

CHICOPEE BANCORP, INC.  
Form 10-Q  
May 09, 2014

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

FORM 10-Q

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

For the quarterly period ended March 31, 2014

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-51996

CHICOPEE BANCORP, INC.  
(Exact name of registrant as specified in its charter)

Massachusetts 20-4840562  
(State or other jurisdiction of incorporation or (I.R.S. Employer Identification No.)  
organization)

70 Center Street, Chicopee, Massachusetts 01013  
(Address of principal executive offices) (Zip Code)  
(413) 594-6692  
(Registrant's telephone number, including area code)

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

Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large Accelerated Filer  Accelerated Filer   
Non-Accelerated Filer  Smaller Reporting Company

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

As of May 8, 2014, there were 5,438,085 shares of the Registrant's Common Stock outstanding.

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## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## CHICOPEE BANCORP, INC. AND SUBSIDIARIES

## CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(Dollars In Thousands)

(Unaudited)

	March 31, 2014	December 31, 2013
<b>ASSETS</b>		
Cash and due from banks	\$ 13,142	\$ 9,100
Federal funds sold	1,036	426
Interest-bearing deposits with the Federal Reserve Bank of Boston	22,256	9,389
Total cash and cash equivalents	36,434	18,915
Available-for-sale securities, at fair value	407	602
Held-to-maturity securities, at cost (fair value of \$41,606 at March 31, 2014 and \$49,338 at December 31, 2013)	40,993	48,606
Federal Home Loan Bank stock, at cost	3,914	3,914
Loans, net of allowance for loan losses of (\$4,462 at March 31, 2014 and \$4,596 at December 31, 2013)	488,170	485,619
Loans held for sale	396	70
Other real estate owned	135	407
Mortgage servicing rights	352	381
Bank owned life insurance	14,261	14,173
Premises and equipment, net	9,043	9,181
Accrued interest and dividends receivable	1,528	1,609
Deferred income tax asset	3,057	3,042
Other assets	1,167	1,208
Total assets	\$ 599,857	\$ 587,727
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>Deposits</b>		
Demand deposits	\$ 94,590	\$ 90,869
NOW accounts	42,181	40,774
Savings accounts	50,546	49,755
Money market deposit accounts	111,688	111,126
Certificates of deposit	157,680	157,242
Total deposits	456,685	449,766
Federal Home Loan Bank advances	52,187	44,992
Accrued expenses and other liabilities	327	739
Total liabilities	509,199	495,497
<b>Stockholders' equity</b>		
Common stock (no par value, 20,000,000 shares authorized, 7,439,368 shares issued; 5,438,085 and 5,435,885 shares outstanding at March 31, 2014 and December 31, 2013, respectively)	72,479	72,479

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Treasury stock, at cost (2,001,283 and 2,003,483 shares at March 31, 2014 and December 31, 2013, respectively)	(26,394	) (26,435	)
Additional paid-in-capital	3,377	3,299	
Unearned compensation (restricted stock awards)	(11	) (12	)
Unearned compensation (Employee Stock Ownership Plan)	(3,496	) (3,571	)
Retained earnings	44,678	46,418	
Accumulated other comprehensive income	25	52	
Total stockholders' equity	90,658	92,230	
Total liabilities and stockholders' equity	\$599,857	\$587,727	

See accompanying notes to unaudited consolidated financial statements.

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CHICOPEE BANCORP, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF OPERATIONS  
(In Thousands, Except for Number of Shares and Per Share Amounts)  
(Unaudited)

	Three Months Ended March 31,	
	2014	2013
Interest and dividend income:		
Loans, including fees	\$5,204	\$5,456
Interest and dividends on securities	411	424
Interest on other interest-earning assets	8	14
Total interest and dividend income	5,623	5,894
Interest expense:		
Deposits	714	958
Securities sold under agreements to repurchase	—	3
Federal Home Loan Bank advances	213	189
Total interest expense	927	1,150
Net interest income	4,696	4,744
Provision for (reduction of) loan losses	2,201	(70)
Net interest income, after provision for (reduction of) loan losses	2,495	4,814
Non-interest income:		
Service charges, fees and commissions	496	502
Net loan sales and servicing	53	264
Net gain on sales of available-for-sale securities	34	—
Net loss on sale of other real estate owned	(82)	(40)
Income from bank owned life insurance	88	92
Other non-interest income	—	24
Total non-interest income	589	842
Non-interest expenses:		
Salaries and employee benefits	2,516	2,533
Occupancy expenses	448	425
Furniture and equipment	183	204
FDIC insurance assessment	84	68
Data processing services	346	312
Professional fees	180	217
Advertising expense	169	147
Stationery, supplies and postage	60	76
Other non-interest expense	632	652
Total non-interest expenses	4,618	4,634
Income (loss) before income taxes	(1,534)	1,022
Income tax expense (benefit)	(175)	225
Net income (loss)	\$(1,359)	\$797
Earnings (loss) per share:		

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Basic	\$ (0.27	)	\$ 0.16
Diluted	\$ (0.27	)	\$ 0.16

Adjusted weighted average shares outstanding:

Basic	5,079,063	5,040,230
Diluted	5,176,226	5,104,810

See accompanying notes to unaudited consolidated financial statements.

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CHICOPEE BANCORP, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (LOSS)  
(In Thousands)  
(Unaudited)

	Three Months Ended March 31,		
	2014	2013	
Net income (loss)	\$(1,359	) \$797	
Other comprehensive income (loss), net of tax			
Unrealized holding gains (losses) arising during period on investment securities available-for-sale	(8	) 12	
Reclassification adjustment for gains realized in net income (1)	(34	) —	
Tax effect	15	(4	)
Other comprehensive income (loss), net of tax	(27	) 8	
Comprehensive income (loss)	\$(1,386	) \$805	

(1) Reclassified into the consolidated statements of operations in net gain on sales of available-for-sale securities.

See accompanying notes to unaudited consolidated financial statements.



CHICOPEE BANCORP, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
Three Months Ended March 31, 2014 and 2013  
(Dollars In Thousands)  
(Unaudited)

	Common Stock	Treasury Stock	Additional Paid-in Capital	Unearned Compensation (restricted stock awards)	Unearned Compensation (Employee Stock Ownership Plan)	Retained Earnings	Accumulated Other Comprehensive Income	Total
Balance at December 31, 2013	\$72,479	\$(26,435)	\$3,299	\$ (12 )	\$ (3,571 )	\$46,418	\$ 52	\$92,230
Comprehensive income (loss):								
Net loss	—	—	—	—	—	(1,359 )	—	(1,359 )
Change in net unrealized gain on available-for-sale securities (net of deferred income taxes of \$15)	—	—	—	—	—	—	(27 )	(27 )
Total comprehensive loss								(1,386 )
Stock options exercised (2,200 shares)	—	41	(8 )	—	—	—	—	33
Stock option expense	—	—	30	—	—	—	—	30
Change in unearned compensation:								
Restricted stock award expense	—	—	—	1	—	—	—	1
Common stock held by ESOP committed to be released	—	—	56	—	75	—	—	131
Cash dividends declared (\$0.07 per share)	—	—	—	—	—	(381 )	—	(381 )
Balance at March 31, 2014	\$72,479	\$(26,394)	\$3,377	\$ (11 )	\$ (3,496 )	\$44,678	\$ 25	\$90,658
Balance at December 31, 2012	\$72,479	\$(26,567)	\$3,044	\$ (18 )	\$ (3,868 )	\$44,873	\$ 26	\$89,969
Comprehensive income:								
Net income	—	—	—	—	—	797	—	797
Change in net unrealized gain on available-for-sale	—	—	—	—	—	—	8	8

securities (net of deferred income taxes of \$4)								
Total comprehensive income								805
Stock option expense	—	—	28	—	—	—	—	28
Change in unearned compensation:								
Restricted stock award expense	—	—	—	1	—	—	—	1
Common stock held by ESOP committed to be released	—	—	47	—	74	—	—	121
Cash dividends declared (\$0.05 per share)	—	—	—	—	—	(271	)	(271
Balance at March 31, 2013	\$72,479	\$(26,567)	\$3,119	\$ (17	)	\$ (3,794	)	\$45,399
							\$ 34	\$90,653

See accompanying notes to unaudited consolidated financial statements.

CHICOPEE BANCORP, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

	Three Months Ended March	
	31,	2013
	2014	2013
	(In Thousands)	
Cash flows from operating activities:		
Net income (loss)	\$(1,359	) \$797
Adjustments to reconcile net income (loss) to net cash provided (used) by operating activities:		
Depreciation and amortization	172	230
Provision for (reduction of) loan losses	2,201	(70
Increase in cash surrender value of life insurance	(88	) (92
Net realized gain on sales of securities available-for-sale	(34	) —
Realized gains on sales of mortgage loans	(7	) (90
Decrease (increase) in other assets	78	(17
Decrease (increase) in accrued interest and dividends receivable	81	(128
Decrease in FDIC prepaid insurance	—	(9
Net change in loans originated for resale	(326	) (2,224
Write-down of other real estate owned	82	40
(Decrease) increase in other liabilities	(412	) 62
Change in unearned compensation	132	122
Stock option expense	30	28
Net cash provided (used) by operating activities	550	(1,351
Cash flows from investing activities:		
Purchase of premises and equipment	(35	) (82
Loan originations, net of principal payments	(4,752	) 8,637
Proceeds from sales of other real estate owned	190	48
Proceeds from sales of securities available-for-sale	187	—
Purchases of held-to-maturity securities	—	(9,444
Maturities of held-to-maturity securities	7,325	8,711
Proceeds from principal paydowns of held-to-maturity securities	288	406
Proceeds from sale of Federal Home Loan Bank, stock	—	362
Net cash provided by investing activities	3,203	8,638
Cash flows from financing activities:		
Net increase (decrease) in deposits	6,919	(15,095
Net change in repurchase agreements	—	2,958
Payments on long-term FHLB advances	(2,805	) (2,319
Proceeds from long-term FHLB advances	5,000	—
Proceeds from short-term FHLB advances	5,000	—
Cash dividends paid on common stock	(381	) (271
Stock options exercised	33	—
Net cash provided (used) by financing activities	13,766	(14,727
Net increase (decrease) in cash and cash equivalents	17,519	(7,440
Cash and cash equivalents at beginning of year	18,915	39,608

Cash and cash equivalents at end of period	\$36,434	\$32,168
Supplemental cash flow information:		
Interest paid on deposits	\$714	\$958
Interest paid on borrowings	200	242
Income taxes paid	7	7
See accompanying notes to unaudited consolidated financial statements.		

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CHICOPEE BANCORP, INC. AND SUBSIDIARIES  
Notes to Unaudited Consolidated Financial Statements  
March 31, 2014 and 2013

1. Basis of Presentation

Chicopee Bancorp, Inc. (the "Corporation") has no significant assets other than all of the outstanding shares of its wholly-owned subsidiaries, Chicopee Savings Bank (the "Bank") and Chicopee Funding Corporation (collectively, the "Company"). The Corporation was formed on March 14, 2006 and became the holding company for the Bank upon completion of the Bank's conversion from a mutual savings bank to a stock savings bank. The conversion of the Bank was completed on July 19, 2006. The accounts of the Bank include its wholly-owned subsidiaries and a 99% owned subsidiary. The consolidated financial statements of the Company as of March 31, 2014 and for the periods ended March 31, 2014 and 2013 included herein are unaudited. In the opinion of management, all adjustments, consisting only of normal recurring adjustments necessary for a fair presentation of the financial condition, results of operations, changes in stockholders' equity and cash flows, as of and for the periods covered herein, have been made. These financial statements should be read in conjunction with the consolidated financial statements and notes thereto for the year ended December 31, 2013 included in the Company's Annual Report on Form 10-K.

The results for the three month interim period ended March 31, 2014 are not necessarily indicative of the operating results for a full year.

2. Earnings (Loss) Per Share

Basic earnings per share represents income available to common stockholders divided by the adjusted weighted-average number of common shares outstanding during the period. The adjusted outstanding common shares equals the gross number of common shares issued less average treasury shares, unallocated shares of the Chicopee Savings Bank Employee Stock Ownership Plan ("ESOP"), and average dilutive restricted stock awards under the 2007 Equity Incentive Plan. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by the Company relate to outstanding stock options and certain stock awards and are determined using the treasury stock method.

Earnings (loss) per share have been computed based on the following:

(\$ in thousands, except share data )	Three Months Ended March 31,	
	2014	2013
Net income (loss)	\$(1,359 )	\$797
Average number of shares issued	7,439,368	7,439,368
Less: average number of treasury shares	(2,002,114 )	(2,010,783 )
Less: average number of unallocated ESOP shares	(357,089 )	(386,848 )
Less: average number of dilutive restricted stock awards	(1,102 )	(1,507 )
Adjusted weighted average number of common shares outstanding	5,079,063	5,040,230
Plus: dilutive outstanding restricted stock awards	435	446
Plus: dilutive outstanding stock options	96,728	64,134
Weighted average number of diluted shares outstanding	5,176,226	5,104,810

Earnings (loss) per share:

Basic-common stock	\$(0.27	)	\$0.16
Basic-unvested share-based payment awards	\$(0.27	)	\$0.16
Diluted-common stock	\$(0.27	)	\$0.16
Diluted-unvested share-based payment awards	\$(0.27	)	\$0.16

Given the loss for the three months ended March 31, 2014, diluted loss per share did not differ from basic loss per share as all dilutive-potential shares were anti-dilutive. There were 695,198 stock options that were not included in the calculation of diluted earnings per share for the three months ended March 31, 2013 because the effect was anti-dilutive.

### 3. Equity Incentive Plan

#### Stock Options

The Company's 2007 Equity Incentive Plan (the "Plan") was approved by the Company's stockholders at the annual meeting of the Company's stockholders on May 30, 2007. The Plan provides that the Company may grant options to directors, officers and employees for up to 743,936 shares of common stock. Both incentive stock options and non-qualified stock options may be granted under the Plan. The exercise price for each option is equal to the market price of the Company's stock on the date of grant and the maximum term of each option is ten years. The stock options vest over five years in five equal installments on each anniversary of the date of grant.

The Company recognizes compensation expense over the vesting period, based on the grant-date fair value of the options granted. The fair value of each option granted is estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions for options granted during the year ended December 31, 2013.

	Year Ended December 31, 2013	
Expected dividend yield	1.39	%
Weighted average expected term	6.5 years	
Weighted average expected volatility	24.06	%
Weighted average risk-free interest rate	1.25	%

Expected volatility is based on the historical volatility of the Company's stock and other factors. The risk-free interest rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of the grant. The Company uses historical data, such as option exercise and employee termination rates, to calculate the expected option life.

A summary of options under the Plan as of March 31, 2014 and changes during the three months ended March 31, 2014, is as follows:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value (000's)
Outstanding at December 31, 2013	668,598	\$14.58	4.86	\$1,894
Granted	—	—	—	—
Exercised	(2,200	) 15.27	8.28	—
Forfeited or expired	(5,800	) 15.82	8.51	—
Outstanding at March 31, 2014	660,598	\$14.56	4.57	\$2,071
Exercisable at March 31, 2014	546,897	\$14.33	3.77	\$1,842
Exercisable at March 31, 2013	534,598	\$14.26	4.50	\$1,411

There were no options granted during the three months ended March 31, 2014. The weighted-average grant-date fair value of options granted during 2013 was \$3.59. The weighted-average grant-date fair value of the options outstanding and exercisable at March 31, 2014 was \$3.81 and \$3.87, respectively. For the three months ended March

31, 2014, share based compensation expense applicable to options granted under the Plan was \$30,000 and the related tax benefit was \$1,000. For the three months ended March 31, 2013, share based compensation expense applicable to options granted under the Plan was \$28,000 and the related tax benefit was \$1,000. As of March 31, 2014, unrecognized stock-based compensation expense related to non-vested options amounted to \$375,000. This amount is expected to be recognized over a period of 3.32 years.



## Stock Awards

The Plan provides that the Company may grant stock awards to its directors, officers and employees for up to 297,574 shares of common stock. The stock awards vest 20% per year beginning on the first anniversary of the date of grant. The fair market value of the stock awards, based on the market price at the date of grant, is recorded as unearned compensation. Unearned compensation is amortized over the applicable vesting period. The weighted-average grant-date fair value of stock awards as of March 31, 2014 is \$14.08. The Company recorded compensation cost related to stock awards of approximately \$1,000 for the three months ended March 31, 2014 and for the three months ended March 31, 2013. There were no stock awards granted prior to July 1, 2007. There were no stock awards granted by the Company during the three months ended March 31, 2014. The Company granted 2,000 stock awards during the year ended December 31, 2011 with a grant price of \$14.08. As of March 31, 2014, unrecognized stock-based compensation expense related to non-vested restricted stock awards amounted to \$11,000. This amount is expected to be recognized over a period of 1.94 years.

A summary of the status of the Company's stock awards as of March 31, 2014, and changes during the three months ended March 31, 2014, is as follows:

Nonvested Shares	Number of Shares	Weighted Average Grant-Date Fair Value
Outstanding at December 31, 2013	1,200	\$14.08
Granted	—	—
Vested	400	14.08
Forfeited	—	—
Outstanding at March 31, 2014	800	\$14.08

#### 4. Long-term Incentive Plan

On March 13, 2012, the Company adopted the Chicopee Bancorp, Inc. 2012 Phantom Stock Unit Award and Long-Term Incentive Plan (the "Phantom Stock Plan"), effective January 1, 2012, to promote the long-term financial success of the Company and its subsidiaries by providing a means to attract, retain and reward individuals who contribute to such success and to further align their interest with those of the Company's stockholders.

A total of 150,000 phantom stock units will be available for awards under the Phantom Stock Plan. The only awards that may be granted under the Phantom Stock Plan are Phantom Stock Units. A Phantom Stock Unit represents the right to receive a cash payment on the determination date equal to the book value of a share of the Company's stock on the determination date. The settlement of a Phantom Stock Unit on the determination date shall be in cash. Unless the Compensation Committee of the Board of Directors of the Company determines otherwise, the required period of service for full vesting will be three years. The Company's total expense under the Phantom Stock Plan for the three months ended March 31, 2014, and 2013, was \$8,000 and \$4,000, respectively.

#### 5. Recent Accounting Pronouncements (Applicable to the Company)

In January 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2014-04, Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. The ASU was issued to clarify that an in substance repossession or foreclosure occurs, and a credit is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the credit obtaining legal

title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the ASU amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The ASU is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2014, and the ASU is to be adopted using either a modified retrospective transition method or a prospective transition method. The Company does not believe such ASU will have a material effect on the Company's consolidated financial statements for the interim and annual periods in 2014, other than the additional disclosures required.

## 6. Investment Securities

The following tables set forth, at the dates indicated, information regarding the amortized cost and fair value, with gross unrealized gains and losses of the Company's investment securities:

	March 31, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
Available-for-sale securities				
Marketable equity securities	\$369	\$38	\$—	\$407
Total available-for-sale securities	\$369	\$38	\$—	\$407
Held-to-maturity securities				
U.S. Treasury securities	\$—	\$—	\$—	\$—
Corporate and industrial revenue bonds	34,358	576	—	34,934
Certificates of deposit	6,048	7	—	6,055
Collateralized mortgage obligations	587	30	—	617
Total held-to-maturity securities	\$40,993	\$613	\$—	\$41,606
Non-marketable securities				
Federal Home Loan Bank stock	\$3,914	\$—	\$—	\$3,914
Banker's Bank Northeast stock	183	—	—	183
Total non-marketable securities	\$4,097	\$—	\$—	\$4,097
	December 31, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
Available-for-sale securities				
Marketable equity securities	\$522	\$80	\$—	\$602
Total available-for-sale securities	\$522	\$80	\$—	\$602
Held-to-maturity securities				
U.S. Treasury securities	\$5,000	\$—	\$—	\$5,000
Corporate and industrial revenue bonds	34,588	681	—	35,269
Certificates of deposit	8,373	15	—	8,388
Collateralized mortgage obligations	645	36	—	681
Total held-to-maturity securities	\$48,606	\$732	\$—	\$49,338
Non-marketable securities				
Federal Home Loan Bank stock	\$3,914	\$—	\$—	\$3,914
Banker's Bank Northeast stock	183	—	—	183
Total non-marketable securities	\$4,097	\$—	\$—	\$4,097



The amortized cost and estimated fair value of debt securities by contractual maturity at March 31, 2014 are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without prepayment penalties. The collateralized mortgage obligations are allocated to maturity categories according to final maturity date.

	Held-to-maturity Amortized Cost (In Thousands)	Fair Value
Due in one year or less	\$6,048	\$6,055
Due after one year through five years	560	588
Due after five years through ten years	8,021	8,200
Due after ten years	26,364	26,763
	\$40,993	\$41,606

During the three months ended March 31, 2014 proceeds from sales of available-for-sale securities amounted to \$187,000 with gross realized gains of \$34,000. The tax provision applicable to the net realized gain for the three months ended March 31, 2014 was \$8,000. There were no sales of available-for-sale securities during the three months ended March 31, 2013.

#### Unrealized Losses on Investment Securities

Management conducts, at least on a monthly basis, a review of its investment portfolio including available-for-sale and held-to-maturity securities to determine if the fair value of any security has declined below its cost or amortized cost and whether such security is other-than-temporarily impaired. Securities are evaluated individually based on guidelines established by the FASB and the internal policy of the Company and include but are not limited to: (1) intent and ability of the Company to retain the investment for a period of time sufficient to allow for the anticipated recovery in fair value; (2) percentage and length of time which an issue is below book value; (3) financial condition and near-term prospects of the issuer; (4) whether the debtor is current on contractually obligated interest and principal payments; (5) the volatility of the market price of the security; and (6) any other information and observable data considered relevant in determining whether other-than-temporary impairment has occurred, including the expectation of receipt of all principal and interest due.

There were no unrealized losses as of March 31, 2014 and December 31, 2013.

#### U.S. Treasury Securities

The Company did not hold U.S. Treasury securities at March 31, 2014. There were no unrealized losses within the U.S. Treasury securities portfolio at December 31, 2013.

#### Collateralized Mortgage Obligations (“CMO”)

As of March 31, 2014 and December 31, 2013, there were no unrealized losses within the CMO portfolio. The portfolio ended with an unrealized gain of \$30,000 and \$36,000 as of March 31, 2014 and December 31, 2013, respectively. As of March 31, 2014, the Company had six CMO bonds, or eight individual issues, with an aggregate book value of \$587,000. Since the purchase of these bonds, interest payments have been current and the Company expects to receive all principal and interest due.

As of December 31, 2013, the Company had eight CMO bonds, or six individual issues, with an aggregate book value of \$645,000. Since the purchase of these bonds, interest payments have been current and the Company expects to receive all principal and interest due.

#### Corporate and Industrial Revenue Bonds

As of March 31, 2014 and December 31, 2013, there were no unrealized losses within the corporate industrial revenue bond category. The Company had six tax-exempt industrial revenue bonds ("IRB"), with an aggregate book value of \$34.4 million and \$34.6 million at March 31, 2014 and December 31, 2013, respectively. The portfolio ended with unrealized gains of \$576,000 and \$681,000 as of March 31, 2014 and December 31, 2013, respectively.

**Marketable Equity Securities**

As of March 31, 2014 and December 31, 2013 there were no unrealized losses within the marketable equity securities portfolio, and the portfolio ended the period with a net unrealized gain of \$38,000 and \$80,000, respectively.

#### Non-Marketable Securities

The Company is a member of the Federal Home Loan Bank of Boston (“FHLB”). The FHLB is a cooperatively owned wholesale bank for housing and finance in the six New England States. Its mission is to support the residential mortgage and community development lending activities of its members, which include over 450 financial institutions across New England. As a requirement of membership in the FHLB, the Company must own a minimum required amount of FHLB stock, calculated periodically based primarily on the Company’s level of borrowings from the FHLB. The Company uses the FHLB for much of its wholesale funding needs. The Company’s investment in FHLB stock totaled \$3.9 million as of March 31, 2014 and December 31, 2013.

FHLB stock is a non-marketable equity security and therefore is reported at cost, which equals par value. Shares held in excess of the minimum required amount are generally redeemable at par value. For the three months ended March 31, 2014 and for the year ended December 31, 2013, the Company received \$15,000 and \$15,000, respectively, in dividend income from its FHLB stock investment.

The Company periodically evaluates its investment in FHLB stock for impairment based on, among other factors, the capital adequacy of the FHLB and its overall financial condition. There have not been any impairment losses recorded through March 31, 2014 and the Company will continue to monitor its FHLB stock investment.

Banker’s Bank Northeast (BBN) stock is reported under other assets on the Statement of Financial Condition and is carried at cost. The BBN stock investment is evaluated for impairment based on an estimate of the ultimate recovery to par value. As of March 31, 2014 and December 31, 2013, the Company’s investment in BBN totaled \$183,000. There have not been any impairment losses recorded through March 31, 2014 and the Company will continue to monitor its BBN stock investment.

## 7. Loans and Allowance for Loan Losses

The following table sets forth the composition of the Company's loan portfolio in dollar amounts and as a percentage of the total loan portfolio at the dates indicated.

	March 31, 2014		December 31, 2013		
	Amount	Percent of Total	Amount	Percent of Total	
	(Dollars In Thousands)				
Real estate loans:					
Residential(1)	\$113,257	23.0	% \$112,524	23.0	%
Home equity	31,436	6.4	% 32,091	6.6	%
Commercial	215,203	43.8	% 211,161	43.1	%
Total	359,896	73.2	% 355,776	72.7	%
Construction-residential	7,109	1.4	% 6,130	1.3	%
Construction-commercial	43,439	8.8	% 38,441	7.9	%
Total	50,548	10.3	% 44,571	9.2	%
Total real estate loans	410,444	83.5	% 400,347	81.9	%
Consumer loans	2,358	0.5	% 2,405	0.4	%
Commercial and industrial loans	78,912	16.0	% 86,540	17.7	%
Total loans	491,714	100.0	% 489,292	100.0	%
Deferred loan origination costs, net	918		923		
Allowance for loan losses	(4,462)	)	(4,596)	)	
Loans, net	\$488,170		\$485,619		

(1) Excludes loans held for sale of \$396,000 and \$70,000 at March 31, 2014 and December 31, 2013, respectively.

The Company has transferred a portion of its originated commercial real estate and commercial loans to participating lenders. The amounts transferred have been accounted for as sales and therefore not included in the Company's consolidated statements of financial condition. The Company and participating lenders share proportionally, based on participating agreements, any gains or losses that may result from the borrowers lack of compliance with the terms of the loan. The Company continues to service the loans on behalf of the participating lenders. At March 31, 2014 and December 31, 2013, the Company was servicing loans for participating lenders totaling \$15.0 million and \$13.7 million, respectively.

In accordance with the Company's asset/liability management strategy and in an effort to reduce interest rate risk, the Company continues to sell fixed rate, low coupon residential real estate loans to the secondary market. The Company sold \$1.6 million and \$12.0 million in residential real estate loans to the secondary market, during the three month period ended March 31, 2014 and 2013, respectively. The unpaid principal balance of residential real estate loans serviced for others was \$97.0 million at March 31, 2014 and \$97.6 million at December 31, 2013. Servicing rights will continue to be retained on all loans written and sold in the secondary market.

## Credit Quality



To evaluate the risk in the loan portfolio, internal credit risk ratings are used for the following loan segments: commercial real estate, commercial construction and commercial. The risks evaluated in determining an adequate credit risk rating include the financial strength of the borrower and the collateral securing the loan. All commercial real estate, commercial construction and commercial loans are rated from one through nine. Credit risk ratings one through five are considered pass ratings. Classified assets include credit risk ratings of special mention, substandard, doubtful and loss. At least quarterly, classified assets are reviewed by management. Credit risk ratings are updated as soon as information is obtained that indicates a change in the credit risk rating may be warranted.

The following describes the classified credit risk ratings:

**Special mention.** Assets that do not currently expose the Company to sufficient risk to warrant classification in one of the following categories but possess potential weaknesses.

**Substandard.** Assets that have one or more defined weaknesses and are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Non-accruing loans are typically classified as substandard.

Residential real estate and residential construction loans are categorized into pass and substandard risk ratings. Substandard residential loans are loans that are on nonaccrual status and are individually evaluated for impairment.

Consumer loans are considered nonperforming when they are 90 days past due or have not returned to accrual status. Consumer loans are not individually evaluated for impairment.

Home equity loans are considered nonperforming when they are 90 days past due or have not returned to accrual status. Each nonperforming home equity loan is individually evaluated for impairment.

The following table presents an analysis of total loans segregated by risk rating and segment as of March 31, 2014:

	Commercial Credit Risk Exposure			
	Commercial and Industrial (In Thousands)	Commercial Construction	Commercial Real Estate	Total
Pass	\$70,995	\$32,854	\$203,844	\$307,693
Special mention	5,034	6,487	4,155	15,676
Substandard	2,883	4,098	7,204	14,185
Total commercial loans	\$78,912	\$43,439	\$215,203	\$337,554
	Residential Credit Risk Exposure			
	Residential Real Estate (In Thousands)	Residential Construction		Total
Performing	\$110,335	\$7,109		\$117,444
Substandard (nonaccrual)	2,922	—		2,922
Total residential loans	\$113,257	\$7,109		\$120,366
	Consumer Credit Risk Exposure			
	Consumer (In Thousands)	Home Equity		Total
Performing	\$2,333	\$31,196		\$33,529
Nonperforming (nonaccrual)	25	240		265
Total consumer loans	\$2,358	\$31,436		\$33,794



The following table presents an analysis of total loans segregated by risk rating and segment as of December 31, 2013:

	Commercial Credit Risk Exposure			
	Commercial and Industrial (In Thousands)	Commercial Construction	Commercial Real Estate	Total
Pass	\$77,483	\$27,969	\$200,096	\$305,548
Special mention	4,050	6,584	3,594	14,228
Substandard	5,007	3,888	7,471	16,366
Total commercial loans	\$86,540	\$38,441	\$211,161	\$336,142
	Residential Credit Risk Exposure			
	Residential Real Estate (In Thousands)	Residential Construction		Total
Performing	\$110,109	\$6,130		\$116,239
Substandard (nonaccrual)	2,415	—		2,415
Total residential loans	\$112,524	\$6,130		\$118,654
	Consumer Credit Risk Exposure			
	Consumer (In Thousands)	Home Equity		Total
Performing	\$2,397	\$31,798		\$34,195
Substandard (nonaccrual)	8	293		301
Total consumer loans	\$2,405	\$32,091		\$34,496

#### Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. The allowance for loan losses is evaluated on a regular basis by management.

This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

Net charge-offs of \$2.3 million for the three months ended March 31, 2014 were primarily due to losses taken on a \$4.6 million commercial relationship consisting of four commercial real estate loans totaling \$2.1 million and a commercial line of credit totaling \$2.5 million. Management is investigating potential fraudulent activity with one relationship and taking the necessary steps to protect the Company's position and to mitigate additional losses related to this relationship.

The allowance consists of general and allocated components, as further described below.

#### Loans charged off

Commercial and industrial loans. Loans past due more than 120 days are considered for one of three options: charge off the balance of the loan, charge off any excess balance over the fair value of the collateral securing the loan, or continue collection efforts subject to a monthly review until either the balance is collected or a charge-off recommendation can be reasonably made.

Residential loans. In general, a charge-off will not be recommended until a potential shortfall can be determined upon receipt of an updated appraisal and/or title to the property. However, any outstanding loan balance in excess of the fair value of the property, less cost to sell, is classified as a loss in the allocation of loan loss reserves and charged off when the property is acquired before being transferred to OREO.

Consumer loans. Generally all loans are automatically considered for charge-off at 90 to 120 days from the contractual due date, unless there is liquid collateral in hand sufficient to repay principal and interest in full.

## General Component

The general component of the allowance for loan losses is based on historical loss experience adjusted for qualitative factors stratified by the following portfolio segments: residential real estate, residential construction, commercial real estate, commercial, commercial construction, consumer and home equity. Management uses an average of historical losses based on a time frame appropriate to capture relevant loss data for each portfolio segment. Management deems 36 months to be an appropriate time frame on which to base historical losses for each portfolio segment. This historical loss factor is adjusted for qualitative factors for each portfolio segment including, but not limited to: levels/trends in delinquencies; trends in volume and terms of loans; effects of changes in risk selection and changes in lending policies, experience, ability, depth of lending management and staff; and national and local economic conditions. Management follows a similar process to estimate its liability for off-balance-sheet commitments to extend credit.

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

Residential real estate loans enable the borrower to purchase or refinance existing homes, most of which serve as the primary residence of the owner. Repayment is dependent on the credit quality of the borrower. Factors attributable to failure of repayment may include a weakened economy and/or unemployment, as well as possible personal considerations. While the Company anticipates adjustable-rate mortgages will better offset the potential adverse effects of an increase in interest rates as compared to fixed-rate mortgages, the increased mortgage payments required of adjustable-rate loan borrowers in a rising interest rate environment could cause an increase in delinquencies and defaults. The marketability of the underlying property also may be adversely affected in a high interest rate environment.

Commercial real estate loans are secured by commercial real estate and residential investment real estate and generally have larger balances and involve a greater degree of risk than one- to four-family residential mortgage loans. Risks in commercial real estate and residential investment lending are borrower's creditworthiness and the feasibility and cash flow potential of the project. Payments on loans secured by income properties often depend on successful operation and management of the properties. As a result, repayment of such loans may be subject to a greater extent than residential real estate loans to adverse conditions in the real estate market or the economy.

Commercial and residential construction loans are generally considered to involve a higher degree of risk of loss than long-term financing on improved, occupied real estate. Risk of loss on a construction loan depends largely upon the accuracy of the initial estimate of the property's value at completion of construction and the estimated cost (including interest) of construction.

Commercial and industrial loans are of higher risk and typically are made on the basis of the borrower's ability to make repayment from the cash flow of the borrower's business. As a result, the availability of funds for the repayment of commercial loans may depend substantially on the success of the business itself. Further, any collateral securing such loans may depreciate over time, may be difficult to appraise and may fluctuate in value.

Consumer and home equity loans may entail greater risk than do residential mortgage loans, particularly in the case of consumer loans that are unsecured or secured by assets that depreciate rapidly. In such cases, repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment for the outstanding loan and the remaining deficiency often does not warrant further substantial collection efforts against the borrower. In addition, consumer loan collections depend on the borrower's continuing financial stability, and therefore are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount that can be recovered on such loans.

The Company does not disaggregate its portfolio segments into loan classes.

#### Allocated Component

The allocated component relates to loans that are classified as impaired. Impairment is measured on a loan by loan basis for residential real estate, home equity loans, commercial real estate and commercial loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent. An allowance is established when the discounted cash flows or collateral value of the impaired loan is lower than the carrying value of that loan. The Company recognizes the change in present value attributable to the passage of time as provision for loan losses. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment, and the resulting allowance is reported as the general component, as described above.

Loans are considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered

by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

The Company may periodically agree to modify the contractual terms of loans. When a loan is modified and a concession is made to a borrower experiencing financial difficulty, the modification is considered a troubled debt restructuring ("TDR"). All TDRs are classified as impaired.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer loans for impairment evaluation, except for home equity loans.

During the three months ended March 31, 2014, there were no changes in the Company's allowance methodology related to the qualitative or quantitative factors.

The following table presents the allowance for loan losses and select loan information as of and for the three months ended March 31, 2014:

	Residential Real Estate	Residential Construction	Commercial Real Estate	Commercial Construction	Commercial and Industrial	Consumer Loans	Home Equity	Total
Allowance for loan losses	(In Thousands)							
Balance as of December 31, 2013	\$650	\$ 94	\$ 2,121	\$ 435	\$ 1,110	\$ 35	\$ 151	\$4,596
Provision for (reduction of) loan losses	(6	) 16	148	61	1,929	13	40	2,201
Recoveries	—	—	—	—	1	5	—	6
Loans charged off	(233	) —	—	—	(2,033	) (19	) (56	) (2,341
Balance as of March 31, 2014	\$411	\$ 110	\$ 2,269	\$ 496	\$ 1,007	\$ 34	\$ 135	\$4,462
Allowance for loan losses ending balance								
Collectively evaluated for impairment	\$407	\$ 110	\$ 2,129	\$ 496	\$ 997	\$ 34	\$ 135	\$4,308
Individually evaluated for impairment	4	—	140	—	10	—	—	154
	\$411	\$ 110	\$ 2,269	\$ 496	\$ 1,007	\$ 34	\$ 135	\$4,462
Total loans ending balance								
Collectively evaluated for impairment	\$110,092	\$ 7,109	\$ 208,845	\$ 39,341	\$ 77,238	\$ 2,358	\$ 31,196	\$476,179
Individually evaluated for impairment	3,165	—	6,358	4,098	1,674	—	240	15,535
	\$113,257	\$ 7,109	\$ 215,203	\$ 43,439	\$ 78,912	\$ 2,358	\$ 31,436	\$491,714





The following table presents the allowance for loan losses and select loan information as of and for the year ended December 31, 2013:

	Residential Real Estate	Residential Construction	Commercial Real Estate	Commercial Construction	Commercial and Industrial	Consumer Loans	Home Equity	Total
Allowance for loan losses	(In Thousands)							
Balance as of December 31, 2012	\$536	\$ 93	\$ 1,966	\$ 502	\$ 1,099	\$ 44	\$ 124	\$4,364
Provision for (reduction of) loan losses	296	63	(24 )	(67 )	90	30	37	425
Recoveries	1	—	247	—	38	14	—	300
Loans charged off	(183 )	(62 )	(68 )	—	(117 )	(53 )	(10 )	(493 )
Balance as of December 31, 2013	\$650	\$ 94	\$ 2,121	\$ 435	\$ 1,110	\$ 35	\$ 151	\$4,596
Allowance for loan losses ending balance								
Collectively evaluated for impairment	\$407	\$ 94	\$ 2,109	\$ 435	\$ 1,100	\$ 35	\$ 137	\$4,317
Individually evaluated for impairment	243	—	12	—	10	—	14	279
	\$650	\$ 94	\$ 2,121	\$ 435	\$ 1,110	\$ 35	\$ 151	\$4,596
Total loans ending balance								
Collectively evaluated for impairment	\$109,866	\$ 6,130	\$ 206,813	\$ 34,553	\$ 85,168	\$ 2,405	\$ 31,798	\$476,733
Individually evaluated for impairment	2,658	—	4,348	3,888	1,372	—	293	12,559
	\$112,524	\$ 6,130	\$ 211,161	\$ 38,441	\$ 86,540	\$ 2,405	\$ 32,091	\$489,292

The following table presents the allowance for loan losses and select loan information as of and for the three months ended March 31, 2013:

	Residential Real Estate	Residential Construction	Commercial Real Estate	Commercial Construction	Commercial and Industrial	Consumer Loans	Home Equity	Total
Allowance for loan losses	(In Thousands)							
Balance as of December 31, 2012	\$536	\$ 93	\$ 1,966	\$ 502	\$ 1,099	\$ 44	\$ 124	\$4,364
(Reduction of) provision for loan losses	8	(7 )	(58 )	(88 )	64	7	4	(70 )

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Recoveries	—	—	—	—	36	3	—	39
Loans charged off	—	—	—	—	—	(8	) —	(8 )
Balance as of March 31, 2013	\$544	\$ 86	\$ 1,908	\$ 414	\$ 1,199	\$46	\$128	\$4,325
Allowance for loan losses ending balance								
Collectively evaluated for impairment	\$343	\$ 55	\$ 1,861	\$ 414	\$ 1,199	\$46	\$117	\$4,035
Individually evaluated for impairment	201	31	47	—	—	—	11	290
	\$544	\$ 86	\$ 1,908	\$ 414	\$ 1,199	\$46	\$128	\$4,325
Total loans ending balance								
Collectively evaluated for impairment	\$110,713	\$ 4,491	\$ 184,235	\$ 31,354	\$ 83,812	\$ 2,344	\$31,567	\$448,516
Individually evaluated for impairment	2,728	331	3,393	4,269	660	—	184	11,565
	\$113,441	\$ 4,822	\$ 187,628	\$ 35,623	\$ 84,472	\$ 2,344	\$31,751	\$460,081

## Impairment

The following table presents a summary of information pertaining to impaired loans by segment as of and for the three months ended March 31, 2014:

	Recorded Investment	Unpaid Balance	Average Recorded Investment	Related Allowance	Interest Income Recognized
	(In Thousands)				
Impaired loans without a valuation allowance:					
Residential real estate	\$2,640	\$2,870	\$2,088	\$—	\$28
Residential construction	—	—	—	—	—
Commercial real estate	4,914	5,036	4,506	—	17
Commercial construction	4,098	4,098	3,993	—	46
Commercial and industrial	1,560	3,593	1,407	—	16
Consumer	—	—	—	—	—
Home equity	240	296	185	—	3
Total	\$13,452	\$15,893	\$12,179	\$—	\$110
Impaired loans with a valuation allowance:					
Residential real estate	\$525	\$525	\$824	\$4	\$7
Residential construction	—	—	—	—	—
Commercial real estate	1,444	1,444	846	140	3
Commercial construction	—	—	—	—	—
Commercial and industrial	114	114	116	10	1
Consumer	—	—	—	—	—
Home equity	—	—	81	—	—
Total	\$2,083	\$2,083	\$1,867	\$154	\$11
Total impaired loans:					
Residential real estate	\$3,165	\$3,395	\$2,912	\$4	\$35
Residential construction	—	—	—	—	—
Commercial real estate	6,358	6,480	5,352	140	20
Commercial construction	4,098	4,098	3,993	—	46
Commercial and industrial	1,674	3,707	1,523	10	17
Consumer	—	—	—	—	—
Home equity	240	296	266	—	3
Total	\$15,535	\$17,976	\$14,046	\$154	\$121

At March 31, 2014, the Company was not committed to lend any additional funds to borrowers whose loans were nonperforming, impaired or restructured. The \$15.5 million of impaired loans include \$10.3 million of non-accrual loans. The remaining impaired loans are loans for which the Company believes, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement.



The following table presents a summary of information pertaining to impaired loans by segment as of and for the year ended December 31, 2013:

	Recorded Investment	Unpaid Balance	Average Recorded Investment	Related Allowance	Interest Income Recognized
	(In Thousands)				
Impaired loans without a valuation allowance:					
Residential real estate	\$1,535	\$1,535	\$1,455	\$—	\$52
Residential construction	—	—	—	—	—
Commercial real estate	4,099	4,232	3,725	—	192
Commercial construction	3,888	3,888	4,068	—	193
Commercial and industrial	1,254	1,584	937	—	44
Consumer	—	—	—	—	—
Home equity	131	131	131	—	4
Total	\$10,907	\$11,370	\$10,316	\$—	\$485
Impaired loans with a valuation allowance:					
Residential real estate	\$1,123	\$1,123	\$1,056	\$243	\$30
Residential construction	—	—	132	—	—
Commercial real estate	249	249	403	12	23
Commercial construction	—	—	—	—	—
Commercial and industrial	118	118	134	10	3
Consumer	—	—	—	—	—
Home equity	162	162	108	14	1
Total	\$1,652	\$1,652	\$1,833	\$279	\$57
Total impaired loans:					
Residential real estate	\$2,658	\$2,658	\$2,511	\$243	\$82
Residential construction	—	—	132	—	—
Commercial real estate	4,348	4,481	4,128	12	215
Commercial construction	3,888	3,888	4,068	—	193
Commercial and industrial	1,372	1,702	1,071	10	47
Consumer	—	—	—	—	—
Home equity	293	293	239	14	5
Total	\$12,559	\$13,022	\$12,149	\$279	\$542

At December 31, 2013, the Company was not committed to lend any additional funds to borrowers whose loans were nonperforming, impaired or restructured. The \$12.6 million of impaired loans include \$6.8 million of non-accrual loans. The remaining impaired loans are loans for which the Company believes, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement.



The following table presents a summary of information pertaining to impaired loans by segment as of and for the three months ended March 31, 2013:

	Recorded Investment	Unpaid Balance	Average Recorded Investment	Related Allowance	Interest Income Recognized
	(In Thousands)				
Impaired loans without a valuation allowance:					
Residential real estate	\$1,788	\$1,788	\$1,650	\$—	\$12
Residential construction	—	—	—	—	—
Commercial real estate	3,050	3,440	2,942	—	59
Commercial construction	4,269	4,269	4,336	—	50
Commercial and industrial	660	830	663	—	8
Consumer	—	—	—	—	—
Home equity	134	134	115	—	1
Total	\$9,901	\$10,461	\$9,706	\$—	\$130
Impaired loans with a valuation allowance:					
Residential real estate	\$940	\$940	\$1,041	\$201	\$4
Residential construction	331	331	331	31	—
Commercial real estate	343	343	344	47	6
Commercial construction	—	—	—	—	—
Commercial and industrial	—	—	—	—	—
Consumer	—	—	—	—	—
Home equity	50	50	25	11	1
Total	\$1,664	\$1,664	\$1,741	\$290	\$11
Total impaired loans:					
Residential real estate	\$2,728	\$2,728	\$2,691	\$201	\$16
Residential construction	331	331	331	31	—
Commercial real estate	3,393	3,783	3,286	47	65
Commercial construction	4,269	4,269	4,336	—	50
Commercial and industrial	660	830	663	—	8
Consumer	—	—	—	—	—
Home equity	184	184	140	11	2
Total	\$11,565	\$12,125	\$11,447	\$290	\$141

At March 31, 2013, the Company was not committed to lend any additional funds to borrowers whose loans were nonperforming, impaired or restructured. The \$11.6 million of impaired loans include \$3.9 million of non-accrual loans. The remaining impaired loans are loans for which the Company believes, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement.





## Delinquency and Nonaccrual

All loan segments greater than 30 days past due are considered delinquent. The Company calculates the number of days past due based on a 30 day month. Management continuously monitors delinquency and nonaccrual levels and trends. It is the Company's policy to discontinue the accrual of interest on all loan classes when principal or interest payments are delinquent 90 days or more. The accrual of interest is also discontinued for impaired loans that are delinquent 90 days or more or at management's discretion.

All interest accrued, but not collected, for all loan classes, including impaired loans that are placed on nonaccrual or charged off, is reversed against interest income. Interest recognized on these loans is limited to interest payments received until qualifying for return to accrual. All loan classes are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

The following table presents an aging analysis of past due loans and non-accrual loans at March 31, 2014:

	31-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Current	Total Loans	Loans on Nonaccrual
	(In Thousands)						
Residential real estate	\$3,432	\$882	\$467	\$4,781	\$108,476	\$113,257	\$2,922
Residential construction	—	—	—	—	7,109	7,109	—
Commercial real estate	128	1,039	4,607	5,774	209,429	215,203	5,816
Commercial construction	—	—	—	—	43,439	43,439	—
Commercial and industrial	669	68	1,126	1,863	77,049	78,912	1,330
Consumer	35	3	25	63	2,295	2,358	25
Home equity	71	58	136	265	31,171	31,436	240
Total	\$4,335	\$2,050	\$6,361	\$12,746	\$478,968	\$491,714	\$10,333

The following table presents an aging analysis of past due loans and non-accrual loans at December 31, 2013:

	31-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Current	Total Loans	Loans on Nonaccrual
	(In Thousands)						
Residential real estate	\$2,962	\$510	\$1,063	\$4,535	\$107,989	\$112,524	\$2,415
Residential construction	—	—	—	—	6,130	6,130	—
Commercial real estate	662	—	2,802	3,464	207,697	211,161	3,362
Commercial construction	—	—	—	—	38,441	38,441	—
Commercial and industrial	264	149	816	1,229	85,311	86,540	806
Consumer	80	2	6	88	2,317	2,405	8
Home equity	76	8	209	293	31,798	32,091	243
Total	\$4,044	\$669	\$4,896	\$9,609	\$479,683	\$489,292	\$6,834

## TDRs

The Company had no new TDR loan relationships in the three months ended March 31, 2014 and 2013. TDR loans consist of loans where the Company, for economic or legal reasons related to the borrower's financial difficulties, granted a concession to the borrower that the Company would not otherwise consider. TDRs can take the form of a

reduction in the stated interest rate, receipts of assets from a debtor in partial or full satisfaction of a loan, the extension of the maturity date, or the reduction of either the interest or principal. Once a loan has been identified as a TDR, it will continue to be reported as a TDR until the loan is paid in full.

In the normal course of business, the Company may modify a loan for a credit worthy borrower where the modified loan is not considered a TDR. In these cases, the modified terms are consistent with loan terms available to credit worthy borrowers and within normal loan

pricing. The modifications to such loans are done according to existing underwriting standards which include review of historical financial statements, including current interim information if available, and an analysis of the borrower's performance and projections to assess repayment ability going forward.

During the three months ended March 31, 2014 and 2013, the Company had no TDRs that had defaulted and had been modified within the previous twelve month periods. TDR loans are considered defaulted at 90 days past due.

The following is a summary of accruing and nonaccruing TDRs by class for the three months ended March 31, 2014:

For the Three Months Ended March 31, 2014	Number of Modifications	Recorded Investment Pre-Modification	Recorded Investment Post-Modification	Current Balance
	(In Thousands)			
Residential real estate	2	\$ 366	\$ 366	\$366
Residential construction	—	—	—	—
Commercial real estate	5	763	885	885
Commercial construction	—	—	—	—
Commercial and industrial	4	164	164	164
Consumer	—	—	—	—
Home equity	1	34	34	—
Total	12	\$ 1,327	\$ 1,449	\$1,415

The following is a summary of accruing and nonaccruing TDRs by class for the three months ended March 31, 2013:

For the Three Months Ended March 31, 2013	Number of Modifications	Recorded Investment Pre-Modification	Recorded Investment Post-Modification	Current Balance
	(In Thousands)			
Residential real estate	1	\$ 118	\$ 127	\$127
Residential construction	—	—	—	—
Commercial real estate	—	—	—	—
Commercial construction	—	—	—	—
Commercial and industrial	1	67	67	67
Consumer	1	27	27	27
Home equity	1	38	38	38
Total	4	\$ 250	\$ 259	\$259

## 8. Fair Value Measurements

Certain assets and liabilities are recorded at fair value to provide additional insight into the Company's quality of earnings. Some of these assets and liabilities are measured on a recurring basis while others are measured on a nonrecurring basis, with the determination based upon applicable existing accounting pronouncements. For example, available-for-sale securities are recorded at fair value on a recurring basis. Other assets, such as, mortgage servicing rights, loans held for sale, and impaired loans, are recorded at fair value on a nonrecurring basis using the lower of cost or market methodology to determine impairment of individual assets. The Company groups assets and liabilities which are recorded at fair value in three levels, based on the markets in which the assets and liabilities are traded and

the reliability of the assumptions used to determine fair value. Levels within the fair value hierarchy are based on the lowest level of input that is significant to the fair value measurement (with Level 1 considered highest and Level 3 considered lowest). A brief description of each level follows.

Level 1 - Valuation is based upon quoted prices for identical instruments in active markets.

Level 2 - Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3 - Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates that market participants would use in pricing the asset or liability. Valuation includes use of discounted cash flow models and similar techniques.

The fair value methods and assumptions are set forth below.

Cash and cash equivalents. The carrying amounts of cash equivalents, due from banks and federal funds sold approximate their relative fair values. As such, the Company classifies these financial instruments as Level 1.

Held-to-maturity and non-marketable securities. The fair values of held-to-maturity securities are estimated by independent providers. In obtaining such valuation information from third parties, the Company has evaluated their valuation methodologies used to develop the fair values in order to determine whether the valuations are representative of an exit price in the Company's principal markets. The Company's principal markets for its securities portfolios are the secondary institutional markets, with an exit price that is predominately reflective of bid level pricing in those markets. Fair values are calculated based on the value of one unit without regard to any premium or discount that may result from concentrations of ownership of a financial instrument, possible tax ramifications, or estimated transaction costs. If these considerations had been incorporated into the fair value estimates, the aggregate fair value could have been changed. The carrying values of non-marketable securities approximate fair values. As such, the Company classifies held-to-maturity and non-marketable securities as Level 2.

Available-for-sale securities. Fair value of securities are primarily measured using unadjusted information from an independent pricing service. The securities measured at fair value in Level 1 are based on quoted market prices in an active exchange market. These securities include marketable equity securities.

Loans. Fair values are estimated for portfolios of loans with similar financial characteristics. The fair values of performing loans are calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest risk inherent in the loan. The estimates of maturity are based on the Company's historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of current economic and lending conditions, and the effects of estimated prepayments. Assumptions regarding risk, cash flows, and discount rates are judgmentally determined using available market information and specific borrower information. Management has made estimates of fair value presented below that would be indicative of the value negotiated in an actual sale. As such, the Company classifies loans as level 3. Fair values of impaired loans are based on estimated cash flows and are discounted using a rate commensurate with the risk associated with the estimated cash flows, or if collateral dependent, discounted to the appraised value of the collateral, less costs to sell.

Loans held for sale. Loans held for sale are recorded at the lower of carrying value or fair value. The fair value of mortgage loans held for sale is based on what secondary markets are currently offering for portfolios with similar characteristics. As such, the Company classifies loans held for sale as nonrecurring Level 2.

Other real estate owned ("OREO"). Real estate acquired through foreclosure is recorded at fair value. The fair value of OREO is based on property appraisals and an analysis of similar properties currently available. As such, the

Company records OREO as nonrecurring Level 2.

Mortgage servicing rights. Mortgage servicing rights represent the value associated with servicing residential mortgage loans. Servicing assets and servicing liabilities are reported using the amortization method. In evaluating the carrying values of the mortgage servicing rights, the Company obtains third party valuations based on loan level data including note rate, type and term of the underlying loans. As such, the Company classifies mortgage servicing rights as nonrecurring Level 2.

Accrued interest and dividends receivable. The fair value estimate of this financial instrument approximates the carrying value as this financial instrument has a short maturity. It is the Company's policy to stop accruing interest on loans for which it is probable that the interest is not collectable. Therefore, this financial instrument has been adjusted for estimated credit loss. As such, the Company classifies accrued interest and dividends receivable as Level 2.

Deposits. The fair value of deposits is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities. The fair value estimates do not include the benefit that results from the low-cost funding provided by the deposits compared to the cost of borrowing funds in the market. If that value were considered, the fair value of the Company's net assets could increase. As such, the Company classifies deposits as Level 2.

Borrowed funds. The fair value of borrowed funds is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently available for borrowings of similar remaining maturities. As such, the Company classifies borrowed funds as Level 2.

Accrued interest payable. The fair value estimate approximates the carrying amount as this financial instrument has a short maturity. As such, the Company classifies accrued interest payable as Level 2.

Off-balance-sheet instruments. Off-balance-sheet instruments include loan commitments. Fair values for loan commitments have not been presented as the future revenue derived from such financial instruments is not significant.

Limitations. Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These values do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on Management's judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect these estimates. Fair value estimates are based on existing on- and off-balance-sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Other significant assets and liabilities that are not considered financial instruments include the deferred tax asset, premises and equipment, and OREO. In addition, tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of these estimates.

Assets measured at fair value as of March 31, 2014 and December 31, 2013 on a recurring basis are summarized below:

	Fair Value Measurements Using			
		Readily Available	Observable	Determined
	March 31, 2014	Market Prices (Level 1)	Market Data (Level 2)	Fair Value (Level 3)
Assets (market approach)				
Available-for-sale securities				
Equity securities by industry type:				
Financial	\$407	\$407	\$—	\$—
Total equity securities	\$407	\$407	\$—	\$—

	Fair Value Measurements Using			
		Readily Available	Observable	Determined
	December 31, 2013	Market Prices (Level 1)	Market Data (Level 2)	Fair Value (Level 3)



Assets (market approach)	(Dollars In Thousands)			
Available-for-sale securities				
Equity securities by industry type:				
Financial	\$602	\$602	\$—	\$—
Total equity securities	\$602	\$602	\$—	\$—

Assets measured at fair value on a nonrecurring basis as of March 31, 2014 and December 31, 2013 are summarized below:

	Fair Value Measurements Using			
	March 31, 2014	Readily Available Market Prices (Level 1)	Observable Market Data (Level 2)	Determined Fair Value (Level 3)
	(Dollars In Thousands)			
Assets				
Impaired loans	\$3,672	\$—	\$—	\$3,672
Other real estate owned	135	—	135	—
Loans held for sale	396	—	396	—

Impaired loans are presented net of their related specific reserve of \$154,000 and charge offs of \$2.4 million as of March 31, 2014.

	Fair Value Measurements Using			
	December 31, 2013	Readily Available Market Prices (Level 1)	Observable Market Data (Level 2)	Determined Fair Value (Level 3)
	(Dollars In Thousands)			
Assets				
Impaired loans	\$1,869	\$—	\$—	\$1,869
Other real estate owned	407	—	407	—
Loans held for sale	70	—	70	—

Impaired loans are presented net of their related specific reserves of \$279,000 and charge offs of \$126,000 as of December 31, 2013.



## Fair Value of Financial Instruments.

Accounting Standards Codification ("ASC") Topic 825, "Financial Instruments," requires disclosures of fair value information about financial instruments, whether or not recognized in the statement of financial condition, if the fair values can be reasonably determined. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instrument's. In cases where quoted prices are not available, fair values are based on estimates using present value or other valuation techniques using observable inputs when available. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument. FASB ASC Topic 825 excludes certain financial instruments and all non-financial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company.

	Carrying Amount at March 31, 2014 (Dollars In Thousands)	Fair Value Using Readily Available Market Prices (Level 1)	Observable Market Data (Level 2)	Determined Fair Value (Level 3)
Financial assets:				
Cash and cash equivalents	\$36,434	\$36,434	\$—	\$—
Available-for-sale securities	407	407	—	—
Held-to-maturity securities	40,993	—	41,606	—
FHLB stock	3,914	—	3,914	—
Residential real estate	113,511	—	—	115,802
Residential construction	6,999	—	—	6,994
Commercial real estate	213,187	—	—	215,388
Commercial construction	42,943	—	—	41,605
Commercial and industrial	77,905	—	—	77,893
Consumer	2,268	—	—	2,418
Home equity	31,357	—	—	31,605
Net loans	488,170	—	—	491,705
Loans held for sale	396	—	396	—
Accrued interest and dividends receivable	1,528	—	1,528	—
Mortgage servicing rights	352	—	688	—
Financial liabilities:				
Deposits	\$456,685	\$—	\$458,010	\$—
FHLB advances	52,187	—	52,861	—
Accrued interest payable	71	—	71	—

	Carrying Amount at December 31, 2013	Fair Value Using Readily Available Market Prices (Level 1)	Observable Market Data (Level 2)	Determined Fair Value (Level 3)
	(Dollars In Thousands)			
Financial assets:				
Cash and cash equivalents	\$18,915	\$18,915	\$—	\$—
Available-for-sale securities	602	602	—	—
Held-to-maturity securities	48,606	—	49,338	—
FHLB stock	3,914	—	3,914	—
Residential real estate	112,551	—	—	115,372
Residential construction	6,036	—	—	6,028
Commercial real estate	209,286	—	—	211,982
Commercial construction	38,006	—	—	36,432
Commercial and industrial	85,430	—	—	85,511
Consumer	2,370	—	—	2,530
Home equity	31,940	—	—	32,183
Net loans	485,619	—	—	490,038
Loans held for sale	70	—	70	—
Accrued interest and dividends receivable	1,609	—	1,609	—
Mortgage servicing rights	381	—	831	—
Financial liabilities:				
Deposits	\$449,766	\$—	\$458,010	\$—
FHLB advances	44,992	—	45,699	—
Accrued interest payable	59	—	59	—



## 9. Other Comprehensive Income

As of the statement of financial condition dates, accumulated other comprehensive income was entirely comprised of net unrealized gains on available-for-sale investment securities.

The following table illustrates changes in the balances of each component of accumulated other comprehensive income for the dates indicated:

	Three Months Ended March 31,	
	2014	2013
	(Dollars in Thousands)	
Beginning balance	\$52	\$26
Current-period change	(27	) 8
Ending balance	\$25	\$34

During the three months ended March 31, 2014, 10,000 shares issued by one company in the financial industry were sold with a realized gain of \$34,000. There were no sales of available-for-sale securities during the three months ended March 31, 2013.

## 10. Common Stock

On June 1, 2012, the Company announced that the Board of Directors authorized a Seventh Stock Repurchase Program for the purchase of up to 272,000 shares, or approximately 5%, of the Company's then outstanding common stock. As of March 31, 2014, a total of 235,646 shares may be repurchased under the current stock repurchase program. The Company may repurchase its shares from time to time at prevailing prices in the open market, in block transactions or in privately negotiated transactions. Repurchases will be made under rule 10b-5(1) repurchase plans. The repurchased shares will be held by the Company as treasury stock and will be available for general corporate purposes.

## 11. Subsequent Events

Subsequent events represent events or transactions occurring after the balance sheet date but before the financial statements are issued or are available to be issued. Financial statements are considered "issued" when they are widely distributed to shareholders and others for general use and reliance in a form and format that complies with accounting principles generally accepted in the United States of America ("GAAP.") Financial statements are considered "available to be issued" when they are complete in form and format that complies with GAAP and all approvals necessary for their issuance have been obtained.

The Company is a Securities and Exchange Commission filer and management has evaluated subsequent events through the date that the financial statements were issued. On April 25, 2014, the Company announced a quarterly cash dividend of \$0.07 per share of its common stock to stockholders of record as of the close of business on May 9, 2014, payable on or about May 21, 2014.

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

The following analysis discusses changes in the financial condition and results of operations of Chicopee Bancorp Inc. ("the, Company") at March 31, 2014 and December 31, 2013 and for the three months ended March 31, 2014 and 2013, and should be read in conjunction with the Company's Unaudited Consolidated Financial Statements and the notes thereto, appearing in Part I, Item 1 of this document.

Forward-Looking Statements

This Form 10-Q contains certain forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. The Company intends such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the Private Securities Litigation Reform Act of 1995, and is including this statement for purposes of these safe harbor provisions. Forward-looking statements, which are based on certain assumptions and describe future plans, strategies and expectations of the Company, are generally identified by use of the words "believe," "expect," "intend," "anticipate," "estimate," "project" or similar expressions. The Company's ability to predict results or the actual effect of future plans or strategies is inherently uncertain. Factors which could have a material adverse effect on the operations of the Company include, but are not limited to: changes in interest rates, general economic conditions, legislative/regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, the quality or composition of the loan or investment portfolios, demand for loan products, deposit flows, competition, demand for financial services in the Company's market area and accounting principles and guidelines. Additional factors are discussed in the Company's 2013 Annual Report on Form 10-K under "Item 1A-Risk Factors" and in "Part II. Item 1A. Risk Factors" of this 10-Q. These risks and uncertainties should be considered in evaluating forward-looking statements and undue reliance should not be placed on such statements.

Except as required by law, the Company does not undertake – and specifically disclaims any obligation – to publicly release the result of any revisions which may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

General

Chicopee Savings Bank ("the Bank"), a subsidiary of the Company, is a community-oriented financial institution dedicated to serving the financial services needs of consumers and businesses within its market area. We attract deposits from the general public and use such funds to originate primarily one- to four-family residential real estate loans, commercial real estate loans, commercial loans, multi-family loans, construction loans and consumer loans. At March 31, 2014, we operated out of our main office, lending and operations center, and eight branch offices located in Chicopee, Ludlow, South Hadley, Ware, and West Springfield. All of our offices are located in Western Massachusetts.

CRITICAL ACCOUNTING POLICIES

Management's discussion and analysis of the Company's financial condition is based on the consolidated financial statements which are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). The preparation of such financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and related disclosure of contingent assets and liabilities. On an ongoing basis, Management evaluates its estimates, including those related to the allowance for loan losses, other-than-temporary impairment of securities, the valuation of mortgage servicing rights, and the valuation of other real estate owned. Management bases its estimates on historical experience and on various other assumptions that are believed to be reasonable under the circumstances, the results of which form the basis in making judgments about the carrying values of assets that are not readily apparent from other sources. Actual results could differ from the amount derived from management's estimates and assumptions under different



assumptions or conditions. Additional accounting policies are more fully described in Note 1 in the “Notes to Consolidated Financial Statements” presented in our 2013 Annual Report on Form 10-K. A brief description of our current accounting policies involving significant management judgment follows.

Allowance for Loan Losses. Management believes the allowance for loan losses requires the most significant estimates and assumptions used in the preparation of the consolidated financial statements. The allowance for loan losses is based on Management’s evaluation of the level of the allowance required in relation to the probable losses inherent in the loan portfolio. Management believes the allowance for loan losses is a significant estimate and therefore regularly evaluates it for adequacy by taking into consideration factors such as: levels and historical trends in delinquencies, impaired loans, non-accruing loans, charge-offs and recoveries, and classified assets; trends in the volume and terms of the loans; effects of any change in underwriting policies, procedures, and practices; experience, ability, and depth of management staff; national and local economic trends and conditions; trends and conditions in the industries in which borrowers operate; and effects of changes in credit concentrations. The use of different estimates or assumptions could produce a different provision for loan losses.

**Other-Than-Temporary Impairment of Securities.** One of the significant estimates related to investment securities is the evaluation of other-than-temporary impairment. The evaluation of securities for other-than-temporary impairment is a quantitative and qualitative process, which is subject to risks and uncertainties and is intended to determine whether declines in the fair value of investments should be recognized in current period earnings. The risks and uncertainties include changes in general economic conditions, the issuer's financial condition and/or future prospects, the effects of changes in interest rates or credit spreads and the expected recovery period of unrealized losses. Securities that are in an unrealized loss position are reviewed at least quarterly to determine if other-than-temporary impairment is present based on certain quantitative and qualitative factors and measures. The primary factors considered in evaluating whether a decline in value of securities is other-than-temporary include: (a) the length of time and extent to which the fair value has been less than cost or amortized cost and the expected recovery period of the security, (b) the financial condition, credit rating and future prospects of the issuer, (c) whether the debtor is current on contractually obligated interest and principal payments, (d) the volatility of the securities market price, (e) the intent and ability of the Company to retain the investment for a period of time sufficient to allow for recovery, which may be at maturity and (f) any other information and observable data considered relevant in determining whether other-than-temporary impairment has occurred, including the expectation of receipt of all principal and interest due.

**Mortgage Servicing Rights.** The valuation of mortgage servicing rights is a critical accounting policy which requires significant estimates and assumptions. The Company often sells mortgage loans it originates and retains the ongoing servicing of such loans, receiving a fee for these services, generally 1% of the outstanding balance of the loan per annum. Mortgage servicing rights are recognized when they are acquired through the sale of loans, and are reported in other assets. They are amortized into non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. Management uses an independent firm which specializes in the valuation of mortgage servicing rights to determine the fair value. The Company uses the amortization method for financial reporting. The most important assumption is the anticipated loan prepayment rate, and increases in prepayment speeds result in lower valuations of mortgage servicing rights. Management evaluates for impairment based upon the fair value of the rights, which can vary depending upon current interest rates and prepayment expectations, as compared to amortized cost. The use of different assumptions could produce a different valuation. All of the assumptions are based on standards the Company believes would be utilized by market participants in valuing mortgage servicing rights and are consistently derived and/or benchmarked against independent public sources.

**Valuation of Other Real Estate Owned ("OREO").** Periodically, the Company acquires property through foreclosure or acceptance of a deed in lieu-of-foreclosure as OREO. OREO is recorded at fair value less costs to sell. The valuation of this property is accounted for individually based on its net realizable value on the date of acquisition. At the acquisition date, if the net realizable value of the property is less than the book value of the loan, a charge or reduction in the allowance for loan losses is recorded. If the value of the property becomes subsequently impaired, as determined by an appraisal or an evaluation in accordance with the Company's appraisal policy, the decline is recorded by a charge against current earnings. Upon acquisition of a property, a current appraisal or broker's opinion must substantiate market value for the property.



Comparison of Financial Condition at March 31, 2014 and December 31, 2013

Total assets increased \$12.1 million, or 2.1%, from \$587.7 million at December 31, 2013 to \$599.9 million at March 31, 2014. The increase in total assets was primarily due to the increase in cash and cash equivalents of \$17.5 million, or 92.6%, and an increase in net loans of \$2.6 million, or 0.5%, from \$485.6 million, or 82.6% of total assets at December 31, 2013, to \$488.2 million, or 81.4% of total assets at March 31, 2014, partially offset by a decrease in held-to-maturity securities of \$7.6 million, or 15.7%, to \$41.0 million at March 31, 2014.

The significant components of the \$2.6 million, or 0.05%, increase in net loans was a \$733,000, or 0.7%, increase in one-to-four-family residential real estate loans, a \$6.0 million, or 13.4%, increase in construction loans and an increase of \$4.0 million, or 1.9%, in commercial real estate loans. These increases were partially offset by the decrease in commercial and industrial loans of \$7.6 million, or 8.8% and a \$599,000 or 1.9%, decrease in home equity loans. In accordance with the Company's asset/liability management strategy and in an effort to reduce interest rate risk, the Company continues to sell fixed rate, low coupon residential real estate loans to the secondary market. The Company currently services \$97.0 million in loans sold to the secondary market. In order to service our customers, the servicing rights will continue to be retained on all loans written and sold in the secondary market.

The investment securities portfolio, including held-to-maturity and available-for-sale securities, decreased \$7.8 million, or 15.9%, to \$41.4 million at March 31, 2014 from \$49.2 million at December 31, 2013. This decrease was primarily the result of a \$7.0 million decrease in the held-to-maturity portfolio due to maturities of \$5.0 million in U.S. Treasuries and maturities of \$2.3 million in certificates of deposit. The fair value of available-for-sale securities decreased \$195,000, or 32.3%, from \$602,000, at December 31, 2013 to \$407,000, at March 31, 2014, due to the sale of such securities.

Total deposits increased \$6.9 million, or 1.5%, from \$449.8 million at December 31, 2013 to \$456.7 million at March 31, 2014. Core deposits, which we consider to include all deposits except for certificates of deposit, increased \$6.5 million, or 2.2%, from \$292.5 million at December 31, 2013 to \$299.0 million at March 31, 2014. Demand deposits increased \$3.7 million, or 4.1%, to \$94.6 million, money market accounts increased \$562,000, or 0.51%, to \$111.7 million, NOW accounts increased \$1.4 million, or 3.5%, to \$42.2 million, and savings accounts increased \$791,000, or 1.6%, to \$50.5 million. Certificates of deposit increased \$438,000, or 0.3%, from \$157.2 million at December 31, 2013 to \$157.7 million at March 31, 2014. The increase of 2.2% in core deposits was mostly due to fluctuations in commercial accounts related to business activity and the increase in retail checking accounts. We continue to focus on allowing high cost deposits to mature and be replaced with low cost relationship-based core deposits.

Stockholders' equity was \$90.7 million, or 15.1% of total assets, at March 31, 2014 compared to \$92.2 million, or 15.7% of total assets, at December 31, 2013. The Company's stockholders' equity decreased as a result of the \$1.4 million net loss for the period and the \$381,000 cash dividend paid during the three months ended March 31, 2014, partially offset by an increase of \$76,000, or 2.1%, in stock-based compensation, and an increase in additional paid-in-capital of \$78,000, or 2.4%, related to stock-based compensation.



## Allowance for Loan Losses

	At or for the Three Months Ended March 31,			
	2014		2013	
	(Dollars In Thousands)			
Allowance for loan losses, beginning of period:	\$4,596		\$4,364	
Charged off loans:				
Residential real estate	(233	)	—	
Construction	—		—	
Commercial real estate	—		—	
Commercial	(2,033	)	—	
Home equity	(56	)	—	
Consumer	(19	)	(8	)
Total charged off loans	(2,341	)	(8	)
Recoveries on loans previously charged off:				
Residential real estate	—		—	
Construction	—		—	
Commercial Real Estate	—		—	
Commercial	1		36	
Home equity	—		—	
Consumer	5		3	
Total recoveries	6		39	
Net loan (charge offs) recoveries	(2,335	)	31	
Provision for (reduction in) loan losses	2,201		(70	)
Allowance for loan losses, end of period	\$4,462		\$4,325	
Ratios:				
Net loan charge offs to total average loans	0.48	%	(0.01	)%
Allowance for loan losses to total loans (1)	0.91	%	0.94	%
Allowance for loan losses to nonperforming loans (2)	43.18	%	111.21	%
Recoveries to charge offs	0.26	%	0.72	%
Net loans charged off to allowance for loan losses	52.33	%	0.72	%

(1) Total loans includes net loans plus the allowance for loan losses.

Nonperforming loans consist of all loans 90 days or more past due and other loans which have been identified by the Company as presenting uncertainty with respect to the collectability of interest or principal. At March 31, 2014, the Company had twelve troubled debt restructured loans totaling \$1.3 million, of which eight totaling \$832,000 (2) were included in nonperforming loans. Four of the twelve restructured loans totaling \$496,000 were performing as modified. At March 31, 2013, the Company had seventeen trouble debt restructured loans totaling \$3.5 million, of which ten totaling \$1.2 million were included in nonperforming loans. Seven of the seventeen trouble debt restructurings, totaling \$2.4 million were performing as modified.

Analysis and determination of the allowance for loan losses. The allowance for loan losses is a valuation allowance for probable and estimable credit losses inherent in the loan portfolio. Management evaluates the need to establish allowances against losses on loans on a quarterly basis. When additional allowances are necessary, a provision for loan losses is charged to earnings. The allowance for loan losses is maintained at an amount that management considers appropriate to cover inherent probable and estimable losses in the loan portfolio.



Our methodology for assessing the appropriateness of the allowance for loan losses consists of: (1) a specific allowance on identified problem loans; and (2) a general valuation allowance on the remainder of the loan portfolio. Although we determine the amount of each element of the allowance separately, the entire allowance for loan losses is available for the entire portfolio. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

Specific allowance required for identified problem loans. The allocated component of the allowance for loan losses relates to loans that are classified as impaired. Impairment is measured on a loan by loan basis for residential real estate, home equity loans, commercial real estate and commercial loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent. An allowance is established when the discounted cash flows or collateral value of the impaired loan is lower than the carrying value of that loan. The Company recognizes the change in present value attributable to the passage of time as provision for loan losses. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment, and the resulting allowance is reported as the general component, as described above.

General valuation allowance on the remainder of the loan portfolio. The Company establishes a general allowance for loans that are not delinquent. If not all delinquent loans are impaired, then some delinquent loans are in the general pool. This general valuation allowance is determined by segregating the loans by loan category and assigning percentages to each category. The percentages are adjusted for significant factors that, in management's judgment, affect the collectability of the portfolio as of the evaluation date. These significant factors include: levels and historical trends in delinquencies, impaired loans, nonaccrual loans, charge-offs, recoveries, and classified assets; trends in the volume and terms of loans; effects of any change in underwriting, policies, procedures, and practices; experience, ability, and depth of management and staff; national and local economic trends and conditions; trends and conditions in the industries in which borrowers operate; and effects of changes in credit concentrations. The applied loss factors are reevaluated quarterly to ensure their relevance in the current economic environment.

The Company identifies loans that may need to be charged off as a loss by reviewing all delinquent loans, classified loans and other loans for which management may have concerns about collectability. For individually reviewed loans, the borrower's inability to make payments under the terms of the loan or a shortfall in the fair value of the collateral if the loan is collateral dependent would result in our allocating a portion of the allowance to the loan that was impaired.

The allowance for loan losses is based on management's estimate of the amount required to reflect the potential inherent losses in the loan portfolio, based on circumstances and conditions known or anticipated at each reporting date. There are inherent uncertainties with respect to the collectability of the Company's loans and it is reasonably possible that actual loss experience in the near term may differ from the amounts reflected in this report.

At March 31, 2014, the allowance for loan losses represented 0.91% of total loans and 43.2% of nonperforming loans. The allowance for loan losses decreased \$134,000, or 2.9%, from \$4.6 million at December 31, 2013 to \$4.5 million at March 31, 2014, due to a provision for loan losses of \$2.2 million offset by net charge-offs of \$2.3 million. The provision for loan losses was \$2.2 million for the three months ended March 31, 2014 compared to a credit of \$70,000, for the three months ended March 31, 2013.





## Nonperforming Assets

The following table sets forth information regarding nonaccrual loans and other real estate owned at the dates indicated:

	March 31, 2014	December 31, 2013		
	(Dollars In Thousands)			
Nonaccrual loans (3):				
Residential real estate	\$2,922		\$2,415	
Residential construction	—		—	
Commercial real estate	5,816		3,362	
Commercial construction	—		—	
Commercial and industrial	1,330		806	
Home equity	240		243	
Consumer	25		8	
Total nonaccrual loans	10,333		6,834	
Other real estate owned	135		407	
Total nonperforming assets	\$10,468		\$7,241	
Ratios:				
Total nonperforming loans as a percentage of total loans (1)	2.10	%	1.40	%
Total nonperforming assets as a percentage of total assets (2)	1.75	%	1.23	%

(1) Total loans equals net loans plus the allowance for loan losses.

Nonperforming assets consist of nonperforming loans including nonperforming TDRs and OREO. Nonperforming (2) loans consist of all loans 90 days or more past due and other loans which have been identified by the Company as presenting uncertainty with respect to the collectability of interest or principal.

Loans are placed on nonaccrual status either when reasonable doubt exists as to the timely collection of principal and interest or when a loan becomes 90 days past due unless an evaluation clearly indicates that the loan is (3) well-secured and in the process of collection. At March 31, 2014, there were no loans that were over 90 days delinquent and still accruing interest.

At March 31, 2014, nonperforming loans increased \$3.5 million, or 51.2%, to \$10.3 million compared to \$6.8 million as of December 31, 2013. The increase in nonperforming loans is primarily due to the increase of \$524,000 or 65.0%, in commercial and industrial loans, an increase of \$507,000, or 21.0%, in residential real estate loans, a \$2.5 million, or 73.0%, increase in commercial real estate loans, and a \$17,000, or 212.5%, increase in consumer loans. These increases were partially offset by a decrease of \$3,000, or 1.2%, in home equity loans. Loans that are less than 90 days past due and were previously on nonaccrual continue to be on nonaccrual status until the borrower can demonstrate their ability to make payments according to their loan terms.

The current level of non-performing loans is concentrated with two commercial relationships totaling \$6.1 million, or 59.3% of total non-performing loans. As previously disclosed as a subsequent event in our Annual Report on Form 10-K, a \$4.5 million commercial relationship was placed on non-accrual in the first quarter of 2014. The loans to this borrower are secured by all assets of the borrower, including commercial real estate and personal guarantees. Upon physical inspection early in March of 2014 by management, it was noted that the Company's collateral did not appear to coincide with amounts reported in the financial statements provided by the borrower and the November 2013 results of an independent field exam verifying the borrower's certified inventory level. The borrower could not provide an explanation for the material discrepancy between the physical inventory on site and the most recent financial statements provided by the borrower. Management is investigating potential fraudulent activity and has taken

immediate steps to protect the Company's position. Although we are very early in the process of investigation, management has taken legal action to minimize any additional losses that may result from the suspected fraudulent activity. Total loans involved in the suspected fraud are approximately \$4.5 million. Based on the most recent valuation of the borrower's assets, we have taken a charge-off of \$2.0 million against the allowance for loan losses and the exposure was reduced from \$4.5 million to \$2.5 million at March 31, 2014.

The second impaired commercial relationship, a \$3.6 million commercial real estate loan disclosed in the third quarter of 2013, is in the process of foreclosure. The borrower reported to the Bank in August of 2013 that they were experiencing cash flow difficulties and, although the loans were not 90-days past due at that time, the relationship was placed on non-accrual status on

September 30, 2013. The loans to this borrower are secured by commercial real estate, and all assets of the borrower, including personal guarantees. At March 31, 2014, based on recent appraisals, a specific reserve of \$128,000 was allocated to this loan in the allowance for loan losses. Management continues to monitor this relationship to mitigate any further deterioration in the collateral that could result in future losses.

## Deposits

The following table sets forth the Company's deposit accounts at the dates indicated:

	March 31, 2014		December 31, 2013		
	Balance	Percent of Total Deposits	Balance	Percent of Total Deposits	
	(Dollars In Thousands)				
Demand deposits	\$94,590	20.7	% \$90,869	20.1	%
NOW accounts	42,181	9.2	% 40,774	9.1	%
Savings accounts	50,546	11.1	% 49,755	11.1	%
Money market deposit accounts	111,688	24.5	% 111,126	24.7	%
Total transaction accounts	299,005	65.5	% 292,524	65.0	%
Certificates of deposit	157,680	34.5	% 157,242	35.0	%
Total deposits	\$456,685	100.0	% \$449,766	100.0	%

Total deposits increased \$6.9 million, or 1.5%, from \$449.8 million at December 31, 2013 to \$456.7 million at March 31, 2014. Core deposits, which we consider to include all deposits except for certificates of deposit, increased \$6.5 million, or 2.2%, from \$292.5 million at December 31, 2013 to \$299.0 million at March 31, 2014. Demand deposits increased \$3.7 million, or 4.1%, to \$94.6 million, money market accounts increased \$562,000, or 0.51%, to \$111.7 million, NOW accounts increased \$1.4 million, or 3.5%, to \$42.2 million, and savings accounts increased \$791,000, or 1.6%, to \$50.5 million. Certificates of deposit increased \$438,000, or 0.3%, from \$157.2 million at December 31, 2013 to \$157.7 million at March 31, 2014. The increase of 2.2% in core deposits was mostly due to fluctuations in commercial accounts related to business activity and the increase in retail checking accounts. We continue to focus on allowing high cost deposits to mature and be replaced with low cost relationship based core deposits.



## Borrowings

The following sets forth information concerning the Company's borrowings for the periods indicated:

	March 31, 2014	December 31, 2013	
	(In Thousands)		
Maximum amount of borrowings outstanding at any month-end during the period:			
Federal Home Loan Bank (FHLB) advances	\$53,199	\$44,992	
Securities sold under agreements to repurchase	—	15,312	
Average borrowings outstanding during the period:			
FHLB advances	\$48,695	\$29,202	
Securities sold under agreements to repurchase	—	7,243	
Weighted average interest rate during the period:			
FHLB advances	1.77	%	2.41 %
Securities sold under agreements to repurchase	—	%	0.12 %
Balance outstanding at end of period:			
FHLB advances	\$52,187	\$44,992	
Securities sold under agreements to repurchase	—	—	
Weighted average interest rate at end of period:			
FHLB advances	1.64	%	1.93 %
Securities sold under agreements to repurchase	—	%	— %

The Company utilizes borrowings from a variety of sources to supplement our supply of funds for loans and investments. FHLB advances increased \$7.2 million, or 16.0%, from \$45.0 million at December 31, 2013 to \$52.2 million at March 31, 2014 due to an increase in long-term advances of \$10.0 million, partially offset by payments on advances.

## Comparison of Operating Results for the Three Months Ended March 31, 2014 and 2013

## General

The Company reported a net loss of \$1.4 million, or \$0.27 loss per share, for the three months ended March 31, 2014, compared to net income of \$797,000, or \$0.16 earnings per share, for the same period in 2013. The decrease in net income for the three months ended March 31, 2014 compared to the three months ended March 31, 2013, was a result of the increase in the provision for loan losses of \$2.3 million due to a significant charge off during the quarter, a decrease in non-interest income of \$253,000, or 30.1%, and a decrease of \$48,000, or 1.0%, in net interest income, partially offset by a decrease in non-interest expense of \$16,000, or 0.4%, and a decrease in income tax expense of \$400,000, or 177.9%, due to the lower level of taxable income during the three months ended March 31, 2014.

## Analysis of Net Interest Income

Net interest income represents the difference between income on interest-earning assets and expense on interest-bearing liabilities. Net interest income depends on the relative amounts of interest-earning assets and interest-bearing liabilities and the interest rate earned or paid on them.

The following table sets forth average balances, interest income and expense and yields earned or rates paid on the major categories of assets and liabilities for the periods indicated. The average yields and costs are derived by dividing interest income or expense by the average balance of interest-earning assets or interest-bearing liabilities, respectively. The yields and costs are annualized. Average balances are derived from average daily balances. The yields and costs include fees which are considered adjustments to yields. Loan interest and yield data does not include any accrued interest from non-accruing loans.

	For the Three Months Ended March 31, 2014				2013			
	Average Balance	Interest	Average Yield/ Rate	%	Average Balance	Interest	Average Yield/ Rate	%
(Dollars in Thousands)								
Interest-earning assets:								
Investments (1)	\$48,000	\$669	5.65	%	\$63,993	\$690	4.37	%
Loans:								
Residential real estate loans	113,173	1,112	3.98	%	118,236	1,226	4.21	%
Home Equity	31,691	276	3.53	%	31,623	296	3.80	%
Commercial real estate loans	212,198	2,512	4.80	%	188,338	2,532	5.45	%
Residential Construction	6,747	69	4.15	%	4,933	47	3.86	%
Commercial Construction	40,771	432	4.30	%	35,244	402	4.63	%
Consumer loans	2,368	37	6.34	%	2,432	32	5.34	%
Commercial and industrial loans	82,034	766	3.79	%	82,179	921	4.55	%
Loans, net (2)	488,982	5,204	4.32	%	462,985	5,456	4.78	%
Other interest-earning assets	15,519	8	0.21	%	24,313	14	0.23	%
Total interest-earning assets	552,501	5,881	4.32	%	551,291	6,160	4.53	%
Non-interest earning assets	36,085				36,815			
Total assets	\$588,586				\$588,106			
Interest-bearing liabilities:								
Deposits:								
Money market accounts	\$111,113	\$85	0.31	%	\$118,694	\$87	0.30	%
Savings accounts (3)	50,054	13	0.11	%	49,183	13	0.11	%
NOW accounts	41,093	88	8.68	%	37,873	89	0.94	%
Certificates of deposit	154,635	528	1.38	%	178,064	769	1.75	%
Total interest-bearing deposits	356,895	714	8.11	%	383,814	958	1.01	%
Federal Home Loan Bank advances	48,695	213	1.77	%	31,796	189	2.41	%
Securities sold under agreement to repurchase	—	—	—	%	8,998	3	0.14	%
Total interest-bearing borrowings	48,695	213	1.77	%	40,794	192	1.91	%
Total interest-bearing liabilities	405,590	927	0.93	%	424,608	1,150	1.10	%
Demand deposits	89,581				71,842			
Other non-interest bearing liabilities	673				829			
Total liabilities	495,844				497,279			
Total stockholders' equity	92,742				90,827			
Total liabilities and stockholders' equity	\$588,586				\$588,106			
Net interest-earning assets	\$146,911				\$126,683			
Tax equivalent net interest income/ interest rate spread (4)		4,954	3.39	%		5,010	3.43	%
Tax equivalent net interest margin (5) (net interest income as a percentage of interest-earning assets)			3.64	%			3.69	%
Ratio of interest-earning assets to interest-bearing liabilities			136.22	%			129.84	%
Less: tax equivalent adjustment (1)		(258 )				(266 )		
		\$4,696				\$4,744		



Net interest income as reported in statement of operations

Municipal securities income and net interest income are presented on a tax equivalent basis using a tax rate of 41%.

(1) The tax equivalent adjustment is deducted from the tax equivalent net interest income to agree to the amount reported on the statement of income. See 'Explanation of Use of Non-GAAP Financial Measurements'.

(2) Loans, net excludes loans held for sale and the allowance for loan losses and includes nonperforming loans.

(3) Savings accounts include mortgagors' escrow deposits.

Tax equivalent interest rate spread represents the difference between the weighted average yield on interest-earning

(4) assets and the weighted average cost of interest-bearing liabilities. See 'Explanation of Use of Non-GAAP Financial Measurements'.

(5) See 'Explanation of Use of Non-GAAP Financial Measurements.'

The following table presents the extent to which changes in interest rates and changes in the volume of interest-earning assets and interest-bearing liabilities have affected the Company's tax equivalent interest income and interest expense during the periods indicated. Information is provided in each category with respect to: (i) changes attributable to changes in volume (changes in volume multiplied by prior rate); (ii) changes attributable to changes in rate (changes in rate multiplied by prior volume); and (iii) the net change. The changes attributable to the combined impact of volume and rate have been allocated proportionately to the changes due to volume and the changes due to rate.

	Three Months Ended March 31, 2014 compared to 2013		
	Increase (Decrease)		
	Due to		
	Volume	Rate	Net
	(Dollars in Thousands)		
Interest-earning assets:			
Investment securities (1)	\$(198 )	\$177	\$(21 )
Loans:			
Residential real estate loans	(51 )	(63 )	(114 )
Home equity	1	(21 )	(20 )
Commercial real estate loans	305	(326 )	(21 )
Residential construction	19	3	22
Commercial construction	61	(31 )	30
Consumer loans	(1 )	7	6
Commercial and industrial loans	(2 )	(153 )	(155 )
Total loans	332	(584 )	(252 )
Other interest-earning assets	(5 )	(1 )	(6 )
Total interest-earning assets (2)	\$129	\$(408 )	\$(279 )
Interest-bearing liabilities:			