paid on certificates of deposit. Additionally, a shorter duration in the securities portfolio may be necessary to provide liquidity to compensate for any deposit outflows. The Bank believes, however, based on past experience, a significant portion of its certificates of deposit will be retained. The Bank has the ability, if necessary, to adjust the interest rates offered to its customers in an effort to attract and retain deposits.

Deposit flows are affected by the overall level of interest rates, the interest rates and products offered by the Bank and its local competitors and other factors. The Bank generally manages the pricing of its deposits to be competitive and to increase core deposits and commercial banking relationships. Occasionally, the Bank offers promotional rates on certain deposit products to attract deposits. The Bank experienced no change in FHLB advances for the three months ended March 31, 2012 and experienced a decrease of \$14.1 million for the year ended December 31, 2011.

The Company repurchased 526 shares of the Company's common stock at a cost of \$6,000 during the three months ended March 31, 2012 and 547 shares of the Company's common stock at a cost of \$5,000 during the year ended December 31, 2011, withheld on behalf of plan participants to satisfy tax withholding obligations related to the vesting of restricted shares. Additional discussion about the Company's liquidity and capital resources is contained in Item 7 in the Company's 2011 Annual Report on Form 10-K.

SI Financial Group, Inc. is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, SI Financial Group is responsible for paying any dividends declared to its shareholders and making payments on its subordinated debentures. SI Financial Group also may repurchase shares of its common stock in the future. SI Financial Group's primary sources of funds are the proceeds retained in the stock offering, interest and dividends on securities and dividends received from the Bank. The amount of dividends that the Bank may declare and pay to SI Financial Group in any calendar year, without the receipt of prior approval from the Office of the Comptroller of the Currency ("OCC") but with prior notice to the OCC, cannot exceed net income for that year to date plus retained net income (as defined) for the preceding two calendar years. SI Financial Group believes that such restriction will not have an impact on SI Financial Group's ability to meet its ongoing cash obligations. At March 31, 2012, SI Financial Group had cash and cash equivalents of \$16.3 million and available for sale securities of \$9.5 million.

Payments Due Under Contractual Obligations



Information relating to payments due under contractual obligations is presented in the Company's Form 10-K for the year ended December 31, 2011. There were no material changes in the Company's payments due under contractual obligations between December 31, 2011 and March 31, 2012.

## Off-Balance Sheet Arrangements

In the normal course of operations, the Company engages in a variety of financial transactions that, in accordance with GAAP, are not recorded in its financial statements. These transactions involve, to varying degrees, elements of credit, interest rate and liquidity risk. Such transactions are used primarily to manage customers' requests for funding and take the form of loan commitments, lines of credit and letters of credit.

The contractual amounts of commitments to extend credit represent the amounts of potential accounting loss should the contract be fully drawn upon, the customer defaults and the value of any existing collateral becomes worthless. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. Financial instruments whose contract amounts represent credit risk at March 31, 2012 and December 31, 2011 are as follows:

|   | March 31, 2012 | December 31,<br>2011 |
|---|----------------|----------------------|
|   | (In Thousands) |                      |
| Commitments to extend credit:           |                |                      |
| Future loan commitments                 | \$35,953       | \$31,211             |
| Undisbursed construction loans          | 4,857          | 5,673                |
| Undisbursed home equity lines of credit | 22,924         | 23,172               |
| Undisbursed commercial lines of credit  | 19,961         | 17,995               |
| Overdraft protection lines              | 1,233          | 1,190                |
| Standby letters of credit               | 34             | 34                   |
| Total commitments                       | \$84,962       | \$79,275             |

Future loan commitments at March 31, 2012 and December 31, 2011 included fixed-rate loan commitments of \$5.0 million and \$16.0 million, respectively, at interest rates ranging from 3.00% to 6.25%.

The Bank is a limited partner in three SBICs. At March 31, 2012, the Bank's remaining off-balance sheet commitment for the capital investment in the SBICs was \$1.1 million. The Bank did not recognize any write-downs on its investment in the SBICs during the three months ended March 31, 2012, whereas write-downs of \$72,000 were recognized during the three months ended March 31, 2011.

For the three months ended March 31, 2012, with the exception of the aforementioned commitments, the Company did not engage in any additional off-balance sheet transactions reasonably likely to have a material effect on the Company's financial condition, results of operations or cash flows. See Notes 6 and 12 to the consolidated financial statements contained in the Company's 2011 Annual Report on Form 10-K.

## Item 3. Quantitative and Qualitative Disclosures About Market Risk.

## Qualitative Aspects of Market Risk

The primary market risk affecting the financial condition and operating results of the Company is interest rate risk. Interest rate risk is the exposure of current and future earnings and capital arising from movements in interest rates. The Company manages the interest rate sensitivity of its interest-bearing liabilities and interest-earning assets in an effort to minimize the adverse effects of changes in the interest rate environment. To reduce the volatility of its earnings, the Company has sought to improve the match between asset and liability maturities and rates, while maintaining an acceptable interest rate spread. The Company's strategy for managing interest rate risk generally is to emphasize the origination of adjustable-rate mortgage loans for retention in its loan portfolio. However, the ability to originate adjustable-rate loans depends to a great extent on market interest rates and borrowers' preferences. As an

alternative to adjustable-rate mortgage loans, the Company purchases variable-rate SBA and USDA loans in the secondary market that are fully guaranteed by the U.S. government. These loans have a significantly shorter duration than fixed-rate mortgage loans. Fixed-rate mortgage loans typically have an adverse effect on interest rate sensitivity compared to adjustable-rate loans. Accordingly, the Company has sold more

longer-term fixed-rate mortgage loans in the secondary market in recent periods to manage interest rate risk. The Company may offer attractive rates for existing certificates of deposit accounts to extend their maturities. The Company also uses shorter-term investment securities and longer-term borrowings from the FHLB to help manage interest rate risk.

The Company has an Asset/Liability Committee to communicate, coordinate and control all aspects involving asset/liability management. The committee establishes and monitors the volume, maturities, pricing and mix of assets and funding sources with the objective of managing assets and funding sources to provide results that are consistent with liquidity, growth, risk limits and profitability goals.

On July 1, 2010, the Company entered into an interest rate swap agreement with a third-party financial institution with a notional amount of \$8.0 million, whereby the counterparty will pay a variable rate equal to three-month LIBOR and the Company will pay a fixed rate of 2.44%. The agreement was effective on December 15, 2010 and terminates on December 15, 2015. This agreement was designated as a cash flow hedge against the trust preferred securities issued by SI Capital Trust II. This effectively fixes the interest rate on the \$8.0 million of trust preferred securities at 4.14% for the period December 15, 2010 through December 15, 2015.

On January 9, 2012, the Company entered into an interest rate swap agreement with a third-party financial institution with a notional amount of \$15.0 million, whereby the counterparty will pay a variable rate equal to three-month LIBOR and the Company will pay a fixed rate of 1.255%. The agreement was effective on January 11, 2012 and terminates on January 11, 2017. This agreement was not designated as a hedging instrument.

#### Quantitative Aspects of Market Risk

The Company analyzes its interest rate sensitivity position to manage the risk associated with interest rate movements through the use of interest income simulation. The matching of assets and liabilities may be analyzed by examining the extent to which such assets and liabilities are "interest rate sensitive." An asset or liability is said to be interest rate sensitive within a specific time period if it will mature or reprice within that time period. The Company's goal is to manage asset and liability positions to moderate the effect of interest rate fluctuations on net interest income.

#### Net Interest Income Simulation Analysis

Interest income simulations are completed quarterly and presented to the Asset/Liability Committee. The simulations provide an estimate of the impact of changes in interest rates on net interest income under a range of assumptions. The numerous assumptions used in the simulation process are reviewed by the Asset/Liability Committee on a quarterly basis. Changes to these assumptions can significantly affect the results of the simulation. The simulation incorporates assumptions regarding the potential timing in the repricing of certain assets and liabilities when market rates change and the changes in spreads between different market rates. The simulation analysis incorporates management's current assessment of the risk that pricing margins will change adversely over time due to competition or other factors. Simulation analysis is only an estimate of the Company's interest rate risk exposure at a particular point in time. The Company continually reviews the potential effect changes in interest rates could have on the repayment of rate sensitive assets and funding requirements of rate sensitive liabilities.

The table below sets forth an approximation of the Company's exposure as a percentage of estimated net interest income for the next 12- and 24-month periods using interest income simulation. The simulation uses projected repricing of assets and liabilities at March 31, 2012 on the basis of contractual maturities, anticipated repayments and scheduled rate adjustments. Prepayment rates can have a significant impact on interest income simulation. Because of the large percentage of loans and mortgage-backed securities the Company holds, rising or falling interest rates have a significant impact on the prepayment speeds of the Company's earning assets that in turn affect the rate sensitivity position. When interest rates rise, prepayments tend to slow. When interest rates fall, prepayments tend to rise. The Company's asset sensitivity would be reduced if prepayments slow and vice versa. While the Company believes such

assumptions to be reasonable, there can be no assurance that assumed prepayment rates will approximate actual future mortgage-backed security and loan repayment activity.

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The following table reflects changes in estimated net interest income for the Company at March 31, 2012.

|                                   | Percentage Change in Estimated<br>Net Interest Income Over |           |   |
|-----------------------------------|--|-----------|---|
|                                   | 12 Months  | 24 Months |   |
| 100 basis point increase in rates | 4.42   | % 5.31    | % |
| 200 basis point increase in rates | 5.83   | 6.89      |   |
| 300 basis point increase in rates | 5.34   | 5.91      |   |

Management believes that under the current rate environment, a downward change in interest rates is highly remote. Therefore, management considered three increasing rate scenarios. These limits will be re-evaluated periodically and may be modified as appropriate.

The basis point change in rates in the above table is assumed to occur evenly over the 12- and 24-month periods. As indicated by the results of the above scenarios, net interest income would be positively affected (within our internal guidelines) in the 12- and 24-month periods if rates increased under all scenarios as detailed above, resulting from the Company's strategy to better position the balance sheet for the anticipated increase in market interest rates. The Company's strategy for mitigating interest rate risk includes the purchase of adjustable-rate investment securities and SBA and USDA loans that will reprice in a rising rate environment, selling longer-term and lower fixed-rate residential mortgage loans in the secondary market and restructuring FHLB borrowings to current lower market interest rates while extending their duration. Additionally, the interest rate swap agreement used to hedge the interest rate of the Company's long-term variable-rate debt effectively converts the debt to a fixed-rate, which reflects favorably on net interest income in a rising rate environment.

## Item 4. Controls and Procedures.

The Company's management, including the Company's principal executive officer and principal financial officer, have evaluated the effectiveness of the Company's "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended, (the "Exchange Act"). Based upon their evaluation, the principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective for ensuring that the information required to be disclosed in the reports that the Company files or submits under the Exchange Act with the Securities and Exchange Commission (1) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms and (2) is accumulated and communicated to the Company's management, including its principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure. No changes in the Company's internal control over financial reporting occurred during the quarter ended March 31, 2012 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II. OTHER INFORMATION

## Item 1. Legal Proceedings.

The Company is not involved in any pending legal proceedings believed by management to be material to the Company's financial condition or results of operations. Periodically, there have been various claims and lawsuits against the Bank, such as claims to enforce liens, condemnation proceedings on properties in which the Bank holds a security interest, claims involving the making and servicing of real property loans and other issues incident to the Bank's business. Management believes that these legal proceedings would not have a material adverse effect on the Company's financial condition, results of operations or cash flows.

## Item 1A. Risk Factors.

There are no material changes from the risk factors set forth under Part I, Item 1A. "Risk Factors" in the Company's Annual Report on Form 10-K for the year ended December 31, 2011, which could materially and adversely affect the Company's business, financial condition or future results. The risks described in the Company's Annual Report on Form 10-K are not the only risks that the Company faces. Additional risks and uncertainties not currently known to the Company or that the Company currently deems to be immaterial also may materially adversely affect the Company's business, financial condition and/or operating results.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

The Company's repurchases of equity securities for the three months ended March 31, 2012 were as follows:

| Period                | Total Number of Shares Purchased | Average Price Paid Per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs |
|-----------------------|----------------------------------|------------------------------|--|--|
| January 1 - 31, 2012  | —                                | \$—                          | —  | —  |
| February 1 - 29, 2012 | —                                | —                            | —  | —  |
| March 1 - 31, 2012    | 526                              | 11.16                        | —  | —  |
| Total                 | 526                              | \$11.16                      | —  | —  |

This table includes 526 shares withheld from employees to satisfy tax withholding requirements upon the vesting of restricted stock awards. As of March 31, 2012, the Company had no authorized repurchase programs.



Item 3. Defaults Upon Senior Securities.

None.

Item 4. Mine Safety Disclosures.

None.

Item 5. Other Information.

None.

Item 6. Exhibits.

3.1 Articles of Incorporation of SI Financial Group, Inc. <sup>(1)</sup>

3.2 Bylaws of SI Financial Group, Inc. <sup>(2)</sup>

4 Specimen Stock Certificate of SI Financial Group, Inc. <sup>(1)</sup>

31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer

31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer

32 18 U.S.C. Section 1350 Certifications

101 The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2012, formatted in eXtensible Business Reporting Language (XBRL): (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) the Condensed Statement of Changes in Shareholders' Equity, (v) the Condensed Consolidated Statements of Cash Flows and (vi) related Notes to Consolidated Financial Statements, tagged as blocks of text <sup>(3)</sup>

<sup>(1)</sup> Incorporated herein by reference into this document from the Exhibits on the Registration Statement on Form S-1 (File No. 333-169302), and any amendments thereto, filed with the Securities and Exchange Commission on September 10, 2010.

<sup>(2)</sup> Incorporated herein by reference into this document from the Exhibits to the Company's Current Report on Form 8-K (File No. 000-54241) filed with the Securities and Exchange Commission on February 17, 2011.

<sup>(3)</sup> This exhibit shall not be deemed "filed" for purposes of Section 18 of the Securities and Exchange Act of 1934, or otherwise subject to the liability of that section, and shall not be deemed to be incorporated by reference into any filing under the Securities Act of 1933 or the Securities Act of 1934. As provided in Rule 406T of Regulation S-T, this information is furnished and not filed for purposes of Sections 11 and 12 of the Securities Act of 1933 and Section 18 of the Securities Act of 1934.

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.

SI FINANCIAL GROUP, INC.

Date: May 9, 2012

/s/ Rheo A. Brouillard  
Rheo A. Brouillard  
President and Chief Executive Officer  
(principal executive officer)

Date: May 9, 2012

/s/ Brian J. Hull  
Brian J. Hull  
Executive Vice President, Chief  
Financial Officer, Treasurer and Chief  
Operating Officer  
(principal financial and accounting  
officer)