

SI Financial Group, Inc.  
Form 10-Q  
November 06, 2014

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 September 30, 2014

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 (I.R.S. Employer Identification No.)  
organization)

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

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

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  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   
Non-Accelerated Filer  Smaller Reporting Company

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

As of November 3, 2014, there were 12,783,122 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)

|   | September 30,<br>2014 | December 31,<br>2013 |
|---|-----------------------|----------------------|
| <b>ASSETS:</b>  |                       |                      |
| Cash and due from banks:  |                       |                      |
| Noninterest-bearing   | \$16,942              | \$20,554             |
| Interest-bearing  | 16,676                | 6,767                |
| Total cash and cash equivalents   | 33,618                | 27,321               |
| Available for sale securities, at fair value  | 170,777               | 170,220              |
| Loans held for sale   | 1,123                 | 1,764                |
| Loans receivable (net of allowance for loan losses of \$7,619 at September 30, 2014 and \$6,916 at December 31, 2013)   | 1,041,071             | 1,047,410            |
| Federal Home Loan Bank stock, at cost   | 10,333                | 13,109               |
| Bank-owned life insurance   | 21,159                | 20,726               |
| Premises and equipment, net   | 21,303                | 21,090               |
| Goodwill and other intangibles  | 18,847                | 19,566               |
| Accrued interest receivable   | 3,898                 | 4,021                |
| Deferred tax asset, net   | 9,633                 | 9,705                |
| Other real estate owned, net  | 1,361                 | 2,429                |
| Other assets  | 7,019                 | 9,018                |
| Total assets  | \$1,340,142           | \$1,346,379          |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY:</b>  |                       |                      |
| Liabilities:  |                       |                      |
| Deposits:   |                       |                      |
| Noninterest-bearing   | \$140,992             | \$139,428            |
| Interest-bearing  | 856,847               | 845,321              |
| Total deposits  | 997,839               | 984,749              |
| Mortgagors' and investors' escrow accounts  | 1,794                 | 3,214                |
| Federal Home Loan Bank advances   | 154,148               | 176,272              |
| Junior subordinated debt owed to unconsolidated trust   | 8,248                 | 8,248                |
| Accrued expenses and other liabilities  | 22,007                | 21,054               |
| Total liabilities   | 1,184,036             | 1,193,537            |
| Shareholders' Equity:   |                       |                      |
| Preferred stock (\$.01 par value; 1,000,000 shares authorized; none issued)   | —                     | —                    |
| Common stock (\$.01 par value; 35,000,000 shares authorized; 12,783,122 and 12,798,461 shares issued and outstanding at September 30, 2014 and December 31, 2013, respectively) | 128                   | 128                  |
| Additional paid-in-capital  | 125,369               | 125,277              |
| Unallocated common shares held by ESOP  | (4,248                | ) (4,608             |
| Unearned restricted shares  | (1,422                | ) (1,751             |
| Retained earnings   | 36,546                | 34,644               |

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|  |             |             |   |
|--|-------------|-------------|---|
| Accumulated other comprehensive loss       | (267        | ) (848      | ) |
| Total shareholders' equity                 | 156,106     | 152,842     |   |
| Total liabilities and shareholders' equity | \$1,340,142 | \$1,346,379 |   |

See accompanying notes to unaudited interim consolidated financial statements.

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

|   | Three Months Ended<br>September 30, |         | Nine Months Ended<br>September 30, |          |
|---|-------------------------------------|---------|------------------------------------|----------|
|   | 2014                                | 2013    | 2014                               | 2013     |
| Interest and dividend income:                                   |                                     |         |                                    |          |
| Loans, including fees   | \$10,735                            | \$8,105 | \$32,489                           | \$22,822 |
| Securities:   |                                     |         |                                    |          |
| Taxable interest  | 877                                 | 986     | 2,651                              | 3,078    |
| Tax-exempt interest   | 59                                  | 42      | 160                                | 62       |
| Dividends   | 46                                  | 8       | 143                                | 15       |
| Other   | 11                                  | 10      | 39                                 | 31       |
| Total interest and dividend income                              | 11,728                              | 9,151   | 35,482                             | 26,008   |
| Interest expense:   |                                     |         |                                    |          |
| Deposits  | 1,355                               | 1,241   | 4,033                              | 3,877    |
| Federal Home Loan Bank advances                                 | 602                                 | 736     | 1,921                              | 2,227    |
| Subordinated debt and other borrowings                          | 84                                  | 87      | 251                                | 253      |
| Total interest expense  | 2,041                               | 2,064   | 6,205                              | 6,357    |
| Net interest income   | 9,687                               | 7,087   | 29,277                             | 19,651   |
| Provision for loan losses                                       | 350                                 | 443     | 1,195                              | 633      |
| Net interest income after provision for loan losses             | 9,337                               | 6,644   | 28,082                             | 19,018   |
| Noninterest income:   |                                     |         |                                    |          |
| Total other-than-temporary impairment losses                    | —                                   | —       | —                                  | (8 )     |
| Portion of losses recognized in other comprehensive income/loss | —                                   | —       | —                                  | —        |
| Net impairment losses   | —                                   | —       | —                                  | (8 )     |
| Service fees  | 1,762                               | 1,515   | 5,265                              | 3,964    |
| Wealth management fees  | 293                                 | 302     | 926                                | 846      |
| Increase in cash surrender value of bank-owned life insurance   | 147                                 | 90      | 433                                | 226      |
| Net gain (loss) on sales of securities                          | —                                   | (922 )  | 64                                 | (919 )   |
| Mortgage banking  | 81                                  | 69      | 396                                | 919      |
| Net gain on fair value of derivatives                           | 78                                  | 18      | 69                                 | 191      |
| Other   | 85                                  | 161     | 527                                | 526      |
| Total noninterest income  | 2,446                               | 1,233   | 7,680                              | 5,745    |
| Noninterest expenses:   |                                     |         |                                    |          |
| Salaries and employee benefits                                  | 4,897                               | 4,394   | 15,128                             | 12,923   |
| Occupancy and equipment   | 1,883                               | 1,417   | 5,852                              | 4,104    |
| Computer and electronic banking services                        | 1,417                               | 1,057   | 4,082                              | 2,896    |
| Outside professional services                                   | 420                                 | 298     | 1,422                              | 948      |
| Marketing and advertising                                       | 216                                 | 170     | 754                                | 471      |
| Supplies  | 146                                 | 110     | 465                                | 316      |
| FDIC deposit insurance and regulatory assessments               | 303                                 | 251     | 953                                | 714      |

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|   |         |          |           |            |
|---|---------|----------|-----------|------------|
| Merger expenses                                     | —       | 1,305    | —         | 2,198      |
| Core deposit intangible amortization                | 150     | 55       | 463       | 55         |
| Other real estate operations                        | 72      | 83       | 303       | 402        |
| Other   | 500     | 1,234    | 1,873     | 2,137      |
| Total noninterest expenses                          | 10,004  | 10,374   | 31,295    | 27,164     |
| Income (loss) before income tax provision (benefit) | 1,779   | (2,497   | ) 4,467   | (2,401 )   |
| Income tax provision (benefit)                      | 579     | (755     | ) 1,447   | (522 )     |
| Net income (loss)                                   | \$1,200 | \$(1,742 | ) \$3,020 | \$(1,879 ) |
| Earnings (loss) per share:                          |         |          |           |            |
| Basic   | \$0.10  | \$(0.17  | ) \$0.25  | \$(0.19 )  |
| Diluted   | \$0.10  | \$(0.17  | ) \$0.24  | \$(0.19 )  |

See accompanying notes to unaudited interim consolidated financial statements.



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

|   | Three Months Ended<br>September 30, |           | Nine Months Ended<br>September 30, |           |
|---|-------------------------------------|-----------|------------------------------------|-----------|
|   | 2014                                | 2013      | 2014                               | 2013      |
| Net income (loss)   | \$1,200                             | \$(1,742) | ) \$3,020                          | \$(1,879) |
| Other comprehensive income (loss), net of tax:  |                                     |           |                                    |           |
| Available for sale securities:  |                                     |           |                                    |           |
| Net unrealized holding gains (losses)   | (382)                               | ) (631)   | ) 546                              | (2,211)   |
| Reclassification adjustment for losses (gains) recognized in net income (loss) <sup>(1)</sup> | —                                   | 609       | (42)                               | ) 607     |
| Plus: credit portion of OTTI losses recognized in net loss <sup>(2)</sup>                     | —                                   | —         | —                                  | 5         |
| Plus: noncredit portion of OTTI loss  | —                                   | 163       | —                                  | 124       |
| Net unrealized gains (losses) on available for sale securities                                | (382)                               | ) 141     | 504                                | (1,475)   |
| Net unrealized gain on interest-rate swap derivative  | 31                                  | 10        | 77                                 | 82        |
| Other comprehensive income (loss)   | (351)                               | ) 151     | 581                                | (1,393)   |
| Comprehensive income (loss)   | \$849                               | \$(1,591) | ) \$3,601                          | \$(3,272) |

<sup>(1)</sup> Amounts are included in net gain (loss) on the sales of securities in noninterest income on the consolidated statements of operations. Income tax expense (benefit) associated with the reclassification adjustment for the three and nine months ended September 30, 2014 was \$0 and \$22,000, respectively, and \$(313,000) and \$(312,000) for the three and nine months ended September 30, 2013, respectively.

<sup>(2)</sup> Amounts are included in net impairment losses recognized in noninterest income on the consolidated statements of operations. Income tax expense associated with the reclassification adjustment for both the three and nine months ended September 30, 2014 totaled \$0, respectively, and amounted to \$0 and \$3,000, for the three and nine months ended September 30, 2013, respectively.

See accompanying notes to unaudited interim consolidated financial statements.

SI FINANCIAL GROUP, INC.  
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY  
FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2014  
(In Thousands, Except Share Data / Unaudited)

|  | Common Stock |         | Additional<br>Paid-in<br>Capital | Unallocated                         |                                  | Retained<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Loss | Total<br>Shareholders'<br>Equity |
|--|--------------|---------|----------------------------------|-------------------------------------|----------------------------------|----------------------|---|----------------------------------|
|  | Shares       | Dollars |                                  | Common<br>Shares<br>Held<br>by ESOP | Unearned<br>Restricted<br>Shares |                      |   |                                  |
| Balance at<br>December 31, 2013                  | 12,798,461   | \$ 128  | \$ 125,277                       | \$(4,608 )                          | \$(1,751 )                       | \$ 34,644            | \$ (848 )                                     | \$ 152,842                       |
| Comprehensive<br>income                          | —            | —       | —                                | —                                   | —                                | 3,020                | 581   | 3,601                            |
| Cash dividends<br>declared (\$0.09 per<br>share) | —            | —       | —                                | —                                   | —                                | (1,107 )             | —   | (1,107 )                         |
| Equity incentive<br>plan compensation            | —            | —       | 230                              | —                                   | 329                              | —                    | —   | 559                              |
| Allocation of 36,477<br>ESOP shares              | —            | —       | 56                               | 360                                 | —                                | —                    | —   | 416                              |
| Tax benefit from<br>share-based<br>compensation  | —            | —       | 4                                | —                                   | —                                | —                    | —   | 4                                |
| Stock options<br>exercised                       | 51,806       | —       | 552                              | —                                   | —                                | —                    | —   | 552                              |
| Common shares<br>repurchased                     | (67,145 )    | —       | (750 )                           | —                                   | —                                | (11 )                | —   | (761 )                           |
| Balance at<br>September 30, 2014                 | 12,783,122   | \$ 128  | \$ 125,369                       | \$(4,248 )                          | \$(1,422 )                       | \$ 36,546            | \$ (267 )                                     | \$ 156,106                       |

See accompanying notes to unaudited interim consolidated financial statements.

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

|  | Nine Months Ended<br>September 30, |           |
|--|------------------------------------|-----------|
|  | 2014                               | 2013      |
| Cash flows from operating activities:  |                                    |           |
| Net income (loss)  | \$3,020                            | \$(1,879) |
| Adjustments to reconcile net income (loss) to net cash provided by operating activities: |                                    |           |
| Provision for loan losses  | 1,195                              | 633       |
| Employee stock ownership plan expense  | 416                                | 417       |
| Equity incentive plan expense  | 559                                | 576       |
| Excess tax benefit from share-based compensation   | (4)                                | (4)       |
| Amortization of investment premiums and discounts, net                                   | 724                                | 921       |
| Amortization of loan premiums and discounts, net   | 1,051                              | 1,071     |
| Depreciation and amortization of premises and equipment                                  | 1,921                              | 1,355     |
| Amortization of core deposit intangible  | 463                                | 55        |
| Amortization of deferred debt issue costs  | 79                                 | 227       |
| Net loss (gain) on sales of securities   | (64)                               | 919       |
| Net gain on fair value of derivatives  | (69)                               | (191)     |
| Deferred income tax benefit  | 28                                 | 67        |
| Loans originated for sale  | (12,633)                           | (36,927)  |
| Proceeds from sale of loans held for sale  | 13,353                             | 40,464    |
| Net gain on sales of loans held for sale   | (201)                              | (735)     |
| Net gain on sales of loans held for investment   | —                                  | (201)     |
| Net loss on sales or write-downs of other real estate owned                              | 67                                 | 25        |
| Increase in cash surrender value of bank-owned life insurance                            | (433)                              | (226)     |
| Impairment charge on long-lived assets   | 175                                | —         |
| Other-than-temporary impairment losses on securities                                     | —                                  | 8         |
| Change in operating assets and liabilities:  |                                    |           |
| Accrued interest receivable  | 123                                | 42        |
| Other assets   | 1,947                              | (2,008)   |
| Accrued expenses and other liabilities   | 1,143                              | 1,974     |
| Net cash provided by operating activities  | 12,860                             | 6,583     |
| Cash flows from investing activities:  |                                    |           |
| Purchases of available for sale securities   | (24,626)                           | (40,863)  |
| Proceeds from sales of available for sale securities                                     | 1,109                              | 13,108    |
| Proceeds from maturities of and principal repayments on available for sale securities    | 23,063                             | 31,786    |
| Redemption of Federal Home Loan Bank stock   | 2,776                              | 325       |
| Loan principal collections, net of originations  | 42,628                             | 28,811    |
| Purchases of loans   | (38,643)                           | (20,115)  |
| Net cash paid from acquisition of Newport Bancorp, Inc.                                  | —                                  | (8,935)   |
| Proceeds from sales of loans held for investment   | —                                  | 3,189     |
| Proceeds from sales of other real estate owned   | 1,109                              | 1,255     |
| Purchases of premises and equipment  | (2,134)                            | (1,868)   |
| Net cash provided by investing activities  | 5,282                              | 6,693     |



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

|  | Nine Months Ended<br>September 30, |           |
|--|------------------------------------|-----------|
|  | 2014                               | 2013      |
| Cash flows from financing activities:                      |                                    |           |
| Net increase in deposits                                   | 13,090                             | 7,971     |
| Net decrease in mortgagors' and investors' escrow accounts | (1,420                             | ) (1,738  |
| Proceeds from Federal Home Loan Bank advances              | 10,000                             | 40,000    |
| Repayments of Federal Home Loan Bank advances              | (32,203                            | ) (44,000 |
| Excess tax benefit from share-based compensation           | 4                                  | 4         |
| Cash dividends on common stock                             | (1,107                             | ) (860    |
| Stock options exercised                                    | 552                                | 15        |
| Common shares repurchased                                  | (761                               | ) (9      |
| Net cash provided by (used in) financing activities        | (11,845                            | ) 1,383   |
| <br>   |                                    |           |
| Net change in cash and cash equivalents                    | 6,297                              | 14,659    |
| Cash and cash equivalents at beginning of period           | 27,321                             | 37,689    |
| Cash and cash equivalents at end of period                 | \$33,618                           | \$52,348  |
| <br>   |                                    |           |
| Supplemental cash flow information:                        |                                    |           |
| Interest paid  | \$6,234                            | \$6,146   |
| Income taxes paid, net                                     | (555                               | ) 1,312   |
| Transfer of loans to other real estate owned               | 108                                | 1,407     |

See accompanying notes to unaudited interim consolidated financial statements.

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2014 AND 2013 AND DECEMBER 31, 2013

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

Nature of Business

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

On September 6, 2013, the Company acquired Newport Bancorp, Inc. ("Newport"), and its wholly-owned subsidiary, Newport Federal Savings Bank. The acquisition added six full-service banking offices in eastern Connecticut and Rhode Island.

Principles of Consolidation

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

Basis of Financial Statement Presentation

The interim consolidated financial statements and related notes have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information, with the instructions to Form 10-Q and Rule 10.01 of Regulation S-X of the Securities and Exchange Commission ("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 September 30, 2014 and for the three and nine months ended September 30, 2014 and 2013 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, 2013 contained in the Company's Form 10-K.

In the opinion of management, the accompanying unaudited interim consolidated financial statements reflect all of the adjustments, consisting only of normal and recurring adjustments, necessary for a fair presentation of the financial condition, results of operations and cash flows as of and for the periods covered herein. The results of operations for the three and nine months ended September 30, 2014 are not necessarily indicative of the operating results for the year ending December 31, 2014 or for any other period.

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

relate to the determination of the allowance for loan losses, other-than-temporary impairment (“OTTI”) of securities, deferred income taxes and the impairment of long-lived assets.

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2014 AND 2013 AND DECEMBER 31, 2013

Reclassifications

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

Loans Receivable

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

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

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

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

Allowance for Loan Losses

The allowance for loan losses, a material estimate which could change significantly in the near-term, is established through a provision for loan losses charged to earnings to account for losses that are inherent in the loan portfolio and estimated to occur, and is maintained at a level that management considers adequate to absorb losses in the loan portfolio. Loan losses are charged against the allowance for loan losses when management believes 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 and trends of nonperforming loans, delinquencies, classified assets and loan charge-offs and evaluations of loans and other relevant factors.



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

• Specific allowance for identified impaired loans. For loans 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

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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, classified loans, nonaccrual loans, troubled debt restructurings and other loan modifications; trends in nature, volume and terms of loans; existence and effect of/or changes in the level of credit concentrations; effects of changes in lending policies, procedures and practices, including underwriting standards and collection, charge-off and recovery practices; changes in the quality of loan review and degree of oversight; experience, ability and depth of lending management and staff; national, regional and local economic trends and conditions and impact on the value of underlying collateral for collateral dependent loans; effect of external factors, including legal and regulatory requirements.

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, correct estimates of the sale price of the property, time to sell at an adequate price and market conditions.

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

Bank also provides loans to investors in the time share industry, which are secured by consumer receivables, and provides loans for capital improvements to condominium associations, which are secured by the assigned rights to levy special assessments to condominium owners.

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

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

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

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



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Common Share Repurchases

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

Recent Accounting Pronouncements

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

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

NOTE 2. EARNINGS (LOSS) PER SHARE

Basic earnings (loss) per share is calculated by dividing the net income (loss) 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 (loss) per share since the shares participate in dividends and the rights to the dividends are non-forfeitable. Diluted earnings (loss) per share is computed in a manner similar to

basic earnings (loss) 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. Repurchased common shares

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and unallocated common shares held by the Bank's ESOP are not deemed outstanding for earnings (loss) 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 (loss) per share calculations. The Company had anti-dilutive common shares outstanding of 677,590 and 485,459 for the three and nine months ended September 30, 2014, respectively, and 534,492 and 595,761 for the three and nine months ended September 30, 2013, respectively.

The computation of earnings (loss) per share is as follows:

|   | Three Months Ended<br>September 30,<br>2014   |            | September 30,<br>2013 |            |
|---|---|------------|-----------------------|------------|
|   | 2014  |            | 2013                  |            |
|   | (Dollars in Thousands, Except Per Share Data) |            |                       |            |
| Net income (loss)                           | \$1,200                                       | \$ (1,742) | \$3,020               | \$ (1,879) |
| Weighted average common shares outstanding: |   |            |                       |            |
| Basic                                       | 12,310,368                                    | 10,310,210 | 12,315,829            | 9,814,017  |
| Effect of dilutive stock options            | 23,065  | —          | 38,382                | —          |
| Diluted                                     | 12,333,433                                    | 10,310,210 | 12,354,211            | 9,814,017  |
| Earnings (loss) per share:                  |   |            |                       |            |
| Basic                                       | \$0.10  | \$ (0.17)  | \$0.25                | \$ (0.19)  |
| Diluted                                     | \$0.10  | \$ (0.17)  | \$0.24                | \$ (0.19)  |

## NOTE 3. SECURITIES

Available for sale securities:

The amortized cost, gross unrealized gains and losses and fair values of available for sale securities at September 30, 2014 and December 31, 2013 are as follows:

|   | September 30, 2014 |                              |                               |               |
|---|--------------------|------------------------------|-------------------------------|---------------|
|   | Amortized<br>Cost  | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|   | (In Thousands)     |                              |                               |               |
| Debt securities:                                |                    |                              |                               |               |
| U.S. Government and agency obligations          | \$63,021           | \$338                        | \$ (236)                      | \$63,123      |
| Government-sponsored enterprises                | 24,492             | 78                           | (136)                         | 24,434        |
| Mortgage-backed securities: <sup>(1)</sup>      |                    |                              |                               |               |
| Agency - residential                            | 70,260             | 887                          | (1,383)                       | 69,764        |
| Non-agency - residential                        | 375                | 15                           | (3)                           | 387           |
| Corporate debt securities                       | 1,000              | 8                            | —                             | 1,008         |
| Collateralized debt obligation                  | 1,187              | 1                            | —                             | 1,188         |
| Obligations of state and political subdivisions | 4,041              | 172                          | (27)                          | 4,186         |



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|                                     |           |         |          |             |
|-------------------------------------|-----------|---------|----------|-------------|
| Tax-exempt securities               | 6,610     | 82      | (5       | ) 6,687     |
| Total available for sale securities | \$170,986 | \$1,581 | \$(1,790 | ) \$170,777 |

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

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|   | December 31, 2013 |                              |                               |               |
|---|-------------------|------------------------------|-------------------------------|---------------|
|   | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|   | (In Thousands)    |                              |                               |               |
| Debt securities:                                |                   |                              |                               |               |
| U.S. Government and agency obligations          | \$54,228          | \$485                        | \$(168)                       | ) \$54,545    |
| Government-sponsored enterprises                | 26,551            | 134                          | (393)                         | ) 26,292      |
| Mortgage-backed securities: <sup>(1)</sup>      |                   |                              |                               |               |
| Agency - residential                            | 77,037            | 889                          | (1,809)                       | ) 76,117      |
| Non-agency - residential                        | 530               | 26                           | (2)                           | ) 554         |
| Corporate debt securities                       | 3,708             | 90                           | —                             | 3,798         |
| Collateralized debt obligation                  | 1,210             | —                            | (19)                          | ) 1,191       |
| Obligations of state and political subdivisions | 4,063             | 141                          | (81)                          | ) 4,123       |
| Tax-exempt securities                           | 3,841             | —                            | (266)                         | ) 3,575       |
| Foreign government securities                   | 25                | —                            | —                             | 25            |
| Total available for sale securities             | \$171,193         | \$1,765                      | \$(2,738)                     | ) \$170,220   |

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

The amortized cost and fair value of debt securities by contractual maturities at September 30, 2014 are presented below. Maturities are based on the final contractual payment dates, and do not reflect the impact of potential prepayments or early redemptions. Because mortgage-backed securities ("MBS") are not due at a single maturity date, they are not included in the maturity categories in the following maturity summary.

|                             | Amortized<br>Cost | Fair<br>Value |
|-----------------------------|-------------------|---------------|
|                             | (In Thousands)    |               |
| Within 1 year               | \$6,268           | \$6,292       |
| After 1 but within 5 years  | 39,057            | 39,040        |
| After 5 but within 10 years | 17,169            | 17,222        |
| After 10 years              | 37,857            | 38,072        |
|                             | 100,351           | 100,626       |
| Mortgage-backed securities  | 70,635            | 70,151        |
| Total debt securities       | \$170,986         | \$170,777     |

The following is a summary of realized gains and losses on the sales of securities for the three and nine months ended September 30, 2014 and 2013:

| Three Months Ended<br>September 30,<br>2014 |      | Nine Months Ended<br>September 30,<br>2014 |      |
|---|------|--|------|
| 2013  | 2014 | 2013                                       | 2013 |
| (In Thousands)                              |      |  |      |

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|  |     |        |        |        |   |
|--|-----|--------|--------|--------|---|
| Gross gains on sales                   | \$— | \$37   | \$64   | \$40   |   |
| Gross losses on sales                  | —   | (959   | ) —    | (959   | ) |
| Net gain (loss) on sales of securities | \$— | \$(922 | ) \$64 | \$(919 | ) |

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Proceeds from the sale of available for sale securities were \$1.1 million for the nine months ended September 30, 2014 and \$12.1 million and \$13.1 million for the three and nine months ended September 30, 2013, respectively. There were no security sales for the three months ended September 30, 2014.

The following tables present information pertaining to securities with gross unrealized losses at September 30, 2014 and December 31, 2013, aggregated by investment category and length of time the individual securities have been in a continuous unrealized loss position.

| September 30, 2014                              | Less Than 12 Months |                   | 12 Months Or More |                   | Total      |                   |
|---|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
|   | (In Thousands)      |                   |                   |                   |            |                   |
| U.S. Government and agency obligations          | \$22,003            | \$59              | \$12,910          | \$177             | \$34,913   | \$236             |
| Government sponsored enterprises                | 5,630               | 9                 | 5,852             | 127               | 11,482     | 136               |
| Mortgage-backed securities:                     |                     |                   |                   |                   |            |                   |
| Agency - residential                            | 8,558               | 115               | 32,777            | 1,268             | 41,335     | 1,383             |
| Non-agency - residential                        | —                   | —                 | 135               | 3                 | 135        | 3                 |
| Obligations of state and political subdivisions | —                   | —                 | 1,219             | 27                | 1,219      | 27                |
| Tax-exempt securities                           | —                   | —                 | 1,148             | 5                 | 1,148      | 5                 |
| Total   | \$36,191            | \$183             | \$54,041          | \$1,607           | \$90,232   | \$1,790           |
|   |                     |                   |                   |                   |            |                   |
| December 31, 2013                               | 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          | \$21,921            | \$142             | \$883             | \$26              | \$22,804   | \$168             |
| Government-sponsored enterprises                | 12,376              | 393               | —                 | —                 | 12,376     | 393               |
| Mortgage-backed securities:                     |                     |                   |                   |                   |            |                   |
| Agency - residential                            | 38,119              | 1,772             | 2,686             | 37                | 40,805     | 1,809             |
| Non-agency - residential                        | 169                 | 2                 | —                 | —                 | 169        | 2                 |
| Collateralized debt obligation                  | —                   | —                 | 1,191             | 19                | 1,191      | 19                |
| Obligations of state and political subdivisions | 1,187               | 81                | —                 | —                 | 1,187      | 81                |
| Tax-exempt securities                           | 3,575               | 266               | —                 | —                 | 3,575      | 266               |
| Total   | \$77,347            | \$2,656           | \$4,760           | \$82              | \$82,107   | \$2,738           |

At September 30, 2014, forty-three debt securities with gross unrealized losses had aggregate depreciation of approximately 1.95% of the Company's amortized cost basis. The majority of the unrealized losses are related to the Company's agency MBS. There were no investments deemed other-than-temporarily impaired for the three and nine months ended September 30, 2014. Impairment charges recognized on investments deemed other-than-temporarily impaired were \$0 and \$8,000 for the three and nine months ended September 30, 2013. The following summarizes, by

security type, the basis for management's determination during the preparation of the financial statements that the applicable investments within the Company's securities portfolio were not other-than-temporarily impaired at September 30, 2014.

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U.S. Government and Agency Obligations. The unrealized losses on the Company's U.S. Government and agency obligations related primarily to a widening of the rate spread to comparable treasury securities. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell the securities before their anticipated recovery, which may be at maturity, the Company did not consider these securities to be other-than-temporarily impaired at September 30, 2014.

Government Sponsored Enterprises. The unrealized losses on the Company's government sponsored enterprises were also caused by interest rate movement. The contractual cash flows of these investments are guaranteed by a government sponsored agency. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost of our investment. As a result of (1) the decline in market value being attributable to changes in interest rates and not credit quality, (2) the Company's position that it does not intend to sell these securities and (3) it is not more likely than not that the Company will be required to sell the securities before their anticipated recovery, which may be at maturity, the Company did not consider these securities to be other-than-temporarily impaired at September 30, 2014.

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 September 30, 2014.

Mortgage-backed Securities - Non-agency - Residential. The unrealized losses on the Company's non-agency - residential mortgage-backed securities relate to one investment which has been evaluated by management and no potential credit losses were identified. The Company does not intend to sell this security and it is not more likely than not that the Company will be required to sell this security before the recovery of its amortized cost basis, which may be maturity, the Company did not consider this investment to be other-than-temporarily impaired at September 30, 2014.

Obligations of State and Political Subdivisions. The unrealized losses on the Company's obligations of state and political subdivisions relate to two investments in municipal general obligation bonds purchased during the second quarter of 2013. The unrealized loss was mainly attributable to the widening of interest rate spreads for these securities since their purchase date. Management monitors the financial data of the individual municipalities to ensure that they meet minimum credit standards. Since the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost basis, which may be at maturity, the Company did not record impairment losses at September 30, 2014.

Tax-exempt Securities. The unrealized losses on the Company's tax-exempt securities relate to one municipal general obligation bond purchased during the second quarter of 2013. The unrealized loss was mainly attributable to the widening of interest rate spread for this security since its purchase date. Management monitors the financial data of the individual municipality to ensure that it meets minimum credit standards. Since 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 recovery of its amortized cost basis, which may be at maturity, the Company did not record an impairment loss at

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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 (loss) for the three and nine months ended September 30, 2014 and 2013.

|  | Three Months Ended    |       | Nine Months Ended     |        |
|--|-----------------------|-------|-----------------------|--------|
|  | September 30,<br>2014 | 2013  | September 30,<br>2014 | 2013   |
|  | (In Thousands)        |       |                       |        |
| Balance at beginning of period   | \$—                   | \$267 | \$—                   | \$259  |
| Amounts related to credit for which OTTI losses were not previously recognized | —                     | —     | —                     | 8      |
| Reduction for securities sold during the period (realized)                     | —                     | (205  | ) —                   | (205 ) |
| Balance at end of period   | \$—                   | \$62  | \$—                   | \$62   |



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

## Loan Portfolio

The composition of the Company's loan portfolio at September 30, 2014 and December 31, 2013 is as follows:

|  | September 30, 2014<br>(In Thousands) | December 31, 2013 |
|--|--------------------------------------|-------------------|
| Real estate loans:                           |                                      |                   |
| Residential - 1 to 4 family                  | \$434,766                            | \$449,812         |
| Multi-family and commercial                  | 294,177                              | 285,660           |
| Construction                                 | 13,416                               | 10,162            |
| Total real estate loans                      | 742,359                              | 745,634           |
| Commercial business loans:                   |                                      |                   |
| SBA and USDA guaranteed                      | 118,524                              | 137,578           |
| Time share                                   | 42,090                               | 28,615            |
| Condominium association                      | 20,517                               | 18,442            |
| Other  | 68,592                               | 69,705            |
| Total commercial business loans              | 249,723                              | 254,340           |
| Consumer loans:                              |                                      |                   |
| Home equity                                  | 48,677                               | 44,284            |
| Indirect automobile                          | 4,329                                | 6,354             |
| Other  | 2,003                                | 2,116             |
| Total consumer loans                         | 55,009                               | 52,754            |
| Total loans                                  | 1,047,091                            | 1,052,728         |
| Deferred loan origination costs, net of fees | 1,599                                | 1,598             |
| Allowance for loan losses                    | (7,619)                              | (6,916)           |
| Loans receivable, net                        | \$1,041,071                          | \$1,047,410       |

The Company purchased commercial loans totaling \$38.6 million during the nine months ended September 30, 2014. For the twelve months ended December 31, 2013, the Company purchased commercial business loans totaling \$23.0 million.

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## Allowance for Loan Losses

Changes in the allowance for loan losses for the three and nine months ended September 30, 2014 and 2013 are as follows:

| Three Months Ended<br>September 30, 2014   | Residential -<br>1 to 4 Family | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total   |
|--|--------------------------------|-----------------------------------|--------------|------------------------|----------|---------|
|  | (In Thousands)                 |                                   |              |                        |          |         |
| Balance at beginning of period             | \$984                          | \$3,465                           | \$221        | \$2,208                | \$567    | \$7,445 |
| Provision for loan losses                  | 123                            | 135                               | 26           | 21                     | 45       | 350     |
| Loans charged-off                          | (137 )                         | (1 )                              | —            | —                      | (42 )    | (180 )  |
| Recoveries of loans previously charged-off | —                              | —                                 | —            | 1                      | 3        | 4       |
| Balance at end of period                   | \$970                          | \$3,599                           | \$247        | \$2,230                | \$573    | \$7,619 |
| <br>                                       |                                |                                   |              |                        |          |         |
| Nine Months Ended<br>September 30, 2014    | Residential -<br>1 to 4 Family | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total   |
|  | (In Thousands)                 |                                   |              |                        |          |         |
| Balance at beginning of period             | \$975                          | \$3,395                           | \$169        | \$1,875                | \$502    | \$6,916 |
| Provision for loan losses                  | 281                            | 347                               | 78           | 364                    | 125      | 1,195   |
| Loans charged-off                          | (317 )                         | (144 )                            | —            | (13 )                  | (75 )    | (549 )  |
| Recoveries of loans previously charged-off | 31                             | 1                                 | —            | 4                      | 21       | 57      |
| Balance at end of period                   | \$970                          | \$3,599                           | \$247        | \$2,230                | \$573    | \$7,619 |
| <br>                                       |                                |                                   |              |                        |          |         |
| Three Months Ended<br>September 30, 2013   | 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             | \$999                          | \$2,947                           | \$30         | \$1,531                | \$500    | \$6,007 |
| Provision for loan losses                  | 99                             | 11                                | 83           | 231                    | 19       | 443     |
| Loans charged-off                          | (128 )                         | —                                 | —            | —                      | (10 )    | (138 )  |
| Recoveries of loans previously charged-off | 1                              | 1                                 | —            | 2                      | 6        | 10      |
| Balance at end of period                   | \$971                          | \$2,959                           | \$113        | \$1,764                | \$515    | \$6,322 |
| <br>                                       |                                |                                   |              |                        |          |         |
| Nine Months Ended<br>September 30, 2013    | Residential -<br>1 to 4 Family | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total   |
|  | (In Thousands)                 |                                   |              |                        |          |         |
|  | \$1,125                        | \$3,028                           | \$22         | \$1,735                | \$477    | \$6,387 |

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|  |       |         |       |         |       |         |   |
|--|-------|---------|-------|---------|-------|---------|---|
| Balance at beginning of period             |       |         |       |         |       |         |   |
| Provision for loan losses                  | 401   | 56      | 91    | 27      | 58    | 633     |   |
| Loans charged-off                          | (586  | ) (197  | ) —   | —       | (71   | ) (854  | ) |
| Recoveries of loans previously charged-off | 31    | 72      | —     | 2       | 51    | 156     |   |
| Balance at end of period                   | \$971 | \$2,959 | \$113 | \$1,764 | \$515 | \$6,322 |   |

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Further information pertaining to the allowance for loan losses at September 30, 2014 and December 31, 2013 is as follows:

| September 30, 2014   | Residential -<br>1 to 4 Family<br>(In Thousands) | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total       |
|--|--|-----------------------------------|--------------|------------------------|----------|-------------|
| Allowance for loans individually evaluated and deemed to be impaired                     | \$314  | \$131                             | \$—          | \$75                   | \$—      | \$520       |
| Allowance for loans individually or collectively evaluated and not deemed to be impaired | 656  | 3,468                             | 247          | 2,155                  | 573      | 7,099       |
| Allowance for loans acquired with deteriorated credit quality                            | —  | —                                 | —            | —                      | —        | —           |
| Total allowance for loan losses  | \$970  | \$3,599                           | \$247        | \$2,230                | \$573    | \$7,619     |
| Loans individually evaluated and deemed to be impaired                                   | \$5,222  | \$1,971                           | \$—          | \$765                  | \$—      | \$7,958     |
| Loans individually or collectively evaluated and not deemed to be impaired               | 429,169  | 287,943                           | 13,416       | 248,597                | 55,009   | 1,034,134   |
| Amount of loans acquired with deteriorated credit quality                                | 375  | 4,263                             | —            | 361                    | —        | 4,999       |
| Total loans  | \$434,766  | \$294,177                         | \$13,416     | \$249,723              | \$55,009 | \$1,047,091 |
| December 31, 2013  | Residential -<br>1 to 4 Family<br>(In Thousands) | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total       |
| Allowance for loans individually evaluated and deemed to be impaired                     | \$341  | \$185                             | \$—          | \$4                    | \$—      | \$530       |
| Allowance for loans individually or collectively evaluated and not deemed to be impaired | 634  | 3,210                             | 169          | 1,871                  | 502      | 6,386       |
| Allowance for loans acquired with deteriorated credit quality                            | —  | —                                 | —            | —                      | —        | —           |
|  | \$975  | \$3,395                           | \$169        | \$1,875                | \$502    | \$6,916     |

Total allowance for loan  
losses

|  |           |           |          |           |          |             |
|--|-----------|-----------|----------|-----------|----------|-------------|
| Loans individually evaluated<br>and deemed to be impaired                        | \$5,695   | \$3,036   | \$—      | \$385     | \$—      | \$9,116     |
| Loans individually or<br>collectively evaluated and<br>not deemed to be impaired | 443,734   | 277,483   | 10,162   | 252,930   | 52,754   | 1,037,063   |
| Amount of loans acquired<br>with deteriorated credit<br>quality                  | 383       | 5,141     | —        | 1,025     | —        | 6,549       |
| Total loans  | \$449,812 | \$285,660 | \$10,162 | \$254,340 | \$52,754 | \$1,052,728 |

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## Past Due Loans

The following represents an aging of loans at September 30, 2014 and December 31, 2013:

| September 30, 2014          | 30-59<br>Days<br>Past Due | 60-89<br>Days<br>Past Due | 90 Days or<br>More<br>Past Due | Total 30<br>Days or<br>More<br>Past Due | Current     | Total<br>Loans |
|-----------------------------|---------------------------|---------------------------|--------------------------------|---|-------------|----------------|
|                             | (In Thousands)            |                           |                                |   |             |                |
| Real Estate:                |                           |                           |                                |   |             |                |
| Residential - 1 to 4 family | \$36                      | \$430                     | \$1,271                        | \$1,737                                 | \$433,029   | \$434,766      |
| Multi-family and commercial | 642                       | 426                       | 619                            | 1,687                                   | 292,490     | 294,177        |
| Construction                | —                         | —                         | —                              | —                                       | 13,416      | 13,416         |
| Commercial Business:        |                           |                           |                                |   |             |                |
| SBA and USDA guaranteed     | 2,104                     | 818                       | —                              | 2,922                                   | 115,602     | 118,524        |
| Time share                  | —                         | —                         | —                              | —                                       | 42,090      | 42,090         |
| Condominium association     | 61                        | —                         | —                              | 61                                      | 20,456      | 20,517         |
| Other                       | 288                       | —                         | 432                            | 720                                     | 67,872      | 68,592         |
| Consumer:                   |                           |                           |                                |   |             |                |
| Home equity                 | 152                       | —                         | —                              | 152                                     | 48,525      | 48,677         |
| Indirect automobile         | 80                        | 28                        | —                              | 108                                     | 4,221       | 4,329          |
| Other                       | —                         | —                         | —                              | —                                       | 2,003       | 2,003          |
| Total                       | \$3,363                   | \$1,702                   | \$2,322                        | \$7,387                                 | \$1,039,704 | \$1,047,091    |
| December 31, 2013           | 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 | \$5,402                   | \$783                     | \$1,473                        | \$7,658                                 | \$442,154   | \$449,812      |
| Multi-family and commercial | 1,057                     | —                         | 1,388                          | 2,445                                   | 283,215     | 285,660        |
| Construction                | —                         | —                         | —                              | —                                       | 10,162      | 10,162         |
| Commercial Business:        |                           |                           |                                |   |             |                |
| SBA and USDA guaranteed     | 7,266                     | 1,161                     | 66                             | 8,493                                   | 129,085     | 137,578        |
| Time share                  | —                         | —                         | —                              | —                                       | 28,615      | 28,615         |
| Condominium association     | —                         | —                         | —                              | —                                       | 18,442      | 18,442         |
| Other                       | —                         | 171                       | 338                            | 509                                     | 69,196      | 69,705         |
| Consumer:                   |                           |                           |                                |   |             |                |
| Home equity                 | 258                       | 36                        | 49                             | 343                                     | 43,941      | 44,284         |
| Indirect automobile         | 80                        | 47                        | 16                             | 143                                     | 6,211       | 6,354          |
| Other                       | 1                         | 1                         | —                              | 2                                       | 2,114       | 2,116          |
| Total                       | \$14,064                  | \$2,199                   | \$3,330                        | \$19,593                                | \$1,033,135 | \$1,052,728    |

The Company did not have any loans that were past due 90 days or more and still accruing interest at September 30, 2014 or December 31, 2013.

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## Impaired and Nonaccrual Loans

The following is a summary of impaired loans and nonaccrual loans at September 30, 2014 and December 31, 2013:

| September 30, 2014   | Impaired Loans <sup>(1)</sup> |                                |                      |                     |
|--|-------------------------------|--------------------------------|----------------------|---------------------|
|  | Recorded<br>Investment        | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Nonaccrual<br>Loans |
|  | (In Thousands)                |                                |                      |                     |
| Impaired loans without valuation allowance: <sup>(2)</sup> |                               |                                |                      |                     |
| Real Estate:   |                               |                                |                      |                     |
| Residential - 1 to 4 family                                | \$3,188                       | \$3,312                        | \$—                  | \$2,800             |
| Multi-family and commercial                                | 4,701                         | 4,898                          | —                    | 636                 |
| Commercial business - Other                                | 975                           | 975                            | —                    | 589                 |
| Total impaired loans without valuation allowance           | 8,864                         | 9,185                          | —                    | 4,025               |
| Impaired loans with valuation allowance:                   |                               |                                |                      |                     |
| Real Estate:   |                               |                                |                      |                     |
| Residential - 1 to 4 family                                | 2,409                         | 2,420                          | 314                  | 366                 |
| Multi-family and commercial                                | 1,533                         | 1,623                          | 131                  | 370                 |
| Commercial business - Other                                | 151                           | 151                            | 75                   | 151                 |
| Total impaired loans with valuation allowance              | 4,093                         | 4,194                          | 520                  | 887                 |
| Total impaired loans                                       | \$12,957                      | \$13,379                       | \$520                | \$4,912             |

<sup>(1)</sup> Includes loans acquired with deteriorated credit quality and performing TDRs.<sup>(2)</sup> Includes loans acquired with deteriorated credit quality from the Newport merger.

| December 31, 2013  | Impaired Loans <sup>(1)</sup> |                                |                      |                     |
|--|-------------------------------|--------------------------------|----------------------|---------------------|
|  | Recorded<br>Investment        | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Nonaccrual<br>Loans |
|  | (In Thousands)                |                                |                      |                     |
| Impaired loans without valuation allowance: <sup>(2)</sup> |                               |                                |                      |                     |
| Real Estate:   |                               |                                |                      |                     |
| Residential - 1 to 4 family                                | \$3,641                       | \$3,822                        | \$—                  | \$3,241             |
| Multi-family and commercial                                | 6,853                         | 7,050                          | —                    | 1,655               |
| Commercial business - Other                                | 1,402                         | 1,402                          | —                    | 377                 |
| Consumer - Home equity                                     | —                             | —                              | —                    | 53                  |
| Consumer - Indirect automobile                             | —                             | —                              | —                    | 16                  |
| Total impaired loans without valuation allowance           | 11,896                        | 12,274                         | —                    | 5,342               |
| Impaired loans with valuation allowance:                   |                               |                                |                      |                     |
| Real Estate:   |                               |                                |                      |                     |
| Residential - 1 to 4 family                                | 2,437                         | 2,448                          | 341                  | 319                 |
| Multi-family and commercial                                | 1,324                         | 1,414                          | 185                  | 1,324               |
| Commercial business - Other                                | 8                             | 8                              | 4                    | 8                   |
| Total impaired loans with valuation allowance              | 3,769                         | 3,870                          | 530                  | 1,651               |



|                      |           |           |        |          |
|----------------------|-----------|-----------|--------|----------|
| Total impaired loans | \$ 15,665 | \$ 16,144 | \$ 530 | \$ 6,993 |
|----------------------|-----------|-----------|--------|----------|

(1) Includes loans acquired with deteriorated credit quality and performing TDRs.

(2) Includes loans acquired with deteriorated credit quality from the Newport merger.

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The Company reviews and establishes, if necessary, an allowance for certain impaired loans for the amount by which the present value of expected cash flows (or observable market price of loan or fair value of the collateral if the loan is collateral dependent) are lower than the carrying value of the loan. At September 30, 2014 and December 31, 2013, the Company concluded that certain impaired loans required no valuation allowance as a result of management's measurement of impairment. No additional funds are committed to be advanced to those borrowers whose loans are deemed impaired.

Additional information related to impaired loans is as follows:

|                                | Three Months Ended<br>September 30, 2014 |                                  |   | Nine Months Ended<br>September 30, 2014 |                                  |   |
|--------------------------------|--|----------------------------------|---|---|----------------------------------|---|
|                                | Average<br>Recorded<br>Investment        | Interest<br>Income<br>Recognized | Interest<br>Income<br>Recognized<br>on Cash Basis | Average<br>Recorded<br>Investment       | Interest<br>Income<br>Recognized | Interest<br>Income<br>Recognized<br>on Cash Basis |
|                                | (In Thousands)                           |                                  |   |   |                                  |   |
| Real Estate:                   |  |                                  |   |   |                                  |   |
| Residential - 1 to 4 family    | \$5,829                                  | \$27                             | \$4   | \$5,987                                 | \$117                            | \$47  |
| Multi-family and<br>commercial | 6,262                                    | 70                               | —   | 6,989                                   | 312                              | 72  |
| Commercial business - Other    | 1,145                                    | 6                                | —   | 1,123                                   | 34                               | 15  |
| Consumer - Home equity         | 22                                       | 2                                | 2   | 40                                      | 3                                | 3   |
| Consumer - Other               | 20                                       | —                                | —   | 10                                      | —                                | —   |
| Total                          | \$13,278                                 | \$105                            | \$6   | \$14,149                                | \$466                            | \$137   |
|                                |  |                                  |   |   |                                  |   |
|                                | Three Months Ended<br>September 30, 2013 |                                  |   | Nine Months Ended<br>September 30, 2013 |                                  |   |
|                                | Average<br>Recorded<br>Investment        | Interest<br>Income<br>Recognized | Interest<br>Income<br>Recognized<br>on Cash Basis | Average<br>Recorded<br>Investment       | Interest<br>Income<br>Recognized | Interest<br>Income<br>Recognized<br>on Cash Basis |
|                                | (In Thousands)                           |                                  |   |   |                                  |   |
| Real Estate:                   |  |                                  |   |   |                                  |   |
| Residential - 1 to 4 family    | \$6,984                                  | \$43                             | \$24  | \$7,168                                 | \$201                            | \$149   |
| Multi-family and<br>commercial | 5,589                                    | 29                               | —   | 5,093                                   | 75                               | —   |
| Commercial business - Other    | 965                                      | 5                                | —   | 710                                     | 12                               | 5   |
| Consumer - Home equity         | 203                                      | —                                | —   | 297                                     | 27                               | 27  |
| Total                          | \$13,741                                 | \$77                             | \$24  | \$13,268                                | \$315                            | \$181   |

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## 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 assets is not warranted.

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

The following tables present the Company's loans by risk rating at September 30, 2014 and December 31, 2013:

| September 30, 2014              | Not Rated      | Pass      | Special<br>Mention | Substandard | Doubtful | Loss | Total       |
|---------------------------------|----------------|-----------|--------------------|-------------|----------|------|-------------|
|                                 | (In Thousands) |           |                    |             |          |      |             |
| <b>Real Estate:</b>             |                |           |                    |             |          |      |             |
| Residential - 1 to 4 family     | \$—            | \$427,270 | \$1,333            | \$6,163     | \$—      | \$—  | \$434,766   |
| Multi-family and commercial     | —              | 265,266   | 16,967             | 11,944      | —        | —    | 294,177     |
| Construction                    | —              | 13,416    | —                  | —           | —        | —    | 13,416      |
| Total real estate loans         | —              | 705,952   | 18,300             | 18,107      | —        | —    | 742,359     |
| <b>Commercial Business:</b>     |                |           |                    |             |          |      |             |
| SBA and USDA guaranteed         | 118,524        | —         | —                  | —           | —        | —    | 118,524     |
| Time share                      | —              | 42,090    | —                  | —           | —        | —    | 42,090      |
| Condominium association         | —              | 20,517    | —                  | —           | —        | —    | 20,517      |
| Other                           | —              | 63,589    | 2,768              | 2,235       | —        | —    | 68,592      |
| Total commercial business loans | 118,524        | 126,196   | 2,768              | 2,235       | —        | —    | 249,723     |
| <b>Consumer:</b>                |                |           |                    |             |          |      |             |
| Home equity                     | —              | 48,570    | 59                 | 48          | —        | —    | 48,677      |
| Indirect automobile             | —              | 4,316     | —                  | 13          | —        | —    | 4,329       |
| Other                           | —              | 2,003     | —                  | —           | —        | —    | 2,003       |
| Total consumer loans            | —              | 54,889    | 59                 | 61          | —        | —    | 55,009      |
| Total loans                     | \$118,524      | \$887,037 | \$21,127           | \$20,403    | \$—      | \$—  | \$1,047,091 |



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| December 31, 2013               | Not Rated      | Pass      | Special<br>Mention | Substandard | Doubtful | Loss | Total       |
|---------------------------------|----------------|-----------|--------------------|-------------|----------|------|-------------|
|                                 | (In Thousands) |           |                    |             |          |      |             |
| Real Estate:                    |                |           |                    |             |          |      |             |
| Residential - 1 to 4 family     | \$—            | \$441,646 | \$1,296            | \$6,870     | \$—      | \$—  | \$449,812   |
| Multi-family and commercial     | —              | 250,667   | 18,363             | 16,630      | —        | —    | 285,660     |
| Construction                    | —              | 10,162    | —                  | —           | —        | —    | 10,162      |
| Total real estate loans         | —              | 702,475   | 19,659             | 23,500      | —        | —    | 745,634     |
| Commercial Business:            |                |           |                    |             |          |      |             |
| SBA and USDA guaranteed         | 137,578        | —         | —                  | —           | —        | —    | 137,578     |
| Time share                      | —              | 28,615    | —                  | —           | —        | —    | 28,615      |
| Condominium association         | —              | 18,442    | —                  | —           | —        | —    | 18,442      |
| Other                           | —              | 63,959    | 2,230              | 3,516       | —        | —    | 69,705      |
| Total commercial business loans | 137,578        | 111,016   | 2,230              | 3,516       | —        | —    | 254,340     |
| Consumer:                       |                |           |                    |             |          |      |             |
| Home equity                     | —              | 44,117    | 66                 | 101         | —        | —    | 44,284      |
| Indirect automobile             | —              | 6,338     | —                  | 16          | —        | —    | 6,354       |
| Other                           | —              | 2,116     | —                  | —           | —        | —    | 2,116       |
| Total consumer loans            | —              | 52,571    | 66                 | 117         | —        | —    | 52,754      |
| Total loans                     | \$137,578      | \$866,062 | \$21,955           | \$27,133    | \$—      | \$—  | \$1,052,728 |

Troubled Debt Restructurings

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

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

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



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The following table provides information on loans modified as TDRs during the nine months ended September 30, 2014 and 2013. There were no loans modified as TDRs during the three months ended September 30, 2014 and 2013.

|                             | Nine Months Ended September 30,<br>2014      |                        |  | 2013               |                        |  |
|-----------------------------|--|------------------------|--|--------------------|------------------------|--|
|                             | Number of<br>Loans<br>(Dollars in Thousands) | Recorded<br>Investment | Allowance<br>for Loan<br>Losses (End<br>of Period) | Number of<br>Loans | Recorded<br>Investment | Allowance<br>for Loan<br>Losses (End<br>of Period) |
| Residential - 1 to 4 family | 1  | \$100                  | \$—  | 1                  | \$408                  | \$—  |
| Multi-family and commercial | 2  | 1,416                  | 50   | —                  | —                      | —  |
| Commercial business - other | 2  | 314                    | —  | —                  | —                      | —  |
| Total                       | 5  | \$1,830                | \$50   | 1                  | \$408                  | \$—  |

During the modification process, there were no loan charge-offs or principal reductions for the loans included in the above tables.

The following table provides the recorded investment, by type of modification, during the three and nine months ended September 30, 2014 and 2013 for modified loans identified as TDRs.

|   | Three Months Ended September 30,<br>2014 |      | Nine Months Ended September 30,<br>2014 |       |
|---|--|------|---|-------|
|   | 2014                                     | 2013 | 2014                                    | 2013  |
| Interest rate adjustments                       | \$—                                      | \$—  | \$379                                   | \$—   |
| Combination of rate and payment <sup>(1)</sup>  | —  | —    | 288                                     | —     |
| Combination of rate and maturity <sup>(2)</sup> | —  | —    | 1,163                                   | 408   |
| Total   | \$—                                      | \$—  | \$1,830                                 | \$408 |

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

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

There were no TDRs in payment default (defined as 90 days or more past due) within twelve months of restructure for the three and nine months ended September 30, 2014 and 2013.

**Loans Acquired with Deteriorated Credit Quality**

The following is a summary of loans acquired with evidence of credit deterioration from Newport as of September 30, 2014 and December 31, 2013.

|                                 | Contractual<br>Required<br>Payments<br>Receivable<br>(In Thousands) | Cash Expected<br>To Be Collected | Non-Accrutable<br>Discount | Accrutable<br>Yield | Loans<br>Receivable |
|---------------------------------|---|----------------------------------|----------------------------|---------------------|---------------------|
| Balance at December 31,<br>2013 | \$7,776   | \$6,549                          | \$1,227                    | \$—                 | \$6,549             |

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|                                  |         |          |        |     |         |   |
|----------------------------------|---------|----------|--------|-----|---------|---|
| Collections                      | (216    | ) (183   | ) (33  | ) — | (183    | ) |
| Dispositions                     | (1,722  | ) (1,367 | ) (355 | ) — | (1,367  | ) |
| Balance at September 30,<br>2014 | \$5,838 | \$4,999  | \$839  | \$— | \$4,999 |   |



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## NOTE 5. PREMISES AND EQUIPMENT

Premises and equipment at September 30, 2014 and December 31, 2013 are summarized as follows:

|   | September 30, 2014<br>(In Thousands) | December 31, 2013 |
|---|--------------------------------------|-------------------|
| Land                                      | \$4,746                              | \$4,311           |
| Buildings                                 | 11,813                               | 11,497            |
| Leasehold improvements                    | 10,780                               | 10,762            |
| Furniture and equipment                   | 12,435                               | 12,549            |
| Construction in process                   | 545                                  | 45                |
|   | 40,319                               | 39,164            |
| Accumulated depreciation and amortization | (19,016                              | ) (18,074         |
| Premises and equipment, net               | \$21,303                             | \$21,090          |

At September 30, 2014 and December 31, 2013, construction in process related to design and site costs associated with a new branch location. At September 30, 2014, the Company had outstanding commitments related to the construction of a new branch location and the renovation of an existing branch totaling \$2.1 million.

## NOTE 6. OTHER COMPREHENSIVE INCOME (LOSS)

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income (loss). 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 (loss) are components of comprehensive income (loss).

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

|   | Nine Months Ended September 30, 2014 |                |                      |
|---|--------------------------------------|----------------|----------------------|
|   | Before Tax<br>Amount                 | Tax<br>Effects | Net of Tax<br>Amount |
| Securities:   | (In Thousands)                       |                |                      |
| Unrealized holding gains on available for sale securities               | \$828                                | \$(282         | ) \$546              |
| Reclassification adjustment for gains recognized in net income          | (64                                  | ) 22           | (42                  |
| Unrealized holding gains on available for sale securities, net of taxes | 764                                  | (260           | ) 504                |
| Derivative instrument:  |                                      |                |                      |
| Change in fair value of effective cash flow hedging derivative          | 117                                  | (40            | ) 77                 |
| Other comprehensive income  | \$881                                | \$(300         | ) \$581              |

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

|   | September 30, 2014 |         |            |
|---|--------------------|---------|------------|
|   | Before Tax         | Tax     | Net of Tax |
|   | Amount             | Effects | Amount     |
|   | (In Thousands)     |         |            |
| Net unrealized losses on available for sale securities        | \$(209             | ) \$71  | \$(138     |
| Net unrealized loss on effective cash flow hedging derivative | (195               | ) 66    | (129       |
| Accumulated other comprehensive loss                          | \$(404             | ) \$137 | \$(267     |
|   |                    |         | )          |
|   |                    |         | )          |
|   |                    |         | )          |
|   | December 31, 2013  |         |            |
|   | Before Tax         | Tax     | Net of Tax |
|   | Amount             | Effects | Amount     |
|   | (In Thousands)     |         |            |
| Net unrealized losses on available for sale securities        | \$(973             | ) \$331 | \$(642     |
| Net unrealized loss on effective cash flow hedging derivative | (312               | ) 106   | (206       |
| Accumulated other comprehensive loss                          | \$(1,285           | ) \$437 | \$(848     |
|   |                    |         | )          |
|   |                    |         | )          |
|   |                    |         | )          |

## 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 September 30, 2014 and December 31, 2013, 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.

In July 2013, the FRB released its final rules which will implement the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain changes required by the Dodd-Frank Act. These rules become effective January 1, 2015 for community banks and will increase both the quality and quantity of capital held by banks. The final rule implements strict eligibility criteria for regulatory capital instruments and improves the

methodology for calculating risk-weighted assets to enhance risk sensitivity. Consistent with the international Basel framework, the final rule includes a new minimum capital requirement of common equity Tier I capital to risk-weighted assets of 4.5 percent and a common equity Tier I capital conservation buffer of 2.5 percent of risk-weighted assets. The capital conservation buffer will be phased in beginning January 1, 2016, at 0.625 percent of

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risk-weighted assets, increasing each year until fully implemented at 2.5 percent on January 1, 2019. In addition, the final rule raises the minimum ratio of Tier I capital to risk-weighted assets requirement from 4 percent to 6 percent and includes a minimum leverage ratio of 4 percent for all banking organizations.

The Bank's actual capital amounts and ratios as of September 30, 2014 and December 31, 2013 were as follows:

|                                 | Actual                 |       | For Capital Adequacy Purposes |       | To Be Well Capitalized Under Prompt Corrective Action Provisions |       |   |
|---------------------------------|------------------------|-------|-------------------------------|-------|--|-------|---|
|                                 | Amount                 | Ratio | Amount                        | Ratio | Amount   | Ratio |   |
| September 30, 2014              | (Dollars in Thousands) |       |                               |       |  |       |   |
| Tier I Capital Ratio            | \$122,307              | 9.32  | % \$52,474                    | 4.00  | % \$65,593   | 5.00  | % |
| Tier I Risk-based Capital Ratio | 122,307                | 14.90 | 32,837                        | 4.00  | 49,256   | 6.00  |   |
| Total Risk-based Capital Ratio  | 130,514                | 15.90 | 65,674                        | 8.00  | 82,093   | 10.00 |   |
| Tangible Equity Ratio           | 122,307                | 9.32  | 19,678                        | 1.50  | N/A  | N/A   |   |
| December 31, 2013               | (Dollars in Thousands) |       |                               |       |  |       |   |
| Tier I Capital Ratio            | \$117,477              | 8.94  | % \$52,550                    | 4.00  | % \$65,688   | 5.00  | % |
| Tier I Risk-based Capital Ratio | 117,477                | 14.71 | 31,936                        | 4.00  | 47,905   | 6.00  |   |
| Total Risk-based Capital Ratio  | 124,964                | 15.65 | 63,873                        | 8.00  | 79,841   | 10.00 |   |
| Tangible Equity Ratio           | 117,477                | 8.94  | 19,706                        | 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. Transfers between levels are recognized at the end of a reporting period, if applicable.

Valuation is based on quoted prices in active markets for identical assets or liabilities. Level 1 assets and Level 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.

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Determination of Fair Value

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

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

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

**Securities available for sale.** Included in the available for sale category are 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 a nationally-recognized, third-party pricing service to estimate fair value measurements for the majority of its portfolio. The pricing service evaluates each asset class based on relevant market information considering observable data, but these prices do not represent binding quotes. The fair value prices on all investments are reviewed for reasonableness by management. Securities measured at fair value in Level 3 include a collateralized debt obligation that is 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 that reprice frequently and have no significant change in credit risk, fair values are based on carrying values. The fair value of fixed-rate loans are estimated by discounting the future cash flows using the rates at the end of the period in which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. Fair values for nonperforming loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

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



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

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

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

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

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

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

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

The following tables present assets and liabilities measured at fair value on a recurring basis as of September 30, 2014 and December 31, 2013. The Company had no significant transfers into or out of Levels 1, 2 or 3 during the three and nine months ended September 30, 2014.

|   | September 30, 2014 |          |         | Total    |
|---|--------------------|----------|---------|----------|
|   | Level 1            | Level 2  | Level 3 |          |
|   | (In Thousands)     |          |         |          |
| Assets:   |                    |          |         |          |
| U.S. Government and agency obligations                        | \$21,903           | \$41,220 | \$—     | \$63,123 |
| Government-sponsored enterprises                              | —                  | 24,434   | —       | 24,434   |
| Mortgage-backed securities                                    | —                  | 70,151   | —       | 70,151   |
| Corporate debt securities                                     | —                  | 1,008    | —       | 1,008    |
| Collateralized debt obligation                                | —                  | —        | 1,188   | 1,188    |
| Obligations of state and political subdivisions               | —                  | 4,186    | —       | 4,186    |
| Tax-exempt securities   | —                  | 6,687    | —       | 6,687    |
| Forward loan sale commitments and derivative loan commitments | —                  | —        | 34      | 34       |



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|                               |          |           |         |           |
|-------------------------------|----------|-----------|---------|-----------|
| Total assets                  | \$21,903 | \$147,686 | \$1,222 | \$170,811 |
| Liabilities:                  |          |           |         |           |
| Interest rate swap agreements | \$—      | \$300     | \$—     | \$300     |
| Total liabilities             | \$—      | \$300     | \$—     | \$300     |

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|   | December 31, 2013         |                  |                | Total            |
|---|---------------------------|------------------|----------------|------------------|
|   | Level 1<br>(In Thousands) | Level 2          | Level 3        |                  |
| <b>Assets:</b>  |                           |                  |                |                  |
| U.S. Government and agency obligations                        | \$8,975                   | \$45,570         | \$—            | \$54,545         |
| Government-sponsored enterprises                              | —                         | 26,292           | —              | 26,292           |
| Mortgage-backed securities                                    | —                         | 76,671           | —              | 76,671           |
| Corporate debt securities                                     | —                         | 3,798            | —              | 3,798            |
| Collateralized debt obligation                                | —                         | —                | 1,191          | 1,191            |
| Obligations of state and political subdivisions               | —                         | 4,123            | —              | 4,123            |
| Tax-exempt securities   | —                         | 3,575            | —              | 3,575            |
| Foreign government securities                                 | —                         | 25               | —              | 25               |
| Forward loan sale commitments and derivative loan commitments | —                         | —                | 22             | 22               |
| <b>Total assets</b>   | <b>\$8,975</b>            | <b>\$160,054</b> | <b>\$1,213</b> | <b>\$170,242</b> |
| <b>Liabilities:</b>   |                           |                  |                |                  |
| Interest rate swap agreements                                 | \$—                       | \$486            | \$—            | \$486            |
| <b>Total liabilities</b>                                      | <b>\$—</b>                | <b>\$486</b>     | <b>\$—</b>     | <b>\$486</b>     |

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

|  | Collateralized<br>Debt<br>Obligations<br>(In Thousands) | Derivative Loan and<br>Forward Loan Sale<br>Commitments, Net |
|--|---|--|
| Balance at December 31, 2013                                   | \$1,191   | \$22   |
| Total realized and unrealized gains included in net income     | —   | 12   |
| Total unrealized losses included in other comprehensive income | (3)   | ) —  |
| Balance at September 30, 2014                                  | \$1,188   | \$34   |

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

The Company may also be required, from time to time, to measure certain other financial assets on a nonrecurring basis in accordance with generally accepted accounting principles. These adjustments to fair value usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets. The following table summarizes the fair value hierarchy used to determine each adjustment and the carrying value of the related individual assets at September 30, 2014 and December 31, 2013. There were no liabilities measured at fair value on a nonrecurring basis at September 30, 2014 and December 31, 2013.

|                | At September 30, 2014     |         |         | At December 31, 2013 |         |         |
|----------------|---------------------------|---------|---------|----------------------|---------|---------|
|                | Level 1<br>(In Thousands) | Level 2 | Level 3 | Level 1              | Level 2 | Level 3 |
| Impaired loans | \$—                       | \$—     | \$639   | \$—                  | \$—     | \$1,384 |

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|                         |     |     |         |     |     |         |
|-------------------------|-----|-----|---------|-----|-----|---------|
| Other real estate owned | —   | —   | 1,361   | —   | —   | 2,429   |
| Total assets            | \$— | \$— | \$2,000 | \$— | \$— | \$3,813 |

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

|                         | Three Months Ended September 30, |      | Nine Months Ended September 30, |       |
|-------------------------|----------------------------------|------|---------------------------------|-------|
|                         | 2014                             | 2013 | 2014                            | 2013  |
|                         | (In Thousands)                   |      |                                 |       |
| Impaired loans          | \$22                             | \$33 | \$126                           | \$318 |
| Other real estate owned | 10                               | —    | 25                              | 32    |
| Total losses            | \$32                             | \$33 | \$151                           | \$350 |

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 September 30, 2014 and December 31, 2013. The estimated fair value amounts at September 30, 2014 and December 31, 2013 have been measured as of each respective date, and have not been re-evaluated or updated for purposes of the consolidated financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each period-end. The information presented should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only required for a limited portion of the Company's assets. Due to the wide range of valuation techniques and the degree of subjectivity used in making the estimate, comparisons between the Company's disclosures and those of other banks may not be meaningful.

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As of September 30, 2014 and December 31, 2013, the recorded carrying amounts and estimated fair values of the Company's financial instruments are as follows:

|   | September 30, 2014 |          |         |           |           |
|---|--------------------|----------|---------|-----------|-----------|
|   | Carrying<br>Amount | Level 1  | Level 2 | Level 3   | Total     |
| Financial Assets:                                     |                    |          |         |           |           |
| (In Thousands)  |                    |          |         |           |           |
| Cash and cash equivalents                             | \$33,618           | \$33,618 | \$—     | \$—       | \$33,618  |
| Available for sale securities                         | 170,777            | 21,903   | 147,686 | 1,188     | 170,777   |
| Loans held for sale                                   | 1,123              | —        | —       | 1,236     | 1,236     |
| Loans receivable, net                                 | 1,041,071          | —        | —       | 1,053,622 | 1,053,622 |
| Federal Home Loan Bank stock                          | 10,333             | —        | —       | 10,333    | 10,333    |
| Accrued interest receivable                           | 3,898              | —        | —       | 3,898     | 3,898     |
| Financial Liabilities:                                |                    |          |         |           |           |
| Deposits  | 997,839            | —        | —       | 1,000,885 | 1,000,885 |
| Mortgagors' and investors' escrow accounts            | 1,794              | —        | —       | 1,794     | 1,794     |
| Federal Home Loan Bank advances                       | 154,148            | —        | 155,537 | —         | 155,537   |
| Junior subordinated debt owed to unconsolidated trust | 8,248              | —        | 5,949   | —         | 5,949     |
| On-balance Sheet Derivative Financial Instruments:    |                    |          |         |           |           |
| Assets:   |                    |          |         |           |           |
| Derivative loan commitments                           | 28                 | —        | —       | 28        | 28        |
| Forward loan sale commitments                         | 6                  | —        | —       | 6         | 6         |
| Liabilities:  |                    |          |         |           |           |
| Interest rate swap agreements                         | 300                | —        | 300     | —         | 300       |
|   |                    |          |         |           |           |
|   | December 31, 2013  |          |         |           |           |
|   | Carrying<br>Amount | Level 1  | Level 2 | Level 3   | Total     |
| Financial Assets:                                     |                    |          |         |           |           |
| (In Thousands)  |                    |          |         |           |           |
| Cash and cash equivalents                             | \$27,321           | \$27,321 | \$—     | \$—       | \$27,321  |
| Available for sale securities                         | 170,220            | 8,975    | 160,054 | 1,191     | 170,220   |
| Loans held for sale                                   | 1,764              | —        | —       | 1,766     | 1,766     |
| Loans receivable, net                                 | 1,047,410          | —        | —       | 1,050,834 | 1,050,834 |
| Federal Home Loan Bank stock                          | 13,109             | —        | —       | 13,109    | 13,109    |
| Accrued interest receivable                           | 4,021              | —        | —       | 4,021     | 4,021     |
| Financial Liabilities:                                |                    |          |         |           |           |
| Deposits  | 984,749            | —        | —       | 987,705   | 987,705   |
| Mortgagors' and investors' escrow accounts            | 3,214              | —        | —       | 3,214     | 3,214     |
| Federal Home Loan Bank advances                       | 176,272            | —        | 178,448 | —         | 178,448   |
| Junior subordinated debt owed to unconsolidated trust | 8,248              | —        | 6,337   | —         | 6,337     |
| On-balance Sheet Derivative Financial Instruments:    |                    |          |         |           |           |
| Assets:   |                    |          |         |           |           |

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|                               |     |   |     |    |     |
|-------------------------------|-----|---|-----|----|-----|
| Derivative loan commitments   | 14  | — | —   | 14 | 14  |
| Forward loan sale commitments | 8   | — | —   | 8  | 8   |
| Liabilities:                  |     |   |     |    |     |
| Interest rate swap agreements | 486 | — | 486 | —  | 486 |

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## NOTE 9. DERIVATIVE INSTRUMENTS AND HEDGING ACTIVITIES

## Derivative Financial Instruments

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

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

## Derivative Instruments Designated As Hedging Instruments

The Company uses long-term variable rate debt as a source of funds for use in the Company's lending and investment activities and other general business purposes. These debt obligations expose the Company to variability in interest payments due to changes in interest rates. If interest rates increase, interest expense increases. Conversely, if interest rates decrease, interest expense decreases. Management believes it is prudent to limit the variability of a portion of its interest payments and, therefore, hedges its variable-rate interest payments on its junior subordinated debentures. 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 September 30, 2014 and December 31, 2013, information pertaining to the outstanding interest rate swap agreement used to hedge variable rate debt is as follows:

|  | September 30, 2014     | December 31, 2013 |   |
|--|------------------------|-------------------|---|
|  | (Dollars in Thousands) |                   |   |
| Notional amount                                | \$8,000                | \$8,000           |   |
| Weighted average fixed pay rate                | 2.44                   | % 2.44            | % |
| Weighted average variable receive rate         | 0.23                   | % 0.24            | % |
| Weighted average maturity in years             | 1.2                    | 2.0               |   |
| Unrealized loss relating to interest rate swap | \$195                  | \$312             |   |

At September 30, 2014 and December 31, 2013, 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 September 30, 2014 and December 31, 2013 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.



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The Company's derivative contract contains a provision establishing a collateral requirement (subject to minimum collateral posting thresholds) based on the Company's external credit rating. If the Company's junior subordinated debt rating was to fall below the level generally recognized as investment grade, the counterparty to such derivative contract could require additional collateral on the derivative transaction in a net liability position (after considering the effect of bilateral netting arrangements and posted collateral). The Company had previously posted collateral of \$400,000 in the normal course of business for a derivative instrument, with a credit-related contingent feature, that was in a net liability position at September 30, 2014 and December 31, 2013.

Derivative Instruments Not Designated As Hedging Instruments

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

Interest Rate Swap Agreement - In 2012, the Company entered into an interest rate swap agreement that does not meet the hedge accounting requirements of FASB's "Derivatives and Hedging" standard, to manage the Company's exposure to interest rate movements and other identified risks. At September 30, 2014 and December 31, 2013, information pertaining to the Company's interest rate swap agreement not designated as a hedge is as follows:

|  | September 30, 2014     | December 31, 2013 |   |
|--|------------------------|-------------------|---|
|  | (Dollars in Thousands) |                   |   |
| Notional amount                                | \$15,000               | \$15,000          |   |
| Weighted average fixed pay rate                | 1.26                   | % 1.26            | % |
| Weighted average variable receive rate         | 0.23                   | % 0.25            | % |
| Weighted average maturity in years             | 2.3                    | 3.0               |   |
| Unrealized loss relating to interest rate swap | \$105                  | \$174             |   |

The Company reported a gain in fair value on the interest rate swap not designated as a hedge of \$78,000 and \$69,000 in noninterest income for the three and nine months ended September 30, 2014, respectively.

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

Outstanding derivative loan commitments expose the Company to the risk that the price of the loans arising from exercise of the loan commitment might decline from inception of the rate lock to funding of the loan due to increases in mortgage interest rates. If interest rates increase, the values of these loan commitments decrease. Conversely, if interest rates decrease, the value of these loan commitments increase. The notional amount of undesignated mortgage loan commitments was \$5.6 million at September 30, 2014. At September 30, 2014, the fair value of such commitments was a net asset of \$28,000.

Forward Loan Sale Commitments - To protect against the price risk inherent in derivative loan commitments, the Company utilizes "mandatory delivery" forward loan sale commitments to mitigate the risk of potential decreases in the

value of loans that would result from the exercise of the derivative loan commitments.

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

The Company expects that these forward loan sale commitments will experience changes in fair value opposite to the change in fair value of derivative loan commitments. The notional amount of undesignated forward loan sale commitments was \$3.0 million at September 30, 2014. At September 30, 2014, the fair value of such commitments was a net asset of \$6,000.

## Interest Rate Risk Management - Derivative Instruments

The following table presents the fair values of derivative instruments as well as their classification on the consolidated balance sheets at September 30, 2014 and December 31, 2013.

|  | Balance Sheet Location | September 30, 2014 |                      | December 31, 2013 |                      |
|--|------------------------|--------------------|----------------------|-------------------|----------------------|
|  |                        | Notional Amount    | Estimated Fair Value | Notional Amount   | Estimated Fair Value |
| Derivative designated as hedging instrument:       |                        |                    |                      |                   |                      |
| Interest rate swap                                 | Other Liabilities      | \$8,000            | \$(195 )             | \$8,000           | \$(312 )             |
| Derivatives not designated as hedging instruments: |                        |                    |                      |                   |                      |
| Interest rate swap                                 | Other Liabilities      | 15,000             | (105 )               | 15,000            | (174 )               |
| Derivative loan commitments                        | Other Assets           | 5,595              | 28                   | 3,129             | 14                   |
| Forward loan sale commitments                      | Other Assets           | 3,016              | 6                    | 3,581             | 8                    |

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 September 30, 2014 and December 31, 2013 and the results of operations for the three and nine months ended September 30, 2014 and 2013. 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 2013 Annual Report on Form 10-K.

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

Management's ability to predict results or the effect of future plans or strategies is inherently uncertain. Factors that could have a material adverse effect on the operations of the Company and its subsidiaries include, but are not limited to, changes in interest rates, national and regional economic conditions, legislative and regulatory changes, monetary and fiscal policies of the United States government, including policies of the United States Treasury and the Federal Reserve Board, the quality and composition of the loan and investment portfolios, demand for loan products, deposit flows, competition, failing to achieve the expected cost savings or revenue synergies related to the Newport acquisition, 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, other-than-temporary impairment 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 2013 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 September 30, 2014 and December 31, 2013

Assets:

Summary. Assets decreased \$6.2 million, or 0.5%, to \$1.34 billion at September 30, 2014 principally due to decreases of \$6.3 million in net loans receivable, \$2.8 million in FHLB stock and other real estate owned of \$1.1 million, offset by an increase of \$6.3 million in cash and cash equivalents.

Loans Receivable, Net. Contributing to the decrease of \$6.3 million in net loans receivable were reductions in residential mortgage loan originations and principal repayments of SBA and USDA guaranteed loans, offset by increases in time share, condominium association and home equity loans. Changes in the loan portfolio consisted of the following:

Residential Real Estate. Residential mortgage loans comprised 41.5% of the total loan portfolio at September 30, 2014. The residential mortgage portfolio decreased \$15.0 million, or 3.3%, partly due to the sale of \$13.3 million of fixed-rate residential mortgage loans. Residential mortgage loan originations decreased \$19.7 million during the first nine months of 2014 over the comparable period in 2013, as a result of rising interest rates and reduced activity in the housing market.

Multi-family and Commercial Real Estate. Multi-family and commercial real estate loans represented 28.1% of total loans at September 30, 2014 and increased \$8.5 million, or 3.0%, during the first nine months of 2014. Loan originations for multi-family and commercial real estate loans were \$36.0 million, representing an increase of \$26.0 million during the first nine months of 2014 compared to the same period in 2013.

Construction. Construction loans, which include both residential and commercial construction loans, increased \$3.3 million for the first nine months of 2014 as a result of commercial construction volume.

Commercial Business. Commercial business loans represented 23.9% of total loans at September 30, 2014. Commercial business loans decreased \$4.6 million, or 1.8%, for the first nine months of 2014 primarily due to decreases of \$19.1 million and \$1.1 million in SBA and USDA guaranteed loans and other commercial business loans, respectively, offset by increases of \$13.5 million and \$2.1 million in time share and condominium association lending, respectively. Commercial business loan originations decreased \$53.7 million as compared to the same period in 2013. At September 30, 2014, unfunded lines of credit related to time share lending totaled \$38.1 million as a result of an experienced lender dedicated to identifying new opportunities for growth within the time share industry.

Consumer. Consumer loans represented 5.3% of the Company's total loan portfolio at September 30, 2014. Consumer loans increased \$2.3 million during the first nine months of 2014 as a result of an increase of \$4.4 million in home equity loans, offset by a decrease of \$2.0 million in indirect automobile loans. Loan originations for consumer loans totaled \$21.1 million, representing an increase of \$7.7 million, for the first nine months of 2014 over the comparable period in 2013 resulting from a home equity line of credit promotion.

The allowance for loan losses totaled \$7.6 million at September 30, 2014 compared to \$6.9 million at December 31, 2013. The ratio of the allowance for loan losses to total loans increased to 0.73% at September 30, 2014 from 0.66% at December 31, 2013, which was necessitated by an increase in commercial loans, which carry a higher degree of risk than other loans held in portfolio.

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

|   | September 30<br>2014 | December 31,<br>2013 |  |   |
|---|----------------------|----------------------|--|---|
| (Dollars in Thousands)  |                      |                      |  |   |
| Nonaccrual loans:   |                      |                      |  |   |
| Real estate loans:  |                      |                      |  |   |
| Residential - 1 to 4 family   | \$3,166              | \$3,560              |  |   |
| Multi-family and commercial   | 1,006                | 2,979                |  |   |
| Total real estate loans   | 4,172                | 6,539                |  |   |
| Commercial business loans - Other   | 740                  | 385                  |  |   |
| Consumer loans:   |                      |                      |  |   |
| Home equity   | —                    | 53                   |  |   |
| Indirect automobile   | —                    | 16                   |  |   |
| Total nonaccrual loans  | 4,912                | 6,993                |  |   |
| Accruing loans past due 90 days or more                                     | —                    | —                    |  |   |
| Total nonperforming loans <sup>(1)</sup>                                    | 4,912                | 6,993                |  |   |
| Other real estate owned, net <sup>(2)</sup>                                 | 1,361                | 2,429                |  |   |
| Total nonperforming assets  | 6,273                | 9,422                |  |   |
| Accruing troubled debt restructurings                                       | 3,300                | 2,192                |  |   |
| Total nonperforming assets and troubled debt restructurings                 | \$9,573              | \$11,614             |  |   |
| Allowance for loan losses as a percent of nonperforming loans               | 155.11               | % 98.90              |  | % |
| Total nonperforming loans to total loans                                    | 0.47                 | % 0.66               |  | % |
| Total nonperforming loans to total assets                                   | 0.37                 | % 0.52               |  | % |
| Total nonperforming assets and troubled debt restructurings to total assets | 0.71                 | % 0.86               |  | % |

<sup>(1)</sup> Includes nonperforming TDRs totaling \$943,000 and \$319,000 at September 30, 2014 and December 31, 2013, respectively.

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

The decrease in nonperforming assets was due to a decrease in nonaccrual loans and other real estate owned. Nonperforming multi-family and commercial real estate loans decreased \$2.0 million and residential mortgage loans decreased \$394,000 during the first nine months of 2014.

Other real estate owned decreased \$1.1 million from December 31, 2013 to September 30, 2014, primarily as a result of the sale of nine residential properties with a carrying value of \$1.0 million and net write-downs of \$32,000. At September 30, 2014, other real estate owned included three commercial properties and one residential property.

Over the past few years, the Company has sought to restructure nonperforming loans rather than pursue foreclosure or liquidation, believing this approach achieves the best economic outcome for the Company in view of the current economic environment. Modified payment terms for TDRs generally involve deferred principal payments, interest rate concessions, a combination of deferred principal payments and interest rate concessions or a combination of maturity extensions and interest rate concessions. TDRs increased to \$4.2 million at September 30, 2014, compared to \$2.5 million at December 31, 2013, resulting from the addition of four commercial loans with a recorded investment of \$1.7 million and one residential loan with a recorded investment of \$100,000. Of the TDRs, \$3.3 million and \$2.2 million were performing in accordance with their restructured terms at September 30, 2014 and December 31, 2013, respectively. The Company anticipates that these borrowers will repay all contractual principal and interest in accordance with the terms of their restructured loan agreements.



**Liabilities:**

Summary. Liabilities decreased \$9.5 million, or 0.8%, to \$1.18 billion at September 30, 2014 compared to \$1.19 billion at December 31, 2013. Deposits increased \$13.1 million, or 1.3%, which included increases in certificates of deposit and noninterest-bearing deposits of \$15.4 million and \$1.6 million, respectively, offset by a decrease in NOW and money market accounts of \$4.0 million. Deposit growth remained strong due to marketing and promotional initiatives and competitively-priced deposit products. Borrowings decreased \$22.1 million from \$184.5 million at December 31, 2013 to \$162.4 million at September 30, 2014, resulting from net repayments of FHLB advances.

**Equity:**

Summary. Shareholders' equity increased \$3.3 million from \$152.8 million at December 31, 2013 to \$156.1 million at September 30, 2014. The increase in shareholders' equity was attributable to net income of \$3.0 million, the exercise of stock options of \$552,000 and a decrease in net unrealized loss on available for sale securities aggregating \$504,000 (net of taxes), offset by dividends of \$1.1 million and common shares repurchased totaling \$761,000.

Accumulated Other Comprehensive Loss. Accumulated other comprehensive loss is comprised of the unrealized gains and losses on available for sale securities and unrealized gains and losses on an interest rate swap designated as a hedge, net of taxes. The net unrealized losses on available for sale securities, net of taxes, totaled \$138,000 at September 30, 2014 compared to net unrealized losses of \$642,000 at December 31, 2013. The net unrealized loss on the interest rate swap, net of taxes, totaled \$129,000 at September 30, 2014 compared to a net unrealized loss on the interest rate swap, net of taxes, of \$206,000 at December 31, 2013.

**Results of Operations for the Three and Nine Months Ended September 30, 2014 and 2013**

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

Summary. The Company reported net income of \$1.2 million for the three months ended September 30, 2014, representing an increase of \$2.9 million, compared to a net loss of \$1.7 million for the three months ended September 30, 2013. The Company reported net income of \$3.0 million for the nine months ended September 30, 2014, representing an increase of \$4.9 million, compared to a net loss of \$1.9 million for the nine months ended September 30, 2013. The acquisition of Newport in September 2013 contributed to the higher net income for the three and nine months ended September 30, 2014, as a result of increases in net interest income and noninterest income. Lower net income for the three and nine months ended September 30, 2013 was the result of costs totaling \$1.3 million and \$2.2 million (pre-tax), respectively, associated with the acquisition of Newport, losses realized on security sales and penalties related to the prepayment of FHLB advances.

Interest and Dividend Income. Total interest and dividend income increased \$2.6 million, or 28.2%, to \$11.7 million for the quarter ended September 30, 2014, compared to the same period in 2013. The increase in interest and dividend income was due to an increase in the average balance of loans, offset by lower yields on loans versus the same period in 2013. Interest income on loans and securities reflect net amortization of \$108,000 and \$88,000 for the three months ended September 30, 2014 and 2013, respectively, related to fair value adjustments of loans and securities resulting



from the Newport acquisition. The average yield earned on interest-earning assets increased 3 basis points to 3.71%, despite the 8 basis points decline in the yield on loans to 4.08%. Average

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interest-earning assets increased \$270.4 million to \$1.26 billion during the third quarter of 2014, due to an increase in the average balance of loans of \$271.3 million and other interest earning assets of \$9.9 million, offset by a decrease of \$10.7 million in the average balance of securities compared to the same quarter in 2013.

Total interest and dividend income increased \$9.5 million, or 36.4%, to \$35.5 million for the nine months ended September 30, 2014, compared to the same period in 2013, offset by lower yields on loans. The increase in interest and dividend income was due to an increase in the average balance of loans and an increase of 3 basis points in the average yield earned on interest-earning assets versus the same period in 2013. Interest income on loans and securities reflect net amortization of \$124,000 and \$88,000 for the nine months ended September 30, 2014 and 2013, respectively, related to fair value adjustments of loans and securities resulting from the Newport acquisition. The average yield earned on interest-earning assets increased to 3.76%, despite the decline of 14 basis points in the yield on loans to 4.14%. Average interest-earning assets increased \$329.9 million to \$1.26 billion during the first nine months of 2014, due to an increase in the average balance of loans of \$336.7 million and other interest-earning assets of \$5.0 million, offset by a decrease in the average balance of securities of \$11.8 million compared to the same period in 2013.

**Interest Expense.** For the quarter ended September 30, 2014, interest expense decreased \$23,000, or 1.1%, resulting from lower rates paid on deposits and borrowings, offset by a higher average balance of deposits and FHLB advances. Lower interest expense on deposits and borrowings reflect net accretion of \$482,000 and \$645,000 for the three months ended September 30, 2014 and 2013, respectively, related to fair value adjustments of deposits and borrowings resulting from the Newport acquisition. Average interest-bearing deposits increased \$185.8 million to \$863.3 million and the average rate paid decreased 11 basis points to 0.62%. Increases in the average balance of NOW and money market deposits, certificates of deposit and savings accounts totaled \$100.7 million, \$82.0 million and \$2.9 million, respectively. The average balance of FHLB advances increased \$39.2 million while the average rate declined 99 basis points to 1.54%.

For the nine months ended September 30, 2014, interest expense decreased \$152,000, or 2.4%, to \$6.2 million compared to \$6.4 million for the comparable period in 2013 resulting from lower rates paid on deposits and borrowings, offset by a higher average balance of deposits and FHLB advances. Lower interest expense on deposits and borrowings reflect net accretion of \$1.5 million and \$645,000 for the nine months ended September 30, 2014 and 2013, respectively, related to fair value adjustments of deposits and borrowings resulting from the Newport acquisition. Average interest-bearing deposits increased \$223.5 million to \$864.6 million and the average rate paid decreased 19 basis points to 0.62%. Increases in the average balance of NOW and money market deposits, certificates of deposit and savings accounts totaled \$132.6 million, \$85.9 million and \$4.9 million, respectively. The average balance of FHLB advances increased \$63.3 million while the average rate declined 136 basis points to 1.55%.

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

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|  | At or For the Three Months Ended September 30,<br>2014 |                         |                           | 2013               |                         |                           |   |
|--|--|-------------------------|---------------------------|--------------------|-------------------------|---------------------------|---|
|  | Average<br>Balance                                     | Interest &<br>Dividends | Average<br>Yield/<br>Rate | Average<br>Balance | Interest &<br>Dividends | Average<br>Yield/<br>Rate |   |
|  | (Dollars in Thousands)                                 |                         |                           |                    |                         |                           |   |
| Interest-earning assets:   |  |                         |                           |                    |                         |                           |   |
| Loans <sup>(1) (2)</sup>   | \$ 1,044,702   | \$ 10,735               | 4.08                      | % \$ 773,439       | \$ 8,105                | 4.16                      | % |
| Securities <sup>(3)</sup>  | 184,376  | 1,002                   | 2.16                      | 195,119            | 1,050                   | 2.13                      |   |
| Other interest-earning assets  | 28,237   | 11                      | 0.15                      | 18,314             | 10                      | 0.22                      |   |
| Total interest-earning assets  | 1,257,315  | 11,748                  | 3.71                      | 986,872            | 9,165                   | 3.68                      |   |
| Noninterest-earning assets   | 91,287   |                         |                           | 75,664             |                         |                           |   |
| Total assets   | \$ 1,348,602   |                         |                           | \$ 1,062,536       |                         |                           |   |
| Interest-bearing liabilities:  |  |                         |                           |                    |                         |                           |   |
| Deposits:  |  |                         |                           |                    |                         |                           |   |
| Business checking  | \$ 180   | —                       | —                         | \$(14 )            | —                       | —                         |   |
| NOW and money market   | 450,011  | 143                     | 0.13                      | 349,346            | 122                     | 0.14                      |   |
| Savings <sup>(4)</sup>   | 46,854   | 20                      | 0.17                      | 43,909             | 18                      | 0.16                      |   |
| Certificates of deposit <sup>(5)</sup>   | 366,219  | 1,192                   | 1.29                      | 284,216            | 1,101                   | 1.54                      |   |
| Total interest-bearing deposits  | 863,264  | 1,355                   | 0.62                      | 677,457            | 1,241                   | 0.73                      |   |
| Federal Home Loan Bank advances  | 154,664  | 602                     | 1.54                      | 115,508            | 736                     | 2.53                      |   |
| Subordinated debt  | 8,248  | 84                      | 4.04                      | 8,248              | 85                      | 4.09                      |   |
| Other borrowed funds   | —  | —                       | —                         | 3,931              | 2                       | 0.20                      |   |
| Total interest-bearing liabilities   | 1,026,176  | 2,041                   | 0.79                      | 805,144            | 2,064                   | 1.02                      |   |
| Noninterest-bearing liabilities  | 165,503  |                         |                           | 119,042            |                         |                           |   |
| Total liabilities  | 1,191,679  |                         |                           | 924,186            |                         |                           |   |
| Total shareholders' equity   | 156,923  |                         |                           | 138,350            |                         |                           |   |
| Total liabilities and shareholders' equity   | \$ 1,348,602   |                         |                           | \$ 1,062,536       |                         |                           |   |
| Net interest-earning assets  | \$ 231,139   |                         |                           | \$ 181,728         |                         |                           |   |
| Tax equivalent net interest income <sup>(3)</sup>  |  | 9,707                   |                           |                    | 7,101                   |                           |   |
| Tax equivalent interest rate spread <sup>(6)</sup>   |  |                         | 2.92                      | %                  |                         | 2.66                      | % |
| Tax equivalent net interest margin as a percentage of interest-earning assets <sup>(7)</sup> |  |                         | 3.06                      | %                  |                         | 2.85                      | % |
| Average of interest-earning assets to average interest-bearing liabilities                   |  |                         | 122.52                    | %                  |                         | 122.57                    | % |
| Less tax equivalent adjustment <sup>(3)</sup>  |  | (20 )                   |                           |                    | (14 )                   |                           |   |

|                     |         |         |
|---------------------|---------|---------|
| Net interest income | \$9,687 | \$7,087 |
|---------------------|---------|---------|

(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 operations.

(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.

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|  | At or For the Nine Months Ended September 30,<br>2014 |                         |                           | 2013               |                         |                           |   |
|--|---|-------------------------|---------------------------|--------------------|-------------------------|---------------------------|---|
|  | Average<br>Balance                                    | Interest &<br>Dividends | Average<br>Yield/<br>Rate | Average<br>Balance | Interest &<br>Dividends | Average<br>Yield/<br>Rate |   |
| (Dollars in Thousands)   |   |                         |                           |                    |                         |                           |   |
| Interest-earning assets:   |   |                         |                           |                    |                         |                           |   |
| Loans <sup>(1) (2)</sup>   | \$1,048,969   | \$32,489                | 4.14                      | % \$712,285        | \$22,822                | 4.28                      | % |
| Securities <sup>(3)</sup>  | 185,649   | 3,008                   | 2.17                      | 197,408            | 3,176                   | 2.15                      |   |
| Other interest-earning assets  | 28,558  | 39                      | 0.18                      | 23,574             | 31                      | 0.18                      |   |
| Total interest-earning assets  | 1,263,176   | 35,536                  | 3.76                      | 933,267            | 26,029                  | 3.73                      |   |
| Noninterest-earning assets   | 91,825  |                         |                           | 55,512             |                         |                           |   |
| Total assets   | \$1,355,001   |                         |                           | \$988,779          |                         |                           |   |
| Interest-bearing liabilities:  |   |                         |                           |                    |                         |                           |   |
| Deposits:  |   |                         |                           |                    |                         |                           |   |
| Business checking  | \$155   | —                       | —                         | \$33               | —                       | —                         |   |
| NOW and money market   | 454,573   | 441                     | 0.13                      | 321,930            | 344                     | 0.14                      |   |
| Savings <sup>(4)</sup>   | 47,026  | 61                      | 0.17                      | 42,175             | 55                      | 0.17                      |   |
| Certificates of deposit <sup>(5)</sup>   | 362,829   | 3,531                   | 1.30                      | 276,966            | 3,478                   | 1.68                      |   |
| Total interest-bearing deposits  | 864,583   | 4,033                   | 0.62                      | 641,104            | 3,877                   | 0.81                      |   |
| Federal Home Loan Bank advances  | 165,472   | 1,921                   | 1.55                      | 102,158            | 2,227                   | 2.91                      |   |
| Subordinated debt  | 8,248   | 251                     | 4.07                      | 8,248              | 251                     | 4.07                      |   |
| Other borrowed funds   | —   | —                       | —                         | 1,325              | 2                       | 0.20                      |   |
| Total interest-bearing liabilities   | 1,038,303   | 6,205                   | 0.80                      | 752,835            | 6,357                   | 1.13                      |   |
| Noninterest-bearing liabilities  | 160,653   |                         |                           | 105,574            |                         |                           |   |
| Total liabilities  | 1,198,956   |                         |                           | 858,409            |                         |                           |   |
| Total shareholders' equity   | 156,045   |                         |                           | 130,370            |                         |                           |   |
| Total liabilities and shareholders' equity   | \$1,355,001   |                         |                           | \$988,779          |                         |                           |   |
| Net interest-earning assets  | \$224,873   |                         |                           | \$180,432          |                         |                           |   |
| Tax equivalent net interest income <sup>(3)</sup>  |   | 29,331                  |                           |                    | 19,672                  |                           |   |
| Tax equivalent interest rate spread <sup>(6)</sup>   |   |                         | 2.96                      | %                  |                         | 2.60                      | % |
| Tax equivalent net interest margin as a percentage of interest-earning assets <sup>(7)</sup> |   |                         | 3.10                      | %                  |                         | 2.82                      | % |
| Average of interest-earning assets to average interest-bearing liabilities                   |   |                         | 121.66                    | %                  |                         | 123.97                    | % |
| Less tax equivalent adjustment <sup>(3)</sup>  |   | (54                     | )                         |                    | (21                     | )                         |   |

|                     |          |          |
|---------------------|----------|----------|
| Net interest income | \$29,277 | \$19,651 |
|---------------------|----------|----------|

(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 operations.

(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.

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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<br>September 30, 2014 and 2013 |           |         | Nine Months Ended<br>September 30, 2014 and 2013 |            |         |
|------------------------------------|---|-----------|---------|--|------------|---------|
|                                    | Increase (Decrease) Due To<br>Rate                | Volume    | Net     | Increase (Decrease) Due To<br>Rate               | Volume     | Net     |
|                                    | (In Thousands)                                    |           |         |  |            |         |
| Interest-earning assets:           |   |           |         |  |            |         |
| Interest and dividend income:      |   |           |         |  |            |         |
| Loans <sup>(1)(2)</sup>            | \$(160  | ) \$2,790 | \$2,630 | \$(785   | ) \$10,452 | \$9,667 |
| Securities <sup>(3)</sup>          | 10  | (58       | ) (48   | ) 19   | (187       | ) (168  |
| Other interest-earning assets      | (3  | ) 4       | 1       | 1  | 7          | 8       |
| Total interest-earning assets      | (153  | ) 2,736   | 2,583   | (765   | ) 10,272   | 9,507   |
| Interest-bearing liabilities:      |   |           |         |  |            |         |
| Interest expense:                  |   |           |         |  |            |         |
| Deposits <sup>(4)</sup>            | (205  | ) 319     | 114     | (919   | ) 1,075    | 156     |
| Federal Home Loan Bank<br>advances | (338  | ) 204     | (134    | ) (1,318   | ) 1,012    | (306    |
| Subordinated debt                  | (1  | ) —       | (1      | ) —  | —          | —       |
| Other borrowed funds               | (1  | ) (1      | ) (2    | ) (1   | ) (1       | ) (2    |
| Total interest-bearing liabilities | (545  | ) 522     | (23     | ) (2,238   | ) 2,086    | (152    |
| Change in net interest income      | \$392   | \$2,214   | \$2,606 | \$1,473  | \$8,186    | \$9,659 |

<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 operations.

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

Provision for Loan Losses. The provision for loan losses decreased \$93,000 for the third quarter of 2014 compared to the same period in 2013, as a result of reductions in nonperforming loans and reserves for impaired loans, offset by increased net loan charge-offs. The provision for loan losses increased \$562,000 for the nine months ended September 30, 2014, compared to the same period in 2013, primarily due to an increase in commercial loans outstanding which carry a higher degree of risk than other loans held in portfolio, offset by decreases in nonperforming loans and loan charge-offs. At September 30, 2014, nonperforming loans totaled \$4.9 million, compared to \$7.7 million at September 30, 2013, resulting from decreases in nonperforming multi-family and commercial mortgage loans and residential mortgage loans of \$1.7 million and \$1.3 million, respectively. Net loan charge-offs were \$176,000 and \$492,000 for the three and nine months months ended September 30, 2014, respectively, consisting primarily of residential and commercial mortgage loan charge-offs, compared to net loan charge-offs of \$128,000 and \$698,000 for the three and nine months ended September 30, 2013, respectively.





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

|   | Three Months Ended     |                    | Change  |         | Nine Months Ended  |                    | Change  |         |         |   |
|---|------------------------|--------------------|---------|---------|--------------------|--------------------|---------|---------|---------|---|
|   | September 30, 2014     | September 30, 2013 | Dollars | Percent | September 30, 2014 | September 30, 2013 | Dollars | Percent |         |   |
|   | (Dollars in Thousands) |                    |         |         |                    |                    |         |         |         |   |
| Net impairment losses   | \$—                    | \$—                | \$—     | —       | % \$—              | \$(8               | ) \$8   | (100.0  | )%      |   |
| Service fees  | 1,762                  | 1,515              | 247     | 16.3    |                    | 5,265              | 3,964   | 1,301   | 32.8    |   |
| Wealth management fees  | 293                    | 302                | (9      | ) (3.0  | )                  | 926                | 846     | 80      | 9.5     |   |
| Increase in cash surrender value of bank-owned life insurance | 147                    | 90                 | 57      | 63.3    |                    | 433                | 226     | 207     | 91.6    |   |
| Net gain (loss) on sales of securities                        | —                      | (922               | ) 922   | (100.0  | )                  | 64                 | (919    | ) 983   | (107.0  | ) |
| Mortgage banking  | 81                     | 69                 | 12      | 17.4    |                    | 396                | 919     | (523    | ) (56.9 | ) |
| Net gain on fair value of derivatives                         | 78                     | 18                 | 60      | 333.3   |                    | 69                 | 191     | (122    | ) (63.9 | ) |
| Other   | 85                     | 161                | (76     | ) (47.2 | )                  | 527                | 526     | 1       | 0.2     |   |
| Total noninterest income                                      | \$2,446                | \$1,233            | \$1,213 | 98.4    | %                  | \$7,680            | \$5,745 | \$1,935 | 33.7    | % |

Increases in service fees and the cash surrender value of bank-owned life insurance ("BOLI") contributed to higher noninterest income during 2014, offset for the nine-month period by a decline in mortgage banking activities and a reduction in the fair value of certain derivative instruments. Service fees increased \$247,000 and \$1.3 million for the three and nine months ended September 30, 2014, respectively, compared to the same periods in the prior year, as a result of additional deposit customers from the Newport acquisition. The increase in the cash surrender value of BOLI for 2014 was the result of additional BOLI policies acquired in the Newport acquisition. Mortgage banking fees increased \$12,000 during the third quarter of 2014 and decreased \$523,000 during the nine months ended September 30, 2014, as compared to the same periods in the prior year. The decrease for the nine-month period was due to a lower volume of residential mortgage loan sales as compared to 2013 due to higher interest rates. Other noninterest income for the first nine months of 2014 included the reimbursement of \$250,000 in legal fees and other foreclosure expenses incurred in a prior period on two commercial loans, offset by an impairment charge of \$175,000 to reduce the carrying value of one of the Bank's small business investment company limited partnerships. For the three and nine months ended September 30, 2013, the Company recognized net losses of \$922,000 and \$919,000, primarily related to the sale of \$3.4 million in collateralized debt obligations and non-agency mortgage-backed securities previously classified as substandard, offset by a gain of \$201,000 on the sale of \$3.0 million in commercial business loans held for investment reported in other noninterest income.

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

|   | Three Months Ended     |                    | Change  |         | Nine Months Ended  |                    | Change   |         |         |   |
|---|------------------------|--------------------|---------|---------|--------------------|--------------------|----------|---------|---------|---|
|   | September 30, 2014     | September 30, 2013 | Dollars | Percent | September 30, 2014 | September 30, 2013 | Dollars  | Percent |         |   |
|   | (Dollars in Thousands) |                    |         |         |                    |                    |          |         |         |   |
| Salaries and employee benefits                    | \$4,897                | \$4,394            | \$503   | 11.4    | %                  | \$15,128           | \$12,923 | \$2,205 | 17.1    | % |
| Occupancy and equipment                           | 1,883                  | 1,417              | 466     | 32.9    |                    | 5,852              | 4,104    | 1,748   | 42.6    |   |
| Computer and electronic banking services          | 1,417                  | 1,057              | 360     | 34.1    |                    | 4,082              | 2,896    | 1,186   | 41.0    |   |
| Outside professional services                     | 420                    | 298                | 122     | 40.9    |                    | 1,422              | 948      | 474     | 50.0    |   |
| Marketing and advertising                         | 216                    | 170                | 46      | 27.1    |                    | 754                | 471      | 283     | 60.1    |   |
| Supplies  | 146                    | 110                | 36      | 32.7    |                    | 465                | 316      | 149     | 47.2    |   |
| FDIC deposit insurance and regulatory assessments | 303                    | 251                | 52      | 20.7    |                    | 953                | 714      | 239     | 33.5    |   |
| Merger expenses                                   | —                      | 1,305              | (1,305) | (100.0) | )                  | —                  | 2,198    | (2,198) | (100.0) | ) |
| Core deposit intangible amortization              | 150                    | 55                 | 95      | 172.7   |                    | 463                | 55       | 408     | 741.8   |   |
| Other real estate operations                      | 72                     | 83                 | (11)    | (13.3)  | )                  | 303                | 402      | (99)    | (24.6)  | ) |
| Other   | 500                    | 1,234              | (734)   | (59.5)  | )                  | 1,873              | 2,137    | (264)   | (12.4)  | ) |
| Total noninterest expenses                        | \$10,004               | \$10,374           | \$(370) | (3.6)   | )%                 | \$31,295           | \$27,164 | \$4,131 | 15.2    | % |

Noninterest expenses decreased \$370,000 for the third quarter of 2014 and increased \$4.1 million for the first nine months of 2014, compared to the same periods in 2013. Excluding merger costs, noninterest expenses increased for both the three and nine months ended September 30, 2014 as a result of incremental operating costs attributable to the six acquired branches from the Newport merger. Increases in salaries and benefits included additional staff and higher benefit costs. An increase in outside professional services expense was primarily related to contractual payments to former Newport officers under their noncompetition agreements. Other noninterest expenses for the first nine months of 2014 included increases of \$380,000 in fraudulent debit card transactions, core deposit intangible amortization of \$463,000 associated with the assumption of Newport deposits and prepayment penalties totaling \$75,000 for the early extinguishment of certain FHLB borrowings. For the three and nine months ended September 30, 2013, noninterest expenses included pre-tax merger costs for the acquisition of Newport of \$1.3 million and \$2.2 million, respectively, and prepayment penalties totaling \$659,000 for the early extinguishment of FHLB borrowings.

Income Tax Provision. The provision for income taxes increased \$1.3 million and \$2.0 for the three and nine months ended September 30, 2014, respectively, compared to the same period in 2013. The effective tax rate for the three months ended September 30, 2014 and 2013 was 32.6% and 30.2%, respectively. The effective tax rate for the first nine months of 2014 and 2013 was 32.4% and 21.7%, respectively. Higher net income in 2014 contributed to a higher effective tax rate for both periods presented.

#### 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 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 September 30, 2014, cash and

cash equivalents totaled \$33.6 million. Securities classified as available for sale, which provide additional sources of liquidity, totaled \$170.8 million at September 30, 2014. In addition, at September 30, 2014, the Bank had the ability to borrow \$106.7 million from the FHLB, which includes overnight lines of credit of \$10.0 million. On that date, the Bank had FHLB advances outstanding of \$154.1 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 nine months ended September 30, 2014, the Bank originated \$111.8 million of loans and purchased \$24.6 million of securities and \$38.6 million of loans. For the year ended December 31, 2013, the Bank originated \$217.5 million of loans and purchased \$54.7 million of securities and \$23.0 million of loans.

Financing activities consist primarily of activity in deposit accounts and in borrowed funds. The net increase in total deposits, including mortgagors' and investors' escrow accounts, was \$11.7 million for the nine months ended September 30, 2014. Certificates of deposit due within one year of September 30, 2014 totaled \$156.9 million, or 15.7% 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. 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.

FHLB advances decreased \$22.1 million during the nine months ended September 30, 2014 and increased \$78.6 million during the year ended December 31, 2013.

The Company repurchased 67,145 shares of the Company's common stock at a cost of \$761,000 during the first nine months of 2014 and 8,336 shares of the Company's common stock at a cost of \$98,000 during the year ended December 31, 2013. Additional discussion about the Company's liquidity and capital resources is contained in Item 7 in the Company's 2013 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 may continue to repurchase shares of its common stock in the future. SI Financial Group's primary sources of funds are 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 September 30, 2014, SI Financial Group had cash

and cash equivalents of \$12.7 million and available for sale securities of \$3.0 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, 2013. There were no material changes in the Company's payments due under contractual obligations between December 31, 2013 and September 30, 2014.

### Off-Balance Sheet Arrangements

As a financial services provider, we routinely are a party to various financial instruments with off-balance sheet risks, such as commitments to extend credit, standby letters of credit and unused lines of credit. While these contractual obligations represent our future cash requirements, a significant portion of the commitments to extend credit may expire without being drawn upon. 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 September 30, 2014 and December 31, 2013 are as follows:

|   | September 30, 2014<br>(In Thousands) | December 31, 2013 |
|---|--------------------------------------|-------------------|
| Commitments to extend credit:           |                                      |                   |
| Commitments to originate loans          | \$ 11,045                            | \$ 8,742          |
| Undisbursed construction loans          | 9,770                                | 9,193             |
| Undisbursed home equity lines of credit | 45,106                               | 41,031            |
| Undisbursed commercial lines of credit  | 66,360                               | 59,930            |
| Overdraft protection lines              | 1,224                                | 1,221             |
| Standby letters of credit               | 81                                   | 81                |
| Total commitments                       | \$ 133,586                           | \$ 120,198        |

Future loan commitments at September 30, 2014 and December 31, 2013 included fixed-rate loan commitments of \$4.8 million and \$6.9 million, respectively, at interest rates ranging from 2.50% to 5.00% and 2.75% to 5.75%, respectively.

The Bank is a limited partner in two small business investment corporations ("SBICs"). At September 30, 2014, the Bank's remaining off-balance sheet commitment for the capital investment in the SBICs was \$572,000. The Bank recognized write-downs of \$175,000 and \$81,000 on its investment in one of the SBICs during the nine months ended September 30, 2014 and 2013, respectively.

For the nine months ended September 30, 2014, 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 2013 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.

In July 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, which effectively converts the variable interest rate on the \$8.0 million of trust preferred securities to a fixed rate of 4.14% for the period of December 15, 2010 through December 15, 2015.

In January 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

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repricing of assets and liabilities at September 30, 2014 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.

The following table reflects changes in estimated net interest income for the Company at September 30, 2014.

|                                   | Percentage Change in Estimated<br>Net Interest Income Over |    |           |    |
|-----------------------------------|--|----|-----------|----|
|                                   | 12 Months  |    | 24 Months |    |
| 100 basis point decrease in rates | (2.10  | )% | (3.44     | )% |
| 300 basis point increase in rates | (0.38  | )  | (0.99     | )  |
| 400 basis point increase in rates | (0.46  | )  | (1.45     | )  |

As indicated by the results of the above scenarios, net interest income would be adversely affected (within our internal guidelines) in the 12- and 24-month periods if rates decreased 100 basis points or increased 300 or 400 basis points. Net interest income would be only minimally impacted if rates increased 300 and 400 basis points as a result of the Company's initiative to 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, restructuring FHLB advances to current lower market interest rates while extending their duration and utilizing certain derivative instruments such as forward loan sale commitments to manage the risk of loss associated with its mortgage banking activities. 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 of interest, 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 September 30, 2014 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, 2013, 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 September 30, 2014 were as follows:

| Period                 | Total Number of Shares Purchased <sup>(1)</sup> | 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 |
|------------------------|---|------------------------------|--|--|
| July 1 - 31, 2014      | —   | \$—                          | —  | 22,963   |
| August 1 - 31, 2014    | 22,963  | 11.07                        | 22,963   | —  |
| September 1 - 30, 2014 | 163   | 11.15                        | —  | —  |
| Total                  | 23,126  | \$11.07                      | 22,963   |  |

<sup>(1)</sup> On May 8, 2012, the Company announced that the Board of Directors had approved a stock repurchase program authorizing the Company to repurchase up to 5%, or 528,815 shares, of its common stock from time to time, depending on market conditions. All shares have been repurchased under this repurchase program.

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 September 30, 2014, formatted in eXtensible Business Reporting Language (XBRL): (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Operations, (iii) the Consolidated Statements of Comprehensive Income (Loss), (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.

<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 December 19, 2012.

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: November 6, 2014

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

Date: November 6, 2014

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

Date: November 6, 2014

/s/ Lauren L. Murphy  
Lauren L. Murphy  
Senior Vice President, Corporate  
Controller and Principal Accounting  
Officer  
(principal accounting officer)