

UNITY BANCORP INC /NJ/
Form 10-Q
May 11, 2012

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

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED March 31, 2012

OR

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

Commission file number 1-12431

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

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

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

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

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

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

The number of shares outstanding of each of the registrant's classes of common equity stock, as of May 1, 2012
common stock, no par value: 7,462,572 shares outstanding

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PART I - CONSOLIDATED FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements (Unaudited)

Unity Bancorp, Inc.
Consolidated Balance Sheets
At March 31, 2012, December 31, 2011 and March 31, 2011
(Unaudited)

(In thousands)	March 31, 2012	December 31, 2011	March 31, 2011
ASSETS			
Cash and due from banks	\$ 17,986	\$ 17,688	\$ 15,478
Federal funds sold and interest-bearing deposits	53,831	64,886	39,880
Cash and cash equivalents	71,817	82,574	55,358
Securities:			
Securities available for sale, at fair value	110,181	88,765	103,238
Securities held to maturity (fair value of \$18,934, \$19,879, and \$17,774, respectively)	17,880	18,771	17,577
Total securities	128,061	107,536	120,815
Loans:			
SBA held for sale	8,015	7,668	9,933
SBA held to maturity	62,251	64,175	74,657
SBA 504	47,651	55,108	60,092
Commercial	284,861	283,104	283,135
Residential mortgage	132,192	134,090	132,512
Consumer	47,782	48,447	54,193
Total loans	582,752	592,592	614,522
Less: Allowance for loan losses	16,339	16,348	15,275
Net loans	566,413	576,244	599,247
Premises and equipment, net	12,321	11,350	10,782
Bank owned life insurance ("BOLI")	9,179	9,107	8,885
Deferred tax assets	7,115	6,878	7,833
Federal Home Loan Bank stock	4,088	4,088	4,206
Accrued interest receivable	3,672	3,703	3,725
Other real estate owned ("OREO")	1,625	3,032	2,602
Prepaid FDIC insurance	2,386	2,545	2,994
Goodwill and other intangibles	1,526	1,530	1,541
Other assets	1,995	2,259	2,845
Total Assets	\$ 810,198	\$ 810,846	\$ 820,833
LIABILITIES AND SHAREHOLDERS' EQUITY			
Liabilities:			
Deposits:			
Noninterest-bearing demand deposits	\$ 108,618	\$ 101,193	\$ 91,247
Interest-bearing demand deposits	103,018	104,749	101,878

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Savings deposits	281,535	278,603	293,750
Time deposits, under \$100,000	94,513	102,809	110,050
Time deposits, \$100,000 and over	55,417	56,617	59,851
Total deposits	643,101	643,971	656,776
Borrowed funds	75,000	75,000	75,000
Subordinated debentures	15,465	15,465	15,465
Accrued interest payable	498	523	569
Accrued expenses and other liabilities	2,132	2,329	2,642
Total liabilities	736,196	737,288	750,452
Commitments and contingencies	-	-	-
Shareholders' equity:			
Cumulative perpetual preferred stock	19,683	19,545	19,146
Common stock	53,846	53,746	52,842
Accumulated deficit	(345)	(854)	(2,006)
Accumulated other comprehensive income	818	1,121	399
Total Shareholders' Equity	74,002	73,558	70,381
Total Liabilities and Shareholders' Equity	\$ 810,198	\$ 810,846	\$ 820,833
Preferred shares	21	21	21
Issued common shares	7,463	7,459	7,222
Outstanding common shares	7,463	7,459	7,222

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

Unity Bancorp
Consolidated Statements of Operations
For the three months ended March 31, 2012 and 2011
(Unaudited)

(In thousands, except per share amounts)	For the three months ended March 31,	
	2012	2011
INTEREST INCOME		
Federal funds sold and interest-bearing deposits	\$ 32	\$ 11
Federal Home Loan Bank stock	51	66
Securities:		
Available for sale	721	864
Held to maturity	173	287
Total securities	894	1,151
Loans:		
SBA	924	1,236
SBA 504	759	955
Commercial	4,183	4,306
Residential mortgage	1,655	1,831
Consumer	560	686
Total loans	8,081	9,014
Total interest income	9,058	10,242
INTEREST EXPENSE		
Interest-bearing demand deposits	136	139
Savings deposits	354	581
Time deposits	913	1,097
Borrowed funds and subordinated debentures	847	950
Total interest expense	2,250	2,767
Net interest income	6,808	7,475
Provision for loan losses	1,200	2,500
Net interest income after provision for loan losses	5,608	4,975
NONINTEREST INCOME		
Branch fee income	386	344
Service and loan fee income	302	243
Gain on sale of SBA loans held for sale, net	157	111
Gain on sale of mortgage loans, net	411	169
BOLI income	73	73
Net security gains	224	125
Other income	162	190
Total noninterest income	1,715	1,255
NONINTEREST EXPENSE		
Compensation and benefits	3,182	3,057
Occupancy	609	720
Processing and communications	534	507
Furniture and equipment	362	384
Professional services	190	202
Loan collection costs	180	224

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OREO expenses	124	222
Deposit insurance	171	319
Advertising	146	118
Other expenses	461	405
Total noninterest expense	5,959	6,158
Income before provision (benefit) for income taxes	1,364	72
Provision (benefit) for income taxes	459	(148)
Net income	905	220
Preferred stock dividends & discount accretion	396	384
Income available (loss attributable) to common shareholders	\$ 509	\$ (164)
Net income (loss) per common share - Basic	\$ 0.07	\$ (0.02)
- Diluted	\$ 0.07	\$ (0.02)
Weighted average common shares outstanding - Basic	7,460	7,219
Diluted	7,792	7,219

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

Unity Bancorp
 Consolidated Statements of Comprehensive Income
 For the three months ended March 31, 2012 and 2011
 (Unaudited)

(In thousands)	For the three months ended March 31,	
	2012	2011
Net income	\$ 905	\$ 220
Other comprehensive income, net of tax:		
Unrealized gains (losses) on securities:		
Unrealized holding gains (losses) arising during the period	(180)	275
Less: Reclassification adjustment for gains included in net income	149	83
Total unrealized gains (losses) on securities	(329)	192
Unrealized gains on cash flow hedge derivatives:		
Unrealized holding gains arising during the period	26	84
Total other comprehensive income (loss)	(303)	276
Total comprehensive income	\$ 602	\$ 496

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

Unity Bancorp, Inc.
Consolidated Statements of Changes in Shareholders' Equity
For the three months ended March 31, 2012 and 2011
(Unaudited)

(In thousands)	Preferred Stock	Common Stock Shares	Common Stock Amount	Accumulated Deficit	Treasury Stock	Accumulated Other Comprehensive Income	Total Shareholders' Equity
Balance, December 31, 2010	\$ 19,019	7,211	\$ 55,884	\$ (772)	\$ (4,169)	\$ 123	\$ 70,085
Net income				220			220
Unrealized holding gains on securities and cash flow derivatives						276	276
Accretion of discount on preferred stock	127			(127)			-
Dividends on preferred stock (5% annually)				(259)			(259)
Retire Treasury stock			(3,101)	(1,068)	4,169		-
Common stock issued and related tax effects (a)		11	59				59
Balance, March 31, 2011	\$ 19,146	7,222	\$ 52,842	\$ (2,006)	\$ -	\$ 399	\$ 70,381

(In thousands)	Preferred Stock	Common Stock Shares	Common Stock Amount	Accumulated Deficit	Treasury Stock	Accumulated Other Comprehensive Income	Total Shareholders' Equity
Balance, December 31, 2011	\$ 19,545	7,459	\$ 53,746	\$ (854)		\$ 1,121	\$ 73,558
Net income				905			905
Unrealized holding losses on securities and cash flow derivatives						(303)	(303)
Accretion of discount on preferred stock	138			(138)			-
Dividends on preferred stock (5% annually)				(258)			(258)
Common stock issued and related tax effects (a)		4	100				100
Balance, March 31, 2012	\$ 19,683	7,463	\$ 53,846	\$ (345)		\$ 818	\$ 74,002

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

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

Unity Bancorp, Inc.
Consolidated Statements of Cash Flows
For the three months ended March 31, 2012 and 2011
(Unaudited)

(In thousands)	For the three months ended March 31,	
	2012	2011
OPERATING ACTIVITIES		
Net income	\$ 905	\$ 220
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,200	2,500
Net amortization of purchase premiums and discounts on securities	217	146
Depreciation and amortization	270	302
Deferred income tax benefit	(36)	(467)
Net security gains	(224)	(125)
Stock compensation expense	83	35
Loss on sale of OREO	117	-
Gain on sale of SBA loans held for sale, net	(157)	(111)
Gain on sale of mortgage loans, net	(411)	(169)
Origination of mortgage loans held for sale	(21,242)	(9,671)
Origination of SBA loans held for sale	(2,240)	(601)
Proceeds from sale of mortgage loans held for sale, net	21,653	9,840
Proceeds from sale of SBA loans held for sale, net	2,050	1,177
Loss on sale or disposal of premises and equipment	17	-
Net change in other assets and liabilities	244	257
Net cash provided by operating activities	2,446	3,333
INVESTING ACTIVITIES:		
Purchases of securities available for sale	(32,108)	(10,953)
Maturities and principal payments on securities held to maturity	855	3,584
Maturities and principal payments on securities available for sale	7,363	9,922
Proceeds from sale of securities available for sale	2,824	5,172
Proceeds from sale of OREO	1,600	-
Net decrease (increase) in loans	8,596	(1,246)
Purchases of premises and equipment	(1,222)	(112)
Net cash provided by (used in) investing activities	(12,092)	6,367
FINANCING ACTIVITIES:		
Net increase (decrease) in deposits	(870)	1,988
Proceeds from exercise of stock options	17	2
Dividends on preferred stock	(258)	(258)
Net cash provided by (used in) financing activities	(1,111)	1,732
Increase (decrease) in cash and cash equivalents	(10,757)	11,432
Cash and cash equivalents, beginning of period	82,574	43,926
Cash and cash equivalents, end of period	\$ 71,817	\$ 55,358
SUPPLEMENTAL DISCLOSURES:		

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Cash:

Interest paid	\$	2,275	\$	2,755
Income taxes paid		389		334
Noncash investing activities:				
Transfer of loans to other real estate owned		350		605

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

Unity Bancorp, Inc.
Notes to the Consolidated Financial Statements (Unaudited)
March 31, 2012

NOTE 1. Significant Accounting Policies

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

Estimates that are particularly susceptible to significant changes relate to the determination of the allowance for loan losses, the valuation of deferred income tax assets and the fair value of financial instruments. Management believes that the allowance for loan losses is adequate. While management uses available information to recognize losses on loans, future additions to the allowance for loan losses may be necessary based on changes in economic conditions. The interim unaudited consolidated financial statements included herein have been prepared in accordance with instructions for Form 10-Q and the rules and regulations of the Securities and Exchange Commission ("SEC"). The results of operations for the three months ended March 31, 2012 are not necessarily indicative of the results which may be expected for the entire year. As used in this Form 10-Q, "we" and "us" and "our" refer to Unity Bancorp, Inc., and its consolidated subsidiary, Unity Bank, depending on the context. Certain information and financial disclosures required by generally accepted accounting principles have been condensed or omitted from interim reporting pursuant to SEC rules. Interim financial statements should be read in conjunction with the Company's consolidated financial statements and notes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

Stock Transactions

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

Stock Option Plans

Grants under the Company's incentive and nonqualified option plans generally vest over 3 years and must be exercised within 10 years of the date of grant. The exercise price of each option is the market price on the date of grant. As of March 31, 2012, 1,720,529 shares have been reserved for issuance upon the exercise of options, 638,140 option grants are outstanding, and 960,398 option grants have been exercised, forfeited or expired, leaving 121,991 shares available for grant.

No options were granted during the three months ended March 31, 2012 or 2011.

Financial Accounting Standards Board Accounting Standards Codification ("FASB ASC") Topic 718, "Compensation - Stock Compensation," requires an entity to recognize the fair value of equity awards as compensation expense over the period during which an employee is required to provide service in exchange for such an award (vesting period). Compensation expense related to stock options totaled \$40 thousand and \$19 thousand for the three months ended March 31, 2012 and 2011, respectively. The related income tax benefit was approximately \$14 thousand and \$8 thousand for the three months ended March 31, 2012 and 2011, respectively. As of March 31, 2012, unrecognized compensation costs related to nonvested share-based compensation arrangements granted under the Company's stock option plans totaled approximately \$324 thousand. That cost is expected to be recognized over a weighted average period of 2.3 years.

Transactions under the Company's stock option plans for the three months ended March 31, 2012 are summarized in the following table:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Outstanding at December 31, 2011	642,647	\$ 6.80	5.3	\$517,867
Options granted	-	-		
Options exercised	(3,841)	4.44		
Options forfeited	(333)	3.98		
Options expired	(333)	3.98		
Outstanding at March 31, 2012	638,140	\$ 6.81	5.1	\$466,713
Exercisable at March 31, 2012	493,889	\$ 6.98	3.9	\$427,726

The following table summarizes information about stock options outstanding at March 31, 2012:

Range of Exercise Price	Options Outstanding			Options Exercisable	
	Options Outstanding	Weighted Average Remaining Contractual Life (in years)	Weighted Average Exercise Price	Options Exercisable	Weighted Average Exercise Price
\$ 0.00 - 4.00	123,083	7.1	\$3.87	105,832	\$3.86
4.01 - 8.00	336,799	5.5	6.06	209,799	5.77
8.01 - 12.00	121,617	1.9	9.22	121,617	9.22
12.01 - 16.00	56,641	4.7	12.54	56,641	12.54
Total	638,140	5.1	\$6.81	493,889	\$6.98

The following table presents information about options exercised during the three months ended March 31, 2012 and 2011:

	For the three months ended March 31,	
	2012	2011
Number of options exercised	3,841	40,472
Total intrinsic value of options exercised	\$6,055	\$81,347
Cash received from options exercised	17,046	2,364
Tax deduction realized from options exercised	513	32,490

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

Restricted Stock Awards

Restricted stock awards granted to date vest over a period of 4 years and are recognized as compensation to the recipient over the vesting period. The awards are recorded at fair market value at the time of grant and amortized into salary expense on a straight line basis over the vesting period. As of March 31, 2012, 221,551 shares of restricted stock were reserved for issuance, of which 45,162 shares are available for grant.

There were no restricted stock awards granted during the three months ended March 31, 2012 and 2011.

Compensation expense related to the restricted stock awards totaled \$43 thousand and \$16 thousand for the three months ended March 31, 2012 and 2011, respectively. As of March 31, 2012, there was approximately \$471 thousand of unrecognized compensation cost related to nonvested restricted stock awards granted under the Company's stock incentive plans. That cost is expected to be recognized over a weighted average period of 3.3 years.

The following table summarizes nonvested restricted stock activity for the three months ended March 31, 2012:

	Shares	Average Grant Date Fair Value
Nonvested restricted stock at December 31, 2011	93,684	\$ 6.06
Granted	-	-
Vested	(1,971)	7.62
Forfeited	-	-
Nonvested restricted stock at March 31, 2012	91,713	\$ 6.02

Income Taxes

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

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

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

Derivative Instruments and Hedging Activities

The Company may use derivative instruments, such as interest rate swaps, to manage interest rate risk. The Company recognizes all derivative instruments at fair value as either assets or liabilities in other assets or other liabilities. The accounting for changes in the fair value of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as an accounting hedge, the gain or loss is recognized in trading noninterest income. The Company had no derivative instruments at March 31, 2012, and all of the Company's derivative instruments qualified as hedging instruments at December 31, 2011.

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

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

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

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

Loans Held To Maturity and Loans Held For Sale

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

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

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

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

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

The Company evaluates its loans for impairment. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. The Company has defined impaired loans to be all troubled debt restructurings and nonperforming loans. Impairment is evaluated in total for smaller-balance loans of a similar nature (consumer and residential mortgage loans), and on an individual basis for other loans. Troubled debt restructurings ("TDRs") occur when a creditor, for economic or legal reasons related to a debtor's financial condition, grants a concession to the debtor that it would not otherwise consider. These concessions typically include reductions in interest rate, extending the maturity of a loan, or a combination of both. Interest income on accruing TDRs is credited to operations primarily based upon the principal amount outstanding, as stated in the paragraphs above. Impairment of a loan is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate. Impairment can also be measured based on a loan's observable market price or the fair value of collateral, net of estimated costs to sell, if the loan is collateral dependent. If the measure of the impaired loan is less than the recorded investment in the loan, the Company establishes a valuation allowance, or adjusts existing valuation allowances, with a corresponding charge or credit to the provision for loan losses.

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

The Company originates loans to customers under an SBA program that historically has provided for SBA guarantees of up to 90 percent of each loan. The Company generally sells the guaranteed portion of its SBA loans to a third party and retains the servicing, holding the nonguaranteed portion in its portfolio. When sales of SBA loans do occur, the premium received on the sale and the present value of future cash flows of the servicing assets are recognized in income.

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

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

Allowance for Loan Losses and Unfunded Loan Commitments

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

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

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

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

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

Other-Than-Temporary Impairment

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

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

security's amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security's fair value and the present value of future expected cash flows is due to factors that are not credit related and is recognized in other comprehensive income.

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

NOTE 2. Litigation

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

NOTE 3. Net Income per Share

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

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

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

	For the three months ended March 31,	
(In thousands, except per share amounts)	2012	2011
Net income	\$905	\$ 220
Less: Preferred stock dividends and discount accretion	396	384
Income available to common shareholders	\$509	\$ (164)
Weighted average common shares outstanding - Basic	7,460	7,219
Plus: Potential dilutive common stock equivalents	332	-
Weighted average common shares outstanding - Diluted	7,792	7,219
Net income per common share -		
Basic	\$0.07	\$ (0.02)
Diluted	0.07	(0.02)
Stock options and common stock excluded from the income per share computation as their effect would have been anti-dilutive	506	361

The "potential dilutive common stock equivalents" and the "stock options and common stock excluded from the income per share calculation as their effect would have been anti-dilutive" shown in the table above include the impact of 764,778 common stock warrants issued to the U.S. Department of Treasury under the Capital Purchase Program in December 2008, as applicable. These warrants were dilutive for the three months ended March 31, 2012 and 2011.

NOTE 4. Income Taxes

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

For the quarter ended March 31, 2012, the Company reported income tax expense of \$459 thousand for an effective tax rate of 33.7 percent, compared to an income tax benefit of \$148 thousand for the prior year's quarter.

The Company did not recognize or accrue any interest or penalties related to income taxes during the three months ended March 31, 2012 and 2011. The Company does not have an accrual for uncertain tax positions as of March 31, 2012 or December 31, 2011, as deductions taken and benefits accrued are based on widely understood administrative practices and procedures and are based on clear and unambiguous tax law. Tax returns for all years 2008 and thereafter are subject to future examination by tax authorities.

NOTE 5. Other Comprehensive Income

The following table shows the changes in other comprehensive income (loss) for the three months ended March 31, 2012 and 2011:

(In thousands)	For the three months ended March 31, 2012			For the three months ended March 31, 2011		
	Pre-tax	Tax	After-tax	Pre-tax	Tax	After-tax
Net unrealized gains (losses) on securities:						
Balance, beginning of period			\$ 1,147			\$ 423
Unrealized holding gains (losses) on securities arising during the period	\$ (324)	\$ (144)	(180)	\$ 446	\$ 171	275
Less: Reclassification adjustment for gains included in net income	224	75	149	125	42	83
Net unrealized gains (losses) on securities arising during the period	(548)	(219)	(329)	321	129	192
Balance, end of period			\$ 818			\$ 615
Net unrealized gains (losses) on cash flow hedges:						
Balance, beginning of period			\$ (26)			\$ (300)
Unrealized holding gains on cash flow hedges arising during the period	\$ 43	\$ 17	26	\$ 139	\$ 55	84
Balance, end of period			\$ -			\$ (216)
Total Accumulated Other Comprehensive Income			\$ 818			\$ 399

NOTE 6. Fair Value

Fair Value Measurement

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

Level 1 Inputs

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

Level 2 Inputs

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

Level 3 Inputs

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

Fair Value on a Recurring Basis

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

Securities Available for Sale

The fair value of available for sale ("AFS") securities is the market value based on quoted market prices, when available, or market prices provided by recognized broker dealers (Level 1). If listed prices or quotes are not

available, fair value is based upon quoted market prices for similar or identical assets or other observable inputs (Level 2) or externally developed models that use unobservable inputs due to limited or no market activity of the instrument (Level 3).

As of March 31, 2012, the fair value of the Company's AFS securities portfolio was \$110.2 million. Approximately 54 percent of the portfolio was made up of residential mortgage-backed securities, which had a fair value of \$60.0 million at March 31, 2012. Approximately \$58.4 million of the residential mortgage-backed securities are guaranteed by the Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA") or the Federal Home Loan Mortgage Corporation ("FHLMC"). The underlying loans for these securities are residential mortgages that are geographically dispersed throughout the United States. All AFS securities were classified as Level 2 assets at March 31, 2012. The valuation of AFS securities using Level 2 inputs was primarily determined using the market approach, which uses quoted prices for similar assets or liabilities in active markets and all other relevant information. It includes model pricing, defined as valuing securities based upon their relationship with other benchmark securities.

Interest Rate Swap Agreements

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

There were no changes in the inputs or methodologies used to determine fair value during the period ended March 31, 2012, as compared to the periods ended December 31, 2011 and March 31, 2011. The tables below present the balances of assets and liabilities measured at fair value on a recurring basis as of March 31, 2012 and December 31, 2011.

(In thousands)	As of March 31, 2012			
	Level 1	Level 2	Level 3	Total
Financial Assets:				
Securities available for sale:				
U.S. government sponsored entities	\$ -	\$ 4,282	\$ -	\$ 4,282
State and political subdivisions	-	17,072	-	17,072
Residential mortgage-backed securities	-	59,966	-	59,966
Commercial mortgage-backed securities	-	8,168	-	8,168
Corporate and other securities	-	20,693	-	20,693
Total securities available for sale	-	110,181	-	110,181

(In thousands)	As of December 31, 2011			
	Level 1	Level 2	Level 3	Total
Financial Assets:				
Securities available for sale:				
U.S. government sponsored entities	\$ -	\$ 5,376	\$ -	\$ 5,376
State and political subdivisions	-	17,878	-	17,878
Residential mortgage-backed securities	-	57,924	-	57,924
Commercial mortgage-backed securities	-	210	-	210
Corporate and other securities	-	7,377	-	7,377
Total securities available for sale	-	88,765	-	88,765
Financial Liabilities:				
Interest rate swap agreements	\$ -	\$ 43	\$ -	\$ 43

Fair Value on a Nonrecurring Basis

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

Other Real Estate Owned ("OREO")

The fair value was determined using appraisals, which may be discounted based on management's review and changes in market conditions (Level 3 Inputs). All appraisals must be performed in accordance with the Uniform Standards of Professional Appraisal Practice ("USPAP"). Appraisals are certified to the Company and performed by appraisers on the Company's approved list of appraisers. Evaluations are completed by a person independent of Company management. The content of the appraisal depends on the complexity of the property. Appraisals are completed on a "retail value" and an "as is value".

The Company requires current real estate appraisals on all loans that become OREO or in-substance foreclosure, loans that are classified substandard, doubtful or loss, or loans that are over \$100,000 and nonperforming. Prior to each balance sheet date, the Company values impaired collateral-dependent loans and OREO based upon a third party appraisal, broker's price opinion, drive by appraisal, automated valuation model, updated market evaluation, or a combination of these methods. The amount is discounted for the decline in market real estate values (for original appraisals), for any known damage or repair costs, and for selling and closing costs. The amount of the discount is dependent upon the method used to determine the original value. The original appraisal is generally used when a loan is first determined to be impaired. When applying the discount, the Company takes into consideration when the appraisal was performed, the collateral's location, the type of collateral, any known damage to the property and the type of business. Subsequent to entering impaired status and the Company determining that there is a collateral shortfall, the Company will generally, depending on the type of collateral, order a third party appraisal, broker's price opinion, automated valuation model or updated market evaluation. Subsequent to receiving the third party results, the Company will discount the value 6-10% for selling and closing costs.

Partially charged-off loans are measured for impairment based upon an appraisal for collateral-dependant loans. When an updated appraisal is received for a nonperforming loan, the value on the appraisal is discounted in the manner discussed above. If there is a deficiency in the value after the Company applies these discounts, management applies a specific reserve and the loan remains in nonaccrual status. The receipt of an updated appraisal would not qualify as a reason to put a loan back into accruing status. The Company removes loans from nonaccrual status when the borrower makes six months of contractual payments and demonstrates the ability to service the debt going forward. Charge-offs are determined based upon the loss that management believes the Company will incur after evaluating collateral for impairment based upon the valuation methods described above and the ability of the borrower to pay any deficiency.

Impaired Collateral-Dependent Loans

The fair value of impaired collateral-dependent loans is derived in accordance with FASB ASC Topic 310, "Receivables." Fair value is determined based on the loan's observable market price or the fair value of the collateral. The valuation allowance for impaired loans is included in the allowance for loan losses in the consolidated balance sheets. At March 31, 2012, the valuation allowance for impaired loans was \$3.9 million, a decrease of \$568 thousand from \$4.4 million at December 31, 2011.

The following tables present the assets and liabilities carried on the balance sheet by caption and by level within the hierarchy (as described above) as of March 31, 2012 and December 31, 2011:

Fair value at March 31, 2012					Gains (losses) from fair value changes
					For the three months ended March
(In thousands)	Level 1	Level 2	Level 3	Total	31, 2012
Financial Assets:					
Other real estate owned ("OREO")	\$ -	\$ -	\$ 566	\$566	\$ (156)
Impaired collateral-dependent loans	-	-	11,851	11,851	568

Fair value at March 31, 2011					Losses from fair value changes
					For the three months ended March
(In thousands)	Level 1	Level 2	Level 3	Total	31, 2011
Financial Assets:					
Other real estate owned ("OREO")	\$ -	\$ -	\$ 1,702	\$1,702	\$ (404)
Impaired collateral-dependent loans	-	-	6,886	6,886	(320)

Fair Value of Financial Instruments

FASB ASC Topic 825, "Financial Instruments," requires the disclosure of the estimated fair value of certain financial instruments, including those financial instruments for which the Company did not elect the fair value option. These estimated fair values as of March 31, 2012 and December 31, 2011 have been determined using available market information and appropriate valuation methodologies. Considerable judgment is required to interpret market data to develop estimates of fair value. The estimates presented are not necessarily indicative of amounts the Company could realize in a current market exchange. The use of alternative market assumptions and estimation methodologies could have had a material effect on these estimates of fair value. The methodology for estimating the fair value of financial assets and liabilities that are measured on a recurring or nonrecurring basis are discussed above. The following methods and assumptions were used to estimate the fair value of other financial instruments for which it is practicable to estimate that value:

Cash and Cash Equivalents

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

Securities Held to Maturity

For securities held to maturity, the carrying value is a reasonable estimate of fair value, as it is not expected that the securities would settle at a price significantly less than the par value of the investment.

SBA loans held for sale

The fair value of SBA loans held for sale is estimated by using a market approach that includes significant other observable inputs.

Loans

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

Federal Home Loan Bank Stock

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

SBA Servicing Assets

SBA servicing assets do not trade in an active, open market with readily observable prices. The Company estimates the fair value of SBA servicing assets using discounted cash flow models incorporating numerous assumptions from the perspective of a market participant including market discount rates and prepayment speeds.

Deposit Liabilities

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

Borrowed Funds & Subordinated Debentures

The fair value of borrowings is estimated by discounting the projected future cash flows using current market rates.

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Standby Letters of Credit

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At March 31, 2012, the Bank had standby letters of credit outstanding of \$1.3 million, as compared to \$1.8 million at December 31, 2011. The fair value of these commitments is nominal.

The table below presents the carrying amount and estimated fair values of the Company's financial instruments not previously presented as of March 31, 2012 and December 31, 2011:

(In thousands)	Fair Value Level	March 31, 2012		December 31, 2011	
		Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:					
Cash and cash equivalents	Level 1	\$ 71,817	\$ 71,817	\$ 82,574	\$ 82,574
Securities held to maturity	Level 2	17,880	18,934	18,771	19,879
SBA loans held for sale	Level 2	8,015	8,671	7,668	8,192
Loans, net of allowance for loan losses	Level 2	558,398	559,340	568,576	572,165
Federal Home Loan Bank stock	Level 2	4,088	4,088	4,088	4,088
SBA servicing assets	Level 3	396	396	418	418
Accrued interest receivable	Level 2	3,672	3,672	3,703	3,703
Financial liabilities:					
Deposits	Level 2	643,101	645,938	643,971	647,281
Borrowed funds and subordinated debentures	Level 2	90,465	101,764	90,465	102,533
Accrued interest payable	Level 2	498	498	523	523

Note 7. Securities

This table provides the major components of securities available for sale (“AFS”) and held to maturity (“HTM”) at amortized cost and estimated fair value at March 31, 2012 and December 31, 2011:

(In thousands)	March 31, 2012				December 31, 2011			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Securities								
Available for sale:								
US Government sponsored entities	\$ 4,203	\$ 79	\$ -	\$ 4,282	\$ 5,274	\$ 102	\$ -	\$ 5,376
State and political subdivisions	16,574	559	(61)	17,072	17,031	856	(9)	17,878
Residential mortgage-backed securities	58,882	1,375	(291)	59,966	56,546	1,655	(277)	57,924
Commercial mortgage-backed securities	8,200	4	(36)	8,168	208	2	-	210
Corporate and other securities	20,963	163	(433)	20,693	7,799	5	(427)	7,377
Total securities available for sale	\$ 108,822	\$ 2,180	\$ (821)	\$ 110,181	\$ 86,858	\$ 2,620	\$ (713)	\$ 88,765
Securities Held to maturity:								
State and political subdivisions	\$ 2,990	\$ 253	\$ -	\$ 3,243	\$ 2,992	\$ 192	\$ -	\$ 3,184
Residential mortgage-backed securities	12,200	360	(22)	12,538	13,083	329	(31)	13,381
Commercial mortgage-backed securities	2,690	463	-	3,153	2,696	618	-	3,314
Total securities held to maturity	\$ 17,880	\$ 1,076	\$ (22)	\$ 18,934	\$ 18,771	\$ 1,139	\$ (31)	\$ 19,879

This table provides the remaining contractual maturities and yields of securities within the investment portfolios. The carrying value of securities at March 31, 2012 is primarily distributed by contractual maturity. Mortgage-backed securities and other securities, which may have principal prepayment provisions, are distributed based on contractual maturity. Expected maturities will differ materially from contractual maturities as a result of early prepayments and calls. The total weighted average yield excludes equity securities.

Within one year	After one year through five years	After five years through ten years	After ten years	Total carrying value
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(In thousands)	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Available for sale at fair value:										
US Government sponsored entities	\$ -	-	% \$ 1,865	1.47 %	\$ 1,511	2.15 %	\$ 906	3.68 %	\$ 4,282	2.18 %
State and political subdivisions	-	-	147	6.50	8,619	2.92	8,306	3.62	17,072	3.29
Residential mortgage-backed securities	72	3.87	209	3.53	1,436	4.52	58,249	2.92	59,966	2.96
Commercial mortgage-backed securities	-	-	-	-	-	-	8,168	2.75	8,168	2.75
Corporate and other securities	-	-	2,344	2.77						