

Edgar Filing: UNION BANKSHARES INC - Form 10-Q

UNION BANKSHARES INC  
Form 10-Q  
August 14, 2008

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

OR

( ) TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended: June 30, 2008

Commission file number: 001-15985

UNION BANKSHARES, INC.

VERMONT 03-0283552

P.O. BOX 667  
MAIN STREET  
MORRISVILLE, VT 05661

Registrant's telephone number: 802-888-6600

Former name, former address and former fiscal year, if changed since last report: Not applicable

Securities registered pursuant to section 12(b) of the Act:

Common Stock, \$2.00 par value ----- (Title of class)	American Stock Exchange ----- (Exchanges registered on)
---	---

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes [ ] No [X]

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes [ ] No [X]

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 [ ]

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. (Check one):

Large accelerated filer [ ] Accelerated filer [ ] Non-accelerated filer [ ]  
(Do not check if a smaller reporting company) Smaller reporting company [X]

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of July 31, 2008:

Common Stock, \$2 par value 4,488,822 shares

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#### Part 1 Financial Information Item 1. Financial Statements

##### UNION BANKSHARES, INC. AND SUBSIDIARY CONSOLIDATED BALANCE SHEETS

	June 30, 2008 ----	December 31, 2007 ----
	(Unaudited)	
	(Dollars in thousands)	
<b>Assets</b>		
Cash and due from banks	\$ 12,147	\$ 12,815
Federal funds sold and overnight deposits	11,778	614
	-----	-----
Cash and cash equivalents	23,925	13,429

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Interest bearing deposits in banks	7,986	11,868
Investment securities available-for-sale	27,463	33,822
Loans held for sale	2,486	7,711
Loans	316,988	310,594
Allowance for loan losses	(3,424)	(3,378)
Unearned net loan fees	(104)	(111)
Net loans	313,460	307,105
Accrued interest receivable	1,748	2,077
Premises and equipment, net	7,068	6,462
Other assets	11,422	10,887
Total assets	\$395,558	\$393,361
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Noninterest bearing	\$ 55,203	\$ 56,155
Interest bearing	265,563	267,806
Total deposits	320,766	323,961
Borrowed funds	27,855	20,328
Accrued interest and other liabilities	5,175	6,998
Total liabilities	353,796	351,287
Commitments and Contingencies		
Stockholders' Equity		
Common stock, \$2.00 par value; 7,500,000 shares authorized at 6/30/08 and 12/31/07; 4,921,786 shares issued at 6/30/08 and 12/31/07	9,844	9,844
Paid-in capital	205	202
Retained earnings	35,870	35,791
Treasury stock at cost; 432,964 shares at 6/30/08 and 418,817 at 12/31/07	(3,220)	(2,939)
Accumulated other comprehensive loss	(937)	(824)
Total stockholders' equity	41,762	42,074
Total liabilities and stockholders' equity	\$395,558	\$393,361

The accompanying notes are an integral part of these unaudited consolidated financial statements.

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	Three Months Ended June 30,		S
	2008	2007	2
	----	----	-
	(Dollars in thousands except		
Interest income			
Interest and fees on loans	\$ 5,594	\$ 5,944	\$ 1
Interest on debt securities			
Taxable	270	256	
Tax exempt	81	50	
Dividends	17	27	
Interest on federal funds sold and overnight deposits	28	77	
Interest on interest bearing deposits in banks	105	122	
	-----	-----	-----
Total interest income	6,095	6,476	1
	-----	-----	-----
Interest expense			
Interest on deposits	1,481	1,880	
Interest on borrowed funds	296	179	
	-----	-----	-----
Total interest expense	1,777	2,059	
	-----	-----	-----
Net interest income	4,318	4,417	
Provision for loan losses	90	-	
	-----	-----	-----
Net interest income after provision for loan losses	4,228	4,417	
	-----	-----	-----
Noninterest income			
Trust income	100	83	
Service fees	897	854	
Net gain on sales of investment securities available-for-sale	16	47	
Net gain on sales of loans held for sale	14	23	
Other income	139	108	
	-----	-----	-----
Total noninterest income	1,166	1,115	
	-----	-----	-----
Noninterest expense			
Salaries and wages	1,604	1,549	
Pension and employee benefits	706	520	
Occupancy expense, net	223	214	
Equipment expense	317	281	
Other expenses	1,076	977	
	-----	-----	-----
Total noninterest expense	3,926	3,541	
	-----	-----	-----
Income before provision for income taxes	1,468	1,991	
Provision for income taxes	278	505	
	-----	-----	-----
Net income	\$ 1,190	\$ 1,486	\$
	=====	=====	=====
Earnings per common share	\$ 0.27	\$ 0.33	\$
	=====	=====	=====

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Weighted average number of common shares outstanding	4,490,635	4,529,158	4,49
	=====	=====	=====
Dividends per common share	\$ 0.28	\$ 0.28	
	=====	=====	=====

The accompanying notes are an integral part of these unaudited consolidated financial statements.

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UNION BANKSHARES, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY  
(Unaudited)

	Common Stock				
	Shares, net of Treasury	Amount	Paid-in capital	Retained earnings	Treasury stock
	-----	-----	-----	-----	-----
	(Dollars in thousands)				
Balances, December 31, 2007	4,502,969	\$9,844	\$202	\$35,791	\$(2,939)
Comprehensive income:					
Net income	-	-	-	2,596	-
Other comprehensive income, net of tax:					
Change in net unrealized gain (loss) on investment securities available-for-sale, net of reclassification adjustment and tax effects	-	-	-	-	-
Change in net unrealized gain (loss) on unfunded defined benefit plan liability, net of reclassification adjustment and tax effects	-	-	-	-	-
Total other comprehensive income					
Total comprehensive income					
Cash dividends declared (\$0.56 per share)	-	-	-	(2,517)	-
Issuance of stock options	-	-	3	-	-
Purchase of treasury stock	(14,147)	-	-	-	(281)
	-----	-----	-----	-----	-----
Balances, June 30, 2008	4,488,822	\$9,844	\$205	\$35,870	\$(3,220)

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The accompanying notes are an integral part of these unaudited consolidated financial statements.

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UNION BANKSHARES, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

	Six Months Ended	
	June 30, 2008	June 30, 2007
	-----	-----
	(Dollars in thousands)	
Cash Flows From Operating Activities		
Net Income	\$ 2,596	\$ 2,721
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation	388	380
Provision for loan losses	140	45
Credit for deferred income taxes	(80)	(170)
Net amortization of investment securities available-for-sale	2	7
Equity in losses of limited partnerships	194	133
Issuance of stock options	3	5
Write-down of impaired assets	6	-
Write-downs of other real estate owned	11	48
Decrease in unamortized loan fees	(8)	(12)
Proceeds from sales of loans held for sale	13,023	9,297
Origination of loans held for sale	(7,626)	(8,663)
Net gain on sales of loans held for sale	(172)	(50)
Net gain on sales of investment securities available-for-sale	(16)	(37)
Net loss on disposals of premises and equipment	50	-
Net loss (gain) on sales of repossessed property	2	(4)
Net gain on sales of other real estate owned	(1)	(28)
Decrease (increase) in accrued interest receivable	316	(167)
Decrease (increase) in other assets	324	(76)
(Decrease) increase in income taxes	(366)	47
Decrease in accrued interest payable	(501)	(58)
Increase in other liabilities	404	874
	-----	-----
Net cash provided by operating activities	8,689	4,292
	-----	-----
Cash Flows From Investing Activities		
Interest bearing deposits in banks		
Maturities and redemptions	5,654	395
Purchases	(1,772)	(5,417)
Investment securities available-for-sale		
Sales	1,803	501
Maturities, calls and paydowns	5,406	1,250
Purchases	(1,025)	(4,982)
Net (purchase) redemption of Federal Home Loan Bank stock	(526)	82
Net (increase) decrease in loans	(7,435)	10,254
Recoveries of loans charged off	30	27
Purchases of premises and equipment	(1,044)	(396)

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Investments in limited partnerships (1,129) (356)

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	Six Months Ended	
	June 30, 2008	June 30, 2007
	-----	-----
	(Dollars in thousands)	
Proceeds from sales of other real estate owned	265	23
Proceeds from sales of premises and equipment	-	23
Proceeds from sales of repossessed property	46	23
	-----	-----
Net cash provided by investing activities	273	1,427
	-----	-----
<b>Cash Flows From Financing Activities</b>		
Net increase in borrowings outstanding	7,527	4,326
Net decrease in noninterest bearing deposits	(952)	(7,931)
Net decrease in interest bearing deposits	(2,243)	(3,026)
Purchase of treasury stock	(281)	(243)
Dividends paid	(2,517)	(2,538)
	-----	-----
Net cash provided by (used in) financing activities	1,534	(9,412)
	-----	-----
Net increase (decrease) in cash and cash equivalents	10,496	(3,693)
Cash and cash equivalents		
Beginning	13,429	20,957
	-----	-----
Ending	23,925	\$17,264
	=====	=====
<b>Supplemental Disclosures of Cash Flow Information</b>		
Interest paid	\$ 4,201	\$ 4,092
	=====	=====
Income taxes paid	\$ 900	\$ 1,035
	=====	=====
<b>Supplemental Schedule of Noncash Investing and Financing Activities</b>		
Change in unrealized losses on investment securities available-for-sale	\$ (189)	\$ (261)
	=====	=====
Change in unrealized loss on unfunded defined benefit pension plan liability	\$ 17	\$ -
	=====	=====
Other real estate acquired in settlement of loans	\$ 1,047	\$ 197
	=====	=====

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Reposessed property acquired in settlement of loans	\$ 79 =====	\$ 20 =====
Investment in limited partnerships acquired by capital contributions payable	\$ - =====	\$ 902 =====
Loans originated to finance the sale of other real estate owned	\$ 214 =====	\$ 115 =====

The accompanying notes are an integral part of these unaudited consolidated financial statements.

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UNION BANKSHARES, INC. AND SUBSIDIARY

Note 1. Basis of Presentation

The accompanying interim unaudited consolidated financial statements of Union Bankshares, Inc. (the Company) as of June 30, 2008 and 2007, and for the three and six months then ended have been prepared in conformity with U.S. generally accepted accounting principles (GAAP), general practices within the banking industry, and the accounting policies described in the Company's Annual Report to Shareholders and Annual Report on Form 10-K for the year ended December 31, 2007. In the opinion of Company's management, all adjustments, consisting only of normal recurring adjustments and disclosures necessary for a fair presentation of the information contained herein have been made. This information should be read in conjunction with the Company's 2007 Annual Report to Shareholders, 2007 Annual Report on Form 10-K, and current reports on Form 8-K. The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the full fiscal year ending December 31, 2008, or any other interim period.

Certain amounts in the 2007 unaudited consolidated financial statements have been reclassified to conform to the 2008 presentation.

Note 2. Commitments and Contingencies

In the normal course of business, the Company is involved in various legal proceedings. In the opinion of management, any liability resulting from such proceedings would not have a material adverse effect on the Company's financial condition or results of operations.

Note 3. Per Share Information

Earnings per common share amounts are computed based on the weighted average number of shares of common stock outstanding during the period and reduced for shares held in treasury. The assumed conversion of available outstanding stock options does not result in material dilution.

Note 4. Recent Accounting Pronouncements

In June, 2008 the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 163, "Accounting for Financial Guarantee Insurance Contracts an interpretation of FASB Statement No. 60. This Statement requires that an insurance enterprise recognize a claim liability prior to an event of default (insured event) when there is evidence that credit deterioration has occurred in an insured financial obligation. This Statement also clarifies how Statement 60 applies to financial guarantee insurance contracts, including recognition and measurement to be used to account for premium revenue and claim liabilities. This Statement is effective for financial statements issued for fiscal years beginning after December 15, 2008, and all interim periods within those fiscal years, except for some disclosures about the insurance enterprise's risk-management activities. This Statement



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requires that disclosures about the risk-management activities of the insurance enterprise be effective for the first period (including interim periods) beginning after issuance of this Statement. Except for those disclosures, earlier application is not permitted. This Statement is not expected to have any impact on the consolidated financial statements of the Company as it does not issue any financial guarantee insurance contracts.

In May, 2008, the FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles." This Statement identifies the sources of accounting principles and the framework for selecting the principles to be used in the preparation of financial statements of nongovernmental entities that are presented in conformity with GAAP in the United States. The Statement is effective 60 days following the Securities and Exchange Commission's (SEC) approval of the Public Company Accounting Oversight Board amendments to AU Section 411, "The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles." Neither the FASB or the Company expects that this Statement will result in a change in current practice. However, transition provisions have been provided if the application of the Statement results in a change in practice. The Company is evaluating whether or not this Statement will result in a change in practice.

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In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133". The objective of this Statement is to amend and expand the disclosure requirements of Statement 133 with the intent to provide users of financial statements with an enhanced understanding of: a) how and why an entity uses derivative instruments, b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The Statement requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk related contingent features in derivative agreements. The statement is effective for financial statements issued for fiscal years beginning after November 15, 2008 with earlier adoption encouraged. The Company is in the process of evaluating the impact of this statement on the disclosures in its financial statements but it is not expected to have a material impact.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements - an amendment of Accounting Research Bulletin No.51". The objective of this Statement is to improve the relevance, comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing accounting and reporting standards that require specific financial statement disclosure, consistent accounting treatment for changes in a parent's ownership interest and fair value measurement on the deconsolidation of a subsidiary. The Statement applies to all entities that prepare consolidated financial statements but will affect only those entities that have an outstanding noncontrolling interest in one or more subsidiaries or that deconsolidate a subsidiary. The Statement is effective for fiscal years and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company has no noncontrolling interests in a subsidiary and therefore does not expect there to be any impact on the consolidated financial statements.

In December 2007, the FASB issued Statement No. 141R, (revised) "Business Combinations" which replaces Statement No. 141. The objective of this Statement is to improve the relevance, representational faithfulness, and comparability

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of the information that a reporting entity provides in its financial reports about a business combination and its effects. To accomplish that, this Statement establishes principles and requirements for how the acquirer: (1) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree, (2) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and (3) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The Statement shall be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Earlier application is prohibited. This Statement would affect the Company for any acquisitions after December 31, 2008.

In November 2007, the SEC issued SAB No. 109, "Written Loan Commitments Recorded at Fair Value Through Earnings". SAB No 109 supersedes SAB 105, "Application of Accounting Principles to Loan Commitments," and indicates that the expected net future cash flows from loan servicing should be included in the measurement of all associated written loan commitments that are accounted for at fair value through earnings under SFAS No. 159's fair-value election or for written mortgage loan commitments for loans that will be held-for-sale when funded that are marked-to-market as derivatives under SFAS No. 133 (derivative loan commitments). The guidance in SAB No. 109 is applied on a prospective basis to derivative loan commitments issued or modified in fiscal quarters beginning after December 15, 2007. SAB No. 109 was adopted by the Company on January 1, 2008 and did not have a material impact on the Company's consolidated financial statements.

### Note 5. Defined Benefit Pension Plan

Union Bank (Union), the Company's sole subsidiary, sponsors a noncontributory defined benefit pension plan covering all eligible employees. The plan provides defined benefits based on years of service and final average salary.

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Net periodic pension benefit cost for the three and six months ended June 30, consisted of the following components:

	Three Months Ended		Six Months Ended	
	2008	2007	2008	2007
	----	----	----	----
	(Dollars in thousands)			
Service cost	\$ 136	\$ 127	\$ 272	\$ 259
Interest cost on projected benefit obligation	168	154	335	302
Expected return on plan assets	(164)	(151)	(329)	(301)
Amortization of prior service cost	1	1	3	3
Amortization of net loss	7	5	14	10
	-----	-----	-----	-----
Net periodic benefit cost	\$ 148	\$ 136	\$ 295	\$ 273
	=====	=====	=====	=====

There were actuarial assumption changes between the first and second quarters of 2007 and the first and second quarters of 2008 as SFAS No. 87, Employers' Accounting for Pensions states that measurements are based on the assumptions used for the previous year-end measurements unless more recent measurements of

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both plan assets and obligations are available, or a significant event occurs. Therefore, 2008 net periodic benefit costs are based on December 31, 2007 actuarial assumptions while the 2007 costs are based on December 31, 2006 actuarial assumptions.

### Note 6. Other Comprehensive Income (Loss)

The components of accumulated other comprehensive loss, net of tax at June 30, were:

	2008	2007
	----	----
	(Dollars in thousands)	
Net unrealized loss on investment securities available-for-sale	\$(125)	\$ (326)
Defined benefit pension plan:		
Net unrealized actuarial loss	(791)	(822)
Net unrealized prior service cost	(21)	(27)
	-----	-----
Total	\$(937)	\$(1,175)
	=====	=====

The following is a summary of changes in other comprehensive income (loss) for the three and six months ended June 30:

	Three Months Ended		Six Months Ended	
	2008	2007	2008	2007
	----	----	----	----
	(Dollars in thousands)			
Investment securities available-for-sale:				
Change in net unrealized losses on investment securities available-for-sale	\$(465)	\$(362)	\$(172)	\$(224)
Reclassification adjustment for gains realized in income	(16)	(47)	(16)	(37)
	-----	-----	-----	-----
Net unrealized losses	(481)	(409)	(188)	(261)
Tax effect	(164)	(139)	(64)	(89)
	-----	-----	-----	-----
Net of tax amount	\$(317)	\$(270)	\$(124)	\$(172)
	-----	-----	-----	-----
Defined benefit pension plan:				
Reclassification adjustment for amortization of net actuarial loss, realized in net income	\$ 7	\$ -	\$ 14	\$ -
Reclassification adjustment for amortization of prior service cost, realized in net income	1	-	3	-
	-----	-----	-----	-----
Total	8	-	17	-
Tax effect	3	-	6	-
	-----	-----	-----	-----
Net of tax amount	\$ 5	\$ -	\$ 11	\$ -
	-----	-----	-----	-----
Total, net of tax	\$(312)	\$(270)	\$(113)	\$(172)
	=====	=====	=====	=====

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### Note 7: Fair Value Measurements

The FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities." This Statement generally permits the measurement of selected eligible financial instruments at fair value at specified election dates. SFAS No. 157, "Fair Value Measurements", generally establishes the definition of fair value expands disclosures about fair value measurement and establishes a hierarchy of the levels of fair value measurement techniques. SFAS 157 and SFAS 159 are effective for fiscal years beginning after November 15, 2007. Effective January 1, 2008, the Company adopted SFAS 159 and SFAS 157, but has not elected to apply the fair value option to any financial assets or liabilities other than those situations where other accounting pronouncements require fair value measurements. In accordance with FASB Staff Position No. 157-2, "Effective Date of FASB Statement No. 157," the Company has delayed the application of SFAS No. 157 to nonfinancial assets and nonfinancial liabilities until January 1, 2009. Management does not anticipate that such application will have a material effect on the financial position of the Company.

Under SFAS No. 157, the three levels of the fair value hierarchy are:

- o Level 1 - Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;
- o Level 2 - Quoted prices for similar assets or liabilities in active markets, quoted prices in markets that are not active, or inputs that are observable, either directly or indirectly, for substantially the full term of the asset or liability;
- o Level 3 - Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e. supported by little or no market activity).

A financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

The following table presents the fair value measurements of assets recognized in the accompanying balance sheet measured at fair value on a recurring basis and the level within the SFAS No. 157 fair value hierarchy in which the fair value measurements fall at June 30, 2008:

	Fair Value Measurements at Reporting Date (Dollars in Thousands)		
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)
Investment securities available-for-sale	\$ 27,463	\$ 9,357	\$ 18,106

Fair values for available for sale securities are estimated by an independent bond pricing service for identical assets or significantly similar securities. The pricing service uses a variety of techniques to arrive at fair value including market maker bids, quotes and pricing models. Inputs to the pricing models include recent trades, benchmark interest rates, spreads and actual and projected cash flows. Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value in the aggregate. The fair value of loans held for sale is determined, when possible,

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using quoted secondary market prices. If no such quoted price exists, the fair value of a loan is determined using quoted prices for similar asset or assets, adjusted for the specific attributes of that loan. As of June 30, 2008 the carrying amount of loans held for sale was at cost and therefore no fair value disclosure is included on these loans in the table above.

Certain financial assets and financial liabilities are measured at fair value on a nonrecurring basis, that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). Financial assets and financial liabilities measured at fair value on a non-recurring basis were not significant at June 30, 2008.

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### 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

##### GENERAL

The following discussion and analysis by management focuses on those factors that had a material effect on Union Bankshares, Inc.'s (Company's) financial position as of June 30, 2008, and as of December 31, 2007, and its results of operations for the three and six months ended June 30, 2008 and 2007. This discussion is being presented to provide a narrative explanation of the financial statements and should be read in conjunction with the consolidated financial statements and related notes and with other financial data appearing elsewhere in this filing and with the Company's Annual Report on Form 10-K for the year ended December 31, 2007. In the opinion of the Company's management, the interim unaudited data reflects all adjustments, consisting only of normal recurring adjustments, and disclosures necessary to fairly present the Company's consolidated financial position and results of operations for the interim period. Management is not aware of the occurrence of any events after June 30, 2008, which would materially affect the information presented.

##### CAUTIONARY ADVICE ABOUT FORWARD LOOKING STATEMENTS

The Company may from time to time make written or oral statements that are considered "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Forward-looking statements may include financial projections, statements of plans and objectives for future operations, estimates of future economic performance and assumptions relating thereto. The Company may include forward-looking statements in its filings with the Securities and Exchange Commission (SEC), in its reports to stockholders, including this Quarterly Report, in press releases, other written materials, and in statements made by senior management to analysts, rating agencies, institutional investors, representatives of the media and others.

Forward-looking statements reflect management's current expectations and are subject to uncertainties, both general and specific, and risk exists that those predictions, forecasts, projections and other estimates contained in forward-looking statements will not be achieved. When management uses any of the words "believes," "expects," "anticipates," "intends," "plans," "seeks," "estimates", or similar expressions, they are making forward-looking statements. Many possible events or factors, including those beyond the control of management, could affect the future financial results and performance of the Company. This could cause results or performance to differ materially from

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those expressed in forward-looking statements. The possible events or factors that might affect forward-looking statements include, but are not limited to, the following:

- o uses of monetary, fiscal, and tax policy by various governments;
- o political, legislative, or regulatory developments in Vermont, New Hampshire, or the United States including changes in laws concerning accounting, taxes, financial reporting, banking, and other aspects of the financial services industry;
- o developments in general economic or business conditions nationally, in Vermont, or in northern New Hampshire, including interest rate fluctuations, market fluctuations and perceptions, job creation and unemployment rates, ability to attract new business, and inflation and the effects of such changes on the Company or its customers;
- o changes in the competitive environment for financial services organizations, including increased competition from tax-advantaged credit unions, mutual banks and out-of-market competitors offering financial services over the internet;
- o the Company's ability to attract and retain key personnel;
- o adverse changes in the local real estate market, which negatively impacts collateral values and the Company's ability to recoup loan losses through disposition of real estate collateral;
- o changes in technology, including demands for greater automation which could present operational issues or significant capital outlays;

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- o acts or threats of terrorism or war, and actions taken by the United States or other governments that might adversely affect business or economic conditions for the Company or its customers;
- o adverse changes in the securities market generally or in the market for financial institution securities which could adversely affect the value of the Company's stock;
- o any actual or alleged conduct which could harm the Company's reputation;
- o natural or other disasters which could affect the ability of the Company to operate under normal conditions;
- o the Company's ability to retain and attract deposits and loans;
- o illegal acts of theft or fraud perpetuated against the Company's subsidiary bank or its customers;
- o unanticipated lower revenues or increased cost of funds, loss of customers or business, or higher operating expenses;
- o the failure of assumptions underlying the establishment of the allowance for loan losses and estimations of values of collateral and various financial assets and liabilities;
- o the amount invested in new business opportunities and the timing of these investments;
- o the failure of actuarial, investment, work force, salary, and other assumptions underlying the establishment of reserves for future pension costs or changes in legislative or regulatory requirements;
- o future cash requirements might be higher than anticipated due to loan commitments or unused lines of credit being drawn upon or depositors withdrawing their funds;
- o assumptions made regarding interest rate movement and sensitivity could vary substantially if actual experience differs from historical experience which could adversely affect the Company's results of operations; and
- o the creditworthiness of current loan customers is different from management's understanding or changes dramatically and therefore the allowance for loan losses becomes inadequate.

When evaluating forward-looking statements to make decisions with respect to

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the Company, investors and others are cautioned to consider these and other risks and uncertainties and are reminded not to place undue reliance on such statements. Forward-looking statements speak only as of the date they are made and the Company undertakes no obligation to update them to reflect new or changed information or events, except as may be required by federal securities laws.

### CRITICAL ACCOUNTING POLICIES

The Company has established various accounting policies which govern the application of accounting principles generally accepted in the United States of America in the preparation of the Company's financial statements. Certain accounting policies involve significant judgments and assumptions by management which have a material impact on the reported amount of assets, liabilities, revenues and expenses and related disclosures of contingent assets and liabilities in the consolidated financial statements and accompanying notes. The SEC has defined a company's critical accounting policies as the ones that are most important to the portrayal of the company's financial condition and results of operations, and which require the company to make its most difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Based on this definition, the Company has identified the accounting policies and judgments most critical to the Company. The judgments and assumptions used by management are based on historical experience and other factors, which are believed to be reasonable under the circumstances. Because of the nature of the judgments and assumptions made by management, actual results could differ from estimates and have a material impact on the carrying value of assets, liabilities, or the results of operations of the Company.

The Company believes the allowance for loan losses is a critical accounting policy that requires the most significant judgments and estimates used in the preparation of its consolidated financial statements. In estimating the allowance for loan losses, management utilizes historical experience as well as other factors including the effect of changes in the local real estate market on collateral values, the effect on the loan portfolio of current economic indicators and their probable impact on borrowers and changes in delinquent, nonperforming or impaired loans. Changes in these factors may cause management's estimate of the allowance for loan losses to increase or decrease and result in adjustments to the Company's provision for loan losses in future periods. For additional information see, FINANCIAL CONDITION - Allowance for Loan Losses below.

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The Company's pension benefit obligations and net periodic benefit cost are actuarially determined based on the following assumptions: discount rate, estimated future return on plan assets, wage base rate, anticipated mortality rates, Consumer Price Index rate, and rate of increase in compensation levels. The determination of the pension benefit obligations and net periodic benefit cost is a critical accounting estimate as it requires the use of estimates and judgment related to the amount and timing of expected future cash out flows for benefit payments and cash in flows for maturities and returns on plan assets. Changes in estimates and assumptions could have a material impact to the Company's financial condition or results of operations.

The Company also has other key accounting policies, which involve the use of estimates, judgments and assumptions that are significant to understanding the results including the valuation of deferred tax assets and of investment securities. Although management believes that its estimates, assumptions and judgments are reasonable, they are based upon information presently available. Actual results may differ significantly from these estimates under different

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assumptions, judgments or conditions.

### OVERVIEW

The Company's net income was \$1.2 million for the quarter ended June 30, 2008, compared with net income of \$1.5 million for the same period in 2007, or a \$296 thousand or 19.9% decrease between years. The decrease was the cumulative result of a drop in net interest income of \$99 thousand, a loan loss provision of \$90 thousand for the second quarter of 2008 compared to \$0 for the same period in 2007 and increases in all categories of noninterest expense totaling \$385 thousand. These increases were partially offset by a \$51 thousand increase in noninterest income and a \$227 decrease in the provision for income taxes. The decrease in the provision for income taxes was partially a result of the reduced taxable income and partially a result of \$39 thousand in low income and rehabilitation federal tax credits booked during the second quarter of 2008 on a late 2007 investment in a low income housing project. The Company faced a challenging interest rate environment as the prime rate had been reduced seven times since September 2007 from 8.25% to 5.00% on April 30, 2008. Total interest income decreased by \$381 thousand, or 5.9% to \$6.1 million in 2008 versus the \$6.5 million in the second quarter of 2007, while the decrease in interest expense from \$2.1 million in 2007 to \$1.8 million in 2008 was only \$282 thousand, or 13.7% between periods. The result of the changes in interest income and expense was that net interest income for the second quarter of 2008 was \$4.3 million, down \$99 thousand or 2.2% from the second quarter of 2007 of \$4.4 million. During the second quarter of 2008, the Company's net interest margin decreased 31 basis points to 4.83%, from 5.14% for the second quarter of 2007. The Company's net interest spread declined 24 basis points to 4.38% for the second quarter of 2008, compared to 4.59% for the same period last year. The decline in the net interest spread was primarily the result of the decline in average interest rates earned on loans as the 325 basis point drop in the prime rate between the second quarter of 2007 and the second quarter of 2008 had an effect on the repricing of adjustable rate loans and the volume of refinancings, as customers took advantage of the lower rates. Further drops in the prime rate and/or increases in competitors deposit rates could be problematic going forward as the individual instruments re-price.

The Company's total assets increased slightly from \$393.4 million at December 31, 2007, to \$395.6 million at June 30, 2008, an increase of \$2.2 million, or 0.6% despite the seasonal payoff on June 30, 2008 of \$9.5 million in municipal loans. Deposits decreased from \$324.0 million at December 31, 2007 to \$320.8 million at June 30, 2008, a decrease of \$3.2 million, or 1.0%. This decrease reflects a normal seasonal trend for the Company, exacerbated by the redemption of \$10.3 million of municipal certificates of deposit on June 30, 2008, as municipalities comply with state law requirements for short term funding. Total loans including loans held for sale increased \$1.2 million or 0.4% from \$318.3 million at December 31, 2007 to \$319.5 million at June 30, 2008. This increase would have been much larger except for the one day municipal loan aberration as loan demand has been strong due to lower interest rates, a changing competitive environment due to the sale of a number of our competitors, and a recent good winter season in northern Vermont and New Hampshire.

There was no provision for loan losses during the second quarter of 2007 versus a \$90 thousand provision for the second quarter of 2008. The increase in the provision for the quarter is mainly due to growth in the loan portfolio, as classified loans decreased between quarters. Total loans have shown

strong growth of \$12.9 million or 4.2% since June 30, 2007 with the majority of the growth being in the commercial real estate portfolio, while municipal loans, which have a very low reserve factor, have dropped \$2.1 million. Loans



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past due 30-89 days have declined from a year ago but nonperforming loans have risen from \$3.5 million to \$7.7 million in that same timeframe. Two million of the \$7.7 million have guarantees of the U.S. Government or state agencies in place. In addition to the loans that have government guarantees, the balance of the non-performing loans are comprised of two large customer relationships which are both conservatively secured by real estate. See Asset Quality Section on page 26 for further details.

Noninterest expenses are up \$385 thousand, or 10.9% for the second quarter of 2008 to \$3.9 million from \$3.6 million for the second quarter of 2007, primarily due to the costs of health care which was \$152 thousand higher for the second quarter of 2008 than the second quarter of 2007, an increase in salary expense of \$55 thousand due primarily to hiring associated with the planned third quarter 2008 addition of two branches, and the increase in retirement benefit expense accrual of \$36 thousand as interest rates and the stock market have decreased during 2008 thereby increasing the Company's expense. The Company took a \$25 thousand write off to expense the net book value of the Company's reader/sorter and related software as the Company no longer utilizes those items since the implementation of electronic branch capture.

The following unaudited per share information and key ratios depict several measurements of performance or financial condition for or at the three and six months ended June 30, 2008 and 2007, respectively:

	Three Months Ended June 30,		Six Mon
	2008	2007	2008
Return on average assets (ROA) (1)	1.20%	1.57%	1.3
Return on average equity (ROE) (1)	11.33%	14.31%	12.3
Net interest margin (1)(2)	4.83%	5.14%	4.9
Efficiency ratio (3)	70.37%	63.48%	69.6
Net interest spread (4)	4.38%	4.59%	4.4
Loan to deposit ratio	99.60%	99.25%	99.6
Net loan charge-offs to average loans not held for sale (1)	0.08%	0.02%	0.0
Allowance for loan losses to loans not held for sale	1.08%	1.10%	1.0
Non-performing assets to total assets	2.16%	1.05%	2.1
Equity to assets	10.56%	11.10%	10.5
Total capital to risk weighted assets	16.55%	17.20%	16.5
Book value per share	\$9.30	\$9.22	\$9.
Earnings per share	\$0.27	\$0.33	\$0.
Dividends paid per share	\$0.28	\$0.28	\$0.
Dividend payout ratio (5)	103.70%	84.85%	96.5

- 
- (1) Annualized
  - (2) The ratio of tax equivalent net interest income to average earning assets.
  - (3) The ratio of noninterest expense to tax equivalent net interest income and noninterest income, securities gains and losses.
  - (4) The difference between the average rate earned on assets minus the average rate paid on liabilities.
  - (5) Cash dividends declared and paid per share divided by consolidated net income per share.

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## RESULTS OF OPERATIONS

Net Interest Income. The largest component of the Company's operating income is net interest income, which is the difference between interest and dividend income received from interest-earning assets and the interest expense paid on interest-bearing liabilities. The Company's net interest income decreased \$99 thousand, or 2.2%, to \$4.3 million for the three months ended June 30, 2008, from \$4.4 million for the three months ended June 30, 2007. The net interest spread decreased 21 basis points to 4.38% for the three months ended June 30, 2008, from 4.59% for the three months ended June 30, 2007. The decline in the net interest spread was primarily the result of the drop in average interest rates earned on loans as the 325 basis point drop in the prime rate from September 2007 to April 2008 had an effect on the repricing of adjustable rate loans as well as on the volume of refinancing activity as customers took advantage of the lower rates. The adverse effect of declining rates on the Company's net interest spread was mitigated somewhat by a 52 basis point decline in the rate paid on deposits in the second quarter of 2008 versus the same period last year. The net interest margin for the second quarter of 2008 decreased 31 basis points to 4.83% from the 2007 period at 5.14%. Further decrease in the prime rate would not necessarily be beneficial to the Company in the near term, especially if funding rates did not follow a similar downward trend. See "OTHER FINANCIAL CONSIDERATIONS - Market Risk and Asset and Liability Management."

Yields Earned and Rates Paid. The following table shows, for the periods indicated, the total amount of income recorded from average interest-earning assets and the related average yields, the interest expense associated with average interest-bearing liabilities, the related average rates paid, and the relative net interest spread and net interest margin. Yield and rate information is calculated on an annualized tax equivalent basis. Yield and rate information for a period is average information for the period, and is calculated by dividing the annualized tax equivalent income or expense item for the period by the average balance of the appropriate balance sheet item during the period. Net interest margin is annualized tax equivalent net interest income divided by average interest-earning assets. Nonaccrual loans are included in asset balances for the appropriate periods, but recognition of interest on such loans is discontinued and any remaining accrued interest receivable is reversed in conformity with federal regulations.

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	Three months ended June 30		
	2008		
Average Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Balance
(Dollars in thousands)			
<b>Average Assets:</b>			
Federal funds sold and overnight deposits	\$ 5,624	\$ 28	1.97%
Interest bearing deposits in banks	8,734	105	4.84%
Investment securities (1), (2)	29,470	352	5.24%
Loans, net (1), (3)	322,887	5,594	7.06%
FHLB of Boston stock	1,857	16	3.40%

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Total interest-earning assets (1)	368,572	6,095	6.76%	352,185
Cash and due from banks	9,868			9,969
Premises and equipment	6,891			6,114
Other assets	10,784			9,422
	-----			-----
Total assets	\$396,115			\$377,690
	=====			=====
Average Liabilities and Stockholders' Equity:				
NOW accounts	\$ 54,167	\$ 76	0.56%	\$ 52,848
Savings/money market accounts	91,529	302	1.33%	93,537
Time deposits	126,098	1,103	3.52%	123,720
Borrowed funds	27,330	296	4.29%	14,455
	-----	-----	----	-----
Total interest bearing liabilities	299,124	1,777	2.38%	284,560
Noninterest bearing deposits	49,175			45,499
Other liabilities	5,806			6,098
	-----			-----
Total liabilities	354,105			336,157
Stockholders' equity	42,010			41,533
	-----			-----
Total liabilities and stockholders' equity	\$396,115			\$377,690
	=====			=====
Net interest income		\$4,318		
		=====		
Net interest spread (1)			4.38%	
			=====	
Net interest margin (1)			4.83%	
			=====	

- 
- (1) Average yields reported on a tax-equivalent basis.
  - (2) Average balances of investment securities are calculated on the amortized cost basis.
  - (3) Includes loans held for sale and is net of unearned income and allowance for loan losses.

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	Six months ended June 30,			
	2008			
	Average	Interest	Average	Average
	Balance	Earned/ Paid	Yield/ Rate	Balance
	-----	-----	-----	-----
	(Dollars in thousands)			
Average Assets:				
Federal funds sold and overnight deposits	\$ 5,013	\$ 59	2.36%	\$ 6,920
Interest bearing deposits in banks	9,472	231	4.93%	8,583
Investment securities (1), (2)	31,330	753	5.25%	25,884

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Loans, net (1), (3)	317,452	11,279	7.26%	308,599
FHLB of Boston stock	1,731	37	4.25%	1,395
	-----	-----	-----	-----
Total interest-earning assets (1)	364,998	12,359	6.94%	351,381
Cash and due from banks	9,892			10,184
Premises and equipment	6,860			6,093
Other assets	11,046			9,140
	-----			-----
Total assets	\$392,796			\$376,798
	=====			=====
Average Liabilities and Stockholders' Equity:				
NOW accounts	\$ 53,168	\$ 161	0.61%	\$ 51,608
Savings/money market accounts	90,021	637	1.43%	94,216
Time deposits	125,244	2,339	3.77%	121,244
Borrowed funds	25,835	564	4.34%	14,909
	-----	-----	-----	-----
Total interest bearing liabilities	294,268	3,701	2.53%	281,977
Noninterest bearing deposits	50,210			47,480
Other liabilities	6,168			5,728
	-----			-----
Total liabilities	350,646			335,185
Stockholders' equity	42,150			41,613
	-----			-----
Total liabilities and stockholders' equity	\$392,796			\$376,798
	=====			=====
Net interest income		\$ 8,658		
		=====		
Net interest spread (1)			4.41%	
			=====	
Net interest margin (1)			4.90%	
			=====	

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- (1) Average yields reported on a tax-equivalent basis.
- (2) Average balances of investment securities are calculated on the amortized cost basis.
- (3) Includes loans held for sale and is net of unearned income and allowance for loan losses.

Rate/Volume Analysis. The following table describes the extent to which changes in average interest rates and changes in volume of average interest earning assets and interest bearing liabilities have affected the Company's interest income and interest expense during the period indicated. For each category of interest earning assets and interest bearing liabilities information is provided on changes attributable to:

- o changes in volume (change in volume multiplied by prior rate);
- o changes in rate (change in rate multiplied by prior volume); and
- o total change in rate and volume.

Changes attributable to both rate and volume have been allocated

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proportionately to the change due to volume and the change due to rate.

Three Months Ended June 30, 2008  
Compared to  
Three Months Ended June 30, 2007  
Increase/(Decrease) Due to Change In

	Volume	Rate	Net
	-----	----	---
	(Dollars in thousands)		
Interest earning assets:			
Federal funds sold and overnight deposits	\$ (2)	\$ (47)	\$ (49)
Interest bearing deposits in banks	(19)	2	(17)
Investment securities	24	18	42
Loans, net	281	(631)	(350)
FHLB of Boston stock	6	(13)	(7)
	-----	-----	-----
Total interest earning assets	\$ 290	\$ (671)	\$ (381)
	-----	-----	-----
Interest bearing liabilities:			
NOW accounts	\$ 3	\$ (35)	\$ (32)
Savings/money market accounts	(9)	(105)	(114)
Time deposits	26	(279)	(253)
Borrowed funds	143	(26)	117
	-----	-----	-----
Total interest bearing liabilities	\$ 163	\$ (445)	\$ (282)
	-----	-----	-----
Net change in net interest income	\$ 127	\$ (226)	\$ (99)
	-----	-----	-----

Six Months Ended June 30, 2008  
Compared to  
Six Months Ended June 30, 2007  
Increase/(Decrease) Due to Change In

	Volume	Rate	Net
	-----	----	---
	(Dollars in thousands)		
Interest earning assets:			
Federal funds sold and overnight deposits	\$ (41)	\$ (80)	\$ (121)
Interest bearing deposits in banks	22	13	35
Investment securities	121	38	159
Loans, net	340	(905)	(565)
FHLB of Boston stock	10	(23)	(13)
	-----	-----	-----
Total interest earning assets	\$ 452	\$ (957)	\$ (505)
	-----	-----	-----
Interest bearing liabilities:			
NOW accounts	\$ 6	\$ (47)	\$ (41)
Savings/money market accounts	(36)	(152)	(188)
Time deposits	85	(384)	(299)
Borrowed funds	241	(46)	195
	-----	-----	-----
Total interest bearing liabilities	\$ 296	\$ (629)	\$ (333)
	-----	-----	-----
Net change in net interest income	\$ 156	\$ (328)	\$ (172)
	-----	-----	-----

Three Months Ended June 30, 2008, compared to Three Months Ended June 30, 2007.

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Interest and Dividend Income. The Company's interest and dividend income decreased \$381 thousand, or 5.9%, to \$6.1 million for the three months ended June 30, 2008, from \$6.5 million for the three months ended June 30, 2007. During the second quarter of 2008, average earning assets increased \$16.4 million, or 4.7%, to \$368.6 million, from \$352.2 million for the three months ended June 30, 2007. However, the increase in interest income resulting from the rise in average earning assets was more than offset by the lower rates earned on loans, federal funds sold, and Federal Home Loan Bank of Boston stock in second quarter of 2008 versus 2007. In particular, interest income on loans decreased during the second quarter of 2008 versus the 2007 comparison period despite an increase in average loan volume between periods. Average loans approximated \$322.9 million at an average yield of 7.06% for the three months ended June 30, 2008, up \$15.1 million from \$307.8 million at an average yield of 7.85% for the three months ended June 30, 2007. The increase in volume was more than offset by a 79 basis point

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decrease in yield. Loan demand has risen during 2008 due to the lower interest rates, the successful implementation of a call program and the changes in the competitive landscape.

The 325 basis point drop in the prime rate from September 2007 at 8.25% to April 2008 at 5.00% impacted variable rate loans with monthly and quarterly repricing. The impact on annually repricing loans has not yet been fully felt, but will not be positive for the Company, as adjustable rate loans continue to reprice at lower rates.

The average balance of investments (including mortgage-backed securities) increased \$2.6 million or 9.5%, to \$29.5 million for the three months ended June 30, 2008, from \$26.9 million for the three months ended June 30, 2007. The average level of interest bearing deposits in banks for the quarter was \$8.7 million, down \$1.6 million or 15.7% from the 2007 average level of \$10.4 million, as maturing FDIC insured certificates of deposit were utilized to fund loan demand. The average level of federal funds sold and overnight deposits decreased \$151 thousand, to \$5.6 million or 1.97% for the three months ended June 30, 2008, from \$5.8 million or 5.20% for the three months ended June 30, 2007. Interest income from non-loan instruments decreased \$31 thousand or 5.8% between periods, with \$501 thousand for the second quarter of 2008 versus \$532 thousand for the same period of 2007, reflecting the overall decreases in yields on federal funds sold and overnight deposits as well as on the FHLB of Boston stock, coupled with volume decreases on federal funds sold and interest bearing deposits.

Interest Expense. The Company's interest expense decreased \$282 thousand, or 13.7%, to \$1.8 million for the three months ended June 30, 2008, from \$2.1 million for the three months ended June 30, 2007. Of this decrease, \$445 thousand was a result of the decrease in rates, partially offset by the \$163 thousand attributable to the increase in volume, primarily related to the rise in borrowed funds to support loan demand.

Interest expense on deposits decreased \$399 thousand or 21.2% to \$1.5 million for the quarter ended June 30, 2008, from \$1.9 million for the quarter ended June 30, 2007. Competition for deposits has remained strong with growth in average deposits for the quarter at \$1.7 million or 0.6%. Interest rates paid have not dropped as much as anticipated given the prime rate drop. Management believes consumers have become more rate sensitive over the last two years due to advertised "specials" and the proliferation of nonlocal financial institutions trying to gather deposits throughout the Company's market area. Average time deposits rose to \$126.1 million for the three months ended June 30, 2008, from \$123.7 million for the three months ended June 30, 2007, or an

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increase of \$2.4 million or 1.9%. While the majority of these deposits are new funds for the Company, there has been movement of deposits from lower yielding savings accounts to higher paying certificates of deposit within its account base. The average rate paid on time deposits decreased 88 basis points, to 3.52% from 4.40% for the three months ended June 30, 2008 and 2007, respectively. The average balances for money market and savings accounts decreased \$2.0 million, or 2.2%, to \$91.5 million for the three months ended June 30, 2008, from \$93.5 million for the three months ended June 30, 2007 as interest rates on time deposits continued to be higher, which appeared to motivate customers to move funds into certificates of deposit and lock in the higher rates. A \$1.4 million or 2.5% increase in NOW accounts brought the average balance up to \$54.2 million from \$52.8 million between the two years.

Interest expense on borrowed funds increased from \$179 thousand for the quarter ended June 30, 2007 to \$296 thousand for the quarter ended, June 30, 2008 as average funds borrowed from the FHLB of Boston increased from \$14.5 million to \$27.3 million between years, although the average rate paid on borrowed funds declined 62 basis points between periods. The increasing loan demand, the slow growth in deposits on average between the quarters ended June 30, 2007 and June 30, 2008, and the opportunity to lock in some low rate long term funding before the long end of the yield curve rose led the Company to increase its reliance on borrowed funds.

Provision for Loan Losses. There was a \$90 thousand loan loss provision for the quarter ended June 30, 2008 and there was no provision for the quarter ended June 30, 2007. The provision was deemed necessary for the second quarter of 2008 in light of net charge-offs for the quarter ended June 30, 2008 of \$67 thousand, continuing strong loan growth, an upward trend over the prior year in the dollar amount of loans with higher risk characteristics and a softening of the economy, which has resulted in an increase in nonperforming loans. These factors were partially offset by a decline in classified loans between periods.

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For further details see, FINANCIAL CONDITION -"Allowance for Loan Losses" below.

Noninterest income. The following table sets forth changes from the second quarter of 2007 to the second quarter of 2008 for components of noninterest income:

	For The Three Months Ended June 30,			
	2008	2007	\$ Variance	% Variance
	-----	-----	-----	-----
	(Dollars in thousands)			
Trust income	\$ 100	\$ 83	\$ 17	20.5
Service fees	897	854	43	5.0
Net gains on sales of investment securities	16	47	(31)	(66.0)
Net gains on sales of loans held for sale	14	23	(9)	(39.1)
Other	139	108	31	28.7
	-----	-----	-----	
Total noninterest income	\$1,166	\$1,115	\$ 51	4.6
	=====	=====	=====	

Trust Income. Trust income has risen for the three months ended June 30, 2008 mainly due to a number of new trust relationships.

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Service fees. The increase resulted primarily from a rise in overdraft fees of \$7 thousand, or 2.3%; merchant program income of \$12 thousand, or 13.3%; and ATM/Debit Card usage fees increase of \$21 thousand, or 12.0%. These increases were partially offset by a decline in foreign exchange fees of \$11 thousand, or 54.0% as the price of the U.S. dollar continued to decline.

Net gains on sales of loans held for sale. Residential real estate loans of \$7.3 million were sold for a net gain of \$14 thousand during the second quarter of 2008, versus sales of \$5.8 million for a net gain of \$23 thousand during the second quarter of 2007.

Other. The increase resulted primarily from the increase in net mortgage servicing right fees of \$13 thousand or 127.7%.

Noninterest expense. The following table sets forth changes from the second quarter of 2007 to the second quarter of 2008 for components of noninterest expense:

	For The Three Months Ended June 30,			
	2008	2007	\$ Variance	% Variance
	(Dollars in thousands)			
Salaries and wages	\$1,604	\$1,549	\$ 55	3.6
Pension and employee benefits	706	520	186	35.8
Occupancy expense, net	223	214	9	4.2
Equipment expense	317	281	36	12.8
Equity in losses of affordable housing investments	97	66	31	47.0
Other	979	911	68	7.5
	-----	-----	-----	
Total noninterest expense	\$3,926	\$3,541	\$385	10.9
	=====	=====	=====	

Salaries and wages and related expenses. The increase in 2008 over 2007 was due primarily to regular salary activity and hiring associated with the planned third quarter 2008 addition of two branches. This increase was partially offset by increased efficiency in operations which allowed the Company to grow while reducing a few staff positions. There was an increase in the accrual for pension plan expense of \$36 thousand or 31.4% due to lower interest rates in 2008 compared to 2007. There was also an increase of \$152 thousand or 73.9% in the Company's medical costs due to staff or their dependents experiencing a greater number of serious illnesses or procedures. The Company self-insures healthcare costs to a specific individual and aggregate level and carries "excess" coverage for major claims.

Equipment Expense. The increase between years is mainly due to the \$25 thousand write-off during the second quarter of 2008 of the undepreciated value of the Company's reader/sorter and related software and equipment which are no longer being utilized due to the implementation of branch capture imaging hardware and software.

Equity in losses of affordable housing investments. Two new investments in low income housing partnerships were made in late 2007 which increased the amount



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of equity in the losses of these projects to be recorded in 2008.

Other. The net change between years has many components of both increases and decreases; the largest two being an \$11 thousand increase in trust department expenses mainly due to the expansion of the department and a reduction in the quarter's expenses of foreclosures and other real estate owned which was \$56 thousand during the second quarter of 2007 versus \$36 thousand during the second quarter of 2008.

Income Tax Expense. The Company has provided for current and deferred federal income taxes for the current and all prior periods presented. The Company's provision for income taxes was \$278 thousand for the three months ended June 30, 2008 compared to \$505 thousand for the same period in 2007, reflecting the decrease in taxable net income between periods and the \$39 thousand in low income or rehabilitation tax credits available in 2008 on two low income housing investments made in late 2007. The Company's effective tax rate decreased to just 18.9% for the three months ended June 30, 2008, from 25.4% for the same period in 2007, reflecting the reduction in taxable net income and the tax credits received.

Six Months Ended June 30, 2008, compared to Six Months Ended June 30, 2007.

Interest and Dividend Income. The Company's interest and dividend income decreased \$505 thousand, or 3.9%, to \$12.4 million for the six months ended June 30, 2008, from \$12.9 million for the six months ended June 30, 2007, with average earning assets increasing \$13.6 million, or 3.9%, to \$365.0 million for the six months ended June 30, 2008, from \$351.4 million for the six months ended June 30, 2007. The increase in interest income resulting from the rise in average earning assets was more than offset by the lower rates earned on loans, federal funds sold, and FHLB of Boston stock in the first six months of 2008 versus 2007. Interest income on loans decreased during the first six months of 2008 versus the 2007 comparison period despite an increase in average loan volume between periods. Average loans approximated \$317.5 million at an average yield of 7.26% for the six months ended June 30, 2008, up \$8.9 million from \$308.6 million at an average yield of 7.84% for the six months ended June 30, 2007. The increase in volume was more than offset by a 58 basis point decrease in yield resulting mostly from the 325 basis point drop in the prime rate from 8.25% in September 2007 to 5.00% in April 2008 where it remains as of the date of this report. Loan demand has risen during 2008 due to lower interest rates, the successful implementation of a call program and the changes in the competitive landscape.

The average balance of investments (including mortgage-backed securities) increased \$5.4 million or 21.0%, to \$31.3 million for the six months ended June 30, 2008, from \$25.9 million for the six months ended June 30, 2007. The average level of interest bearing deposits in banks for the six months ended June 30, 2008 was \$9.5 million up \$0.9 million or 10.4% from the 2007 average level of \$8.6 million, as FDIC insured certificates of deposit in other financial institutions was one of the highest yielding and safest investment options available. The increase in the investment portfolio and interest bearing deposits in banks from the first half of 2007 reflects the slower loan demand of 2007 but that has changed in 2008 and the cash flows from maturing or called instruments are being utilized to fund loans. The average level of federal funds sold and overnight deposits decreased \$1.9 million, to \$5.0 million at a rate of 2.36% for the six months ended June 30, 2008, from \$6.9 million at a rate of 5.18% for the six months ended June 30, 2007, as funds were utilized to support the rising loan demand. Interest income from non-loan instruments increased \$60 thousand or 5.9% between periods, with \$1.1 million in income for these items for the six months ended June 30, 2008 and \$1.0 million for the six months ended June 30, 2007, reflecting the overall increase in yields on investment securities and volume increases on all instruments except federal funds sold.

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Interest Expense. The Company's interest expense decreased \$332 thousand, or 8.2%, to \$3.7 million for the six months ended June 30, 2008, from \$4.0 million for the six months ended June 30, 2007. Of this decrease, \$628 thousand was a result of the decrease in rates, partially offset by a \$296 thousand increase attributable to an increase in volume, primarily related to the rise in borrowed funds to support loan demand.

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Interest expense on deposits decreased \$527 thousand or 14.4% to \$3.1 million for the six months ended, June 30, 2008, from \$3.7 million for the six months ended June 30, 2007. Competition for deposits has remained strong with growth in average deposits for the six months ended June 30, 2008 of \$1.4 million or 0.5% from the six months ended June 30, 2007. Volume growth has started to improve towards the end of the first half of 2008 as there has been a flight to quality by customers concerned about the stock market declines and bank failures. Average time deposits rose to \$125.2 million for the six months ended June 30, 2008, from \$121.2 million for the six months ended June 30, 2007, or an increase of \$4.0 million or 3.3%. While the majority of these deposits are new funds for the Company, there has been movement of deposits from lower yielding savings accounts to higher paying certificates of deposit within its account base. The average rate paid on time deposits decreased 62 basis points, to 3.77% from 4.39% for the six months ended June 30, 2008 and 2007, respectively. The average balances for money market and savings accounts decreased \$4.2 million, or 4.5%, to \$90.0 million for the six months ended June 30, 2008, from \$94.2 million for the six months ended June 30, 2007 as interest rates on time deposits were higher which appeared to motivate customers to move funds into certificates of deposit and lock in the higher rates, especially given the potential for a steep downward trend in interest rates paid given the drop in the discount rate by the Federal Open Market Committee (FOMC) and the decrease in the prime rate during the first six months of 2008. A \$1.6 million or 3.0% increase in NOW accounts brought the average balance up to \$53.2 million from \$51.6 million between the two years.

Interest expense on borrowed funds increased from \$369 thousand for the six months ended June 30, 2007 to \$564 thousand for the six months ended, June 30, 2008 as average funds borrowed from the FHLB of Boston increased from \$14.9 million to \$25.8 million between years, although the average rate paid on borrowed funds declined 58 basis points between periods. The increasing loan demand, the slow growth in deposits on average between the periods ended June 30, 2007 and June 30, 2008, and the opportunity to lock in some low rate long term funding before the long end of the yield curve rose led the Company to increase its reliance on borrowed funds.

Provision for Loan Losses. There was a \$140 thousand loan loss provision for the six months ended June 30, 2008 and there was a \$45 thousand provision for the six months ended June 30, 2007. The increase in the provision was deemed necessary for the first half of 2008 in light of net charge-offs of \$94 thousand for the six months ended June 30, 2008, growth in loans not held for sale of \$6.4 million since December 31, 2007, and an increase in past due loans of \$4.0 million. These factors were partially offset by the decrease in classified loans. For further details see, FINANCIAL CONDITION -"Allowance for Loan Losses" below.

Noninterest income. The following table sets forth changes from the first half of 2007 to the first half of 2008 for components of noninterest income:

For The Six Months Ended June 30,

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	2008	2007	\$ Variance	% Variance
	----	----	-----	-----
	(Dollars in thousands)			
Trust income	\$ 193	\$ 167	\$ 26	15.6
Service fees	1,752	1,650	102	6.2
Net gains on sales of investment securities	16	37	(21)	(56.8)
Net gains on sales of loans held for sale	172	50	122	244.0
Other	153	134	19	14.2
	-----	-----	----	
Total noninterest income	\$2,286	\$2,038	\$248	12.2
	=====	=====	=====	

Trust Income. Trust income has risen for the six months ended June 30, 2008 mainly due to a number of new trust relationships.

Service fees. The increase resulted primarily from a rise in overdraft fees of \$22 thousand, or 3.6%; merchant program income increase of \$37 thousand, or 18.0%; and the increase in ATM/Debit Card usage fees of \$41 thousand, or 11.8%. These increases were partially offset by a decline in foreign exchange fees of \$20.6 thousand, or 71.2% as the price of the U.S. dollar continued to decline.

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Net gains on sales of loans held for sale. Residential real estate loans of \$12.9 million were sold for a net gain of \$172 thousand during the six months ended June 30, 2008, versus sales of \$9.2 million for a net gain of \$50 thousand during the six months ended June 30, 2007.

Noninterest expense. The following table sets forth changes from the first half of 2007 to the first half of 2008 for components of noninterest expense:

	For The Six Months Ended June 30,			
	2008	2007	\$ Variance	% Variance
	----	----	-----	-----
	(Dollars in thousands)			
Salaries and wages	\$3,189	\$3,127	\$ 62	2.0
Pension and employee benefits	1,374	1,180	194	16.4
Occupancy expense, net	491	434	57	13.1
Equipment expense	609	543	66	12.2
Equity in losses of affordable housing investments	194	133	61	45.9
Other	1,897	1,772	125	7.1
	-----	-----	----	
Total noninterest expense	\$7,754	\$7,189	\$565	7.9
	=====	=====	=====	

Salaries and wages and related expenses. The increase in 2008 over 2007 was due primarily to regular salary activity offset partially by increased efficiency in operations which allowed the Company to grow while reducing a few staff positions. An increase in the accrual for pension plan expense of \$24 thousand or 8.8% and a \$173 thousand or 36.7% increase in the Company's medical costs for which the Company is self insured up to specific individual and aggregate limits were partially offset by a decrease of \$15 thousand or 36.6% in the

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company's dental insurance costs.

Occupancy expense, net. The \$57 thousand or 13.1% increase between periods is due primarily to the increase in snowplowing costs between years due to a winter season of heavy snow and ice, the increase in fuel costs despite the mild winter temperatures, the increase in depreciation and real estate taxes in 2008 as the renovation work on two administrative buildings in Morrisville was completed in 2007, a decrease in rental income, and the increase in rental expense.

Equipment Expense. The increase between years is partially due to the purchase of a Microsoft open license by the Company which allows the Company to increase the number of personal computers on its network and to migrate to future software upgrades, the \$23 thousand write-off during the first quarter of 2008 of the undepreciated value of the Company's merchant services equipment which are now being expensed as the value is under the Company's capitalization limit and the write-off during the second quarter of 2008 of \$25 thousand for the undepreciated value of the reader/sorter and related equipment and software which are no longer used since the implementation of branch capture imaging hardware and software.

Equity in losses of affordable housing investments. Two new investments in low income housing partnerships were made in late 2007 which increased the amount of equity in the losses of these projects to be recorded in 2008.

Other. The net change between years has many components; the largest being a \$34 thousand increase in training and development costs mainly related to the roll out of the new personal computers and related software as well as the new branch imaging system.

Income Tax Expense. The Company has provided for current and deferred federal income taxes for the current and all prior periods presented. The Company's provision for income taxes was \$454 thousand for the six months ended June 30, 2008 compared to \$913 thousand for the same period in 2007, reflecting the receipt of federal rehabilitation tax credits of \$195 thousand available in 2008 resulting from the completion of affordable housing investment partnership projects, the increase in annual low income housing credits due to the new projects and the decrease in taxable net income between periods. The Company's effective tax rate decreased to just 14.9% for the six months ended June 30, 2008, from 25.1% for the same period in 2007, reflecting the federal rehabilitation tax credit and the reduction in taxable net income.

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### FINANCIAL CONDITION

At June 30, 2008 the Company had total consolidated assets of \$395.6 million, including gross loans and loans held for sale ("total loans") of \$319.5 million, deposits of \$320.8 million and stockholders' equity of \$41.8 million. The Company's total assets increased \$2.2 million or 0.6% to \$395.6 million at June 30, 2008, from \$393.4 million at December 31, 2007, which was offset in part by a normal seasonal fluctuation for the Company in loans associated primarily with municipal accounts. In particular, the overall increase was partially offset by the payoff of \$9.5 million in tax anticipation municipal loans on the last business day of June to comply with Vermont law governing short term municipal finance. As anticipated, municipal loans increased \$8.0 million on the first business day of the next quarter, reflecting the seasonal fluctuations in these loans. Net loans and loans held for sale were \$315.9 million, or 79.9% of total assets at June 30, 2008, as compared to \$314.8 million, or 80.0% of total assets at December 31, 2007.

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Cash and cash equivalents, including federal funds sold and overnight deposits, increased \$10.5 million, or 78.2%, to \$23.9 million at June 30, 2008, from \$13.4 million at December 31, 2007. Interest bearing deposits in banks decreased \$3.9 million or 32.7% from \$11.9 million at December 31, 2007 to \$8.0 million at June 30, 2008 as maturities on these instruments were used to fund increasing loan demand. Investment securities available-for-sale decreased from \$33.8 million at December 31, 2007, to \$27.5 million at June 30, 2008, a \$6.3 million, or 18.6%, decrease. The securities available-for-sale and interest bearing deposits in banks decreased from 11.6% of total assets at December 31, 2007 to 9.0% at June 30, 2008, reflecting deployment of available cash resources to fund loan demand.

Deposits decreased \$3.2 million, or 1.0%, to \$320.8 million at June 30, 2008, from \$324.0 million at December 31, 2007, reflecting a pattern of the seasonal variation in dollars on deposit including the redemption of \$10.3 million in certificates of deposit on the last day of the second quarter by municipal customers in order to comply with state law to payoff their tax anticipation notes annually. Municipal time deposits increased \$9.7 million on July 1, 2008 as the municipalities redeposited funds at the start of their new fiscal year. Noninterest bearing deposits decreased from \$56.2 million at December 31, 2007 to \$55.2 million at June 30, 2008, a \$1.0 million or 1.7% decrease. Interest bearing deposits decreased \$2.2 million, or 0.8%, from \$267.8 million at December 31, 2007, to \$265.6 million at June 30, 2008. (See average balances and rates in the Yields Earned and Rates Paid tables on Page 17 as well as the municipal customer comment above.) Aggressive rate competition from in-market and out-of-market financial institutions makes deposit accounts harder to attract and retain.

Total borrowings increased to \$27.9 million at June 30, 2008 from \$20.3 million, at December 31, 2007 as the Company took advantage of low rate FHLB of Boston advances available during the first two months of the year to support the growing loan demand at rates much lower and achievable with greater administrative ease than medium term time deposits could be gathered, as well as to specifically match fund a large new loan relationship.

Total stockholders' equity decreased slightly to \$41.8 million at June 30, 2008 from \$42.1 at December 31, 2007, reflecting net income of \$2.6 million for the first half of 2008, less regular cash dividends paid of \$2.5 million, the purchase of Treasury stock totaling \$281 thousand, and an increase of \$113 thousand in accumulated other comprehensive loss. (See Capital Resources section on Page 37)

Loans Held for Sale and Loan Portfolios. The Company's total loans primarily consist of adjustable-rate and fixed-rate mortgage loans secured by one-to-four family, multi-family residential or commercial real estate. As of June 30, 2008, the Company's total loan portfolio was \$319.5 million, or 80.8% of assets, up from \$318.3 million, or 80.9% of assets as of December 31, 2007, and up from \$306.5 million or 81.6% of assets as of June 30, 2007. Total loans (including loans held for sale) have increased \$1.2 million since December 31, 2007 in spite of the \$9.5 million of municipal loans that paid off on June 30, 2008 in accordance with state law. Eight million in municipal loans were booked on July 1, 2008 as the municipal's fiscal year began. Average net loans (including loans held for sale) were \$308.6 million for the first half of 2007 and have increased to \$317.5 million for the first half of 2008. The Company sold \$12.9 million of loans held for sale during the first half of 2008 resulting in a gain on sale of loans of \$172 thousand, compared with loan sales of \$9.2 million and related gain on sale of loans of \$50 thousand for

the first half of 2007. The Company recognizes that competition for good loans

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is strong, however is able to originate loans to both current and new customers while maintaining credit quality. The Company has seen a pickup in loan demand during the first half of 2008 in part due to lower interest rates which has engendered some refinancing activity, loans generated from the Bank's call program and competitive changes in the Bank's marketplace. The good winter season in both northern Vermont and New Hampshire also encouraged businesses to put some money back into infrastructure and equipment. The only category where loan demand has slowed is in the construction portfolio.

The following table shows information on the composition of the Company's total loan portfolio as of June 30, 2008 and December 31, 2007:

Loan Type	June 30, 2008		December 31, 2007	
	Amount	Percent	Amount	Percent
(Dollars in thousands)				
Residential real estate	\$121,192	38.0	\$115,303	36.2
Construction real estate	17,839	5.6	20,190	6.4
Commercial real estate	142,912	44.7	133,320	41.9
Commercial	19,095	6.0	16,537	5.2
Consumer	7,197	2.2	7,175	2.3
Municipal loans	8,753	2.7	15,069	4.7
Term Federal Funds Sold	-	-	3,000	0.9
Loans Held for Sale	2,486	0.8	7,711	2.4
<b>Total loans</b>	<b>319,474</b>	<b>100.0</b>	<b>318,305</b>	<b>100.0</b>
Deduct:				
Allowance for loan losses	(3,424)		(3,378)	
Unearned net loan fees	(104)		(111)	
<b>Net loans and loans held for sale</b>	<b>\$315,946</b>		<b>\$314,816</b>	

The Company originates and sells some residential mortgages into the secondary market, with most such sales made to the Federal Home Loan Mortgage Corporation (FHLMC/"Freddie Mac") and the Vermont Housing Finance Agency (VHFA). At June 30, 2008, the Company serviced a \$213.9 million residential real estate mortgage portfolio, approximately \$92.2 million of which was serviced for unaffiliated third parties. Additionally, the Company originates commercial real estate and commercial loans under various SBA, United States Department of Agriculture Rural Development Authority and Vermont Economic Development Authority programs which provide an agency guarantee for a portion of the loan amount. The Company occasionally sells the guaranteed portion of the loan to other financial concerns and will retain servicing rights, which generates fee income. The Company serviced \$4.4 million of commercial and commercial real estate loans for unaffiliated third parties as of June 30, 2008. The Company capitalizes servicing rights on these fees and recognizes gains and losses on the sale of the principal portion of these loans as they occur. The unamortized balance of servicing rights on loans sold with servicing retained was \$312 thousand at June 30, 2008, with an estimated market value in excess of their carrying value.

In the ordinary course of business, the Company occasionally participates out, on a non-recourse basis, a portion of commercial or real estate loans to other financial institutions for liquidity or credit concentration management purposes. The total of loans participated out as of June 30, 2008 was \$15.4 million.

Asset Quality. The Company, like all financial institutions, is exposed to certain credit risks including those related to the value of the collateral

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that secures its loans and the ability of borrowers to repay their loans. Management closely monitors the Company's loan and investment portfolios, other real estate and other assets owned for potential problems and reports to the Company's and the subsidiary's Boards of Directors at regularly scheduled meetings. Policies set forth portfolio diversification levels to mitigate concentration risk.

The Company's Board of Directors has set forth lending policies (which are periodically reviewed and revised as appropriate) that include conservative individual lending limits for officers, aggregate and advisory board approval levels, Board approval for large credit relationships, a loan review program and other limits or standards deemed necessary and prudent. The Company's loan review department is supervised by an experienced former regulatory examiner and staffed by a Certified Public Accountant as

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well as other experienced personnel and encompasses a quality control process for loan documentation and underwriting. The Company also maintains a monitoring process to assess the credit quality and degree of risk in the loan portfolio. The Company performs periodic concentration analyses based on various factors such as industries, collateral types, large credit sizes and officer portfolio loads. The Company has established underwriting guidelines to be followed by its officers, exceptions not addressed by the underwriting guidelines are required to be approved by a senior loan officer or the Board of Directors. The Company monitors its delinquency levels for any negative or adverse trends. There can be no assurance, however, that the Company's loan portfolio will not become subject to increasing pressures from deteriorating borrower credit due to general or local economic conditions.

Restructured loans include the Company's troubled debt restructurings that involved forgiving a portion of interest or principal on any loans, refinancing loans at a rate materially less than the market rate, rescheduling loan payments, or granting other concessions to a borrower due to financial or economic reasons related to the debtor's financial difficulties. Restructured loans do not include qualifying restructured loans that have complied with the terms of their restructure agreement for a satisfactory period of time. There were none of these loans at June 30, 2008 and \$184 thousand at December 31, 2007.

Loans on which the accrual of interest has been discontinued are designated as nonaccrual loans. Management reviews the loan portfolio continuously for evidence of problem loans. Such loans are placed under close supervision with consideration given to placing the loan on nonaccrual status. Loans are designated as nonaccrual when reasonable doubt exists as to the full collection of interest and principal. Normally, when a loan is placed on nonaccrual status, all interest previously accrued but not collected is reversed against current period interest income. Income on such loans is then recognized only to the extent that cash is received and where the future collection of interest and principal is probable. Interest accruals are resumed on such loans only when they are brought fully current with respect to interest and principal and when, in the judgment of management, the loans are estimated to be fully collectible as to both principal and interest.

The Company had loans in nonaccrual status totaling \$2.8 million, or 0.88% of gross loans at June 30, 2008, \$3.3 million, or 1.06%, at December 31, 2007, and \$3.0 million, or 0.97%, at June 30, 2007. Certain loans in non-accrual status are covered in part by guarantees of U.S. Government or state agencies. Approximately \$276 thousand of the balances in this category were covered by such guarantees at June 30, 2008. The aggregate interest income not recognized on such nonaccrual loans amounted to approximately \$469 thousand and \$464

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thousand as of June 30, 2008 and 2007, respectively and \$457 thousand as of December 31, 2007.

The Company had \$4.9 million in loans past due 90 days or more and still accruing at June 30, 2008 and \$2.3 million at December 31, 2007. Certain loans past due 90 days or more and still accruing interest are covered in part by guarantees of U.S. Government or state agencies. Approximately \$1.7 million of the commercial and commercial real estate balances in this category were covered by such guarantees at June 30, 2008. The majority of the increase was in commercial real estate loans with one well secured relationship of \$1.9 million comprising the majority of the increase. We are actively working with the borrower to bring the loan back to current status.

At June 30, 2008, and December 31, 2007, respectively, the Company had internally classified certain loans totaling \$18 thousand and \$21 thousand, respectively. In management's view, such loans represent a higher degree of risk and could become nonperforming loans in the future. While still on a performing status, in accordance with the Company's credit policy, loans are internally classified when a review indicates the existence of any of the following conditions makes the likelihood of collection questionable:

- o the financial condition of the borrower is unsatisfactory;
- o repayment terms have not been met;
- o the borrower has sustained losses that are sizable, either in absolute terms or relative to net worth;
- o confidence is diminished;
- o loan covenants have been violated;
- o collateral is inadequate; or
- o other unfavorable factors are present.

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The Company has been actively working with customers who may be delinquent or headed for problems due to the downturn in the economy and the slowdown in the residential real estate market. Northern New England did not experience these issues as soon or to the extent of other parts of the country, however the effects have started to be felt. The downturn in the economy, the price of gasoline and heating fuel, and the potential for less tourist traffic are worrisome. To aid customers in reducing their energy costs, the Company has introduced a new GreenLend(TM) Program working with Efficiency Vermont and the United States Department of Agriculture Rural Development Agency to offer low interest rate loans to consumer and commercial customers to purchase, install or upgrade energy efficient systems or vehicles or renewable energy sources.

One of the benefits of being a community financial institution is our employees' and Boards' knowledge of the community and borrowers which allows us to be proactive in working closely with our loan customers. The Company's delinquency rates have historically run higher than similar institutions while losses have been lower. The Company did not target sub-prime borrowers and has not experienced an elevated delinquency in this area.

On occasion real estate properties are acquired through or in lieu of loan foreclosure. These properties are to be sold and are initially recorded at the lesser of the recorded loan or fair value at the date of the Company's acquisition of the property, with fair value based on an appraisal for more significant properties and on management's estimate for minor properties. The Company had two residential real estate properties totaling \$280 thousand and four commercial real estate properties totaling \$517 thousand classified as OREO at June 30, 2008, compared to a total of two properties composed of \$10 thousand of residential real estate and \$216 thousand of commercial real estate property at December 31, 2007. There was an allowance for losses on other real



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estate owned of \$11 thousand at June 30, 2008 and \$25 thousand at December 31, 2007 which have been netted out of the values above. The other real estate owned was included in Other Assets on the Consolidated Balance Sheet at both time periods.

The Company has scheduled auctions for various OREO properties over the next few months. Due to an apparent softening in the real estate market the potential to recover all principal and related costs for the auctions is uncertain.

Allowance for Loan Losses. Some of the Company's loan customers ultimately do not make all of their contractually scheduled payments, requiring the Company to charge off a portion or all of the remaining principal balance due. The Company maintains an allowance for loan losses to absorb such losses. The allowance is maintained at a level which, by management's best estimate, is adequate to absorb probable credit losses inherent in the loan portfolio; however, actual loan losses may vary from current estimates.

Adequacy of the allowance for loan losses is determined using a consistent, systematic methodology, which analyzes the risk inherent in the loan portfolio. In addition to evaluating the collectibility of specific loans when determining the adequacy of the allowance, management also takes into consideration other factors such as changes in the mix and size of the loan portfolio, historic loss experience, the amount of delinquencies and loans adversely classified, industry trends, and the impact of the local and regional economy on the Company's borrowers. The adequacy of the allowance for loan losses is assessed by an allocation process whereby specific loss allocations are made against certain adversely classified loans and general loss allocations are made against segments of the loan portfolio which have similar attributes. While the Company allocates the allowance for loan losses based on a percentage by category to total loans, the portion of the allowance for loan losses allocated to each category does not represent the total available for future losses which may occur within the loan category since the total allowance for possible loan losses is a valuation reserve applicable to the entire portfolio.

The allowance for loan losses is increased by a provision for loan losses, which is charged to earnings, and reduced by charge-offs, net of recoveries. The provision for loan losses represents the current period credit cost associated with maintaining an appropriate allowance for loan losses. Based on an evaluation of the loan portfolio, management presents a quarterly analysis of the allowance for loan losses to the Board of Directors, indicating any changes since the last review and any recommendations as to adjustments in the allowance. Additionally, bank regulatory agencies regularly review the Company's allowance for loan losses as an integral part of their examination process.

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For the quarter ended June 30, 2008, the methodology used to determine the provision for loan losses was unchanged from the prior quarter or year. The Company's loan portfolio balance not held for sale increased from December 31, 2007 despite the maturity of \$3.0 million in Term Fed Funds during the first quarter, the payoff of \$9.5 million in municipal loans on June 30, 2008 and a decrease of \$2.4 million in construction real estate loans. All other types of loans grew between periods, see chart on page 26 for further details.

As a result of the combined changes in volumes and the net charge-offs for the second quarter of \$67 thousand, the Company designated a \$90 thousand loan loss provision for the quarter ended June 30, 2008 which left the allowance for loan losses at \$3.4 million at June 30, 2008 up \$46 thousand from December 31, 2007. The \$79 thousand in charge-offs for the quarter included \$19 thousand due to

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credit card fraud, one commercial real estate relationship which has since been paid off, one residential property loan which has been moved to other real estate owned and seven small consumer loan chargeoffs. There were no material changes in the lending programs or terms during the quarter.

The following table reflects activity in the allowance for loan losses for the three and six months ended June 30, 2008 and 2007:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2008	2007	2008	2007
	(Dollars in thousands)			
Balance at beginning of period	\$3,401	\$3,342	\$3,378	\$3,338
Charge-offs				
Real Estate	50	--	50	30
Commercial	--	--	39	--
Consumer and other	29	26	35	54
Total charge-offs	79	26	124	84
Recoveries				
Real Estate	1	1	2	8
Commercial	2	1	4	2
Consumer and other	9	8	24	17
Total recoveries	12	10	30	27
Net charge-offs	(67)	(16)	(94)	(57)
Provision for loan losses	90	--	140	45
Balance at end of period	\$3,424	\$3,326	\$3,424	\$3,326

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The following table shows the internal breakdown of the Company's allowance for loan losses by category of loan (net of loans held for sale) and the percentage of loans in each category to total loans in the respective portfolios at the dates indicated:

	June 30, 2008		December 31, 2007	
	Amount	Percent	Amount	Percent
	(Dollars in thousands)			
Real Estate				
Residential	\$ 821	38.4	\$ 710	35.7
Commercial	1,997	44.9	2,011	42.9
Construction	178	5.6	202	6.5
Other Loans				
Commercial	301	6.0	277	5.3
Consumer installment	112	2.3	112	2.3
Municipal, Other and Unallocated	15	2.8	66	7.3

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Total	\$3,424 =====	100.0 =====	\$3,378 =====	100.0 =====
Ratio of net charge offs to average loans not held for sale(1)		0.06%		0.07%
Ratio of allowance for loan losses to loans not held for sale		1.08%		1.09%
Ratio of allowance for loan losses to nonperforming loans (2)		44.34%		60.47%

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- (1) Annualized  
(2) Non-performing loans include loans in non-accrual status and loans past due 90 days or more and still accruing.

Notwithstanding the categories shown in the table above, all funds in the allowance for loan losses are available to absorb loan losses in the portfolio, regardless of loan category.

Management of the Company believes, in their best estimate, that the allowance for loan losses at June 30, 2008, is adequate to cover probable credit losses inherent in the Company's loan portfolio as of such date. However, there can be no assurance that the Company will not sustain losses in future periods, which could be greater than the size of the allowance for loan losses at June 30, 2008. See CRITICAL ACCOUNTING POLICIES. While the Company recognizes that an economic slowdown may adversely impact its borrowers' financial performance and ultimately their ability to repay their loans, management continues to be cautiously optimistic about the collectability of the Company's loan portfolio.

Investment Activities. At June 30, 2008, the reported value of investment securities available-for-sale was \$27.5 million or 6.9% of assets. The amount in investment securities available-for-sale decreased slightly from \$33.8 million, or 8.6% of assets at December 31, 2007.

The Company had no securities classified as held-to-maturity or trading. The reported value of investment securities available-for-sale at June 30, 2008 reflects net unrealized losses of \$189 thousand compared to a net unrealized loss of \$1 thousand as of December 31, 2007. The offset of the unrealized losses, net of income tax effect, was a \$124 thousand loss reflected in the Company's accumulated other comprehensive income (loss) component of stockholders' equity at June 30, 2008.

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At June 30, 2008, eight securities with a fair value of \$1.6 million or 5.8% of the portfolio have been in an unrealized loss position for more than twelve months totaling \$59 thousand. These unrealized losses consisted of declines in value of a corporate bond, that has a merger with a stronger organization pending, and seven collateralized mortgage obligation bonds that have declined in value due to the current economic and interest rate environment. As of June 30, 2008, based on our evaluation, management concluded that these were not other than temporarily impaired. The Company has the ability to hold all of these securities, classified as available-for-sale, for the foreseeable future.

At December 31, 2007, the Company had twenty-nine debt securities with a fair value of \$8.8 million, or 26.0% of the investment portfolio, which have been in an unrealized loss position for more than 12 months. The unrealized losses on these securities amounted to \$166 thousand as of December 31, 2007.

Deposits. The following table shows information concerning the Company's average deposits by account type and weighted average nominal rates at which

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interest was paid on such deposits for the periods ended June 30, 2008, and December 31, 2007:

	Six Months Ended June 30, 2008			Year Ended December 31, 2007		
	Average Amount	Percent of Total Deposits	Average Rate	Average Amount	Percent of Total Deposits	Average Rate
	(Dollars in thousands)					
Non-time deposits:						
Noninterest bearing deposits	\$ 50,210	15.8	--	\$ 49,727	15.5	--
NOW accounts	53,168	16.7	0.61%	55,046	17.2	0.61%
Money Market accounts	50,380	15.8	2.16%	51,470	16.0	2.16%
Savings accounts	39,641	12.4	0.50%	41,377	12.9	0.50%
Total non-time deposits	193,399	60.7	0.83%	197,620	61.6	0.83%
Time deposits:						
Less than \$100,000	80,584	25.3	3.52%	78,237	24.4	3.52%
\$100,000 and over	44,660	14.0	4.24%	45,138	14.0	4.24%
Total time deposits	125,244	39.3	3.77%	123,375	38.4	3.77%
Total deposits	\$318,643	100.0	1.99%	\$320,995	100.0	1.99%

The Company continues to see some erosion of nontime interest bearing deposits but is seeing offsetting growth in time deposits.

As a participant in the Certificate of Deposit Account Registry Service (CDARS) of Promontory Interfinancial Network, LLC, there were \$8.5 million of time deposits \$100,000 or less on the balance sheet at June 30, 2008 which are considered to be "brokered" deposits. The deposits are matched dollar for dollar with Union's customer deposits which have been placed in other financial institutions in order to provide those customers with full FDIC insurance coverage.

The following table sets forth information regarding the Company's time deposits in amounts of \$100,000 and over at June 30, 2008 and December 31, 2007 that mature during the periods indicated:

	June 30, 2008	December 31, 2007
	(Dollars in thousands)	
Within 3 months	\$15,474	\$15,443
3 to 6 months	9,090	16,706
6 to 12 months	10,099	11,859
Over 12 months	3,247	2,135
	\$37,910	\$46,143

Certificates of deposit held by the majority of municipal and school district customers matured and were redeemed on June 30, 2008 which is a normal seasonal

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occurrence within the State of Vermont.

Borrowings. Borrowings from the FHLB of Boston were \$27.9 million at June 30, 2008, at a weighted average rate of 4.31%, and \$20.3 million at December 31, 2007, at a weighted average rate of 4.83%. Borrowings were up at June 30, 2008 as the Company took advantage of some medium term, low-rate advances to fund increasing loan demand at lower interest rates and easier generation than time deposits could be gathered, as well as to match fund a large new loan relationship.

### OTHER FINANCIAL CONSIDERATIONS

Market Risk and Asset and Liability Management. Market risk is the potential of loss in a financial instrument arising from adverse changes in market prices, interest rates, foreign currency exchange rates, commodity prices, and equity prices. The Company's market risk arises primarily from interest rate risk inherent in its lending, investing, deposit taking and borrowing activities as yields on assets change in a different time period or in a different amount from that of interest costs on liabilities. Many other factors also affect the Company's exposure to changes in interest rates, such as general and local economic and financial conditions, competitive pressures, customer preferences, and historical pricing relationships.

The earnings of the Company and its subsidiary are affected not only by general economic conditions, but also by the monetary and fiscal policies of the United States and its agencies, particularly the Federal Reserve System. The monetary policies of the Federal Reserve System influence to a significant extent the overall growth of loans, investments, deposits and borrowings; the level of interest rates earned on assets and paid for liabilities; and including interest rates charged on loans and paid on deposits. The nature and impact of future changes in monetary policies are often not predictable.

A key element in the process of managing market risk involves direct involvement by senior management and oversight by the Board of Directors as to the level of risk assumed by the Company in its balance sheet. The Board of Directors reviews and approves risk management policies, including risk limits and guidelines and reviews quarterly the current position in relationship to those limits and guidelines. Daily oversight functions are delegated to the Asset Liability Management Committee ("ALCO"). The ALCO, consisting of senior business and finance officers, actively measures, monitors, controls and manages the interest rate risk exposure that can significantly impact the Company's financial condition and operating results. The ALCO sets liquidity targets based on the Company's financial position and existing and projected economic and market conditions. The Company does not have any market risk sensitive instruments acquired for trading purposes. The Company attempts to structure its balance sheet to maximize net interest income and shareholder value while controlling its exposure to interest rate risk. Strategies might include selling or participating out loans held for sale or investments available-for-sale. The ALCO formulates strategies to manage interest rate risk by evaluating the impact on earnings and capital of such factors as current interest rate forecasts and economic indicators, potential changes in such forecasts and indicators, liquidity, competitive pressures and various business strategies. The ALCO's methods for evaluating interest rate risk include an analysis of the Company's interest rate sensitivity "gap", which provides a static analysis of the maturity and repricing characteristics of the Company's entire balance sheet, and a simulation analysis, which calculates projected net interest income based on alternative balance sheet and interest rate scenarios, including "rate shock" scenarios involving immediate substantial increases or decreases in market rates of interest.

Members of ALCO meet at least weekly to set loan and deposit rates, make investment decisions, monitor liquidity and evaluate the loan demand pipeline.

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Deposit runoff is monitored daily and loan prepayments evaluated monthly. The Company historically has maintained a substantial portion of its loan portfolio on a variable-rate basis and plans to continue this Asset/Liability Management (ALM) strategy in the future. Portions of the variable-rate loan portfolio have interest rate floors and caps which are taken into account by the Company's ALM modeling software to predict interest rate sensitivity, including prepayment risk. As of June 30, 2008, the investment portfolio is all classified as available-for-sale and the modified duration was relatively short. The Company does not utilize any derivative products or invest in any "high risk" instruments.

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The Company's interest rate sensitivity analysis (simulation) as of December 2007 for a 200 basis point declining rate environment (Prime at December 31, 2007 was 7.25% and had dropped to 5.00% by June 30, 2008) projected the following for the six months ended June 30, 2008, compared to the actual results:

	June 30, 2008		
	Projected	Actual	Percentage Difference
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	-----		
	-----		
	(Dollars in thousands)		
Net Interest Income	\$ 8,234	\$8,658	5.1%
Net Income	\$ 2,139	\$2,596	21.4%
Return on Assets	1.12%	1.32%	17.9%
Return on Equity	10.40%	12.32%	18.5%

Actual net income is higher than projected mainly due to the higher actual net interest income than projected as interest rates did not drop on January 1st as an immediate shock would imply but the prime rate dropped 75 basis points to 6.5% on January 22, 2008, another 50 basis points to 6.0% on January 30, 2008, a third drop of 75 basis points on March 18, 2008 to 5.25% and a fourth 25 basis point prime rate drop on April 30, 2008 to bring the Prime Rate down to 5.00%. Also, contributing to higher than expected net income was the gain on sale of loans projected at \$84 thousand and actual gain for the six months ending June 30, 2008 was \$172 thousand. In addition, the federal rehabilitation tax credit received in the first half of 2008 for \$195 thousand from late 2007 investments in affordable housing partnerships which were not projected in the simulation.

Commitments, Contingent Liabilities, and Off-Balance Sheet Arrangements. The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers, to reduce its own exposure to fluctuations in interest rates, and to implement its strategic objectives. These financial instruments include commitments to extend credit, standby letters of credit, interest rate caps and floors written on adjustable-rate loans, commitments to participate in or sell loans, and commitments to buy or sell securities, certificates of deposit or other investment instruments. Such instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized on the balance sheet. The contract or notional amounts of these instruments reflect the extent of involvement the Company has in a particular class of financial instruments.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. The Company uses the same credit policies in making

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commitments and conditional obligations as it does for on-balance-sheet instruments. For interest rate caps and floors written on adjustable-rate loans, the contract or notional amounts do not represent the Company's exposure to credit loss. The Company controls the risk of interest rate cap agreements through credit approvals, limits, and monitoring procedures.

The Company generally requires collateral or other security to support financial instruments with credit risk. As of June 30, 2008 and December 31, 2007, the contract or notional amount of financial instruments that represent credit risk was as follows:

	June 30, 2008	December 31, 2007
	(Dollars in thousands)	
Commitments to originate loans	\$12,353	\$ 7,084
Unused lines of credit	30,964	35,784
Standby letters of credit	1,510	1,248
Credit card arrangements	1,681	1,633
Equity investment commitment to housing limited partnership	214	214
FHLB of Boston MPF credit enhancement obligation, net	29	-
	-----	-----
Total	\$46,751	\$45,963

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Commitments to originate loans are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the loan commitments are expected to expire without being drawn upon and not all credit lines will be utilized, the total commitment amounts do not necessarily represent future cash requirements.

The Company has various financial obligations, including contractual obligations that may require further cash payments. The Company's significant fixed and determinable contractual obligations to third parties at June 30, 2008, and December 31, 2007, were as follows:

	June 30, 2008	December 31, 2007
	(Dollars in thousands)	
Operating lease commitments	\$ 366	\$ 309
Maturities on borrowed funds	27,855	20,328
Deposits without stated maturity (1)	201,902	198,083
Certificates of deposit (1)	118,864	125,878
Pension plan contributions (2)	540	600
Deferred compensation payouts (3)	391	470
Equity in housing limited partnerships	267	1,610
Real estate and construction contracts (4)	270	288
	-----	-----
Total	\$350,455	\$347,566

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- (1) While Union has a contractual obligation to depositors should they wish to withdraw all or some of the funds on deposit, management believes, based on historical analysis, that the majority of these deposits will remain on deposit for the foreseeable future. The amounts exclude payable interest accrued.

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- (2) Funding requirements for pension benefits after 2008 are excluded due to the significant variability in the assumptions required to project the amount and timing of future cash contributions.
- (3) The Company owns life insurance on the lives of the payees, in an amount sufficient to reimburse the Company for the deferred compensation payments should the Company desire to utilize the death benefit proceeds for that purpose. The policies have a current cash surrender value of \$2.1 million which is reflected in the balance sheet under Other Assets.
- (4) Contract to construct a new branch site in St. Albans, Vermont.

The Company's subsidiary bank is required (as are all banks) to maintain vault cash or a noninterest bearing reserve balance as established by Federal Reserve regulations. The Bank's average total reserve for the 14 day maintenance period including June 30, 2008 was \$352 thousand and for December 31, 2007 was \$387 thousand, both of which were satisfied by vault cash. The Company has also committed to maintain a noninterest bearing contracted clearing balance of \$1.0 million at June 30, 2008 with the Federal Reserve Bank of Boston.

Interest Rate Sensitivity "Gap" Analysis. An interest rate sensitivity "gap" is defined as the difference between interest earning assets and interest bearing liabilities maturing or repricing within a given time period. A gap is considered positive when the amount of interest rate sensitive assets exceeds the amount of interest rate sensitive liabilities. A gap is considered negative when the amount of interest rate sensitive liabilities exceeds the amount of interest rate sensitive assets. During a period of rising interest rates, a negative gap would tend to adversely affect net interest income, while a positive gap would tend to result in an increase in net interest income. During a period of falling interest rates, a negative gap would tend to result in an increase in net interest income, while a positive gap would tend to affect net interest income adversely. Because different types of assets and liabilities with the same or similar maturities may react differently to changes in overall market interest rates or conditions, changes in interest rates may affect net interest income positively or negatively even if an institution were perfectly matched in each maturity category.

The Company prepares its interest rate sensitivity "gap" analysis by scheduling interest earning assets and interest bearing liabilities into periods based upon the next date on which such assets and liabilities

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could mature or reprice. The amounts of assets and liabilities shown within a particular period were determined in accordance with the contractual terms of the assets and liabilities, except that:

- o adjustable-rate loans, investment securities, variable-rate time deposits, and FHLB of Boston advances are included in the period when they are first scheduled to adjust and not in the period in which they mature;
- o fixed-rate mortgage-related securities and loans reflect estimated prepayments, which were estimated based on analyses of broker estimates, the results of a prepayment model utilized by the Company, and empirical data;
- o other nonmortgage related fixed-rate loans reflect scheduled contractual amortization, with no estimated prepayments; and
- o NOW, money markets, and savings deposits, which do not have contractual maturities, reflect estimated levels of attrition, which are based on detailed studies by the Company of the sensitivity of each such category of deposit to changes in interest rates.

Management believes that these assumptions approximate actual experience and



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considers them reasonable. However, the interest rate sensitivity of the Company's assets and liabilities in the tables could vary substantially if different assumptions were used or actual experience differs from the historical experience on which the assumptions are based.

The following table shows the Company's rate sensitivity analysis as of June 30, 2008:

	Cumulative repriced			
	3 Months or Less	4 to 12 Months	1 to 3 Years	3 to 5 Years
	(Dollars in thousands, by r			
<b>Interest sensitive assets:</b>				
Federal funds sold and overnight deposits	\$ 11,778	\$ -	\$ -	\$ -
Interest bearing deposits in banks	2,370	1,781	1,963	1,963
Investment securities available-for-sale (1) (3)	1,128	2,889	7,902	5,902
FHLB Stock	-	-	-	-
Loans and loans held for sale (2) (3)	89,089	49,104	68,612	60,612
Total interest sensitive assets	\$104,365	\$53,774	\$78,477	\$ 67,477
<b>Interest sensitive liabilities:</b>				
Time deposits	\$ 42,871	\$58,799	\$15,418	\$ 1,418
Money markets	5,951	-	-	-
Regular savings	3,088	-	-	-
NOW accounts	13,204	-	-	-
Borrowed funds	219	672	1,901	9,901
Total interest sensitive liabilities	\$ 65,333	\$59,471	\$17,319	\$ 10,319
Net interest rate sensitivity gap	\$ 39,032	\$ (5,697)	\$61,158	\$ 56,158
Cumulative net interest rate sensitivity gap	\$ 39,032	\$33,335	\$94,493	\$151,493
Cumulative net interest rate sensitivity gap as a percentage of total assets	9.9%	8.4%	23.9%	38.9%
Cumulative net interest rate sensitivity gap as a percentage of total Interest sensitive assets	10.6%	9.0%	25.6%	41.6%
Cumulative net interest rate sensitivity gap as a percentage of total Interest sensitive liabilities	13.3%	11.4%	32.2%	51.6%

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- (1) Investment securities available-for-sale exclude marketable equity securities with a fair value of \$13 thousand and mutual funds with a value of \$40 thousand that may be sold by the Company at any time.
- (2) Balances shown net of unearned income of \$104 thousand.
- (3) Estimated repayment assumptions considered in Asset/Liability model.

Simulation Analysis. In its simulation analysis, the Company uses computer software to simulate the estimated impact on net interest income and capital

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(Net Fair Value) under various interest rate scenarios, balance sheet trends, and strategies over a relatively short time horizon. These simulations incorporate assumptions about balance sheet dynamics such as loan and deposit growth, product pricing, prepayment speeds on mortgage related assets, principal maturities on other financial instruments, and changes in funding mix. While such assumptions are inherently uncertain as actual rate changes rarely follow any given forecast and asset-liability pricing and other model inputs usually do not remain constant in their historical relationships, management believes that these assumptions are reasonable. Based on the results of these simulations, the Company is able to quantify its estimate of interest rate risk and develop and implement appropriate strategies.

The following chart reflects the cumulative results of the Company's latest simulation analysis for the next twelve months on net interest income, net income, return on assets, return on equity and net fair value ratio. Shocks are intended to capture interest rate risk under extreme conditions by immediately shifting to the new level. The projection utilizes a proportional rate shock, of up and down 300 basis points from the June 30, 2008 prime rate of 5.00%, this is the highest and lowest internal slopes monitored. This slope range was determined to be the most relevant during this economic cycle.

### INTEREST RATE SENSITIVITY ANALYSIS MATRIX (Dollars in thousands)

12 Months Ending	Prime Rate	Net Interest Income	Change %	Net Income	Return on Assets %	Return Equi %
June-09	8.00%	\$20,037	9.7	\$6,600	1.66	15.
	5.00%	\$18,265	0.00	\$5,342	1.31	12.
	2.00%	\$15,448	(15.4)	\$3,366	0.75	7.

The resulting projected cumulative effect of these estimates on net interest income and the net fair value ratio for the twelve month period ending June 30, 2009, are within approved ALCO guidelines for interest rate risk but the return on assets and equity in a down 300 basis point shock scenario are lower than Board guidelines. The simulations of earnings do not incorporate any management actions, which might moderate the negative consequences of interest rate deviations. Therefore, they do not reflect likely actual results, but serve as conservative estimates of interest rate risk under different rate scenarios.

Liquidity. Managing liquidity risk is essential to maintaining both depositor confidence and stability in earnings. Liquidity is a measurement of the Company's ability to meet potential cash requirements, including ongoing commitments to fund deposit withdrawals, repay borrowings, fund investment and lending activities, and for other general business purposes. The Company's principal sources of funds are deposits, amortization and prepayment of loans and securities, maturities of investment securities and other short-term investments, sales of securities and loans available-for-sale, earnings and funds provided from operations. Maintaining a relatively stable funding base, which is achieved by diversifying funding sources, competitively pricing deposit products, and extending the contractual maturity of liabilities, reduces the Company's exposure to rollover risk on deposits and limits reliance on volatile short-term purchased funds. Short-term funding needs arise from declines in deposits or other funding sources, funding of loan commitments, draws on unused lines of credit and requests for new loans. The Company's strategy is to fund assets, to the maximum extent possible, with core deposits that provide a sizable source of relatively stable and low-cost funds. For the

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quarter ended, June 30, 2008, the Company's ratio of average loans to average deposits was 99.7% compared to the prior year of 98.7%.

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In addition, as Union Bank is a member of the FHLB of Boston, it had access to unused lines of credit up to \$3.5 million at June 30, 2008 over and above the \$27.9 million term advances already drawn on the lines, based on FHLB of Boston estimate as of that date; with the purchase of required FHLB of Boston capital stock that amount would rise to \$21.4 million. This line of credit could be used for either short or long term liquidity or other needs. In addition to its borrowing arrangements with the FHLB of Boston, Union Bank maintains a \$7.5 million pre-approved Federal Funds line of credit with an upstream correspondent bank and a small repurchase agreement line with a selected brokerage house. There were no balances outstanding on either line at June 30, 2008. Union is a member of the Certificate of Deposit Account Registry Service ("CDARS") of Promontory Interfinancial Network which allows Union to provide higher FDIC deposit insurance to customers by exchanging deposits with other members and allows Union to purchase deposits from other members as another source of funding. There were no purchased deposits at either June 30, 2008 or December 31, 2007, although Union had exchanged \$8.5 million and \$6.6 million of deposits, respectively, with other CDARS members at those dates.

While scheduled loan and securities payments and FHLB of Boston advances are relatively predictable sources of funds, deposit flows and prepayments on loans and mortgage-backed securities are greatly influenced by general interest rates, economic conditions, and competition. The Company's liquidity is actively managed on a daily basis, monitored by the ALCO, and reviewed periodically with the subsidiary's Board of Directors. The ALCO measures the Company's marketable assets and credit available to fund liquidity requirements and compares the adequacy of that aggregate amount against the aggregate amount of the Company's interest sensitive or volatile liabilities, such as core deposits and time deposits in excess of \$100,000, borrowings and term deposits with short maturities, and credit commitments outstanding. The primary objective is to manage the Company's liquidity position and funding sources in order to ensure that it has the ability to meet its ongoing commitment to its depositors, to fund loan commitments and unused lines of credit, and to maintain a portfolio of investment securities.

The Company's management monitors current and projected cash flows and adjusts positions as necessary to maintain adequate levels of liquidity. Although approximately 84.9% of the Company's time deposits will mature within twelve months, management believes, based upon past experience, (percentage of time deposits to mature within twelve months has ranged from 72.3% to 87.8% over the preceding eight years) the relationships developed with local municipalities, and the variety of deposit products, that Union Bank will retain a substantial portion of these deposits. Management will continue to offer a competitive but prudent pricing strategy to facilitate retention of such deposits. The inverted yield curve for the last year, the proliferation of certificate of deposit specials and the general economic uncertainty have contributed to the shortening of the maturities in time deposits. A reduction in total deposits could be offset by purchases of federal funds, purchases of deposits, short-or-long-term FHLB borrowings, utilization of the repurchase agreement line, or liquidation of investment securities, purchased brokerage certificates of deposit or loans held for sale. Such steps could result in an increase in the Company's cost of funds or a decrease in the yield earned on assets and therefore adversely impact the net interest spread and margin. Management believes the Company has sufficient liquidity to meet all reasonable borrower, depositor, and creditor needs in the present economic environment. However, any projections of future cash needs and flows are subject to substantial uncertainty. Management continually evaluates opportunities to buy/sell

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securities and loans available-for-sale, obtain credit facilities from lenders, or restructure debt for strategic reasons or to further strengthen the Company's financial position.

Capital Resources. Capital management is designed to maintain an optimum level of capital in a cost-effective structure that meets target regulatory ratios; supports management's internal assessment of economic capital; funds the Company's business strategies; and builds long-term stockholder value. Dividends are generally increased in line with long-term trends in earnings per share growth and conservative earnings projections, while sufficient profits are retained to support anticipated business growth, fund strategic investments and provide continued support for deposits. However, for the three months ended June 30, 2008, dividends per share exceeded earnings per share resulting in a dividend payout ratio of 103.70% compared to 96.55% for the six months ended June 30, 2008. The Company and its subsidiary are considered well capitalized under the capital adequacy requirements to which they are subject even with these payout ratios. It is expected future earnings will improve and the past quarter reflected a number of onetime unusual items.

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The total dollar value of the Company's stockholders' equity at June 30, 2008 was \$41.8 down \$300 thousand from December 31, 2007 at \$42.1 million, reflecting net income of \$2.6 million for the first six months of 2008, less cash dividends paid of \$2.5 million, the purchase of 14,147 shares of Treasury stock totaling \$281 thousand, and an increase of \$113 thousand in accumulated other comprehensive loss.

Union Bankshares, Inc. has 7,500,000 shares of \$2.00 par value common stock authorized. As of June 30, 2008, the Company had 4,921,786 shares issued, of which 4,488,822 were outstanding and 432,964 were held in Treasury.

The Board of Directors has authorized the repurchase of up to 100,000 shares of common stock, or approximately 2.2% of the Company's outstanding shares at the authorization date, for an aggregate repurchase cost not to exceed \$2.15 million. Shares can be repurchased in the open market or in negotiated transactions. The repurchase program is open for an unspecified period of time and as such was reauthorized by the Board of Directors at their March 19, 2008 meeting. As of June 30, 2008 the Company had repurchased 14,147 shares under this program, for a total cost of \$281 thousand during the first half of 2008, and 82,902 shares at a total cost of \$1.7 million since the inception of the program in November, 2005.

As of June 30, 2008, there were outstanding employee incentive stock options with respect to shares of the Company's common stock, granted pursuant to Union Bankshares' 1998 Incentive Stock Option Plan. As of such date, 12,750 options were currently exercisable; however none of those options were "in the money". Of the 75,000 shares authorized for issuance under the 1998 Plan, 42,200 shares that had been available for future option grants were taken out of reserve when the 1998 Plan expired in May 2008. A new plan called the 2008 Incentive Stock Option Plan of Union Bankshares, Inc. and Subsidiary was approved by the shareholders at the 2008 annual meeting. The stock to be issued upon exercise of options granted under this Plan consists of authorized but unissued shares of the Common Stock and/or shares held in treasury. Subject to standard anti-dilution adjustments the aggregate number of shares of Common Stock that may be delivered upon exercise of all options granted under the Plan may not exceed fifty thousand (50,000) shares. The Corporation will at all times reserve and keep available such number of shares of Common Stock as shall be sufficient to satisfy the requirements of the Plan. During the second quarter of 2008, no incentive stock options were granted or exercised pursuant to either the 2008 or the 1998 plan.

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Union Bankshares, Inc. and Union Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Management believes, as of June 30, 2008, that both companies meet all capital adequacy requirements to which they are subject. As of June 30, 2008, the most recent calculation categorizes Union Bank as well capitalized under the regulatory framework for prompt corrective action. The prompt corrective action capital category framework applies to FDIC insured depository institutions such as Union but does not apply directly to bank holding companies such as the Company. To be categorized as well capitalized, Union Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table below. There are no conditions or events since June 30, 2008, that management believes have changed either company's category.

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Union Bank's and the Company's actual capital amounts and ratios as of June 30, 2008, are presented in the following table:

	Actual		Minimums For Capital Requirements		Minimum To Be Capitalized For Prompt Corrective Action
	Amount	Ratio	Amount	Ratio	Amount
(Dollars in thousands)					
Total capital to risk weighted assets					
Union Bank	\$45,875	16.5%	\$22,242	8.0%	\$27,803
Company	\$46,129	16.6%	\$22,298	8.0%	N/A
Tier I capital to risk weighted assets					
Union Bank	\$42,451	15.3%	\$11,120	4.0%	\$16,680
Company	\$42,696	15.3%	\$11,148	4.0%	N/A
Tier I capital to average assets					
Union Bank	\$42,451	10.8%	\$15,796	4.0%	\$19,745
Company	\$42,696	10.8%	\$15,828	4.0%	N/A

Regulatory Matters. The Company and Union are subject to periodic examinations by the various regulatory agencies. These examinations include, but are not limited to, procedures designed to review lending practices, risk management, credit quality, liquidity, compliance and capital adequacy. During 2008, the Vermont State Department of Banking performed an examination of Union Bank pursuant to their regular, periodic regulatory reviews. No comments were received from these various bodies that would have a material adverse effect on the Company's liquidity, financial position, capital resources, or results of operations.

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

Information called for by this item is incorporated by reference in Management's Discussion and Analysis of Financial Condition and Results of Operations under the caption "OTHER FINANCIAL CONSIDERATIONS" on pages 32 through 36 in this Form 10-Q.

### Item 4T. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures. The Company's chief executive

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officer and chief financial officer, with the assistance of the Disclosure Control Committee, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) as of June 30, 2008. Based on this evaluation they concluded that those disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by the Company in the reports that it files with the Commission is accumulated and communicated to the Company's management, including its principal executive and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required information.

Management's Report on Internal Control Over Financial Reporting. The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting, as such term is defined in Exchange Act Rule 13a-15(f). The Company's management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of the Company's internal control over financial reporting based on the Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on the results of this evaluation, the Company's management concluded that, as of June 30, 2008, the Company's internal control over financial reporting was effective to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles.

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There have been no changes in the Company's internal controls or in other factors known to the Company that could significantly affect these controls subsequent to the date of the evaluation referred to above. While the Company believes that its existing disclosure controls and procedures have been effective to accomplish these objectives, the Company intends to continue to examine, refine and formalize its disclosure controls and procedures and to monitor ongoing developments in this area.

### PART II OTHER INFORMATION

#### Item 1. Legal Proceedings.

There are no known pending legal proceedings to which the Company or its subsidiary is a party, or to which any of their properties is subject, other than ordinary litigation arising in the normal course of business activities. Although the amount of any ultimate liability with respect to such proceedings cannot be determined, in the opinion of management, any such liability would not have a material effect on the consolidated financial position of the Company and its subsidiary.

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

### ISSUER PURCHASES OF EQUITY SECURITIES

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Total Numbers of Shares Purchased

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Period	Total Number of Shares Purchased	Average Price Paid per Share	as Part of Publicly Announced Plans or Programs (1)
April 2008	700	\$19.96	700
May 2008	1,761	\$19.58	1,761
June 2008	800	\$20.89	800

(1) Since November 18, 2005, the Company has maintained an informal stock repurchase program pursuant to which the Company may repurchase up to \$2.15 million or 100,000 shares of common stock, or approximately 1% of the Company's outstanding shares as of the authorization date. Shares can be repurchased in the open market or through negotiated transactions. The repurchase program is open for an unspecified period of time and is periodically reauthorized by the Board of Directors at their March 19, 2008 meeting. As of June 30, 2008, the Company has repurchased 14,147 shares under this program for a total cost of \$281 thousand during 2008. Under the program, the Company has repurchased 82,902 shares at a total cost of \$1.7 million.

#### Item 4. Submission of Matters to a Vote of Security Holders.

The Company held its annual meeting of shareholders on May 21, 2008. Of 4,492,083 shares outstanding on the record date of the meeting (March 31, 2008) and entitled to vote, 3,468,164 shares were represented in person or by proxy. Two matters were voted on by the shareholders at the meeting; one was to fix the number of directors at nine and to elect the following individuals as directors for the ensuing year:

Nominees	Votes For	Votes Withheld	Votes Abstained	Broker Non-votes
Cynthia D. Borck	3,431,226	36,938	0	-
Steven J. Bourgeois	3,451,746	16,418	0	-
Kenneth D. Gibbons	3,427,991	40,173	0	-
Franklin G. Hovey, II	3,448,710	19,454	0	-
Richard C. Marron	3,451,718	16,446	0	-
Robert P. Rollins	3,443,721	24,443	0	-
Richard C. Sargent	3,427,799	43,365	0	-
John H. Steel	3,451,746	16,418	0	-
Schuyler W. Sweet	3,451,723	16,441	0	-

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The second was to approve the 2008 Incentive Stock Option Plan of Union Bankshares, Inc. and subsidiary which was intended to replace the Company's 1998 Incentive Stock Option Plan, which expired at the annual meeting. There were 2,665,958 votes for, 147,927 votes against, 84,127 votes abstained and 570,152 broker nonvotes. The number of votes in favor was sufficient to approve the Plan.

#### Item 6. Exhibits.

- 31.1 Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2 Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1 Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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- 32.2 Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

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SIGNATURES

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

August 14, 2008

Union Bankshares, Inc.

/s/ Kenneth D. Gibbons

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Kenneth D. Gibbons  
Director, President and  
Chief Executive Officer

/s/ Marsha A. Mongeon

August 1, 2008

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Marsha A. Mongeon  
Chief Financial Officer and Treasurer  
(Principal Financial Officer)

EXHIBIT INDEX

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