

SI Financial Group, Inc.  
Form 10-Q  
August 07, 2013

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

FORM 10-Q  
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT  
OF 1934

For the Quarterly Period Ended June 30, 2013

OR  
o 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 x No o

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 x No o

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 o Accelerated Filer x  
Non-Accelerated Filer o Smaller Reporting Company o

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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 August 2, 2013, there were 10,111,757 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)

|  | June 30,<br>2013 | December 31,<br>2012 |
|--|------------------|----------------------|
| <b>ASSETS:</b>   |                  |                      |
| Cash and due from banks:   |                  |                      |
| Noninterest-bearing  | \$13,406         | \$16,364             |
| Interest-bearing   | 25,143           | 21,325               |
| Total cash and cash equivalents  | 38,549           | 37,689               |
| Available for sale securities, at fair value   | 190,902          | 176,513              |
| Loans held for sale  | 525              | 5,069                |
| Loans receivable (net of allowance for loan losses of \$6,007 at June 30, 2013 and \$6,387 at December 31, 2012)   | 670,445          | 685,163              |
| Federal Home Loan Bank stock, at cost  | 7,753            | 8,078                |
| Bank-owned life insurance  | 9,196            | 9,060                |
| Premises and equipment, net  | 11,458           | 11,216               |
| Goodwill   | 3,451            | 3,451                |
| Accrued interest receivable  | 3,242            | 3,215                |
| Deferred tax asset, net  | 5,448            | 4,639                |
| Other real estate owned, net   | 731              | 1,293                |
| Prepaid FDIC deposit insurance assessment  | —                | 1,312                |
| Other assets   | 7,126            | 6,552                |
| Total assets   | \$948,826        | \$953,250            |
| <b>LIABILITIES AND SHAREHOLDERS' EQUITY:</b>   |                  |                      |
| <b>Liabilities:</b>  |                  |                      |
| <b>Deposits:</b>   |                  |                      |
| Noninterest-bearing  | \$90,470         | \$89,834             |
| Interest-bearing   | 617,852          | 615,314              |
| Total deposits   | 708,322          | 705,148              |
| Mortgagors' and investors' escrow accounts   | 2,786            | 3,207                |
| Federal Home Loan Bank advances  | 93,069           | 98,069               |
| Junior subordinated debt owed to unconsolidated trust  | 8,248            | 8,248                |
| Accrued expenses and other liabilities   | 12,236           | 12,819               |
| Total liabilities  | 824,661          | 827,491              |
| <b>Shareholders' Equity:</b>   |                  |                      |
| Preferred stock (\$.01 par value; 1,000,000 shares authorized; none issued)  | —                | —                    |
| Common stock (\$.01 par value; 35,000,000 shares authorized; 10,111,757 shares issued and outstanding at June 30, 2013; 10,112,310 shares issued and outstanding at December 31, 2012) | 101              | 101                  |
| Additional paid-in-capital   | 95,000           | 94,810               |
| Unallocated common shares held by ESOP   | (4,848           | ) (5,088             |
| Unearned restricted shares   | (1,973           | ) (2,210             |

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|   |           |           |
|---|-----------|-----------|
| Retained earnings                             | 36,016    | 36,733    |
| Accumulated other comprehensive (loss) income | (131      | ) 1,413   |
| Total shareholders' equity                    | 124,165   | 125,759   |
| Total liabilities and shareholders' equity    | \$948,826 | \$953,250 |

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>June 30, |         | Six Months Ended<br>June 30, |          |   |
|---|--------------------------------|---------|------------------------------|----------|---|
|   | 2013                           | 2012    | 2013                         | 2012     |   |
| Interest and dividend income:                                   |                                |         |                              |          |   |
| Loans, including fees   | \$7,194                        | \$7,422 | \$14,717                     | \$15,057 |   |
| Securities:   |                                |         |                              |          |   |
| Taxable interest  | 1,070                          | 1,434   | 2,092                        | 2,991    |   |
| Tax-exempt interest   | 20                             | —       | 20                           | 1        |   |
| Dividends   | 7                              | 10      | 7                            | 26       |   |
| Other   | 11                             | 12      | 21                           | 24       |   |
| Total interest and dividend income                              | 8,302                          | 8,878   | 16,857                       | 18,099   |   |
| Interest expense:   |                                |         |                              |          |   |
| Deposits  | 1,284                          | 1,515   | 2,636                        | 3,110    |   |
| Federal Home Loan Bank advances                                 | 716                            | 816     | 1,491                        | 1,665    |   |
| Subordinated debt   | 83                             | 61      | 166                          | 168      |   |
| Total interest expense  | 2,083                          | 2,392   | 4,293                        | 4,943    |   |
| Net interest income   | 6,219                          | 6,486   | 12,564                       | 13,156   |   |
| Provision for loan losses                                       | 55                             | 432     | 190                          | 916      |   |
| Net interest income after provision for loan losses             | 6,164                          | 6,054   | 12,374                       | 12,240   |   |
| Noninterest income:   |                                |         |                              |          |   |
| Total other-than-temporary impairment losses                    | (8                             | ) —     | (8                           | ) (409   | ) |
| Portion of losses recognized in other comprehensive income/loss | —                              | —       | —                            | 373      |   |
| Net impairment losses   | (8                             | ) —     | (8                           | ) (36    | ) |
| Service fees  | 1,233                          | 1,221   | 2,449                        | 2,431    |   |
| Wealth management fees  | 287                            | 343     | 544                          | 1,410    |   |
| Increase in cash surrender value of bank-owned life insurance   | 68                             | 70      | 136                          | 142      |   |
| Net gain on sales of securities                                 | —                              | 257     | 3                            | 574      |   |
| Mortgage banking  | 271                            | 398     | 850                          | 677      |   |
| Net gain (loss) on fair value of derivatives                    | 126                            | (152    | ) 173                        | (201     | ) |
| Net loss on disposal of SI Trust Servicing operations           | —                              | (212    | ) —                          | (698     | ) |
| Other   | 95                             | 401     | 365                          | 788      |   |
| Total noninterest income  | 2,072                          | 2,326   | 4,512                        | 5,087    |   |
| Noninterest expenses:   |                                |         |                              |          |   |
| Salaries and employee benefits                                  | 4,121                          | 4,016   | 8,529                        | 8,254    |   |
| Occupancy and equipment   | 1,304                          | 1,332   | 2,687                        | 2,818    |   |
| Computer and electronic banking services                        | 971                            | 896     | 1,839                        | 1,889    |   |
| Outside professional services                                   | 382                            | 313     | 650                          | 677      |   |
| Marketing and advertising                                       | 171                            | 220     | 301                          | 372      |   |
| Supplies  | 106                            | 91      | 206                          | 228      |   |

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|   |         |          |         |           |
|---|---------|----------|---------|-----------|
| FDIC deposit insurance and regulatory assessments | 230     | 220      | 463     | 492       |
| Merger expenses                                   | 209     | —        | 893     | —         |
| Other   | 715     | 469      | 1,222   | 1,177     |
| Total noninterest expenses                        | 8,209   | 7,557    | 16,790  | 15,907    |
| Income before income tax provision                | 27      | 823      | 96      | 1,420     |
| Income tax provision                              | 87      | 153      | 233     | 347       |
| Net (loss) income                                 | \$(60   | ) \$670  | \$(137  | ) \$1,073 |
| (Loss) earnings per share:                        |         |          |         |           |
| Basic   | \$(0.01 | ) \$0.07 | \$(0.01 | ) \$0.11  |
| Diluted   | \$(0.01 | ) \$0.07 | \$(0.01 | ) \$0.11  |

See accompanying notes to unaudited interim consolidated financial statements.



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

|  | Three Months Ended<br>June 30, |           | Six Months Ended<br>June 30, |           |
|--|--------------------------------|-----------|------------------------------|-----------|
|  | 2013                           | 2012      | 2013                         | 2012      |
| Net (loss) income  | \$(60                          | ) \$670   | \$(137                       | ) \$1,073 |
| Other comprehensive (loss) income, net of tax:                                       |                                |           |                              |           |
| Net unrealized (loss) gain on available for sale securities:                         |                                |           |                              |           |
| Net unrealized holding (loss) gain on available for sale securities                  | (1,576                         | ) 352     | (1,580                       | ) 979     |
| Reclassification adjustment for gains recognized in net (loss) income <sup>(1)</sup> | —                              | (170      | ) (2                         | ) (379    |
| Plus: credit portion of OTTI losses recognized in net (loss) income <sup>(2)</sup>   | 5                              | —         | 5                            | 24        |
| Plus: noncredit portion of OTTI (loss) gain on available for sale securities         | (4                             | ) 307     | (39                          | ) 667     |
| Net unrealized (losses) gains on available for sale securities                       | (1,575                         | ) 489     | (1,616                       | ) 1,291   |
| Net unrealized gain (loss) on interest-rate swap derivative                          | 44                             | (23       | ) 72                         | (18       |
| Other comprehensive (loss) income  | (1,531                         | ) 466     | (1,544                       | ) 1,273   |
| Comprehensive (loss) income  | \$(1,591                       | ) \$1,136 | \$(1,681                     | ) \$2,346 |

<sup>(1)</sup> Amounts are included in net gain on the sales of securities in noninterest income on the consolidated statements of operations. Income tax expense associated with the reclassification adjustment for the three and six months ended June 30, 2013 was \$0 and \$1,000, respectively, and \$87,000 and \$195,000 for the three and six months ended June 30, 2012, 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 six months ended June 30, 2013 totaled \$3,000 and amounted to \$0 and \$12,000 for the three and six months ended June 30, 2012, respectively.

See accompanying notes to unaudited interim consolidated financial statements.

SI FINANCIAL GROUP, INC.  
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY  
FOR THE SIX MONTHS ENDED JUNE 30, 2013  
(In Thousands, Except Share Data / Unaudited)

|  | Common Stock |         | Additional<br>Paid-in<br>Capital | Unallocated                         |                                  | Retained<br>Earnings | Accumulated                                |            | Total<br>Shareholders'<br>Equity |
|--|--------------|---------|----------------------------------|-------------------------------------|----------------------------------|----------------------|--|------------|----------------------------------|
|  | Shares       | Dollars |                                  | Common<br>Shares<br>Held<br>by ESOP | Unearned<br>Restricted<br>Shares |                      | Other<br>Comprehensive<br>(Loss)<br>Income |            |                                  |
| Balance at<br>December 31, 2012                  | 10,112,310   | \$ 101  | \$94,810                         | \$ (5,088 )                         | \$(2,210 )                       | \$36,733             | \$ 1,413                                   | \$ 125,759 |                                  |
| Comprehensive loss                               | —            | —       | —                                | —                                   | —                                | (137 )               | (1,544 )                                   | (1,681 )   |                                  |
| Cash dividends<br>declared (\$0.06 per<br>share) | —            | —       | —                                | —                                   | —                                | (573 )               | —  | (573 )     |                                  |
| Equity incentive<br>plan compensation            | —            | —       | 147                              | —                                   | 237                              | —                    | —  | 384        |                                  |
| Allocation of 24,318<br>ESOP shares              | —            | —       | 40                               | 240                                 | —                                | —                    | —  | 280        |                                  |
| Tax benefit from<br>share-based<br>compensation  | —            | —       | 3                                | —                                   | —                                | —                    | —  | 3          |                                  |
| Common shares<br>repurchased                     | (553 )       | —       | —                                | —                                   | —                                | (7 )                 | —  | (7 )       |                                  |
| Balance at June 30,<br>2013                      | 10,111,757   | \$ 101  | \$95,000                         | \$ (4,848 )                         | \$(1,973 )                       | \$36,016             | \$ (131 )                                  | \$ 124,165 |                                  |

See accompanying notes to unaudited interim consolidated financial statements.

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

|  | Six Months Ended |           |
|--|------------------|-----------|
|  | June 30,         |           |
|  | 2013             | 2012      |
| Cash flows from operating activities:  |                  |           |
| Net (loss) income  | \$(137           | ) \$1,073 |
| Adjustments to reconcile net (loss) income to net cash provided by operating activities: |                  |           |
| Provision for loan losses  | 190              | 916       |
| Employee stock ownership plan expense  | 280              | 266       |
| Equity incentive plan expense  | 384              | 56        |
| Excess tax benefit from share-based compensation   | (3               | ) (3      |
| Amortization of investment premiums and discounts, net                                   | 603              | 591       |
| Amortization of loan premiums and discounts, net   | 698              | 586       |
| Depreciation and amortization of premises and equipment                                  | 854              | 959       |
| Amortization of core deposit intangible  | —                | 6         |
| Net gain on sales of securities  | (3               | ) (574    |
| Net (gain) loss on fair value of derivatives   | (173             | ) 201     |
| Deferred income tax benefit  | (13              | ) (3      |
| Loans originated for sale  | (25,816          | ) (21,446 |
| Proceeds from sale of loans held for sale  | 30,804           | 24,440    |
| Net loss on disposal of SI Trust Servicing operations                                    | —                | 698       |
| Net gain on sales of loans held for sale   | (731             | ) (553    |
| Net gain on sales of loans held for investment   | (201             | ) —       |
| Net loss on sales or write-downs of other real estate owned                              | 46               | 14        |
| Increase in cash surrender value of bank-owned life insurance                            | (136             | ) (142    |
| Gain on bank-owned life insurance proceeds   | —                | (349      |
| Other-than-temporary impairment losses on securities                                     | 8                | 36        |
| Change in operating assets and liabilities:  |                  |           |
| Accrued interest receivable  | (27              | ) 263     |
| Other assets   | 1,035            | 34        |
| Accrued expenses and other liabilities   | (308             | ) 260     |
| Net cash provided by operating activities  | 7,354            | 7,329     |
| Cash flows from investing activities:  |                  |           |
| Purchases of available for sale securities   | (40,863          | ) (34,086 |
| Proceeds from sales of available for sale securities                                     | 1,000            | 32,417    |
| Proceeds from maturities of and principal repayments on available for sale securities    | 22,417           | 28,530    |
| Redemption of Federal Home Loan Bank stock   | 325              | —         |
| Net decrease (increase) in loans   | 28,909           | (11,799   |
| Purchases of loans   | (18,448          | ) (28,197 |
| Proceeds from sales of loans held for investment   | 3,189            | —         |
| Proceeds from sales of other real estate owned   | 897              | 912       |
| Purchases of premises and equipment  | (1,096           | ) (842    |
| Proceeds from bank-owned life insurance  | —                | 585       |
| Net cash used in investing activities  | (3,670           | ) (12,480 |



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

|  | Six Months Ended |          |
|--|------------------|----------|
|  | June 30,         |          |
|  | 2013             | 2012     |
| Cash flows from financing activities:                      |                  |          |
| Net increase in deposits                                   | 3,174            | 12,034   |
| Net decrease in mortgagors' and investors' escrow accounts | (421             | ) (792   |
| Proceeds from Federal Home Loan Bank advances              | 10,000           | —        |
| Repayments of Federal Home Loan Bank advances              | (15,000          | ) (7,000 |
| Excess tax benefit from share-based compensation           | 3                | 3        |
| Cash dividends on common stock                             | (573             | ) (599   |
| Common shares repurchased                                  | (7               | ) (4,720 |
| Net cash used in financing activities                      | (2,824           | ) (1,074 |
|  |                  |          |
| Net change in cash and cash equivalents                    | 860              | (6,225   |
| Cash and cash equivalents at beginning of period           | 37,689           | 48,412   |
| Cash and cash equivalents at end of period                 | \$38,549         | \$42,187 |
|  |                  |          |
| Supplemental cash flow information:                        |                  |          |
| Interest paid  | \$4,309          | \$4,944  |
| Income taxes paid, net                                     | 1,112            | 113      |
| Transfer of loans to other real estate owned               | 381              | 597      |

See accompanying notes to unaudited interim consolidated financial statements.

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2013 AND 2012 AND DECEMBER 31, 2012

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 offices in eastern Connecticut. Its primary products include savings, checking and certificate of deposit accounts, residential and commercial mortgage loans, commercial business loans and consumer loans. In addition, wealth management services, which include trust, financial planning, life insurance and investment services, are offered to individuals and businesses through the Bank’s 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.

Principles of Consolidation

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

Basis of Financial Statement Presentation

The interim consolidated financial statements and related notes have been prepared in accordance with accounting principles generally accepted in the United States of America (“GAAP”) for interim financial information, with the instructions to Form 10-Q and Rule 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 June 30, 2013 and for the three and six months ended June 30, 2013 and 2012 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, 2012 contained in the Company’s Form 10-K.

In the opinion of management, the accompanying unaudited interim consolidated financial statements reflect all of the adjustments, consisting only of normal and recurring adjustments, necessary for a fair presentation of the financial condition, results of operations and cash flows as of and for the period covered herein. The results of operations for the three and six months ended June 30, 2013 are not necessarily indicative of the operating results for the year ending December 31, 2013 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.

Reclassifications

Certain amounts in the Company's 2012 consolidated financial statements have been reclassified to conform to the 2013 presentation. Such reclassifications had no effect on net income.

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SI FINANCIAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2013 AND 2012 AND DECEMBER 31, 2012

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 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 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

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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 and nonaccrual loans; level of loan charge-offs; trends in volume, nature and terms of loans; existence and effect of/or changes in the level of credit concentrations; effects of changes in risk selection, underwriting standards and other changes in lending policies, procedures and practices; experience/ability and depth of lending management and staff, national and local economic trends and conditions and impact on value of underlying collateral for collateral dependent loans.

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

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

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

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

**Commercial Business –** Loans in this segment are made to businesses and are generally secured by assets of the business. Repayment is expected from the cash flows of the business. A weakened economy and reduced viability of the industry in which the customer operates will have a negative impact on the credit quality in this segment. To a lesser but increasing extent, the Bank provides financing for investors in the time share industry, which are secured by consumer receivables, and finances capital improvements for condominium associations, which are secured by the assigned rights to levy special assessments to condominium owners.

**Consumer –** Loans in this segment primarily include home equity lines of credit (representing both first and second liens) and indirect automobile loans and, to a lesser extent, loans secured by marketable securities, passbook or certificate accounts, motorcycles, automobiles and recreational vehicles, as well as unsecured loans. Consumer loan

collections depend on the borrower's continuing financial stability, and therefore, are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy.

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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. 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, the regulatory agencies, in reviewing the loan portfolio, may request us to increase our allowance for loan losses based on judgments different from ours. In addition, because future events affecting borrowers and collateral cannot be predicted with certainty, the existing allowance for loan losses may not be adequate or increases may be necessary should the quality of any loans deteriorate as a result of the factors discussed above. Any material increase in the allowance for loan losses would adversely affect the Company's financial condition and results of operations.

**Interest and Fees on Loans**

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

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

**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 and retained earnings balances.

**Recent Accounting Pronouncements**

Disclosures about Offsetting Assets and Liabilities – In December 2011, the Financial Accounting Standards Board (“FASB”) amended its standard related to disclosure requirements for offsetting assets and liabilities. Under this amendment, an entity will be required to disclose both gross and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an

agreement similar to a master netting arrangement. This scope would include derivatives, sale and repurchase agreements and reverse sale and repurchase agreements, and securities borrowing and securities lending arrangements. The amendments in this update were effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the disclosures

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required by these amendments retrospectively for all comparative periods presented. The adoption of this amendment had no impact on the Company's consolidated financial statements.

**Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities** - In January 2013, the FASB issued amendments to clarify that the scope of Disclosures about Offsetting Assets and Liabilities applies to derivatives accounted for in accordance with Derivatives and Hedging, including bifurcated embedded derivatives, repurchase agreements, reverse repurchase agreements, securities borrowing and securities lending transactions that are either offset in accordance with applicable guidance or subject to an enforceable master netting arrangement or similar agreement. The amendments in this update were effective for fiscal years beginning on or after January 1, 2013, and interim periods within those annual periods. An entity should provide the required disclosures retrospectively for all comparative periods presented. The adoption of this amendment had no impact on the Company's consolidated financial statements.

**Comprehensive Income - Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income** - In February 2012, the FASB issued an amendment to improve the transparency of reporting these reclassifications by requiring an organization to 1) present the effects on the line items of net income of significant amounts reclassified out of accumulated other comprehensive income and 2) cross-reference to other disclosures currently required under GAAP for other reclassification items to be reclassified directly to net income in their entirety in the same reporting period. The amendments were effective for reporting periods beginning after December 15, 2012. The adoption of this amendment did not have a material impact on the Company's consolidated financial statements. See Consolidated Statements of Comprehensive (Loss) Income.

**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 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 771,538 and 626,396 for the three and six months ended June 30, 2013, respectively, and 131,016 and 237,412 for the three and six months ended June 30, 2012, respectively. For the three and six months ended June 30, 2013, all common stock equivalents were anti-dilutive and were not included in the computation of loss per share because it would result in a reduction in the net loss per share.



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

|   | Three Months Ended                            |           | Six Months Ended |           |
|---|---|-----------|------------------|-----------|
|   | June 30,                                      |           | June 30,         |           |
|   | 2013  | 2012      | 2013             | 2012      |
|   | (Dollars in Thousands, Except Per Share Data) |           |                  |           |
| Net (loss) income                           | \$(60   | ) \$670   | \$(137           | ) \$1,073 |
| Weighted average common shares outstanding: |   |           |                  |           |
| Basic                                       | 9,567,612                                     | 9,821,841 | 9,561,808        | 9,896,154 |
| Effect of dilutive stock options            | —   | 38,300    | —                | 32,661    |
| Diluted                                     | 9,567,612                                     | 9,860,141 | 9,561,808        | 9,928,815 |
| (Loss) earnings per share:                  |   |           |                  |           |
| Basic                                       | \$(0.01                                       | ) \$0.07  | \$(0.01          | ) \$0.11  |
| Diluted                                     | \$(0.01                                       | ) \$0.07  | \$(0.01          | ) \$0.11  |

## NOTE 3. SECURITIES

Available for sale securities:

The amortized cost, gross unrealized gains and losses and approximate fair values of available for sale securities at June 30, 2013 and December 31, 2012 are as follows:

|   | June 30, 2013                    |                              |                               |               |
|---|----------------------------------|------------------------------|-------------------------------|---------------|
|   | Amortized<br>Cost <sup>(1)</sup> | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|   | (In Thousands)                   |                              |                               |               |
| Debt securities:                                |                                  |                              |                               |               |
| U.S. Government and agency obligations          | \$52,798                         | \$1,430                      | \$(39                         | ) \$54,189    |
| Government-sponsored enterprises                | 28,783                           | 342                          | (179                          | ) 28,946      |
| Mortgage-backed securities: <sup>(2)</sup>      |                                  |                              |                               |               |
| Agency - residential                            | 81,831                           | 1,328                        | (1,304                        | ) 81,855      |
| Non-agency - residential                        | 2,080                            | 37                           | (130                          | ) 1,987       |
| Non-agency - HELOC                              | 2,255                            | 74                           | —                             | 2,329         |
| Corporate debt securities                       | 7,021                            | 133                          | (18                           | ) 7,136       |
| Collateralized debt obligations                 | 5,806                            | —                            | (1,353                        | ) 4,453       |
| Obligations of state and political subdivisions | 6,258                            | 182                          | (58                           | ) 6,382       |
| Tax-exempt securities                           | 3,884                            | —                            | (284                          | ) 3,600       |
| Foreign government securities                   | 25                               | —                            | —                             | 25            |
| Total available for sale securities             | \$190,741                        | \$3,526                      | \$(3,365                      | ) \$190,902   |

<sup>(1)</sup> Net of OTTI write-downs recognized in earnings.<sup>(2)</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 one of the GSEs or the U.S. Government.





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|   | December 31, 2012                |                              |                               |               |
|---|----------------------------------|------------------------------|-------------------------------|---------------|
|   | Amortized<br>Cost <sup>(1)</sup> | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|   | (In Thousands)                   |                              |                               |               |
| Debt securities:                                |                                  |                              |                               |               |
| U.S. Government and agency obligations          | \$55,027                         | \$1,255                      | \$(23                         | ) \$56,259    |
| Government-sponsored enterprises                | 23,388                           | 579                          | —                             | 23,967        |
| Mortgage-backed securities: <sup>(2)</sup>      |                                  |                              |                               |               |
| Agency - residential                            | 69,399                           | 2,211                        | (66                           | ) 71,544      |
| Non-agency - residential                        | 4,784                            | 52                           | (124                          | ) 4,712       |
| Non-agency - HELOC                              | 2,555                            | —                            | (78                           | ) 2,477       |
| Corporate debt securities                       | 7,555                            | 188                          | (49                           | ) 7,694       |
| Collateralized debt obligations                 | 5,993                            | —                            | (1,597                        | ) 4,396       |
| Obligations of state and political subdivisions | 5,152                            | 262                          | —                             | 5,414         |
| Foreign government securities                   | 50                               | —                            | —                             | 50            |
| Total available for sale securities             | \$173,903                        | \$4,547                      | \$(1,937                      | ) \$176,513   |

<sup>(1)</sup> Net of OTTI write-downs recognized in earnings.

<sup>(2)</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 one of the GSEs or the U.S. Government.

The amortized cost and fair value of debt securities by contractual maturities at June 30, 2013 are presented below. Actual maturities of mortgage-backed securities ("MBS") may differ from contractual maturities because the mortgages underlying the securities may be called or repaid without any penalties. Because MBSs are not due at a single maturity date, they are not included in the maturity categories in the following maturity summary.

|                             | Amortized<br>Cost<br>(In Thousands) | Fair<br>Value |
|-----------------------------|-------------------------------------|---------------|
| Within 1 year               | \$9,075                             | \$9,129       |
| After 1 but within 5 years  | 25,041                              | 25,502        |
| After 5 but within 10 years | 18,218                              | 18,301        |
| After 10 years              | 52,241                              | 51,799        |
|                             | 104,575                             | 104,731       |
| Mortgage-backed securities  | 86,166                              | 86,171        |
| Total debt securities       | \$190,741                           | \$190,902     |

The following is a summary of realized gains and losses on the sales of securities for the three and six months ended June 30, 2013 and 2012:

| Three Months Ended |      | Six Months Ended |      |
|--------------------|------|------------------|------|
| June 30,           |      | June 30,         |      |
| 2013               | 2012 | 2013             | 2012 |

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|                                | (In Thousands) |       |     |       |
|--------------------------------|----------------|-------|-----|-------|
| Gross gains on sales           | \$—            | \$257 | \$3 | \$627 |
| Gross losses on sales          | —              | —     | —   | (53   |
| Net gain on sale of securities | \$—            | \$257 | \$3 | \$574 |

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Proceeds from the sale of available for sale securities were \$1.0 million for the three and six months ended June 30, 2013 and \$23.1 million and \$32.4 million for the three and six months ended June 30, 2012, respectively.

The following tables present information pertaining to securities with gross unrealized losses at June 30, 2013 and December 31, 2012, aggregated by investment category and length of time the individual securities have been in a continuous unrealized loss position.

|   | Less Than 12 Months |                   | 12 Months Or More |                   | Total      |                   |
|---|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
|   | Fair Value          | Unrealized Losses | Fair Value        | Unrealized Losses | Fair Value | Unrealized Losses |
| June 30, 2013:                                  | (In Thousands)      |                   |                   |                   |            |                   |
| U.S. Government and agency obligations          | \$2,851             | \$17              | \$1,116           | \$22              | \$3,967    | \$39              |
| Government sponsored enterprises                | 6,818               | 179               | —                 | —                 | 6,818      | 179               |
| Mortgage-backed securities:                     |                     |                   |                   |                   |            |                   |
| Agency - residential                            | 42,368              | 1,290             | 669               | 14                | 43,037     | 1,304             |
| Non-agency - residential                        | —                   | —                 | 1,241             | 130               | 1,241      | 130               |
| Corporate debt securities                       | 978                 | 18                | —                 | —                 | 978        | 18                |
| Collateralized debt obligations                 | —                   | —                 | 4,453             | 1,353             | 4,453      | 1,353             |
| Obligations of state and political subdivisions | 1,224               | 58                | —                 | —                 | 1,224      | 58                |
| Tax-exempt securities                           | 3,600               | 284               | —                 | —                 | 3,600      | 284               |
| Total   | \$57,839            | \$1,846           | \$7,479           | \$1,519           | \$65,318   | \$3,365           |
| December 31, 2012:                              | (In Thousands)      |                   |                   |                   |            |                   |
| U.S. Government and agency obligations          | \$—                 | \$—               | \$1,367           | \$23              | \$1,367    | \$23              |
| Mortgage-backed securities:                     |                     |                   |                   |                   |            |                   |
| Agency - residential                            | 6,923               | 37                | 1,404             | 29                | 8,327      | 66                |
| Non-agency - residential                        | 1,926               | 8                 | 1,417             | 116               | 3,343      | 124               |
| Non-agency - HELOC                              | —                   | —                 | 2,477             | 78                | 2,477      | 78                |
| Corporate debt securities                       | —                   | —                 | 946               | 49                | 946        | 49                |
| Collateralized debt obligations                 | —                   | —                 | 4,396             | 1,597             | 4,396      | 1,597             |
| Total   | \$8,849             | \$45              | \$12,007          | \$1,892           | \$20,856   | \$1,937           |

For debt securities with OTTI losses, the Company estimated the portion of loss attributable to credit using a discounted cash flow model in accordance with applicable guidance. Significant inputs for the non-agency mortgage-backed securities included the estimated cash flows of the underlying collateral based on key assumptions, such as default rate, loss severity and prepayment rate. Assumptions used can vary widely from loan to loan, and are influenced by such factors as loan interest rate, geographical location of the borrower, borrower characteristics and collateral type. Significant inputs for the collateralized debt obligations included estimated cash flows and prospective deferrals, defaults and recoveries based on the underlying seniority status and subordination structure of the pooled

trust preferred debt tranche at the time of measurement. Prospective deferral, default and recovery estimates affecting projected cash flows were based on an analysis of the underlying financial condition of the individual issuers, with consideration of the account's capital adequacy, credit quality, lending concentrations and other factors. All cash flow estimates were based on the securities' tranche structure and contractual rate and maturity terms. The Company utilized the services of an independent third-party valuation firm to obtain information about the structure in order to determine how the underlying collateral cash

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flows will be distributed to each security issued from the structure. The present value of the expected cash flows was compared to the Company's holdings to determine the credit-related impairment loss, if any.

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

At June 30, 2013, thirty-one debt securities with gross unrealized losses had aggregate depreciation of approximately 4.9% of the Company's amortized cost basis. The majority of the unrealized losses related to the Company's collateralized debt obligations and non-agency mortgage-backed securities. Impairment charges recognized on investments deemed other-than-temporarily impaired were \$8,000 for the three and six months ended June 30, 2013 compared to \$36,000 of net impairment losses recognized by the Company for the six months ended June 30, 2012. No net impairment losses on securities were recognized for the three months ended June 30, 2012. The following summarizes, by security type, the basis for management's determination during the preparation of the financial statements of whether the applicable investments within the Company's securities portfolio were other-than-temporarily impaired at June 30, 2013.

**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. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell the securities before their anticipated recovery, which may be at maturity, the Company did not consider these securities to be other-than-temporarily impaired at June 30, 2013.

**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 June 30, 2013.

**Mortgage-backed Securities - Non-agency - Residential.** Despite significant improvement in the market, these securities continue to trade well below historic levels, particularly those backed by jumbo or hybrid loan collateral. At June 30, 2013, management evaluated credit rating details for the tranche, as well as credit information on subordinate tranches, potential future credit losses and loss analyses. Additionally, management reviewed reports prepared by an independent third party for certain non-agency mortgage-backed securities. The Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be at maturity.

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The following table details the Company's non-agency residential mortgage-backed securities that were rated below investment grade at June 30, 2013:

| Security               | Class <sup>(1)</sup> | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Lowest Credit Rating <sup>(2)</sup> | Total Credit-Related OTTI <sup>(3)</sup> | Credit Support Coverage Ratios <sup>(4)</sup> |
|------------------------|----------------------|----------------|------------------------|-------------------------|------------|-------------------------------------|--|---|
| (Dollars in Thousands) |                      |                |                        |                         |            |                                     |  |   |
| MBS 1                  | SSNR, AS             | \$1,371        | \$—                    | \$(130)                 | \$1,241    | D                                   | \$197                                    | 0.00  |
| MBS 2                  | PT, AS               | 155            | 10                     | —                       | 165        | C                                   | 8  | 0.00  |
|                        |                      | \$1,526        | \$10                   | \$(130)                 | \$1,406    |                                     | \$205                                    |   |

(1) Class definitions: PT – Pass Through, AS – Accelerated, and SSNR – Super Senior.

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

(3) The OTTI amounts provided in the table represent cumulative credit loss amounts through June 30, 2013.

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

Collateralized Debt Obligations. The unrealized losses on the Company's collateralized debt obligations relate to investments in pooled trust preferred securities ("PTPS"). The PTPS market has stabilized at depressed market values as a result of market saturation. Transactions for PTPS have been limited and have occurred primarily as a result of distressed or forced liquidation sales. The securities were widely held by hedge funds and European banks and used to offset interest rate exposure tied to LIBOR. As the positions have unwound, an excess supply of these securities has saturated the market.

Management evaluated current credit ratings, credit support and stress testing for future defaults related to the Company's PTPS. Management also reviewed analytics provided by the trustee and independent OTTI reviews and associated cash flow analyses performed by an independent third party. The unrealized losses on the Company's PTPS investments were caused by a lack of liquidity, credit downgrades and decreasing credit support. The increased number of bank and insurance company failures has decreased the level of credit support for these investments. A number of lower tranches have foregone payments or have received payment in kind through increased principal allocations. However, the number of deferring securities has been decreasing and a number of reinstatements have occurred recently. Based on the existing credit profile of the remainder of the Company's PTPS investments, management does not believe that these investments will suffer from any further credit-related losses. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be at maturity, the Company did not record additional impairment losses at June 30, 2013.

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The following table details the Company's collateralized debt obligations that are rated below investment grade at June 30, 2013:

| Security               | Class | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value | Lowest Credit Rating <sup>(1)</sup> | Total Credit-Related OTTI <sup>(2)</sup> | % of Current Performing Collateral Coverage |
|------------------------|-------|----------------|------------------------|-------------------------|------------|-------------------------------------|--|---|
| (Dollars in Thousands) |       |                |                        |                         |            |                                     |  |   |
| CDO 1                  | B1    | \$1,000        | \$—                    | \$(468)                 | ) \$532    | CCC-                                | \$—                                      | 107.5                                       |
| CDO 2                  | B3    | 1,000          | —                      | (446)                   | ) 554      | CCC-                                | —  | 107.5                                       |
| CDO 3                  | A2    | 2,578          | —                      | (206)                   | ) 2,372    | B-                                  | 62                                       | 126.8                                       |
| CDO 4                  | A1    | 1,228          | —                      | (233)                   | ) 995      | BB-                                 | —  | 170.6                                       |
|                        |       | \$5,806        | \$—                    | \$(1,353)               | ) \$4,453  |                                     | \$62                                     |   |

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

<sup>(2)</sup> The OTTI amounts provided in the table represent cumulative credit loss amounts through June 30, 2013.

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 (loss) income for the three and six months ended June 30, 2013 and 2012.

|  | Three Months Ended |         | Six Months Ended |         |
|--|--------------------|---------|------------------|---------|
|  | June 30, 2013      | 2012    | June 30, 2013    | 2012    |
|  | (In Thousands)     |         |                  |         |
| Balance at beginning of period   | \$259              | \$1,243 | \$259            | \$1,207 |
| Amounts related to credit for which OTTI losses were not previously recognized | 8                  | —       | 8                | —       |
| Additional credit losses for which OTTI losses were previously recognized      | —                  | —       | —                | 36      |
| Reduction for permanent loss in value of securities during the period          | —                  | (1,071) | ) —              | (1,071) |
| Balance at end of period   | \$267              | \$172   | \$267            | \$172   |



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

## Loan Portfolio

The composition of the Company's loan portfolio at June 30, 2013 and December 31, 2012 is as follows:

|  | June 30,<br>2013<br>(In Thousands) | December 31, 2012 |
|--|------------------------------------|-------------------|
| Real estate loans:                           |                                    |                   |
| Residential - 1 to 4 family                  | \$222,011                          | \$230,664         |
| Multi-family and commercial                  | 192,135                            | 201,951           |
| Construction                                 | 3,511                              | 3,284             |
| Total real estate loans                      | 417,657                            | 435,899           |
| Commercial business loans:                   |                                    |                   |
| SBA and USDA guaranteed                      | 147,223                            | 148,385           |
| Time share                                   | 24,008                             | 23,310            |
| Condominium association                      | 16,729                             | 15,493            |
| Other  | 31,106                             | 26,339            |
| Total commercial business loans              | 219,066                            | 213,527           |
| Consumer loans:                              |                                    |                   |
| Home equity                                  | 27,980                             | 28,375            |
| Indirect automobile                          | 8,001                              | 9,652             |
| Other  | 2,107                              | 2,353             |
| Total consumer loans                         | 38,088                             | 40,380            |
| Total loans                                  | 674,811                            | 689,806           |
| Deferred loan origination costs, net of fees | 1,641                              | 1,744             |
| Allowance for loan losses                    | (6,007)                            | (6,387)           |
| Loans receivable, net                        | \$670,445                          | \$685,163         |

The Company purchased commercial business loans totaling \$18.4 million during the six months ended June 30, 2013. During the year ended December 31, 2012, the Company purchased commercial business loans and consumer loans totaling \$42.9 million and \$6.9 million, respectively.



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## Allowance for Loan Losses

Changes in the allowance for loan losses for the three and six months ended June 30, 2013 and 2012 are as follows:

| Three Months Ended<br>June 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             | \$ 1,101                       | \$ 3,168                          | \$ 27        | \$ 1,534               | \$ 498   | \$ 6,328 |   |
| Provision (credit) for loan losses         | 60                             | (26                               | ) 3          | (3                     | ) 21     | 55       |   |
| Loans charged-off                          | (192                           | ) (197                            | ) —          | —                      | (21      | ) (410   | ) |
| Recoveries of loans previously charged-off | 30                             | 2                                 | —            | —                      | 2        | 34       |   |
| Balance at end of period                   | \$ 999                         | \$ 2,947                          | \$ 30        | \$ 1,531               | \$ 500   | \$ 6,007 |   |
|  |                                |                                   |              |                        |          |          |   |
| Six Months Ended<br>June 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             | \$ 1,125                       | \$ 3,028                          | \$ 22        | \$ 1,735               | \$ 477   | \$ 6,387 |   |
| Provision (credit) for loan losses         | 302                            | 45                                | 8            | (204                   | ) 39     | 190      |   |
| Loans charged-off                          | (458                           | ) (197                            | ) —          | —                      | (61      | ) (716   | ) |
| Recoveries of loans previously charged-off | 30                             | 71                                | —            | —                      | 45       | 146      |   |
| Balance at end of period                   | \$ 999                         | \$ 2,947                          | \$ 30        | \$ 1,531               | \$ 500   | \$ 6,007 |   |
|  |                                |                                   |              |                        |          |          |   |
| Three Months Ended<br>June 30, 2012        | Residential -<br>1 to 4 Family | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total    |   |
| (In Thousands)                             |                                |                                   |              |                        |          |          |   |
| Balance at beginning of period             | \$ 735                         | \$ 2,678                          | \$ 368       | \$ 1,127               | \$ 470   | \$ 5,378 |   |
| Provision (credit) for loan losses         | (32                            | ) 121                             | (54          | ) 280                  | 117      | 432      |   |
| Loans charged-off                          | (29                            | ) (102                            | ) —          | —                      | (103     | ) (234   | ) |
| Recoveries of loans previously charged-off | 51                             | 3                                 | —            | 11                     | 3        | 68       |   |
| Balance at end of period                   | \$ 725                         | \$ 2,700                          | \$ 314       | \$ 1,418               | \$ 487   | \$ 5,644 |   |
|  |                                |                                   |              |                        |          |          |   |
| Six Months Ended<br>June 30, 2012          | Residential -<br>1 to 4 Family | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total    |   |

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(In Thousands)

|  |       |         |       |         |       |         |
|--|-------|---------|-------|---------|-------|---------|
| Balance at beginning of period             | \$759 | \$2,337 | \$280 | \$1,148 | \$446 | \$4,970 |
| Provision for loan losses                  | 5     | 461     | 34    | 258     | 158   | 916     |
| Loans charged-off                          | (92   | ) (102  | ) —   | —       | (122  | ) (316  |
| Recoveries of loans previously charged-off | 53    | 4       | —     | 12      | 5     | 74      |
| Balance at end of period                   | \$725 | \$2,700 | \$314 | \$1,418 | \$487 | \$5,644 |

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Further information pertaining to the allowance for loan losses at June 30, 2013 and December 31, 2012 is as follows:

| June 30, 2013  | Residential -<br>1 to 4 Family | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total     |
|--|--------------------------------|-----------------------------------|--------------|------------------------|----------|-----------|
|  | (In Thousands)                 |                                   |              |                        |          |           |
| Allowance for loans individually evaluated and deemed to be impaired                     | \$342                          | \$100                             | \$—          | \$—                    | \$—      | \$442     |
| Allowance for loans individually or collectively evaluated and not deemed to be impaired | 657                            | 2,847                             | 30           | 1,531                  | 500      | 5,565     |
| Total allowance for loan losses  | \$999                          | \$2,947                           | \$30         | \$1,531                | \$500    | \$6,007   |
| Loans individually evaluated and deemed to be impaired                                   | \$6,870                        | \$3,252                           | \$—          | \$475                  | \$212    | \$10,809  |
| Loans individually or collectively evaluated and not deemed to be impaired               | 215,141                        | 188,883                           | 3,511        | 218,591                | 37,876   | 664,002   |
| Total loans  | \$222,011                      | \$192,135                         | \$3,511      | \$219,066              | \$38,088 | \$674,811 |
| December 31, 2012  | Residential -<br>1 to 4 Family | Multi-family<br>and<br>Commercial | Construction | Commercial<br>Business | Consumer | Total     |
|  | (In Thousands)                 |                                   |              |                        |          |           |
| Allowance for loans individually evaluated and deemed to be impaired                     | \$454                          | \$88                              | \$—          | \$39                   | \$—      | \$581     |
| Allowance for loans individually or collectively evaluated and not deemed to be impaired | 671                            | 2,940                             | 22           | 1,696                  | 477      | 5,806     |
| Total allowance for loan losses  | \$1,125                        | \$3,028                           | \$22         | \$1,735                | \$477    | \$6,387   |
| Loans individually evaluated and deemed to be impaired                                   | \$6,991                        | \$5,873                           | \$—          | \$618                  | \$361    | \$13,843  |
| Loans individually or collectively evaluated and not deemed to be impaired               | 223,673                        | 196,078                           | 3,284        | 212,909                | 40,019   | 675,963   |
| Total loans  | \$230,664                      | \$201,951                         | \$3,284      | \$213,527              | \$40,380 | \$689,806 |



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## Past Due Loans

The following represents an aging of loans at June 30, 2013 and December 31, 2012:

| June 30, 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 | \$139                     | \$21                      | \$2,892                        | \$3,052                                 | \$218,959 | \$222,011      |
| Multi-family and commercial | 574                       | 153                       | 1,633                          | 2,360                                   | 189,775   | 192,135        |
| Construction                | —                         | —                         | —                              | —                                       | 3,511     | 3,511          |
| Commercial Business:        |                           |                           |                                |   |           |                |
| SBA and USDA guaranteed     | 996                       | 1,611                     | —                              | 2,607                                   | 144,616   | 147,223        |
| Time share                  | —                         | —                         | —                              | —                                       | 24,008    | 24,008         |
| Condominium association     | —                         | —                         | —                              | —                                       | 16,729    | 16,729         |
| Other                       | —                         | —                         | 376                            | 376                                     | 30,730    | 31,106         |
| Consumer:                   |                           |                           |                                |   |           |                |
| Home equity                 | 50                        | 1                         | 24                             | 75                                      | 27,905    | 27,980         |
| Indirect automobile         | 49                        | 28                        | —                              | 77                                      | 7,924     | 8,001          |
| Other                       | 2                         | —                         | 7                              | 9                                       | 2,098     | 2,107          |
| Total                       | \$1,810                   | \$1,814                   | \$4,932                        | \$8,556                                 | \$666,255 | \$674,811      |
| December 31, 2012           | 30-59<br>Days<br>Past Due | 60-89<br>Days<br>Past Due | 90 Days or<br>More<br>Past Due | Total 30<br>Days or<br>More<br>Past Due | Current   | Total<br>Loans |
|                             | (In Thousands)            |                           |                                |   |           |                |
| Real Estate:                |                           |                           |                                |   |           |                |
| Residential - 1 to 4 family | \$3,245                   | \$1,725                   | \$3,285                        | \$8,255                                 | \$222,409 | \$230,664      |
| Multi-family and commercial | 4,149                     | —                         | 1,266                          | 5,415                                   | 196,536   | 201,951        |
| Construction                | —                         | —                         | —                              | —                                       | 3,284     | 3,284          |
| Commercial Business:        |                           |                           |                                |   |           |                |
| SBA and USDA guaranteed     | 5,014                     | 1,087                     | —                              | 6,101                                   | 142,284   | 148,385        |
| Time share                  | —                         | —                         | —                              | —                                       | 23,310    | 23,310         |
| Condominium association     | —                         | —                         | —                              | —                                       | 15,493    | 15,493         |
| Other                       | —                         | —                         | 541                            | 541                                     | 25,798    | 26,339         |
| Consumer:                   |                           |                           |                                |   |           |                |
| Home equity                 | 216                       | —                         | 361                            | 577                                     | 27,798    | 28,375         |
| Indirect automobile         | 19                        | —                         | —                              | 19                                      | 9,633     | 9,652          |
| Other                       | 21                        | —                         | —                              | 21                                      | 2,332     | 2,353          |
| Total                       | \$12,664                  | \$2,812                   | \$5,453                        | \$20,929                                | \$668,877 | \$689,806      |

The Company did not have any loans that were past due 90 days or more and still accruing interest at June 30, 2013 or December 31, 2012 .



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## Impaired and Nonaccrual Loans

The following is a summary of impaired loans and nonaccrual loans at June 30, 2013 and December 31, 2012:

| June 30, 2013                                    | Impaired Loans      |                          |                   |                  |
|--|---------------------|--------------------------|-------------------|------------------|
|  | Recorded Investment | Unpaid Principal Balance | Related Allowance | Nonaccrual Loans |
|  | (In Thousands)      |                          |                   |                  |
| Impaired loans without valuation allowance:      |                     |                          |                   |                  |
| Real Estate:                                     |                     |                          |                   |                  |
| Residential - 1 to 4 family                      | \$4,382             | \$4,714                  | \$—               | \$4,371          |
| Multi-family and commercial                      | 2,864               | 3,061                    | —                 | 2,806            |
| Commercial business - Other                      | 475                 | 475                      | —                 | 475              |
| Consumer - Home equity                           | 212                 | 247                      | —                 | 217              |
| Consumer - Other                                 | —                   | —                        | —                 | 7                |
| Total impaired loans without valuation allowance | 7,933               | 8,497                    | —                 | 7,876            |
| Impaired loans with valuation allowance:         |                     |                          |                   |                  |
| Real Estate:                                     |                     |                          |                   |                  |
| Residential - 1 to 4 family                      | 2,488               | 2,488                    | 342               | 758              |
| Multi-family and commercial                      | 388                 | 478                      | 100               | 388              |
| Total impaired loans with valuation allowance    | 2,876               | 2,966                    | 442               | 1,146            |
| Total impaired loans                             | \$10,809            | \$11,463                 | \$442             | \$9,022          |
|  | Impaired Loans      |                          |                   |                  |
| December 31, 2012                                | Recorded Investment | Unpaid Principal Balance | Related Allowance | Nonaccrual Loans |
|  | (In Thousands)      |                          |                   |                  |
| Impaired loans without valuation allowance:      |                     |                          |                   |                  |
| Real Estate:                                     |                     |                          |                   |                  |
| Residential - 1 to 4 family                      | \$3,866             | \$4,013                  | \$—               | \$3,855          |
| Multi-family and commercial                      | 4,407               | 4,407                    | —                 | 1,522            |
| Commercial business - Other                      | 546                 | 546                      | —                 | 470              |
| Consumer - Home equity                           | 361                 | 435                      | —                 | 366              |
| Total impaired loans without valuation allowance | 9,180               | 9,401                    | —                 | 6,213            |
| Impaired loans with valuation allowance:         |                     |                          |                   |                  |
| Real Estate:                                     |                     |                          |                   |                  |
| Residential - 1 to 4 family                      | 3,125               | 3,125                    | 454               | 1,133            |
| Multi-family and commercial                      | 1,466               | 1,556                    | 88                | 236              |
| Commercial business - Other                      | 72                  | 72                       | 39                | 72               |
| Total impaired loans with valuation allowance    | 4,663               | 4,753                    | 581               | 1,441            |
| Total impaired loans                             | \$13,843            | \$14,154                 | \$581             | \$7,654          |

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 June 30, 2013 and December 31,

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2012, 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>June 30, 2013 |                                  |   | Six Months Ended<br>June 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    | \$7,292                             | \$127                            | \$110   | \$7,048                           | \$158                            | \$125   |
| Multi-family and<br>commercial | 3,287                               | 1                                | —   | 4,891                             | 46                               | —   |
| Commercial business - Other    | 382                                 | 1                                | 1   | 493                               | 7                                | 5   |
| Consumer - Home equity         | 318                                 | 11                               | 12  | 377                               | 27                               | 27  |
| Total                          | \$11,279                            | \$140                            | \$123   | \$12,809                          | \$238                            | \$157   |

|                                | Three Months Ended<br>June 30, 2012 |                                  |   | Six Months Ended<br>June 30, 2012 |                                  |   |
|--------------------------------|-------------------------------------|----------------------------------|---|-----------------------------------|----------------------------------|---|
|                                | 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    | \$5,422                             | \$39                             | \$39  | \$5,655                           | \$105                            | \$105   |
| Multi-family and<br>commercial | 9,601                               | 69                               | —   | 9,291                             | 133                              | —   |
| Commercial business - Other    | 601                                 | —                                | —   | 696                               | —                                | —   |
| Consumer - Home equity         | 388                                 | —                                | —   | 344                               | —                                | —   |
| Total                          | \$16,012                            | \$108                            | \$39  | \$15,986                          | \$238                            | \$105   |

**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.

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- 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 June 30, 2013 and December 31, 2012:

| June 30, 2013                   | Not Rated      | Pass      | Special<br>Mention | Substandard | Doubtful | Loss | Total     |
|---------------------------------|----------------|-----------|--------------------|-------------|----------|------|-----------|
|                                 | (In Thousands) |           |                    |             |          |      |           |
| <b>Real Estate:</b>             |                |           |                    |             |          |      |           |
| Residential - 1 to 4 family     | \$—            | \$213,266 | \$676              | \$8,069     | \$—      | \$—  | \$222,011 |
| Multi-family and commercial     | —              | 171,666   | 8,939              | 11,530      | —        | —    | 192,135   |
| Construction                    | —              | 3,511     | —                  | —           | —        | —    | 3,511     |
| Total real estate loans         | —              | 388,443   | 9,615              | 19,599      | —        | —    | 417,657   |
| <b>Commercial Business:</b>     |                |           |                    |             |          |      |           |
| SBA and USDA guaranteed         | 147,223        | —         | —                  | —           | —        | —    | 147,223   |
| Time share                      | —              | 24,008    | —                  | —           | —        | —    | 24,008    |
| Condominium association         | —              | 16,729    | —                  | —           | —        | —    | 16,729    |
| Other                           | —              | 27,318    | 2,537              | 1,251       | —        | —    | 31,106    |
| Total commercial business loans | 147,223        | 68,055    | 2,537              | 1,251       | —        | —    | 219,066   |
| <b>Consumer:</b>                |                |           |                    |             |          |      |           |
| Home equity                     | —              | 27,643    | —                  | 337         | —        | —    | 27,980    |
| Indirect automobile             | —              | 8,001     | —                  | —           | —        | —    | 8,001     |
| Other                           | —              | 2,100     | —                  | 7           | —        | —    | 2,107     |
| Total consumer loans            | —              | 37,744    | —                  | 344         | —        | —    | 38,088    |
| Total loans                     | \$147,223      | \$494,242 | \$12,152           | \$21,194    | \$—      | \$—  | \$674,811 |

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| December 31, 2012               | Not Rated      | Pass      | Special<br>Mention | Substandard | Doubtful | Loss | Total     |
|---------------------------------|----------------|-----------|--------------------|-------------|----------|------|-----------|
|                                 | (In Thousands) |           |                    |             |          |      |           |
| <b>Real Estate:</b>             |                |           |                    |             |          |      |           |
| Residential - 1 to 4 family     | \$—            | \$222,262 | \$723              | \$7,679     | \$—      | \$—  | \$230,664 |
| Multi-family and commercial     | —              | 185,141   | 5,321              | 11,489      | —        | —    | 201,951   |
| Construction                    | —              | 3,284     | —                  | —           | —        | —    | 3,284     |
| Total real estate loans         | —              | 410,687   | 6,044              | 19,168      | —        | —    | 435,899   |
| <b>Commercial Business:</b>     |                |           |                    |             |          |      |           |
| SBA and USDA guaranteed         | 148,385        | —         | —                  | —           | —        | —    | 148,385   |
| Time share                      | —              | 23,310    | —                  | —           | —        | —    | 23,310    |
| Condominium association         | —              | 15,493    | —                  | —           | —        | —    | 15,493    |
| Other                           | —              | 22,244    | 3,399              | 696         | —        | —    | 26,339    |
| Total commercial business loans | 148,385        | 61,047    | 3,399              | 696         | —        | —    | 213,527   |
| <b>Consumer:</b>                |                |           |                    |             |          |      |           |
| Home equity                     | —              | 27,960    | —                  | 415         | —        | —    | 28,375    |
| Indirect automobile             | —              | 9,652     | —                  | —           | —        | —    | 9,652     |
| Other                           | —              | 2,353     | —                  | —           | —        | —    | 2,353     |
| Total consumer loans            | —              | 39,965    | —                  | 415         | —        | —    | 40,380    |
| Total loans                     | \$148,385      | \$511,699 | \$9,443            | \$20,279    | \$—      | \$—  | \$689,806 |

**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 the year of 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 tables provide information on loans modified as TDRs during the three and six months ended June 30, 2013 and 2012.

|                             | Three Months Ended June 30,<br>2013          |                        | 2012               |                        |
|-----------------------------|--|------------------------|--------------------|------------------------|
|                             | Number<br>of Loans<br>(Dollars in Thousands) | Recorded<br>Investment | Number<br>of Loans | Recorded<br>Investment |
| Residential - 1 to 4 family | —  | \$—                    | 3                  | \$434                  |
| Total                       | —  | \$—                    | 3                  | \$434                  |
|                             | Six Months Ended June 30,<br>2013            |                        | 2012               |                        |
|                             | Number<br>of Loans<br>(Dollars in Thousands) | Recorded<br>Investment | Number<br>of Loans | Recorded<br>Investment |
| Residential - 1 to 4 family | 1  | \$408                  | 3                  | \$434                  |
| Total                       | 1  | \$408                  | 3                  | \$434                  |

During the modification process, there was 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 six months ended June 30, 2013 and 2012 for modified loans identified as TDRs.

|   | Three Months Ended June 30,<br>2013 |       | Six Months Ended June 30,<br>2013 |       |
|---|-------------------------------------|-------|-----------------------------------|-------|
|   | 2013                                | 2012  | 2013                              | 2012  |
|   | (In Thousands)                      |       |                                   |       |
| Combination of rate and payment <sup>(1)</sup>  | \$—                                 | \$434 | \$—                               | \$434 |
| Combination of rate and maturity <sup>(2)</sup> | —                                   | —     | 408                               | —     |
| Total   | \$—                                 | \$434 | \$408                             | \$434 |

<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.

For the three and six months ended June 30, 2013 and 2012, there were no TDRs that were in payment default (defined as 90 days or more past due).



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## NOTE 5. PREMISES AND EQUIPMENT

Premises and equipment at June 30, 2013 and December 31, 2012 are summarized as follows:

|   | June 30, 2013<br>(In Thousands) | December 31, 2012 |
|---|---------------------------------|-------------------|
| Land                                      | \$2,890                         | \$2,098           |
| Buildings                                 | 7,018                           | 7,052             |
| Leasehold improvements                    | 7,581                           | 7,563             |
| Furniture and equipment                   | 11,243                          | 10,867            |
| Construction in process                   | 24                              | 84                |
|   | 28,756                          | 27,664            |
| Accumulated depreciation and amortization | (17,298                         | ) (16,448         |
| Premises and equipment, net               | \$11,458                        | \$11,216          |

At June 30, 2013 and December 31, 2012, construction in process related to design and site costs associated with a new branch location. At December 31, 2012, the Company had an outstanding commitment for the purchase of land totaling \$450,000, which was purchased during the quarter ended March 31, 2013.

## NOTE 6. OTHER COMPREHENSIVE (LOSS) INCOME

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

Components of other comprehensive loss and related tax effects are as follows:

|  | Six Months Ended June 30, 2013 |                |                      |
|--|--------------------------------|----------------|----------------------|
|  | Before Tax<br>Amount           | Tax<br>Effects | Net of Tax<br>Amount |
|  | (In Thousands)                 |                |                      |
| Securities:  |                                |                |                      |
| Unrealized holding losses on available for sale securities               | \$(2,394                       | ) \$814        | \$(1,580             |
| Reclassification adjustment for gains recognized in net loss             | (3                             | ) 1            | (2                   |
| Credit portion of OTTI losses recognized in net loss                     | 8                              | (3             | ) 5                  |
| Noncredit portion of OTTI losses on available for sale securities        | (60                            | ) 21           | (39                  |
| Unrealized holding losses on available for sale securities, net of taxes | (2,449                         | ) 833          | (1,616               |
| Derivative instrument:   |                                |                |                      |
| Change in fair value of effective cash flow hedging derivative           | 109                            | (37            | ) 72                 |
| Other comprehensive loss   | \$(2,340                       | ) \$796        | \$(1,544             |

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

|   | June 30, 2013     |         |            |
|---|-------------------|---------|------------|
|   | Before Tax        | Tax     | Net of Tax |
|   | Amount            | Effects | Amount     |
|   | (In Thousands)    |         |            |
| Net unrealized gains on available for sale securities             | \$487             | \$(165) | ) \$322    |
| Noncredit portion of OTTI losses on available for sale securities | (326)             | ) 111   | (215)      |
| Net unrealized loss on effective cash flow hedging derivative     | (361)             | ) 123   | (238)      |
| Accumulated other comprehensive loss                              | \$(200)           | ) \$69  | \$(131)    |
|   |                   |         |            |
|   | December 31, 2012 |         |            |
|   | Before Tax        | Tax     | Net of Tax |
|   | Amount            | Effects | Amount     |
|   | (In Thousands)    |         |            |
| Net unrealized gains on available for sale securities             | \$2,876           | \$(977) | ) \$1,899  |
| Noncredit portion of OTTI losses on available for sale securities | (266)             | ) 90    | (176)      |
| Net unrealized loss on effective cash flow hedging derivative     | (470)             | ) 160   | (310)      |
| Accumulated other comprehensive income                            | \$2,140           | \$(727) | ) \$1,413  |

## 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 June 30, 2013 and December 31, 2012, the Bank met the conditions to be classified as "well capitalized" under the regulatory framework for prompt corrective action. There are no conditions or events since then that management believes have changed the Bank's regulatory category. As a savings and loan holding company regulated by the Federal Reserve Board (the "FRB"), the Company is not currently subject to any separate regulatory capital requirements. The Dodd-Frank Act, however, requires the FRB to promulgate consolidated capital requirements for depository institution holding companies that are no less stringent, quantitatively in terms of components of capital, than those applicable to institutions themselves. There is a five-year transition period before the capital requirements will apply to savings and loan holding companies.



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The Bank's actual capital amounts and ratios as of June 30, 2013 and December 31, 2012 were as follows:

|                                 | Actual                 |       | For Capital Adequacy Purposes |       | To Be Well Capitalized Under Prompt Corrective Action Provisions |       |   |
|---------------------------------|------------------------|-------|-------------------------------|-------|--|-------|---|
|                                 | Amount                 | Ratio | Amount                        | Ratio | Amount   | Ratio |   |
| June 30, 2013                   | (Dollars in Thousands) |       |                               |       |  |       |   |
| Tier I Capital Ratio            | \$104,771              | 11.25 | % \$37,253                    | 4.00  | % \$46,567   | 5.00  | % |
| Tier I Risk-based Capital Ratio | 104,771                | 19.62 | 21,363                        | 4.00  | 32,045   | 6.00  |   |
| Total Risk-based Capital Ratio  | 111,218                | 20.82 | 42,726                        | 8.00  | 53,408   | 10.00 |   |
| Tangible Equity Ratio           | 104,771                | 11.25 | 13,970                        | 1.50  | N/A  | N/A   |   |
| December 31, 2012               | (Dollars in Thousands) |       |                               |       |  |       |   |
| Tier I Capital Ratio            | \$103,547              | 11.08 | % \$37,382                    | 4.00  | % \$46,727   | 5.00  | % |
| Tier I Risk-based Capital Ratio | 103,547                | 20.20 | 20,504                        | 4.00  | 30,757   | 6.00  |   |
| Total Risk-based Capital Ratio  | 109,751                | 21.41 | 41,009                        | 8.00  | 51,262   | 10.00 |   |
| Tangible Equity Ratio           | 103,547                | 11.08 | 14,018                        | 1.50  | N/A  | N/A   |   |

## NOTE 8. FAIR VALUE OF ASSETS AND LIABILITIES

## Fair Value Hierarchy

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

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

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

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

period, if applicable.

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

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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 disclosures of its financial instruments:

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

• **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 collateralized debt obligations that are backed by trust preferred securities issued by banks, thrifts and insurance companies. Management determined that an orderly and active market for these securities and similar securities did not exist based on a significant reduction in trading volume and widening spreads relative to historical levels. The Company estimates future cash flows discounted using a rate management believes is representative of current market conditions. Factors in determining the discount rate include the current level of deferrals and/or defaults, changes in credit rating and the financial condition of the debtors within the underlying securities, broker quotes for securities with similar structure and credit risk, interest rate movements and pricing for new issuances.

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

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

• **Loans receivable.** For variable rate loans 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.

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

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

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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 June 30, 2013 and December 31, 2012. The Company had no significant transfers into or out of Levels 1, 2 or 3 during the six months ended June 30, 2013.

|   | June 30, 2013  |                  |                | Total            |
|---|----------------|------------------|----------------|------------------|
|   | Level 1        | Level 2          | Level 3        |                  |
|   | (In Thousands) |                  |                |                  |
| <b>Assets:</b>  |                |                  |                |                  |
| U.S. Government and agency obligations                        | \$1,026        | \$53,163         | \$—            | \$54,189         |
| Government-sponsored enterprises                              | —              | 28,946           | —              | 28,946           |
| Mortgage-backed securities                                    | —              | 86,171           | —              | 86,171           |
| Corporate debt securities                                     | —              | 7,136            | —              | 7,136            |
| Collateralized debt obligations                               | —              | —                | 4,453          | 4,453            |
| Obligations of state and political subdivisions               | —              | 6,382            | —              | 6,382            |
| Tax-exempt securities   | —              | 3,600            | —              | 3,600            |
| Foreign government securities                                 | —              | 25               | —              | 25               |
| Forward loan sale commitments and derivative loan commitments | —              | —                | 87             | 87               |
| <b>Total assets</b>   | <b>\$1,026</b> | <b>\$185,423</b> | <b>\$4,540</b> | <b>\$190,989</b> |
| <b>Liabilities:</b>   |                |                  |                |                  |
| Forward loan sale commitments and derivative loan commitments | \$—            | \$—              | \$83           | \$83             |



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|                               |     |       |      |       |
|-------------------------------|-----|-------|------|-------|
| Interest rate swap agreements | —   | 498   | —    | 498   |
| Total liabilities             | \$— | \$498 | \$83 | \$581 |

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|   | December 31, 2012         |           |         | Total     |
|---|---------------------------|-----------|---------|-----------|
|   | Level 1<br>(In Thousands) | Level 2   | Level 3 |           |
| Assets:   |                           |           |         |           |
| U.S. Government and agency obligations                        | \$1,035                   | \$55,224  | \$—     | \$56,259  |
| Government-sponsored enterprises                              | —                         | 23,967    | —       | 23,967    |
| Mortgage-backed securities                                    | —                         | 78,733    | —       | 78,733    |
| Corporate debt securities                                     | —                         | 7,694     | —       | 7,694     |
| Collateralized debt obligations                               | —                         | —         | 4,396   | 4,396     |
| Obligations of state and political subdivisions               | —                         | 5,414     | —       | 5,414     |
| Foreign government securities                                 | —                         | 50        | —       | 50        |
| Forward loan sale commitments and derivative loan commitments | —                         | —         | 17      | 17        |
| Total assets  | \$1,035                   | \$171,082 | \$4,413 | \$176,530 |
| Liabilities:  |                           |           |         |           |
| Forward loan sale commitments and derivative loan commitments | \$—                       | \$—       | \$4     | \$4       |
| Interest rate swap agreements                                 | —                         | 849       | —       | 849       |
| Total liabilities   | \$—                       | \$849     | \$4     | \$853     |

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, 2012                                | \$4,396   | \$13   |
| Total realized and unrealized losses included in net loss   | —   | (9)  |
| Total unrealized gains included in other comprehensive loss | 57  | —  |
| Balance at June 30, 2013                                    | \$4,453   | \$4  |

## 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 June 30, 2013 and December 31, 2012. There were no liabilities measured at fair value on a nonrecurring basis at June 30, 2013 and December 31, 2012.

|                | At June 30, 2013          |         |         | At December 31, 2012 |         |         |
|----------------|---------------------------|---------|---------|----------------------|---------|---------|
|                | Level 1<br>(In Thousands) | Level 2 | Level 3 | Level 1              | Level 2 | Level 3 |
| Impaired loans | \$—                       | \$—     | \$1,484 | \$—                  | \$—     | \$1,616 |

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|                         |     |     |         |     |     |         |
|-------------------------|-----|-----|---------|-----|-----|---------|
| Other real estate owned | —   | —   | 731     | —   | —   | 1,293   |
| Total assets            | \$— | \$— | \$2,215 | \$— | \$— | \$2,909 |

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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 June 30, |       | Six Months Ended June 30, |       |
|-------------------------|-----------------------------|-------|---------------------------|-------|
|                         | 2013                        | 2012  | 2013                      | 2012  |
|                         | (In Thousands)              |       |                           |       |
| Impaired loans          | \$74                        | \$171 | \$331                     | \$274 |
| Other real estate owned | 20                          | —     | 32                        | —     |
| Total assets            | \$94                        | \$171 | \$363                     | \$274 |

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, and are charged against the allowance for loan losses.

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 June 30, 2013 and December 31, 2012. The estimated fair value amounts at June 30, 2013 and December 31, 2012 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 June 30, 2013 and December 31, 2012, the recorded carrying amounts and estimated fair values of the Company's financial instruments are as follows:

|   | June 30, 2013      |          |         |         |          |
|---|--------------------|----------|---------|---------|----------|
|   | Carrying<br>Amount | Level 1  | Level 2 | Level 3 | Total    |
| Financial Assets:                                     |                    |          |         |         |          |
| (In Thousands)  |                    |          |         |         |          |
| Cash and cash equivalents                             | \$38,549           | \$38,549 | \$—     | \$—     | \$38,549 |
| Available for sale securities                         | 190,902            | 1,026    | 185,423 | 4,453   | 190,902  |
| Loans held for sale                                   | 525                | —        | —       | 525     | 525      |
| Loans receivable, net                                 | 670,445            | —        | —       | 677,973 | 677,973  |
| Federal Home Loan Bank stock                          | 7,753              | —        | —       | 7,753   | 7,753    |
| Accrued interest receivable                           | 3,242              | —        | —       | 3,242   | 3,242    |
| Financial Liabilities:                                |                    |          |         |         |          |
| Deposits  | 708,322            | —        | —       | 711,645 | 711,645  |
| Mortgagors' and investors' escrow accounts            | 2,786              | —        | —       | 2,786   | 2,786    |
| Federal Home Loan Bank advances                       | 93,069             | —        | 96,152  | —       | 96,152   |
| Junior subordinated debt owed to unconsolidated trust | 8,248              | —        | 5,947   | —       | 5,947    |
| On-balance Sheet Derivative Financial Instruments:    |                    |          |         |         |          |
| Assets:   |                    |          |         |         |          |
| Derivative loan commitments                           | 64                 | —        | —       | 64      | 64       |
| Forward loan sale commitments                         | 23                 | —        | —       | 23      | 23       |
| Liabilities:  |                    |          |         |         |          |
| Derivative loan commitments                           | 83                 | —        | —       | 83      | 83       |
| Interest rate swap agreements                         | 498                | —        | 498     | —       | 498      |

|   | December 31, 2012  |          |         |         |          |
|---|--------------------|----------|---------|---------|----------|
|   | Carrying<br>Amount | Level 1  | Level 2 | Level 3 | Total    |
| Financial Assets:                                     |                    |          |         |         |          |
| (In Thousands)  |                    |          |         |         |          |
| Cash and cash equivalents                             | \$37,689           | \$37,689 | \$—     | \$—     | \$37,689 |
| Available for sale securities                         | 176,513            | 1,035    | 171,082 | 4,396   | 176,513  |
| Loans held for sale                                   | 5,069              | —        | —       | 5,232   | 5,232    |
| Loans receivable, net                                 | 685,163            | —        | —       | 703,925 | 703,925  |
| Federal Home Loan Bank stock                          | 8,078              | —        | —       | 8,078   | 8,078    |
| Accrued interest receivable                           | 3,215              | —        | —       | 3,215   | 3,215    |
| Financial Liabilities:                                |                    |          |         |         |          |
| Deposits  | 705,148            | —        | —       | 709,357 | 709,357  |
| Mortgagors' and investors' escrow accounts            | 3,207              | —        | —       | 3,207   | 3,207    |
| Federal Home Loan Bank advances                       | 98,069             | —        | 102,919 | —       | 102,919  |
| Junior subordinated debt owed to unconsolidated trust | 8,248              | —        | 5,268   | —       | 5,268    |
| On-balance Sheet Derivative Financial Instruments:    |                    |          |         |         |          |

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Assets:

|                               |    |   |   |    |    |
|-------------------------------|----|---|---|----|----|
| Derivative loan commitments   | 13 | — | — | 13 | 13 |
| Forward loan sale commitments | 4  | — | — | 4  | 4  |

Liabilities:

|                               |     |   |     |   |     |
|-------------------------------|-----|---|-----|---|-----|
| Derivative loan commitments   | 3   | — | —   | 3 | 3   |
| Forward loan sale commitments | 1   | — | —   | 1 | 1   |
| Interest rate swap agreements | 849 | — | 849 | — | 849 |

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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, generally hedges a portion of its variable-rate interest payments. To meet this objective, management entered into an interest rate swap agreement, characterized as a cash flow hedge, whereby the Company receives variable interest rate payments determined by three-month LIBOR in exchange for making payments at a fixed interest rate.

At June 30, 2013 and December 31, 2012, information pertaining to the outstanding interest rate swap agreement used to hedge variable rate debt is as follows:

|  | June 30, 2013          | December 31, 2012 |   |
|--|------------------------|-------------------|---|
|  | (Dollars in Thousands) |                   |   |
| Notional amount                                | \$8,000                | \$8,000           |   |
| Weighted average fixed pay rate                | 2.44                   | % 2.44            | % |
| Weighted average variable receive rate         | 0.27                   | % 0.31            | % |
| Weighted average maturity in years             | 2.5                    | 3.0               |   |
| Unrealized loss relating to interest rate swap | \$361                  | \$470             |   |

At June 30, 2013 and December 31, 2012, 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 June 30, 2013 and December 31, 2012, 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 \$600,000 in the normal course of business for a derivative instrument, with a credit-related contingent feature, that was in a net liability position at June 30, 2013 and December 31, 2012.

Derivative Instruments Not Designated As Hedging Instruments

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

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

At June 30, 2013 and December 31, 2012, information pertaining to the Company's interest rate swap agreement not designated as a hedge is as follows:

|  | June 30, 2013          | December 31, 2012 |   |
|--|------------------------|-------------------|---|
|  | (Dollars in Thousands) |                   |   |
| Notional amount                        | \$ 15,000              | \$ 15,000         |   |
| Weighted average fixed pay rate        | 1.26                   | % 1.26            | % |
| Weighted average variable receive rate | 0.28                   | % 0.35            | % |
| Weighted average maturity in years     | 3.5                    | 4.0               |   |

The Company reported a gain in fair value on the interest rate swap not designated as a hedge of \$198,000 and \$242,000 in noninterest income for the three and six months ended June 30, 2013, 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 value 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 \$9.0 million at June 30, 2013. At June 30, 2013, the fair values of such commitments were a net liability of \$19,000.

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 \$5.3 million at June 30, 2013. The fair value of such commitments was a net asset of \$23,000 at June 30, 2013.

## 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 June 30, 2013 and December 31, 2012.

|  | Balance Sheet Location     | June 30, 2013   |                      | December 31, 2012 |                      |
|--|----------------------------|-----------------|----------------------|-------------------|----------------------|
|  |                            | Notional Amount | Estimated Fair Value | Notional Amount   | Estimated Fair Value |
| Derivative designated as hedging instrument:       |                            |                 |                      |                   |                      |
| Interest rate swap                                 | Other Liabilities          | \$8,000         | \$(361 )             | \$8,000           | \$(470 )             |
| Derivatives not designated as hedging instruments: |                            |                 |                      |                   |                      |
| Interest rate swap                                 | Other Liabilities          | 15,000          | (137 )               | 15,000            | (379 )               |
| Derivative loan commitments                        | Other (Liabilities) Assets | 9,043           | (19 )                | 7,844             | 10                   |
| Forward loan sale commitments                      | Other Assets               | 5,323           | 23                   | 5,919             | 3                    |

## NOTE 10. ACQUISITION OF NEWPORT BANCORP, INC.

On March 5, 2013, the Company entered into a definitive merger agreement to acquire Newport Bancorp, Inc. Under the terms of the merger agreement, the shareholders of Newport Bancorp will have the right to elect to receive either \$17.55 in cash or 1.5129 shares of SI Financial Group's common stock in exchange for each share of Newport Bancorp held by them, subject to proration and allocation procedures so that 50% of the outstanding shares of Newport Bancorp common stock is converted into Company common stock and the balance is converted into the cash consideration. The acquisition will add approximately \$426.6 million in assets, \$356.3 million in loans and \$281.0 million in deposits before acquisition accounting adjustments, as well as six full-service banking offices. The Company incurred merger-related costs totaling \$209,000 and \$893,000 (pre-tax) for the three and six months ended June 30, 2013, respectively. The Company anticipates the transaction will close in the third quarter of 2013, subject to shareholder and regulatory approvals and other customary closing conditions.



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 June 30, 2013 and December 31, 2012 and the results of operations for the three and six months ended June 30, 2013 and 2012. 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 2012 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, demand for financial services in the Company's market area, changes in real estate market values in the Company's market area and changes in relevant accounting principles and guidelines. Additional factors that may affect the Company's results are discussed in the Company's Annual Report on Form 10-K and in other reports filed with the Securities and Exchange Commission. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements. Except as required by applicable law or regulation, the Company does not undertake, and specifically disclaims any obligation, to release publicly the result of any revisions that may be made to any forward-looking statements to reflect events or circumstances after the date of the statements or to reflect the occurrence of anticipated or unanticipated events.

#### Critical Accounting Policies

The Company considers accounting policies involving significant judgments and assumptions by management that have, or could have, a material impact on the carrying value of certain assets or on income to be critical accounting policies. The Company considers the determination of allowance for loan losses, OTTI of securities, deferred income taxes and the impairment of long-lived assets to be its critical accounting policies. Additional information about the Company's accounting policies is included in the notes to the Company's consolidated financial statements contained in Part I, Item 1 of this document and in the Company's 2012 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 June 30, 2013 and December 31, 2012

Assets:

Summary. Assets decreased \$4.4 million, or 0.5%, to \$948.8 million at June 30, 2013 from \$953.3 million at December 31, 2012, principally due to decreases of \$14.7 million in net loans receivable and \$4.5 million in loans held for sale, offset by an increase of \$14.4 million in available for sale securities. Securities increased with the purchase of primarily mortgage-backed securities and government-sponsored enterprise securities.

Loans Receivable, Net. Contributing to the decrease of \$14.7 million in net loans receivable were loan sales of \$33.3 million and principal repayments and maturities, offset by loan originations of \$87.2 million and loan purchases of \$18.4 million. Changes in the loan portfolio consisted of the following:

Residential Real Estate. Residential mortgage loans comprised 32.9% of the total loan portfolio at June 30, 2013. The residential mortgage portfolio decreased \$8.7 million, or 3.8%, primarily due to the sale of \$30.4 million of fixed-rate residential mortgage loans, offset by residential mortgage loan originations of \$43.8 million during the first six months of 2013 which represented an increase of \$2.4 million over the comparable period in 2012. Interest rate volatility negatively impacted loan originations during 2013.

Multi-family and Commercial Real Estate. Multi-family and commercial real estate loans represented 28.5% of total loans at June 30, 2013 and decreased \$9.8 million, or 4.9%, during the first half of 2013. Loan originations for multi-family and commercial real estate loans were \$1.6 million, representing a decrease of \$29.1 million during the first six months of 2013 compared to the same period in 2012 resulting from a lack of demand in the market.

Construction. Construction loans, which include both residential and commercial construction loans, increased \$227,000.

Commercial Business. Commercial business loans represented 32.5% of total loans at June 30, 2013. Commercial business loans increased \$5.5 million, or 2.6%, primarily due to the purchase of \$18.4 million in commercial business loans, of which \$15.5 million were SBA and USDA guaranteed loans, and loan originations of \$35.2 million, partially offset by the sale of \$3.0 million of SBA and USDA guaranteed loans during the first half of 2013. Commercial business loan originations increased \$6.2 million over the comparable period in 2012. Commercial business loans included growth in specialized products such as condominium and time share lending of \$1.2 million and \$698,000, respectively. At June 30, 2013, unfunded lines of credit related to time share lending totaled \$26.4 million as a result of an experienced lender dedicated to identifying new opportunities for growth within the time share industry.

Consumer. Consumer loans represented 5.6% of the Company's total loan portfolio at June 30, 2013. Consumer loans decreased \$2.3 million during the first half of 2013. Indirect automobile loans, home equity loans and other consumer loans decreased \$1.7 million, \$395,000 and \$246,000, respectively. Loan originations for consumer loans totaled \$6.6 million, representing an increase of \$1.0 million for the six months ended June 30, 2013 compared to the same period in 2012.

The allowance for loan losses totaled \$6.0 million at June 30, 2013 compared to \$6.4 million at December 31, 2012. The ratio of the allowance for loan losses to total loans decreased from 0.93% at December 31, 2012 to 0.89% at June 30, 2013.

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

|   | June 30, 2013          | December 31,<br>2012 |  |   |
|---|------------------------|----------------------|--|---|
|   | (Dollars in Thousands) |                      |  |   |
| Nonaccrual loans:   |                        |                      |  |   |
| Real estate loans:  |                        |                      |  |   |
| Residential - 1 to 4 family   | \$5,129                | \$4,988              |  |   |
| Multi-family and commercial   | 3,194                  | 1,758                |  |   |
| Total real estate loans   | 8,323                  | 6,746                |  |   |
| Commercial business loans   | 475                    | 542                  |  |   |
| Consumer loans:   |                        |                      |  |   |
| Home equity   | 217                    | 366                  |  |   |
| Other   | 7                      | —                    |  |   |
| Total nonaccrual loans  | 9,022                  | 7,654                |  |   |
| Accruing loans past due 90 days or more                                     | —                      | —                    |  |   |
| Total nonperforming loans <sup>(1)</sup>                                    | 9,022                  | 7,654                |  |   |
| Other real estate owned, net <sup>(2)</sup>                                 | 731                    | 1,293                |  |   |
| Total nonperforming assets  | 9,753                  | 8,947                |  |   |
| Accruing troubled debt restructurings                                       | 1,799                  | 3,826                |  |   |
| Total nonperforming assets and troubled debt restructurings                 | \$11,552               | \$12,773             |  |   |
| Allowance for loan losses as a percent of nonperforming loans               | 66.58                  | % 83.45              |  | % |
| Total nonperforming loans to total loans                                    | 1.34                   | % 1.11               |  | % |
| Total nonperforming loans to total assets                                   | 0.95                   | % 0.80               |  | % |
| Total nonperforming assets and troubled debt restructurings to total assets | 1.22                   | % 1.34               |  | % |

<sup>(1)</sup> Includes nonperforming TDRs totaling \$1.5 million and \$504,000 at June 30, 2013 and December 31, 2012, respectively.

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

Nonperforming residential - 1 to 4 family and multi-family and commercial real estate loans increased \$141,000 and \$1.4 million, respectively, at June 30, 2013. Nonperforming loans are expected to remain elevated in the short-term due to the extended judicial foreclosure process in the State of Connecticut. The modification of loan terms, which may result in TDR classification, may be provided to borrowers when necessary to preserve the unpaid principal balance of certain loans.

Other real estate owned decreased \$562,000 from December 31, 2012 to June 30, 2013, primarily as a result of the sale of two commercial properties and three residential properties with an aggregate carrying value of \$924,000, partially offset by the acquisition of four residential properties with a carrying value of \$382,000. At June 30, 2013, other real estate owned included four residential properties and two commercial properties.

Over the past year, 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, which consisted of two commercial real estate loans and sixteen residential real estate loans, decreased to \$3.2 million at June 30, 2013, compared to \$4.3 million at December 31, 2012 due to principal payments and the removal of TDR classification for loans that returned to their original



contractual terms, offset by the addition of one residential real estate loan. Of the TDRs, \$1.8 million and \$3.8 million were accruing in accordance with their restructured terms at June 30, 2013 and December 31,

2012, 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 \$2.8 million, or 0.3%, to \$824.7 million at June 30, 2013 compared to \$827.5 million at December 31, 2012. Borrowings, including subordinated debentures, decreased \$5.0 million from \$106.3 million at December 31, 2012 to \$101.3 million at June 30, 2013, resulting from net repayments of Federal Home Loan Bank advances. Deposits increased \$3.2 million, or 0.5%, which included increases in NOW and money market accounts of \$14.2 million and savings account deposits of \$2.9 million, offset by a decrease in certificates of deposit of \$14.6 million. Deposits growth remained strong due to marketing and promotional initiatives and competitively-priced deposit products.

**Equity:**

**Summary.** Shareholders' equity decreased \$1.6 million from \$125.8 million at December 31, 2012 to \$124.2 million at June 30, 2013. The decrease in shareholders' equity was attributable to a decline in unrealized gains on available for sale securities aggregating \$1.6 million (net of taxes), dividends of \$573,000 and a net loss of \$137,000, offset by the amortization of equity plan awards of \$667,000 and an unrealized gain of \$72,000 on an interest-rate swap derivative.

**Accumulated Other Comprehensive (Loss) Income.** Accumulated other comprehensive (loss) income 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. Net unrealized gains on available for sale securities, net of taxes, decreased to \$107,000 at June 30, 2013. The net unrealized loss on the interest rate swap, net of taxes, totaled \$238,000 at June 30, 2013 compared to a net unrealized loss on the interest rate swap, net of taxes of \$310,000 at December 31, 2012.

**Results of Operations for the Three and Six Months Ended June 30, 2013 and 2012**

**General.** The Company's results of operations depend primarily on net interest income, which is the difference between the interest income earned on the Company's interest-earning assets, such as loans and investments, and the interest expense on its interest-bearing liabilities, such as deposits and borrowings. The Company also generates noninterest income such as gains on the sale of securities, fees earned from mortgage banking activities, fees from deposits, trust and investment management services, insurance commissions and other fees. The Company's noninterest expenses primarily consist of employee compensation and benefits, occupancy, computer services, furniture and equipment, outside professional services, electronic banking fees, marketing 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 a net loss of \$60,000 for the three months ended June 30, 2013, representing a decrease of \$730,000, compared to net income of \$670,000 for the three months ended June 30, 2012.

The Company reported a net loss of \$137,000 for the six months ended June 30, 2013, representing a decrease of \$1.2 million, compared to net income of \$1.1 million for the six months ended June 30, 2012.

Contributing to the net loss for the three and six months ended June 30, 2013 were expenses totaling \$209,000 and \$893,000, respectively, related to the pending acquisition of Newport Bancorp, Inc.

**Interest and Dividend Income.** Total interest and dividend income decreased \$576,000, or 6.5%, to \$8.3 million for the quarter ended June 30, 2013, compared to the same period in 2012. The decrease in interest income was due to lower yields on securities and loans, offset by an increase of \$23.6 million in the average balance of loans. The average yield

earned on interest-earning assets decreased 25 basis points to 3.68%, with the yield on investment securities decreasing 36 basis points to 2.17% and the yield on loans decreasing 31 basis points to

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4.28%. Average interest-earning assets decreased \$3.8 million to \$904.8 million during the second quarter of 2013, due to decreases in the average balance of securities of \$26.0 million and other interest earning assets of \$1.3 million compared to the same quarter in 2012.

Total interest and dividend income decreased \$1.2 million, or 6.9%, to \$16.9 million for the six months ended June 30, 2013, compared to the same period in 2012. The decrease in interest income was due to lower yields on securities and loans, offset by an increase of \$41.0 million in the average balance of loans. The yield earned on interest-earning assets decreased 25 basis points to 3.75%, with the yield on investment securities decreasing 42 basis points to 2.16% and the yield on loans decreasing 37 basis points to 4.36%. Average interest-earning assets decreased \$4.6 million to \$906.0 million during the first half of 2013, due to decreases in the average balance of securities of \$36.7 million and other interest earning assets of \$8.9 million.

Interest Expense. For the quarter ended June 30, 2013, interest expense decreased \$309,000, or 12.9%, to \$2.1 million compared to \$2.4 million for the same period in 2012, primarily due to lower rates paid on deposits and borrowings and decreases in the average balance of certificates of deposit and FHLB borrowings, offset by increases in the average balance of NOW and money market deposits and savings accounts. Average interest-bearing deposits decreased \$119,000 to \$623.9 million and the average rate paid decreased 15 basis points to 0.83%. An increase in the average balance of NOW and money market deposits and savings accounts totaling \$4.8 million and \$1.0 million, respectively, was offset by a decrease in the average balance of certificates of deposit totaling \$5.7 million, as certain customers shifted from certificates of deposit to NOW and money market accounts and savings accounts. The average balance of FHLB advances decreased \$2.1 million and the average rate decreased 37 basis points to 3.08%. The average rate on subordinated debt, which includes the associated interest rate swap, increased 107 basis points to 4.04% as a result of an increase in the LIBOR rate.

For the six months ended June 30, 2013, interest expense decreased \$650,000, or 13.1%, to \$4.3 million compared to \$4.9 million for the same period in 2012, primarily due to lower rates paid on deposits and borrowings and decreases in the average balance of NOW and money market deposits, FHLB borrowings and certificates of deposit, offset by an increase in the average balance of savings accounts. Average interest-bearing deposits decreased \$2.2 million to \$622.6 million and the average rate paid decreased 15 basis points to 0.85%. An increase in the average balance of savings accounts totaling \$1.0 million, was offset by decreases in the average balance of NOW and money market accounts and certificates of deposit totaling \$2.3 million and \$1.0 million, respectively. The average balance of FHLB advances decreased \$2.3 million and the average rate decreased 28 basis points to 3.15%. The average rate on subordinated debt, including the associated interest rate swap, decreased 4 basis points to 4.06% resulting from a decrease in the LIBOR rate.

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 June 30,<br>2013 |                         |                           | 2012               |                         |                           |   |  |  |
|--|---|-------------------------|---------------------------|--------------------|-------------------------|---------------------------|---|--|--|
|  | 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>   | \$673,787   | \$7,194                 | 4.28                      | % \$650,233        | \$7,422                 | 4.59                      | % |  |  |
| Securities <sup>(3)</sup>  | 203,653   | 1,104                   | 2.17                      | 229,664            | 1,445                   | 2.53                      |   |  |  |
| Other interest-earning assets  | 27,394  | 11                      | 0.16                      | 28,714             | 12                      | 0.17                      |   |  |  |
| Total interest-earning assets  | 904,834   | 8,309                   | 3.68                      | 908,611            | 8,879                   | 3.93                      |   |  |  |
| Noninterest-earning assets   | 45,524  |                         |                           | 49,201             |                         |                           |   |  |  |
| Total assets   | \$950,358   |                         |                           | \$957,812          |                         |                           |   |  |  |
| Interest-bearing liabilities:  |   |                         |                           |                    |                         |                           |   |  |  |
| Deposits:  |   |                         |                           |                    |                         |                           |   |  |  |
| Business checking  | \$54  | —                       | —                         | \$70               | —                       | —                         |   |  |  |
| NOW and money market   | 311,395   | 106                     | 0.14                      | 306,584            | 158                     | 0.21                      |   |  |  |
| Savings <sup>(4)</sup>   | 42,343  | 18                      | 0.17                      | 41,305             | 24                      | 0.23                      |   |  |  |
| Certificates of deposit <sup>(5)</sup>   | 270,093   | 1,160                   | 1.72                      | 275,807            | 1,333                   | 1.94                      |   |  |  |
| Total interest-bearing deposits  | 623,885   | 1,284                   | 0.83                      | 623,766            | 1,515                   | 0.98                      |   |  |  |
| Federal Home Loan Bank advances  | 93,168  | 716                     | 3.08                      | 95,223             | 816                     | 3.45                      |   |  |  |
| Subordinated debt  | 8,248   | 83                      | 4.04                      | 8,248              | 61                      | 2.97                      |   |  |  |
| Total interest-bearing liabilities   | 725,301   | 2,083                   | 1.15                      | 727,237            | 2,392                   | 1.32                      |   |  |  |
| Noninterest-bearing liabilities  | 98,831  |                         |                           | 99,405             |                         |                           |   |  |  |
| Total liabilities  | 824,132   |                         |                           | 826,642            |                         |                           |   |  |  |
| Total shareholders' equity   | 126,226   |                         |                           | 131,170            |                         |                           |   |  |  |
| Total liabilities and shareholders' equity   | \$950,358   |                         |                           | \$957,812          |                         |                           |   |  |  |
| Net interest-earning assets  | \$179,533   |                         |                           | \$181,374          |                         |                           |   |  |  |
| Tax equivalent net interest income <sup>(3)</sup>  |   | 6,226                   |                           |                    | 6,487                   |                           |   |  |  |
| Tax equivalent interest rate spread <sup>(6)</sup>   |   |                         | 2.53                      | %                  |                         | 2.61                      | % |  |  |
| Tax equivalent net interest margin as a percentage of interest-earning assets <sup>(7)</sup> |   |                         | 2.76                      | %                  |                         | 2.87                      | % |  |  |
| Average of interest-earning assets to average interest-bearing liabilities                   |   |                         | 124.75                    | %                  |                         | 124.94                    | % |  |  |
| Less tax equivalent adjustment <sup>(3)</sup>  |   | (7                      | )                         |                    | (1                      | )                         |   |  |  |

|                     |         |         |
|---------------------|---------|---------|
| Net interest income | \$6,219 | \$6,486 |
|---------------------|---------|---------|

(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 Six Months Ended June 30,<br>2013 |                         |                           | 2012               |                         |                           |   |  |
|--|---|-------------------------|---------------------------|--------------------|-------------------------|---------------------------|---|--|
|  | 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>   | \$681,201                                       | \$ 14,717               | 4.36                      | % \$640,156        | \$ 15,057               | 4.73                      | % |  |
| Securities <sup>(3)</sup>  | 198,572   | 2,126                   | 2.16                      | 235,289            | 3,019                   | 2.58                      |   |  |
| Other interest-earning assets  | 26,247  | 21                      | 0.16                      | 35,195             | 24                      | 0.14                      |   |  |
| Total interest-earning assets  | 906,020   | 16,864                  | 3.75                      | 910,640            | 18,100                  | 4.00                      |   |  |
| Noninterest-earning assets   | 45,373  |                         |                           | 49,518             |                         |                           |   |  |
| Total assets   | \$951,393                                       |                         |                           | \$960,158          |                         |                           |   |  |
| Interest-bearing liabilities:  |   |                         |                           |                    |                         |                           |   |  |
| Deposits:  |   |                         |                           |                    |                         |                           |   |  |
| Business checking  | \$56  | —                       | —                         | \$57               | —                       | —                         |   |  |
| NOW and money market   | 307,994   | 222                     | 0.15                      | 310,282            | 373                     | 0.24                      |   |  |
| Savings <sup>(4)</sup>   | 41,293  | 37                      | 0.18                      | 40,206             | 59                      | 0.30                      |   |  |
| Certificates of deposit <sup>(5)</sup>   | 273,281   | 2,377                   | 1.75                      | 274,304            | 2,678                   | 1.96                      |   |  |
| Total interest-bearing deposits  | 622,624   | 2,636                   | 0.85                      | 624,849            | 3,110                   | 1.00                      |   |  |
| Federal Home Loan Bank advances  | 95,373  | 1,491                   | 3.15                      | 97,646             | 1,665                   | 3.43                      |   |  |
| Subordinated debt  | 8,248   | 166                     | 4.06                      | 8,248              | 168                     | 4.10                      |   |  |
| Total interest-bearing liabilities   | 726,245   | 4,293                   | 1.19                      | 730,743            | 4,943                   | 1.36                      |   |  |
| Noninterest-bearing liabilities  | 98,834  |                         |                           | 97,842             |                         |                           |   |  |
| Total liabilities  | 825,079   |                         |                           | 828,585            |                         |                           |   |  |
| Total shareholders' equity   | 126,314   |                         |                           | 131,573            |                         |                           |   |  |
| Total liabilities and shareholders' equity   | \$951,393                                       |                         |                           | \$960,158          |                         |                           |   |  |
| Net interest-earning assets  | \$ 179,775                                      |                         |                           | \$ 179,897         |                         |                           |   |  |
| Tax equivalent net interest income <sup>(3)</sup>  |   | 12,571                  |                           |                    | 13,157                  |                           |   |  |
| Tax equivalent interest rate spread <sup>(6)</sup>   |   |                         | 2.56                      | %                  |                         | 2.64                      | % |  |
| Tax equivalent net interest margin as a percentage of interest-earning assets <sup>(7)</sup> |   |                         | 2.80                      | %                  |                         | 2.91                      | % |  |
| Average of interest-earning assets to average interest-bearing liabilities                   |   |                         | 124.75                    | %                  |                         | 124.62                    | % |  |
| Less tax equivalent adjustment <sup>(3)</sup>  |   | (7 )                    |                           |                    | (1 )                    |                           |   |  |

|                     |           |           |
|---------------------|-----------|-----------|
| Net interest income | \$ 12,564 | \$ 13,156 |
|---------------------|-----------|-----------|

(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.



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>June 30, 2013 and 2012 |         |        | Six Months Ended<br>June 30, 2013 and 2012 |         |        |
|------------------------------------|--|---------|--------|--|---------|--------|
|                                    | Increase (Decrease) Due To                   |         |        | Increase (Decrease) Due To                 |         |        |
|                                    | Rate   | Volume  | Net    | Rate                                       | Volume  | Net    |
|                                    | (In Thousands)                               |         |        |  |         |        |
| Interest-earning assets:           |  |         |        |  |         |        |
| Interest and dividend income:      |  |         |        |  |         |        |
| Loans <sup>(1)(2)</sup>            | \$(497                                       | ) \$269 | \$(228 | ) \$(1,253                                 | ) \$913 | \$(340 |
| Securities <sup>(3)</sup>          | (189   | ) (152  | ) (341 | ) (457                                     | ) (436  | ) (893 |
| Other interest-earning assets      | (1   | ) —     | (1     | ) 2  | (5      | ) (3   |
| Total interest-earning assets      | (687   | ) 117   | (570   | ) (1,708                                   | ) 472   | (1,236 |
| Interest-bearing liabilities:      |  |         |        |  |         |        |
| Interest expense:                  |  |         |        |  |         |        |
| Deposits <sup>(4)</sup>            | (207   | ) (24   | ) (231 | ) (463                                     | ) (11   | ) (474 |
| Federal Home Loan Bank advances    | (83  | ) (17   | ) (100 | ) (135                                     | ) (39   | ) (174 |
| Subordinated debt                  | 22   | —       | 22     | (2   | ) —     | (2     |
| Total interest-bearing liabilities | (268   | ) (41   | ) (309 | ) (600                                     | ) (50   | ) (650 |
| Change in net interest income      | \$(419                                       | ) \$158 | \$(261 | ) \$(1,108                                 | ) \$522 | \$(586 |

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

(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 amount reported in the statements of operations.

(4) Includes mortgagors' and investors' escrow accounts and brokered deposits.

Provision for Loan Losses. The provision for loan losses decreased \$377,000 and \$726,000 for the three and six months ended June 30, 2013, respectively, compared to the same periods in 2012 due to a decrease in nonperforming loans and loans outstanding. At June 30, 2013, nonperforming loans totaled \$9.0 million, compared to \$11.5 million at June 30, 2012 primarily due to decreases in nonperforming multi-family and commercial mortgage loans of \$1.7 million, residential mortgage loans of \$340,000 and consumer loans of \$312,000. Net loan charge-offs were \$376,000 and \$570,000 for the three and six months ended June 30, 2013, respectively, consisting primarily of commercial and residential mortgage loan charge-offs, compared to net loan charge-offs of \$166,000 and \$242,000 for the three and six months ended June 30, 2012, 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   |          | Six Months Ended |         | Change   |          |
|---|------------------------|---------|----------|----------|------------------|---------|----------|----------|
|   | June 30,<br>2013       | 2012    | Dollars  | Percent  | June 30,<br>2013 | 2012    | Dollars  | Percent  |
|   | (Dollars in Thousands) |         |          |          |                  |         |          |          |
| Net impairment losses   | \$(8 )                 | \$—     | \$(8 )   | — %      | \$(8 )           | \$(36 ) | \$28     | (77.8 )% |
| Service fees  | 1,233                  | 1,221   | 12       | 1.0      | 2,449            | 2,431   | 18       | 0.7      |
| Wealth management fees  | 287                    | 343     | (56 )    | (16.3 )  | 544              | 1,410   | (866 )   | (61.4 )  |
| Increase in cash surrender value of bank-owned life insurance | 68                     | 70      | (2 )     | (2.9 )   | 136              | 142     | (6 )     | (4.2 )   |
| Net gain on sales of securities                               | —                      | 257     | (257 )   | (100.0 ) | 3                | 574     | (571 )   | (99.5 )  |
| Mortgage banking  | 271                    | 398     | (127 )   | (31.9 )  | 850              | 677     | 173      | 25.6     |
| Net gain (loss) on fair value of derivatives                  | 126                    | (152 )  | 278      | (182.9 ) | 173              | (201 )  | 374      | (186.1 ) |
| Net loss on disposal of SI Trust Servicing operations         | —                      | (212 )  | 212      | (100.0 ) | —                | (698 )  | 698      | (100.0 ) |
| Other   | 95                     | 401     | (306 )   | (76.3 )  | 365              | 788     | (423 )   | (53.7 )  |
| Total noninterest income                                      | \$2,072                | \$2,326 | \$(254 ) | (10.9 )% | \$4,512          | \$5,087 | \$(575 ) | (11.3 )% |

Wealth management fees decreased during the second quarter of 2013 due to a reduction in estate fees from trust accounts and declined for the first half of 2013, compared to the same period in 2012, primarily due to the sale of SI Trust Servicing, a third-party provider of trust outsourcing services for community banks, in April 2012. The Company recognized an increase in fair value on certain derivative instruments, offset by a decrease in gains on the sale of available for sale securities during the second quarter and first half of 2013, respectively, compared to the same periods in 2012. Mortgage banking fees declined for the second quarter of 2013 as a result of lower gains realized on residential mortgage loan sales versus an increase in mortgage banking fees for the first half of 2013 due to a higher volume of residential mortgage loan sales. Offsetting the decrease in noninterest income for 2013 was a gain of \$201,000 on the sale of \$3.0 million in commercial business loans held for investment. For the comparable quarter in 2012, noninterest income included a gain of \$349,000 resulting from death benefit proceeds from a bank-owned life insurance policy, offset by a termination charge of \$212,000 (pre-tax) related to the sale of SI Trust Servicing. For the comparable six months of 2012, noninterest income included an aggregate loss of \$698,000 (pre-tax) on the sale of SI Trust Servicing, offset by an investment gain of \$355,000 from one of the Bank's small business investment company limited partnerships and the aforementioned gain of \$349,000 related to death benefit proceeds from a bank-owned life insurance policy.

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  |         | Six Months Ended |          | Change   |         |        |   |
|---|------------------------|---------|---------|---------|------------------|----------|----------|---------|--------|---|
|   | June 30, 2013          | 2012    | Dollars | Percent | June 30, 2013    | 2012     | Dollars  | Percent |        |   |
|   | (Dollars in Thousands) |         |         |         |                  |          |          |         |        |   |
| Salaries and employee benefits                    | \$4,121                | \$4,016 | \$105   | 2.6     | %                | \$8,529  | \$8,254  | \$275   | 3.3    | % |
| Occupancy and equipment                           | 1,304                  | 1,332   | (28)    | (2.1)   | )                | 2,687    | 2,818    | (131)   | (4.6)  | ) |
| Computer and electronic banking services          | 971                    | 896     | 75      | 8.4     |                  | 1,839    | 1,889    | (50)    | (2.6)  | ) |
| Outside professional services                     | 382                    | 313     | 69      | 22.0    |                  | 650      | 677      | (27)    | (4.0)  | ) |
| Marketing and advertising                         | 171                    | 220     | (49)    | (22.3)  | )                | 301      | 372      | (71)    | (19.1) | ) |
| Supplies  | 106                    | 91      | 15      | 16.5    |                  | 206      | 228      | (22)    | (9.6)  | ) |
| FDIC deposit insurance and regulatory assessments | 230                    | 220     | 10      | 4.5     |                  | 463      | 492      | (29)    | (5.9)  | ) |
| Merger expenses                                   | 209                    | —       | 209     | —       |                  | 893      | —        | 893     | —      |   |
| Other   | 715                    | 469     | 246     | 52.5    |                  | 1,222    | 1,177    | 45      | 3.8    |   |
| Total noninterest expenses                        | \$8,209                | \$7,557 | \$652   | 8.6     | %                | \$16,790 | \$15,907 | \$883   | 5.6    | % |

Noninterest expenses were higher for the three and six months ended June 30, 2013 compared to the same periods in 2012 mainly due to merger-related costs totaling \$209,000 and \$893,000 (pre-tax), respectively, which included investment banking fees and legal costs associated with the pending acquisition. Increases in salaries and benefits were attributable to higher benefit costs related to equity-based incentive plan compensation and health insurance. Costs associated with foreclosure activities increased \$136,000 and \$103,000 during the second quarter and first half of 2013, respectively, compared to the same periods in 2012. Offsetting the increase in noninterest expenses were decreases in marketing expenses and occupancy expenses related to lower costs associated with utilities, depreciation of premises and equipment and building maintenance.

Income Tax Provision. The provision for income taxes decreased \$66,000 and \$114,000 for the three and six months ended June 30, 2013, compared to the same periods in 2012. The effective tax rate for the three months ended June 30, 2013 and 2012 was 322.2% and 18.6%, respectively. The effective tax rate for the first half of 2013 and 2012 was 242.7% and 24.4%, respectively. The higher effective tax rate for 2013 related to certain nondeductible costs associated with the pending acquisition of Newport Bancorp, Inc. Contributing to the lower effective tax rate for 2012 was a tax-exempt gain on bank-owned life insurance proceeds.

### 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 June 30, 2013, cash and cash equivalents totaled \$38.5 million. Securities classified as available for sale, which provide additional sources of liquidity, totaled \$190.9 million at June 30, 2013. In addition, at June 30, 2013, the Bank had the ability to borrow \$139.8 million from the FHLB, which includes overnight lines of credit of \$10.0 million. On that date, the Bank had FHLB advances outstanding of \$93.1 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 six months ended June 30, 2013, the Bank originated \$87.2 million of loans and purchased \$40.9 million of securities and \$18.4 million of loans. For the year ended December 31, 2012, the Bank originated \$212.7 million of loans and purchased \$41.7 million of securities and \$49.8 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 \$2.8 million for the six months ended June 30, 2013. Certificates of deposit due within one year of June 30, 2013 totaled \$126.9 million, or 17.9%, of total deposits. Management believes that the amount of deposits in shorter-term certificates of deposit reflects customers' hesitancy to invest their funds in longer-term certificates of deposit due to the uncertain interest rate environment. To compensate, the Bank has increased the duration of its borrowings with the FHLB. 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 \$5.0 million during the six months ended June 30, 2013 and \$2.0 million during the year ended December 31, 2012.

The Company repurchased 553 shares of the Company's common stock at a cost of \$7,000 during the six months ended June 30, 2013 and 465,788 shares of the Company's common stock at a cost of \$5.3 million during the year ended December 31, 2012. Additional discussion about the Company's liquidity and capital resources is contained in Item 7 in the Company's 2012 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 June 30, 2013, SI Financial Group had cash and cash equivalents of \$8.9 million and available for sale securities of \$7.8 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, 2012. There were no material changes in the Company's payments due under contractual obligations between December 31, 2012 and June 30, 2013.



## Off-Balance Sheet Arrangements

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

The contractual amounts of commitments to extend credit represent the amounts of potential accounting loss should the contract be fully drawn upon, the customer defaults and the value of any existing collateral becomes worthless. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. Financial instruments whose contract amounts represent credit risk at June 30, 2013 and December 31, 2012 are as follows:

|   | June 30, 2013<br>(In Thousands) | December 31, 2012 |
|---|---------------------------------|-------------------|
| Commitments to extend credit:           |                                 |                   |
| Future loan commitments                 | \$35,784                        | \$11,123          |
| Undisbursed construction loans          | 2,868                           | 3,406             |
| Undisbursed home equity lines of credit | 24,935                          | 23,019            |
| Undisbursed commercial lines of credit  | 42,206                          | 23,842            |
| Overdraft protection lines              | 1,233                           | 1,190             |
| Standby letters of credit               | 61                              | 611               |
| Total commitments                       | \$107,087                       | \$63,191          |

Future loan commitments at June 30, 2013 and December 31, 2012 included fixed-rate loan commitments of \$22.3 million and \$10.6 million, respectively, at interest rates ranging from 2.75% to 5.41% and 2.63% to 7.00%, respectively.

The Bank is a limited partner in three SBICs. At June 30, 2013, the Bank's remaining off-balance sheet commitment for the capital investment in the SBICs was \$849,000. The Bank recognized write-downs of \$81,000 on its investment in one of the SBICs during the six months ended June 30, 2013, whereas the Bank did not recognize any write-downs during the six months ended June 30, 2012. The impaired SBIC is in a condition of capital impairment as defined in the SBA regulations. The SBA called all remaining unfunded capital commitments from limited partners during the second quarter of 2013. Additional sanctions could be imposed by the SBA, as well, including liquidating the assets of the fund. The carrying value for the impaired SBIC was \$175,000 at June 30, 2013.

For the six months ended June 30, 2013, 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 2012 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 repricing of assets and liabilities at June 30, 2013 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 Company's management generally simulates changes to net interest income using three different interest rate scenarios. The first scenario anticipates the maximum foreseeable decrease in rates over the next twelve months; management's assumption was 50 basis points. The second scenario assumed an increase in rates of 300 basis points. The third scenario represented an increase in rates of 300 basis points and incorporated assumption sensitivity stress testing for changes in (1) prepayment speeds, (2) lower interest rates on commercial real estate loans, (3) deposit migration and (4) volume of early withdrawals of certificates of deposit accounts as compared to the second scenario. The limits used are re-evaluated periodically and may be modified as appropriate. The basis point change in rates is assumed to occur evenly over the 12- and 24-month periods. The following table reflects changes in estimated net interest income for the Company at June 30, 2013.

|  | Percentage Change in Estimated<br>Net Interest Income Over |           |       |
|--|--|-----------|-------|
|  | 12 Months  | 24 Months |       |
| 50 basis point decrease in rates                                   | (3.17  | )%        | (4.25 |
| 300 basis point increase in rates                                  | (0.39  | )         | 0.10  |
| 300 basis point increase in rates w/assumption sensitivity testing | (1.95  | )         | (3.10 |

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 50 basis points or increased 300 basis points under the third scenario. Conversely, net interest income would be positively affected (within our internal guidelines) in the 24-month period if rates increased 300 basis points under the second scenario, resulting from the Company's strategy to better position the balance sheet for the anticipated increase in market interest rates. Management believes that under the current rate environment, a downward change in interest rates is unlikely. 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 June 30, 2013 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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## 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, 2012, 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 did not repurchase equity securities during the three months ended June 30, 2013. 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. The maximum number of shares that may yet be purchased under the Company's stock repurchase program are 63,715. The repurchase program will continue until it is completed or terminated by the Company's Board of Directors.

### 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 June 30, 2013, 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 (Loss) Income, (iv) the Condensed Statement of Changes in Shareholders' Equity, (v) the Condensed Consolidated Statements of Cash Flows and (vi) related Notes to Consolidated Financial Statements<sup>(3)</sup>

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

<sup>(2)</sup> Incorporated herein by reference into this document from the Exhibits to the Company's Current Report on Form 8-K (File No. 000-54241) filed with the Securities and Exchange Commission on December 19, 2012.

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

SIGNATURES

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

SI FINANCIAL GROUP, INC.

Date: August 7, 2013

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

Date: August 7, 2013

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