LAKE SHORE BANCORP, INC.
Form 10-K
March 29, 2013

United States

Securities and Exchange Commission

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2012

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

Commission File No.: 000-51821

Lake Shore Bancorp, Inc.

(Exact Name of Registrant as Specified in Its Charter)

United States	
(State or Other Jurisdiction	20-4729288
of Incorporation or Organization)	(I.R.S. Employer Identification No.)

31 East Fourth Street, Dunkirk, NY 14048

(Address of Principal Executive Offices, including zip code)

(716) 366-4070

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act: Common Stock, $0.01 par value per share

Name of each exchange on which registered: The NASDAQ Stock Market, LLC

Securities registered pursuant to Section 12(g) of the Act: None.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes [ ] No [X]

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes [ ] No [X]

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

Indicate by check mark whether the registrant 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 (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes [X] No [ ]

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form

10-K. []

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. (Check one):

Large accelerated filer [ ]　　Accelerated filer [ ]

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

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

The aggregate market value of the voting stock held by non-affiliates of the registrant as of June 30, 2012 was $18,185,808 based on the per share closing price as of June 30, 2012 on the Nasdaq Global Market for the registrant's common stock, which was $10.27.

There were 5,919,132 shares of the registrant's common stock, $.01 par value per share, outstanding at March 25, 2013.

DOCUMENTS INCORPORATED BY REFERENCE:

	Part of 10-K where incorporated
Portions of the registrant's Proxy Statement for the 2013 Annual Meeting of Stockholders	III

LAKE SHORE BANCORP, INC.
ANNUAL REPORT ON FORM 10-K
FOR THE FISCAL YEAR ENDED
DECEMBER 31, 2012

TABLE OF CONTENTS

PART I

Item 1. Business.

General

Lake Shore Bancorp, Inc. (“Lake Shore Bancorp,” the “Company,” “us,” or “we”) operates as a mid-tier, federally chartered savings and loan holding company of Lake Shore Savings Bank (“Lake Shore Savings” or the “Bank”). A majority of Lake Shore Bancorp’s issued and outstanding common stock (61.4%) is held by Lake Shore, MHC (the “MHC”), a federally chartered mutual holding company, which serves as the parent company to Lake Shore Bancorp. The MHC does not engage in any business activity other than its investment in a majority of the common stock of Lake Shore Bancorp. The Board of Governors of the Federal Reserve System (the “Federal Reserve Board”) is the regulator for the MHC. Federal law and regulations require that as long as the MHC is in existence, it must own at least a majority of Lake Shore Bancorp’s common stock. The remaining common shares of Lake Shore Bancorp are owned by public stockholders and the Lake Shore Savings Bank Employee Stock Ownership Plan (“ESOP”). Our common stock is traded on the Nasdaq Global Market under the symbol “LSBK”. Unless the context otherwise requires, all references herein to Lake Shore Bancorp or Lake Shore Savings include Lake Shore Bancorp and Lake Shore Savings on a consolidated basis.

Lake Shore Bancorp, Inc. was organized in 2006 for the purpose of acting as the savings and loan holding company of Lake Shore Savings Bank in connection with the Company’s initial public stock offering. At the time of its organization the Company was a federal corporation regulated by the Office of Thrift Supervision. Effective in July 2011, the regulation of federally chartered savings and loan holding companies was transferred to the Federal Reserve Board under the Dodd-Frank Act. At December 31, 2012, Lake Shore Bancorp had total consolidated assets of $482.4 million, of which $272.9 million was comprised of loans receivable, net and $159.4 million was comprised of available for sale securities. At December 31, 2012, total consolidated deposits were $378.5 million and total consolidated stockholders’ equity was $67.0 million.

Lake Shore Savings Bank was chartered as a New York savings and loan association in 1891. In 2006, the Bank converted from a New York-chartered mutual savings and loan association to a federal savings bank charter. At the time of the re-organization into a federal savings bank charter, the Bank was regulated by the Office of Thrift Supervision. Effective in July 2011, the regulation of federally chartered savings banks was transferred to the Office of the Comptroller of the Currency (“OCC”) under the Dodd-Frank Act.

For over 121 years, the Bank has served the local community of Dunkirk, New York. In 1987, we opened our second office in Fredonia, New York. Since 1993, we have more than quadrupled our asset-size and expanded to ten branch offices. In addition, we have added three administrative office buildings which comprise our corporate headquarters in Dunkirk, New York. Our principal business consists of (1) attracting retail deposits from the general public in the areas surrounding our corporate headquarters and main office in Dunkirk, New York and nine other branch offices in Chautauqua and Erie Counties, New York and (2) investing those deposits, together with funds generated from operations, primarily in one- to four-family residential mortgage loans, commercial real estate loans, home equity loans and lines of credit and, to a lesser extent, commercial business loans, consumer loans, and investment securities. Our revenues are principally derived from interest generated from our loans and interest earned and dividends received on our investment securities. Our primary sources of funds for lending and investments are deposits, borrowings, payments of loan principal and interest, payments on mortgage-backed and asset-backed securities, maturities and calls of investment securities and income resulting from operations in prior periods.

Available Information

Lake Shore Bancorp's annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to such reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, are made available free of charge on our website, www.lakeshoresavings.com, as soon as reasonably practicable after such reports are electronically filed with,

1

or furnished to, the Securities and Exchange Commission. Such reports are also available on the Securities and Exchange Commission's website at www.sec.gov. Information on our website shall not be considered a part of this Form 10-K.

Market Area

Our operations are conducted out of our corporate headquarters and main office in Dunkirk, New York and nine other branch offices. Our branches in Chautauqua County, New York are located in Dunkirk, Fredonia, Jamestown, Lakewood and Westfield. In Erie County, New York our branch offices are located in Depew, East Amherst, Hamburg, Kenmore and Orchard Park. Our first branch office in Erie County opened during April 2003 and the most recent branch office opened in April 2010. We also have seven stand-alone ATMs. The opening of five branch offices in Erie County, New York since 2003 demonstrates the implementation of our growth strategy which is focused on expansion within Erie County while preserving our market share in Chautauqua County. We plan to open our sixth branch office in Erie County during the second quarter of 2013 which will be located in Snyder, New York.

Our geographic market area for loans and deposits is principally located within Chautauqua and Erie Counties, New York. Northern Chautauqua County is located on Lake Erie in the western portion of New York and is approximately 45 miles from Buffalo, New York. There are multiple prime industries in this county and a skilled and productive labor force. Northern Chautauqua County is served by two accredited hospitals and offers higher education opportunities at the State University of New York (SUNY) at Fredonia, a four year liberal arts school, and at SUNY Jamestown, a community college. We have lending or deposit relationships with such institutions. Southern Chautauqua County is more of a tourist area, featuring Chautauqua Lake, but it also hosts a broad diversity of industry, commercial establishments and financial institutions as well as a skilled and productive workforce. Jamestown, New York, where we opened the first of two branch offices in 1996, is the most populous city in Chautauqua County.

Erie County is a metropolitan center located on the western border of New York covering 1,058 square miles. Located within Erie County is the city of Buffalo, the second largest city in the State of New York. As the city of Buffalo has redeveloped, so too have its suburbs throughout Erie County, which also host the Buffalo Niagara International Airport in Cheektowaga, New York and professional sports franchises. One of the main commercial thorough-fares in Erie County is Transit Road, which has experienced robust development in recent years and is the location of one of our branch offices.

The demographic characteristics of our market area are less attractive than national and state measures. Both Chautauqua and Erie Counties exhibit slower rates of population growth when compared to the United States and New York State averages. In addition, both Chautauqua and Erie Counties have lower per capita income and slower growth in per capita income when compared to the United States and the New York State averages. Since Chautauqua County has historically exhibited less attractive demographic characteristics, we may have limited growth opportunities in Chautauqua County. However, Erie County displays a stronger housing market than Chautauqua County and Erie County's population base is five times larger than Chautauqua County, which offers us a new source of customers in the form of deposit and lending opportunities. Notwithstanding these demographic characteristics, our primary market area has historically been stable, with a diversified base of employers and employment sectors. The local economies that we serve are not dependent on one key employer. Transportation equipment is the largest manufacturing industry in the Buffalo area, as well as production of automobile component parts. The principal employment sectors are service-related, wholesale and retail trade, and durable-goods manufacturing. Most of the job opportunities in Chautauqua and Erie Counties have been in service-related industries, and service jobs now account for the largest portion of the workforce.

The challenging economic conditions affecting the national and global financial markets are not having a significant effect on the housing prices in our market area. However, unemployment rates in our market area have increased since December 2011 from approximately 8% to 8.6% in Erie County and 8.9% in

2

Chautauqua County as of December 31, 2012, which may affect our ability to originate residential mortgage loans or attract new deposits.

Our future growth will be influenced by the strength of our regional economy, other demographic trends and the competitive environment. We believe that we have developed lending products and marketing strategies to address the credit-related needs of the residents and small businesses in our local market area.

Competition

We face intense competition both in making loans and attracting deposits. New York State has a high concentration of financial institutions, many of which are branches of large money centers and regional banks which have resulted from the consolidation of the banking industry in New York and surrounding states. Some of these competitors have greater resources than we do and may offer services that we do not provide. For example, we do not offer trust or investment services. Customers who seek “one stop shopping” may be drawn to our competitors who offer such services.

Our competition for loans comes principally from commercial banks, savings institutions, mortgage banking firms, credit unions, mortgage brokers, and other financial service companies. The most direct competition for deposits has historically come from credit unions, commercial banks and savings banks. Specifically, we compete with local financial institutions such as Cattaraugus County Bank and Evans Bank; regional financial institutions such as M&T Bank, Community Bank, NA, and First Niagara Bank; and national financial institutions such as Key Bank and Bank of America. We are significantly smaller than many of these financial institution competitors. We face additional competition for deposits from short-term money market funds, corporate and government securities funds, and from brokerage firms, online banks, mutual funds and insurance companies. We remain very competitive in Chautauqua County, New York and as of June 30, 2012 we had 15.02% of total deposits and ranked 4th out of 12 banks in this market area, according to the FDIC annual deposit market share report. Our deposit market share in Erie County, New York has increased since we entered this market area in 2003. The FDIC annual deposit market share report indicated that total deposit growth increased 5.53% in Erie County from June 30, 2011 to June 30, 2012. To remain competitive, we provide superior customer service and are active participants in our local community.

Lending Activities

General. We have a long-standing commitment to the origination of residential mortgage loans, including home equity loans, and we also originate commercial real estate, commercial and consumer loans. At December 31, 2012 we had total loans of $272.1 million. We currently retain substantially all of the loans that we originate; however, we have sold and may in the future sell residential mortgage loans into the secondary market, with retention of servicing rights. Beginning in June 2010, we began to purchase a limited amount of equipment loans from a third party broker, which are secured by first liens on new equipment purchases by small businesses located in the United States.

The interest rates we offer for loans are affected principally by the demand for loans, the supply of money available for lending purposes and the interest rates offered by our competitors. These factors, in turn, are affected by general and local economic conditions and monetary policies of the federal government, including the Federal Reserve Board.

Loan Portfolio. The following table sets forth the composition of our loan portfolio, by type of loan, in dollar amounts and in percentages at the dates indicated. We did not have any loans held for sale as of these dates.

	At December 31,									
	2012		2011		2010		2009		2008	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total
	(Dollars in thousands)									
Real Estate loans:										
Residential one- to four-family	$167,794	61.68%	$182,922	66.82%	$183,929	70.32%	$185,753	71.89%	$175,808	73.35%
Home equity	30,724	11.29%	30,671	11.20%	30,613	11.71%	30,158	11.67%	28,143	11.74%
Commercial	57,653	21.19%	44,776	16.36%	33,782	12.92%	28,328	10.96%	19,513	8.14%
Construction	416	0.15%	519	0.19%	616	0.24%	365	0.14%	6,479	2.70%
	256,587	94.31%	258,888	94.57%	248,940	95.19%	244,604	94.66%	229,943	95.93%
Other loans:										
Commercial	13,680	5.03%	12,911	4.72%	10,360	3.96%	11,430	4.42%	7,403	3.09%
Consumer	1,791	0.66%	1,948	0.71%	2,224	0.85%	2,377	0.92%	2,350	0.98%
	15,471	5.69%	14,859	5.43%	12,584	4.81%	13,807	5.34%	9,753	4.07%
Total loans	272,058	100.00%	273,747	100.00%	261,524	100.00%	258,411	100.00%	239,696	100.00%
Net deferred loan costs	2,681		2,687		2,460		2,327		2,243	
Allowance for loan losses	(1,806)		(1,366)		(953)		(1,564)		(1,476)	
Loans receivable, net	$272,933		$275,068		$263,031		$259,174		$240,463	

Loan Maturity. The following table presents the contractual maturity of our loans at December 31, 2012. The table does not include the effect of prepayments or scheduled principal amortization. Loans having no stated repayment schedule or maturity and overdraft loans are reported as being due in one year or less.

	Real Estate				Other Loans		
	Residential, One- to Four-Family	Home Equity	Commercial	Construction	Commercial	Consumer	Total
	(Dollars in thousands)						
Amounts due in:							
One year or less	$ 114	$ 651	$ 2	$ -	$ 2,538	$ 888	$ 4,193
After one year through five years	3,216	3,574	3,399	-	4,505	508	15,202
Beyond five years	164,464	26,499	54,252	416	6,637	395	252,663
Total	$ 167,794	$ 30,724	$ 57,653	$ 416	$ 13,680	$ 1,791	$ 272,058
Interest rate terms on amounts due after one year:							
Fixed rate	$ 163,271	$ 3,512	$ 25,620	$ 416	$ 10,984	$ 762	$ 204,565
Adjustable rate	4,409	26,561	32,031	-	158	141	63,300
Total	$ 167,680	$ 30,073	$ 57,651	$ 416	$ 11,142	$ 903	$ 267,865

4

The following table presents our loan originations, purchases, sales, and principal payments for the years indicated.

	For the Year Ended December 31,				
	2012	2011	2010	2009	2008
	(Dollars in thousands)				
Total Loans:					
Balance outstanding at beginning of year	$ 273,747	$ 261,524	$ 258,411	$ 239,696	$ 218,124
Originations:					
Real estate loans	48,091	49,030	46,321	64,725	61,229
Commercial and consumer loans	5,383	7,553	7,580	6,670	4,854
Total originations	53,474	56,583	53,901	71,395	66,083
Loan Purchases - Commercial Loans	1,033	1,679	1,135	-	-
Total Originations and Purchases	54,507	58,262	55,036	71,395	66,083
Deduct:					
Principal repayments:					
Real estate loans	48,382	38,694	38,055	40,439	34,587
Commercial and consumer loans	5,807	6,392	10,568	4,967	8,041
Total principal repayments	54,189	45,086	48,623	45,406	42,628
Transfers to foreclosed real estate	1,001	252	307	708	422
Loan sales - SONYMA(1) & FHLMC(2)	767	639	243	6,300	1,311
Loan sales - guaranteed student loans(3)	-	-	-	-	2
Loans charged off	239	62	2,750	266	148
Total deductions	56,196	46,039	51,923	52,680	44,511
Balance outstanding at end of period	$ 272,058	$ 273,747	$ 261,524	$ 258,411	$ 239,696

(1) State of New York Mortgage Agency.

(2) During 2009, we sold $6.2 million of residential mortgage loans with low yields to the Federal Home Loan Mortgage Corporation (“FHLMC”) in order to offset long term interest rate risk.

(3) During 2008, we were notified that Sallie Mae would no longer purchase student loans. As a result, we now retain student loans in our loan portfolio after a student graduates.

One- to Four-Family Residential Mortgage Lending. We emphasize the origination of residential mortgage loans secured by one-to four- family properties. At December 31, 2012, we had one-to four-family residential loans of $167.8 million, or 61.7%, of the total loan portfolio. Of one- to four-family residential mortgage loans outstanding on that date, 97.4% were fixed rate loans and 2.6% were adjustable rate mortgage loans. At December 31, 2012, approximately 64.3% of our one- to four-family residential mortgage portfolio was secured by property located in Chautauqua County, 31.3% by property located in Erie County and 4.4% by property located elsewhere, primarily in New York State. Approximately 42.6 % of all residential loan originations during fiscal year 2012 were re-financings of loans already in our portfolio.

Our residential mortgage loan originations are obtained from customers, residents of our local communities or referrals from local real estate agents, attorneys and builders. Management believes that the Erie County branch offices will be a significant source of new residential mortgage loan generation. Management believes that expanding our residential mortgage lending will continue to enhance our reputation as a service-oriented institution, particularly in Erie County, where we are actively developing and expanding our market presence.

One-to four-family residential mortgage loan originations are generally for terms of 15, 20 or 30 years, amortized on a monthly basis with interest and principal due either bi-weekly or monthly. One-to four-family residential real estate loans may remain outstanding for significantly shorter periods than their contractual terms as borrowers may refinance or prepay most loans at their option without penalty. Conventional one-to four-family residential mortgage loans originated by us customarily contain "due-on-sale" clauses that permit us to accelerate the indebtedness of the loan upon transfer of ownership of the mortgaged property. We do not offer "interest only" mortgage loans, subprime or "negative amortization" mortgage loans.

Our residential lending policies and procedures ensure that our one-to four-family residential mortgage loans generally conform to secondary market guidelines. We underwrite all conforming rate loans using the same criteria required by the FHLMC. We originate one-to four-family residential mortgage loans with a loan-to-value ratio up to 97%, and up to 103.5% with our Rural Development Guaranteed Loan Program ("GLP") mortgage loan product. Mortgages originated with a loan-to-value ratio exceeding 80% normally require private mortgage insurance. Private mortgage insurance is not required on loans with an 80% or less loan-to-value ratio. We do not originate any sub-prime mortgage loans and we do not have any sub-prime mortgage loans in our residential mortgage loan portfolio.

We offer adjustable rate mortgage loans with a maximum term of 30 years. When an adjustable rate mortgage is originated, the interest rate is established based on market conditions and competitor rates. When the rate on the adjustable rate mortgage is scheduled to re-price, the adjusted interest rate is tied to a specific U.S. Treasury index and a margin is added, taking into consideration the cap and floor rates established at the time of loan origination.

Our adjustable rate one-to four-family residential mortgage loans include limits on increases or decreases in the interest rate of the loan. The interest rate may increase or decrease by a maximum of 2% or 5% per adjustment period with a ceiling rate of 6% over the initial rate, depending on the product, over the life of the loan and a floor rate of 4.25% or 4.50%, depending on product type. The retention of adjustable rate one-to four-family residential mortgage loans in our loan portfolio helps reduce exposure to changes in interest rates. However, there are unquantifiable credit risks resulting from potential increased costs to the borrower as a result of the pricing of adjustable rate mortgage loans. During periods of rising interest rates, the risk of default on one-to four-family adjustable rate mortgage loans may increase due to the increase of interest cost to the borrower.

We regularly provide a loan product to our customers that is underwritten using the criteria required by FHLMC. After a loan is originated and funded, we may sell the loan to FHLMC. During 2012 we did not sell any loans to FHLMC. We sold loans to the State of New York Mortgage Agency ("SONYMA") during 2012 and in prior years and may do so again, from time to time. We retain all servicing rights for one- to four-family residential mortgage loans that we sell.

Home Equity Loans and Lines of Credit. We currently provide all-in-one home equity lines of credit and have provided home equity loans in the past to our customers. At December 31, 2012, home equity loans and lines of credit totaled $30.7 million, or 11.3% of the total loan portfolio, of which 88.5% were adjustable rate loans and 11.5% were fixed rate loans. The all-in-one home equity line of credit must have a minimum line amount of $5,000 up to a maximum of 85% of the total loan-to-value ratio. Home equity lines of credit products, which have interest rates tied to the prime rate, generally have a 15 year draw period and a 15 year payback period. A customer has the option to convert either a portion, or the entire line of credit balance, to a term loan at a fixed rate of interest. As the customer pays down the balance on the term loan, the funds available on the line of credit increase by a like amount. All-in-one home equity lines of credit have 15 year maximum terms.

Commercial Real Estate Loans. We originate commercial real estate loans to finance the purchase of real property, which generally consists of developed real estate, which is typically held as collateral for the loan. At December 31, 2012, commercial real estate loans totaled $57.7 million, or 21.2%, of the total loan portfolio. In underwriting commercial real estate loans, consideration is given to the property's historic cash flow, current and projected occupancy, location, and physical condition. Of the commercial real estate portfolio at December 31, 2012, approximately 27.9% consisted of loans that are collateralized by properties in Chautauqua County, 60.8% by properties in Erie County, and 11.3% by properties located elsewhere in New York State. The average commercial real estate loan is for a principal amount of approximately $385,000 and the largest commercial real estate loan in our portfolio as of December 31, 2012 was $3.9 million and secured by a commercial building used as a shopping plaza with multiple commercial tenants. This loan was performing on that date. We lend up to a maximum loan-to-value ratio of 75% on commercial properties and require a minimum debt coverage ratio of 1.2 to 1.

Commercial real estate lending involves additional risks compared with one-to four-family residential lending, because payments on loans secured by commercial real estate properties are often dependent on the successful operation or management of the properties, and/or the collateral value of the commercial real estate securing the loan, and repayment of such loans may be subject to adverse conditions in the real estate market or economic conditions to a greater extent than one- to four-family residential mortgage loans. Also, commercial real estate loans typically involve large loan balances to single borrowers or groups of related borrowers. Our loan policies limit the amount of loans to a single borrower or group of borrowers to reduce this risk and are designed to set such limits within those prescribed by applicable federal and state statutes and regulations.

Construction Loans. We originate loans to finance the construction of both one-to four-family homes and commercial real estate. These loans typically have a one-year construction period, whereby draws are taken and interest only payments are made. As part of the draw process, inspection and lien checks are required prior to the disbursement of the proceeds. At the end of the construction period, the loan automatically converts to either a conventional or commercial mortgage, as applicable. At December 31, 2012, construction loans totaled $416,000, or less than 1%, of our total loan portfolio.

Commercial Loans. In addition to commercial real estate loans, we also engage in small business commercial lending, including business installment loans, lines of credit, and other commercial loans. At December 31, 2012, commercial loans totaled $13.7 million, or 5.0%, of the total loan portfolio. This amount includes $2.3 million of equipment loans that we have purchased from a third party broker. The average commercial loan is for a principal amount of approximately $73,000 and the largest outstanding commercial loan in our portfolio as of December 31, 2012 was $2.4 million and secured by general business assets. This loan was performing on that date. Most of our commercial loans have fixed interest rates, and are for terms generally not in excess of 10 years. Whenever possible, we collateralize these loans with a lien on business assets and equipment and require the personal guarantees from principals of the borrower. Interest rates on commercial loans generally have higher yields than rates on one- to four-family residential mortgages. We offer commercial loan services designed to give business owners borrowing opportunities for modernization, inventory, equipment, construction, consolidation, real estate, working capital, vehicle purchases, and the refinancing of existing corporate debt.

Commercial loans are generally considered to involve a higher degree of risk than residential mortgage loans because the collateral underlying the loans may be in the form of furniture, fixtures, and equipment and/or inventory subject to market obsolescence. Commercial loans may also involve relatively large loan balances to single borrowers or groups of related borrowers, with the repayment of such loans typically dependent on the successful operation and income stream of the borrower. Such risks can be significantly affected by economic conditions. In addition, commercial business lending generally requires substantially greater oversight efforts compared to residential real estate lending. We conduct in-house reviews of the commercial loan portfolio to ensure adherence to our underwriting standards and policy requirements.

Consumer Loans. We offer a variety of consumer loans. At December 31, 2012, consumer loans totaled $1.8 million, or less than 1%, of the total loan portfolio. The largest component of our consumer loan portfolio are personal consumer loans and overdraft lines of credit, which are available for amounts up to $5,000 for unsecured loans and greater amounts for secured loans depending on the type of loan and value of the collateral. Consumer loans, excluding overdraft lines of protection, generally are offered for terms of up to

7

10 years, depending on the collateral, at fixed interest rates. Our consumer loan portfolio also consists of vehicle loans, motorcycle loans, student loans guaranteed by New York State Higher Education Services Corporation ("HESC"), other unsecured consumer loans up to $5,000, secured and unsecured property improvement loans, and other secured loans.

Generally, the volume of consumer lending has declined as borrowers have opted for home equity lines, where a mortgage-interest federal tax deduction is available, as compared to unsecured loans or loans secured by property other than residential real estate. We continue to make automobile loans directly to borrowers and primarily on used vehicles. We also maintain a portfolio of student loans, guaranteed by New York State Higher Education Services Corporation ("HESC"). During 2008, we discontinued the origination of student loans, as we were notified by Sallie Mae that they would no longer purchase these loans. We hold the student loans remaining in our portfolio and service the loans once the student graduates and begins repayment. We make other consumer loans, which may or may not be secured. The terms of such loans vary depending on the collateral.

Consumer loans are generally originated at higher interest rates than residential mortgage loans but also tend to have a higher credit risk due to the loans being either unsecured or secured by rapidly depreciable assets. Furthermore, consumer loan payments are dependent on the borrower's continuing financial stability, and therefore are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Despite these risks, our level of consumer loan delinquencies generally has been low. No assurance can be given, however, that our delinquency rate or losses will continue to remain low in the future.

Loan Approval Procedures and Authority. Our lending policies are approved by our Board of Directors. Home equity loans in excess of $25,000 and all one-to four-family residential mortgage loans up to $417,000 require approval by the Internal Residential Loan Committee, including one of the following officers: Chief Executive Officer, Vice President – Commercial and Small Business Lending – Chautauqua County or Vice President Chief Commercial Lending Officer. Loans between $417,000 and $1.0 million require the approval of two of the above officers along with another member of the Internal Residential Loan Committee. Loans in excess of $1.0 million require full Board of Directors approval.

For all commercial loans, including commercial real estate loans, certain Vice Presidents and Commercial Lending Officers have authority to approve loans for principal amounts up to $100,000. Commercial loans in excess of $100,000 and up to $500,000 require approval by a member of the Internal Commercial Loan Committee and any one of the following: Chief Executive Officer or Vice President – Chief Commercial Lending Officer. Commercial loans in excess of $500,000 and up to $1.0 million must be approved by three members of the Internal Commercial Loan Committee, two of which must be the Chief Executive Officer, the Vice President – Chief Commercial Lending Officer, or Chairman of the Board (only in the absence of the Chief Executive Officer or the Chief Commercial Lending Officer). Loans in excess of $1.0 million require full Board of Directors approval.

Additionally, branch managers are granted authority to approve certain loans, mainly consumer loans, in smaller amounts deemed appropriate by our Board of Directors. Levels of lending authority for consumer loans are established and granted to specific branch managers and loan officers based on position and experience.

Current Lending Procedures. Upon receipt of a completed loan application from a prospective borrower, we order a credit report and verify certain other information. If necessary, we obtain additional financial or credit related information. We require an appraisal for all mortgage and home equity loans, including loans made to refinance existing mortgage loans. Appraisals are performed by licensed third-party appraisal firms that have been approved by our Board of Directors. An appraisal management firm has been hired to handle all requests for appraisals on mortgage loans. We require title insurance on all mortgage loans and certain other loans. We also require borrowers to obtain hazard insurance, and if applicable, we require borrowers to obtain flood insurance prior to closing. Based on loan-to-value ratios and lending guidelines, escrow accounts may be required for such items as real estate taxes, hazard insurance, flood insurance, and private mortgage insurance premiums.

Asset Quality

One of our key operating objectives has been, and continues to be, maintaining a high level of asset quality. Our high proportion of one-to four-family residential mortgage loans, the maintenance of sound credit standards for new loan originations and loan administration procedures have resulted in low delinquency ratios, especially in light of current economic conditions. These factors have contributed to our strong financial condition.

Collection Procedures. We have adopted a loan collection policy to maintain adequate control on the status of delinquent loans and to ensure compliance with the Fair Debt Collection Practices Act. When a borrower fails to make required payments on a residential, commercial, or consumer loan, we take a number of steps to induce the borrower to cure the delinquency and restore the loan to a current status. Our collections department documents every time a borrower is contacted either by phone or in writing and maintains records of all collection efforts. Once an account becomes delinquent for 15 days, a late notice is mailed to the borrower and any guarantors on a loan. A second notice is mailed following the 30^{th} day of delinquency. At this time, we also directly contact the borrower. Such contact may be repeated if a loan is delinquent between 60-89 days.

Once a one-to four-family residential loan has been delinquent for more than 90 days, the loan is deemed a “classified asset” and is reported to our Board of Directors. In 2010, amendments to the New York State (“NYS”) Real Property Actions and Proceedings Law (“RPAPL”) became effective whereby specific pre-foreclosure procedures for any one-to four-family residence located in NYS must be followed. When the Company wants to pursue foreclosure action against a borrower, the law requires us to mail a 90 day pre-foreclosure notice of the impending foreclosure action to the borrower prior to commencement of the action. Within 3 days of sending this notice, the collection department sends the notice information to the NYS Superintendent of Banks through the NYS Banking Department’s online system. The Company must also send a 30-day demand letter to the borrower sixty days after the initial pre-foreclosure notice was sent. The demand letter includes updated loan balances regarding the potential foreclosure action. In order to receive approval for foreclosure action from the courts, the law requires a mandatory conference hearing between the court, borrower and bank. Prior to proceeding with any foreclosure action in the case of a secured loan, we will review the collateral to determine whether its possession would be cost-effective for us. In cases where the collateral fails to fully secure the loan, in addition to repossessing the collateral, we may also sue on the note underlying the loan.

If a commercial loan has been delinquent for more than 30 days, the loan file is reviewed for classification, and the borrower is contacted. If a commercial loan is 90 days or more past due, the loan is considered non-performing. If the delinquency continues, the borrower is advised of the date that the delinquency must be cured, or the loan is considered to be in default. At that time, foreclosure procedures are initiated on loans secured by real estate, and all other legal remedies are pursued.

The collection procedures for consumer loans include the sending of periodic late notices and letters to a borrower once a loan is past due. On a monthly basis, a review is made of all consumer loans which are 30 days or more past due. Consumer loans that are 180 days delinquent, where the borrowers have failed to demonstrate repayment ability, are classified as loss and charged-off. Once a charge-off decision has been made, the collections manager or management pursues legal action such as small claims court, judgments, salary garnishment and repossessions in an attempt to collect the deficiency from the borrower.

Loans Past Due and Non-performing Assets. We define non-performing loans as loans that are either non-accruing or accruing whose payments are 90 days or more past due. Non-performing assets, including non-performing loans and foreclosed real estate, totaled $3.0 million, or 0.62% of total assets, at December 31, 2012 and $3.1 million, 0.64% of total assets, at December 31, 2011.

9

The following table presents information regarding our non accrual loans, accruing loans delinquent 90 days or more, and foreclosed real estate as of the dates indicated.

	At December 31,				
	2012	2011	2010	2009	2008
	(Dollars in thousands)				
Loans past due 90 days or more but still accruing:					
Real estate loans:					
Residential, one-to four-family	$ 10	$ 328	$ 391	$ 456	$ 562
Home equity	-	21	39	142	25
Commercial	-	-	43	65	46
Construction	-	-	-	-	-
Other loans:					
Commercial loans	-	87	-	-	-
Consumer loans	18	23	59	1	15
Total	$ 28	$ 459	$ 532	$ 664	$ 648
Loans accounted for on a nonaccrual basis:					
Real estate loans:					
Residential, one-to four-family	$ 1,628	$ 1,821	$ 1,279	$ 753	$ 790
Home equity[1]	299	209	122	32	49
Commercial	255	228	370	192	152
Construction	-	-	-	-	-
Other loans:					
Commercial loans	201	76	27	19	-
Consumer loans	9	5	11	17	12
Total non-accrual loans	2,392	2,339	1,809	1,013	1,003
Total nonperforming loans	2,420	2,798	2,341	1,677	1,651
Foreclosed real estate	580	315	304	322	48
Performing Restructured loans	-	-	-	-	-
Total nonperforming assets	$ 3,000	$ 3,113	$ 2,645	$ 1,999	$ 1,699
Ratios:					
Nonperforming loans as a percent of net loans:	0.89 %	1.02 %	0.89 %	0.65 %	0.69 %
Nonperforming assets as a percent of total assets:	0.62 %	0.64 %	0.55 %	0.47 %	0.42 %

[1]As of December 31, 2012 and 2011, one home equity loan for $31,000 and accounted for on a non-accrual basis was restructured and classified as a troubled debt restructuring, due to the borrower’s financial difficulties.

Loans are placed on non-accrual status either when reasonable doubt exists as to the full timely collection of interest and principal, or when a loan becomes 90 days past due, unless an evaluation by the internal Asset Classification Committee, indicates that the loan is well-secured or in the process of collection. Our Asset Classification Committee designates loans on which we stop accruing interest income as non-accrual loans and we reverse outstanding interest income that was previously credited. We may again recognize income in the period that we collect such income, when the ultimate collectability of principal is no longer in doubt. We return a non-accrual loan to accrual status when factors indicating doubtful collection no longer exist.

Our recorded investment in non-accrual loans totaled $2.4 million at December 31, 2012 and $2.3 million at December 31, 2011. If all non-accrual loans had been current in accordance with their terms during the years ended December 31, 2012, 2011 and 2010, interest income on such loans would have amounted to $143,000, $129,000 and $160,000 respectively.

Real estate acquired as a result of foreclosure is classified as foreclosed real estate until such time as it is sold. We carry foreclosed real estate at its fair value less estimated selling costs at the date of acquisition. If a foreclosure action is commenced and the loan is not brought current, paid in full, or refinanced before the foreclosure sale, the property could be sold at the foreclosure sale (to an outside bidder). If not, and we retain the property, then we will sell the real property securing the loan as soon thereafter as practical.

Troubled debt restructurings ("TDRs") occur when we grant borrowers' concessions that we would not otherwise grant but for economic or legal reasons pertaining to the borrower's financial difficulties. A concession is made when the terms of the loan modification are more favorable than the terms the borrower would have received in the current market under similar financial difficulties. These concessions may include, but are not limited to, modifications of the terms of the debt, the transfer of assets or the issuance of an equity interest by the borrower to satisfy all or part of the debt, or the substitution or addition of borrower(s). The Company identifies loans for potential TDRs primarily through direct communication with the borrower and evaluation of the borrower's financial statements, revenue projections, tax returns and credit reports. Even if the borrower is not presently in default, management will consider the likelihood that cash flow shortages, adverse economic conditions, and negative trends may result in a payment default in the near future. Generally, we will not return a TDR to accrual status until the borrower has demonstrated the ability to make principal and interest payments under the restructured terms for at least six consecutive months.

At December 31, 2012 and 2011, one home equity loan for $31,000 was modified and classified as a TDR, due to the borrower's financial difficulties. This loan was placed on nonaccrual status and is included with non-accrual loans in the above table. The loan was classified as a substandard loan with no specific reserve established and was 420 days past due under the modified terms at December 31, 2012. We did not have any TDRs as of December 31, 2010.

Classification of Loans. Federal regulations require us to regularly review and classify our loans. In addition, our regulators have the authority to identify problem loans and, if appropriate, require them to be classified. There are three classifications for problem loans: substandard, doubtful and loss. "Substandard loans" have one or more defined weaknesses and are characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected. A substandard loan would be one inadequately protected by the current net worth and paying capacity of the obligor or pledged collateral, if applicable. "Doubtful loans" have all the weaknesses inherent in substandard loans with the additional characteristic that the weaknesses present make collection or liquidation in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss. A loan classified as a "loss" is considered uncollectible and of such little value that its continuance on the books is not warranted. This does not mean that an asset does not have recovery or salvage value, but simply that it is not practical or desirable to defer writing off all or a portion of a basically worthless asset even though partial recovery may occur in the future. Regulations also provide for a "special mention" category, (i.e. criticized loans) described as loans which do not currently expose us to a sufficient degree of risk to warrant classification but do possess credit deficiencies or potential weaknesses deserving our close attention.

The allowance for loan losses is established through a provision for loan losses based on management evaluation of the losses inherent in the loan portfolio. When we classify loans as either substandard or doubtful, we set aside a loss reserve for such loans as we deem prudent. When we classify problem loans as loss, we typically charge-off the outstanding loan balance against the allowance for loan loss reserve. Our determination as to the classification of our loans and the amount of our loss allowances are subject to review by our regulatory agencies, which can require that we establish additional loss allowances. We regularly review our loan portfolio to determine whether any loans require classification in accordance with applicable regulations. On the basis of our review of our loans at December 31, 2012, classified and criticized loans consisted of special mention loans of $3.9 million, substandard loans of $5.8 million, and doubtful loans of $230,000. The classified loans total included $2.4 million of nonperforming loans.

The following table shows the aggregate amounts of our classified and criticized loans at the dates indicated.

	At December 31,		
	2012	2011	2010
	(Dollars in thousands)		
Special mention loans [1]	$ 3,863	$ 4,546	$ 1,535
Substandard loans [2]	5,773	2,722	2,748
Doubtful loans	230	598	535
Loss loans	-	60	29
Total classified and criticized loans	$ 9,866	$ 7,926	$ 4,847

[1]During 2011, the growth in special mention loans was primarily due to an increase in the commercial real estate loan portfolio which did not warrant classification as the loans did not exhibit any defined weakness which could have resulted in losses if not corrected, but did possess credit deficiencies or potential weaknesses which deserved our close attention.

[2]During 2012, the growth in substandard loans was primarily due to an increase in commercial real estate loans which exhibited one or more defined weaknesses which could lead to losses if not corrected.

Delinquencies. The following table provides information about delinquencies in our loan portfolio at the dates indicated.

	At December 31,					
	2012		2011		2010	
	60-89 Days Past Due	90 + Days Past Due	60-89 Days Past Due	90 + Days Past Due	60-89 Days Past Due	90 + Days Past Due
	(Dollars in thousands)					
Residential real estate [1]	$ 407	$ 1,515	$ 659	$ 2,146	$ 829	$ 1,625
Commercial real estate	-	255	39	228	-	413
Commercial business	20	71	3	159	-	27
Consumer loans	4	26	4	28	13	70
Total	$ 431	$ 1,867	$ 705	$ 2,561	$ 842	$ 2,135

(1) Includes home equity loans and lines of credit and construction loans.

Allowance for Loan Losses. The allowance for loan losses is a valuation account that reflects our evaluation of the losses inherent in our loan portfolio. We maintain the allowance through provisions for loan losses that we charge to income. We charge losses on loans against the allowance for loan losses when we believe the collection of the loan is unlikely.

Our evaluation of risk in maintaining the allowance for loan losses includes the review of all loans on which the collectability of principal may not be reasonably assured. We consider the following factors as part of this evaluation: historical loan loss experience; payment status; the estimated value of the underlying collateral; changes in lending policies, procedures and loan review system; changes in the experience, ability, and depth of lending management and other relevant staff; trends in loan volume and the nature of the loan portfolio; and national and local economic conditions. There may be other factors that may warrant consideration in maintaining an allowance at a level sufficient to provide for probable loan losses. Although our management believes that it has established and maintained the allowance for loan losses to reflect losses inherent in our loan portfolio, based on its evaluation of the factors noted above, future additions may be necessary if economic and other conditions differ substantially from the current operating environment.

In addition, various regulatory agencies periodically review our allowance for loan losses as an integral part of their examination process. These agencies, including the Office of the Comptroller of the Currency, may require us to increase the allowance for loan losses or the valuation allowance for foreclosed real estate based on their evaluation of the information available to them at the time of their examination.

The allowance consists of allocated, general and unallocated components. The allocated component relates to loans that are classified as doubtful, substandard, loss or special mention. See "Asset Quality – Classification of Loans." For such loans that are also classified as impaired, an allowance is established when the discounted cash flows, collateral value or observable market price of the impaired loan is lower than the carrying value of the loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative and environmental factors, as mentioned above. An unallocated component may be maintained to cover uncertainties that could affect management's estimate of probable losses, such as downturns in the local economy. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating allocated and general losses in the portfolio.

A loan is considered impaired when, based on current information and events, it is probable that we will not be able to collect the scheduled payments of principal and 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. Impairment is measured on a loan-by-loan basis for commercial real estate loans 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. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, we do not separately identify individual consumer, home equity or one-to four-family real estate loans for impairment disclosures, unless they are subject to a troubled debt restructuring. At December 31, 2012, there was one commercial real estate loan and two commercial loans classified as impaired loans. At December 31, 2011, there was one commercial real estate loan classified as an impaired loan. Refer to Note 5 in the Notes to the Consolidated Financial Statements for more information on our impaired loans.

Provision for loan losses increased by $241,000 to $656,000 for the year ended December 31, 2012 from $415,000 for the year ended December 31, 2011. The increase in provision for loan losses was primarily due to an increase in our commercial real estate portfolio during 2012, along with an increase in classified loans. Our credit quality continues to remain strong. The ratio of nonperforming loans to total net loans was 0.89% as of December 31, 2012. The majority of our loans are one-to four-family residential mortgage loans or commercial real estate loans backed by first lien collateral on real estate held in the Western New York region. Western New York has not been impacted as severely as other parts of the country by fluctuating real estate market values. We do not hold any sub-prime loans in our loan portfolio.

The following table sets forth activity in our allowance for loan losses and other ratios at or for the years indicated.

	At or for the Year Ended December 31,				
	2012	2011	2010	2009	2008
	(Dollars in thousands)				
Balance at beginning of year:	$ 1,366	$ 953	$ 1,564	$ 1,476	$ 1,226
Provision for loan losses	656	415	2,115	265	391
Charge-offs:					
Real estate loans:					
Residential, one- to four-family	134	-	35	146	102
Home equity	14	29	6	54	-
Commercial	-	15	2,440	24	-
Construction	-	-	-	-	-
Other loans:					
Commercial	80	1	247	9	16
Consumer	11	17	22	33	30
Total charge-offs	239	62	2,750	266	148
Recoveries:					
Real estate loans:					
Residential, one- to four-family	1	4	19	74	-
Home equity	-	-	-	7	-
Commercial	20	52	-	-	-
Construction	-	-	-	-	-
Other loans:					
Commercial	1	-	-	-	3
Consumer	1	4	5	8	4
Total recoveries	23	60	24	89	7
Net charge-offs	216	2	2,726	177	141
Balance at end of year	$ 1,806	$ 1,366	$ 953	$ 1,564	$ 1,476
Average loans outstanding	$ 268,265	$ 270,697	$ 258,150	$ 250,846	$ 228,392
Allowance for loan losses as a percent of total net loans	0.66%	0.50%	0.36%	0.60%	0.61%
Allowance for loan losses as a percent of non-performing loans	74.63%	48.82%	40.71%	93.26%	89.40%
Ratio of net charge-offs to average loans outstanding	0.08%	0.01%	1.06%	0.07%	0.06%

14

The following table presents our allocation of the allowance for loan losses by loan category and the percentage of loans in each category to total loans at the years indicated. The allowance for loan losses allocated to each category is not necessarily indicative of inherent losses in any particular category and does not restrict the use of the allowance to absorb losses in other categories.

	At December 31, 2012			2011			2010			2009		
	Amount	% of Allowance to Total Allowance	% of Loans in Category to Total Loans	Amount	% of Allowance to Total Allowance	% of Loans in Category to Total Loans	Amount	% of Allowance to Total Allowance	% of Loans in Category to Total Loans	Amount	% of Allowance to Total Allowance	% L C tc L
	(Dollars in thousands)											
Real Estate Loans:												
Residential, one- to four-family	$ 393	21.7%	61.7%	$ 441	32.3%	66.8%	$ 407	42.7%	70.4%	$ 265	16.9%	7
Home equity	79	4.4%	11.3%	125	9.2%	11.2%	141	14.8%	11.7%	107	6.8%	1
Commercial (1)(2)(3)	1,118	61.9%	21.2%	522	38.2%	16.4%	278	29.2%	12.9%	932	59.7%	1
Construction	-	-	0.1%	-	-	0.2%	1	0.1%	0.2%	-	-	0
	1,590	88.0%	94.3%	1,088	79.7%	94.6%	827	86.8%	95.2%	1,304	83.4%	9
Other loans:												
Commercial	202	11.2%	5.0%	265	19.4%	4.7%	104	10.9%	4.0%	215	13.7%	4
Consumer	14	0.8%	0.7%	13	0.9%	0.7%	21	2.2%	0.8%	37	2.4%	0
	216	12.0%	5.7%	278	20.3%	5.4%	125	13.1%	4.8%	252	16.1%	5
Total allocated	$ 1,806	100.0%	100.0%	$ 1,366	100.0%	100.0%	$ 952	99.9%	100.0%	$ 1,556	99.5%	1
Total unallocated	-	-		-	-		1	0.1%		8	0.5%	
Balance at end of year	$ 1,806	100.0%		$ 1,366	100.0%		$ 953	100.0%		$ 1,564	100.0%	

(1) The increase as of December 31, 2012 was primarily due to an increase in our commercial real estate portfolio and classified commercial real estate loans.

(2) The increase as of December 31, 2011 was primarily due to the review of certain environmental factors for commercial real estate loans and commercial loans. Management concluded that an increased reserve was needed for its commercial loan portfolio due to the increase in portfolio size and the standard risks presented by these types of loans.

(3) The increases as of December 31, 2009 and 2008 were primarily due to a reserve calculated on three loans to one borrower that were classified as impaired. The reserve was calculated based on the present value of the discounted cash flows in accordance with ASC 310-10-35. A reserve of $570,000 was set aside in 2008 for these loans, with an additional reserve of $127,000 recorded during 2009.

Investment Activities

General. Our Board of Directors reviews and approves our investment policy on an annual basis. This policy dictates that investment decisions be made based on the safety of the investment, liquidity requirements, potential returns, cash flow targets, and consistency with our interest rate risk management strategy. The Board of Directors has delegated primary responsibility for ensuring that the guidelines in the investment policy are followed to the Chief Executive Officer and the Chief Financial Officer. Our Chief Executive Officer and Chief Financial Officer are responsible for making securities portfolio decisions in accordance with established policies and have the authority to purchase and sell securities within the specific guidelines established by the investment policy. In addition, all transactions are reviewed by the Asset/Liability Committee of the Board of Directors which meets at least quarterly.

Our investment policy is designed primarily to manage the interest rate sensitivity of our assets and liabilities, to generate a favorable return without incurring undue interest rate or credit risk, to complement our lending activities and to provide and maintain liquidity within established guidelines. In establishing our investment strategies, we consider our interest rate sensitivity, the types of securities to be held, liquidity and other factors. We have also engaged an independent financial advisor to recommend investment securities according to a plan which has been approved by the Asset/Liability Committee and the Board of Directors. Federal savings banks have authority to invest in various types of assets, including U.S. Government obligations, securities of various federal agencies, obligations of states and municipalities, mortgage-backed and asset-backed securities, collateralized-mortgage obligations, certain time deposits of insured banks and savings institutions, certain bankers' acceptances, repurchase agreements, loans of federal funds, and, subject to certain limits, corporate debt and commercial paper.

As of December 31, 2012, our securities portfolio was classified as "available for sale" and reported at fair value. Our securities portfolio consists of collateralized mortgage obligations, mortgage backed securities, asset-backed securities, U.S. Government obligations and municipal bonds. Nearly all of our mortgage backed securities are directly or indirectly insured or guaranteed by the Federal Home Loan Mortgage Corporation, the Government National Mortgage Association or the Federal National Mortgage Association. The municipal securities we invest in have maturities of 20 years or less and many have private insurance guaranteeing repayment.

We have investments in Federal Home Loan Bank of New York ("FHLBNY") stock, which must be held as a condition of membership in the Federal Home Loan Bank system. The investment in FHLBNY stock is considered restricted and is reported at book value on the Consolidated Statements of Financial Condition.

Fair values of available for sale securities were based on a market approach, with the exception of five private-label asset-backed securities that are not currently trading in an active market. Fair values of these securities were calculated based on a cash flow approach. Securities which are fixed income instruments that are not quoted on an exchange, but are traded in active markets, are valued using prices obtained from our custodian, which used third party data service providers.

Classification of Investments. Federal regulations require us to regularly review and classify our investments based on credit risk in determining credit quality of investment portfolios as well as for calculating risk based capital. A decline in the market value of a security due to interest rate fluctuations is not a basis for adverse classification. Instead, the classification is based on the likelihood of the timely and full collection of principal and interest.

In assessing the credit quality of securities in our investment portfolio, we review the qualitative ratings provided by nationally recognized statistical rating organizations ("NRSROs"), such as Standard and Poor ("S&P"), Moody's or Fitch. Securities that are rated in the first four rating categories by NRSROs are generally considered investment quality and are not adversely classified. If a security has a rating below the first four categories, the Company will review the security and consider it for classification.

A security may be classified as Substandard, Doubtful or Loss. A "Substandard" classification indicates that the investment is inadequately protected by the sound worth and paying capacity of the obligor or of the collateral pledged. Investments classified as "Substandard" must have a well defined weakness or weaknesses that jeopardize the liquidation of the debt, and the Company may sustain some loss if deficiencies are not corrected. A "Doubtful" classification has all the weaknesses of a "Substandard" classification with the added characteristic that the weaknesses make collection or liquidation in full highly questionable and improbable. Investments classified "Loss" are considered uncollectible and their continuance as an asset of the Company is no longer warranted.

The Company's policies require that only investment grade securities are to be purchased. However, the Company may legally hold a "fallen angel," defined as a security that it purchased at investment grade which has subsequently fallen to a below investment grade level.

According to Dodd-Frank, effective January 1, 2013, the use of qualitative ratings from NRSROs can no longer be solely relied upon in determining credit quality of investment securities. The regulators now define "investment grade" as those securities where the issuer has an adequate capacity to meet the financial commitments under the security for the projected life of the investment, which will be met if the risk of default by the obligor is low and full and timely repayment of principal and interest can be expected. Banks are required to meet this standard before purchasing a new investment security and will need to maintain ongoing reviews of its investment portfolio to ensure it meets the safety and soundness requirements that are appropriate for the bank's risk profile and size and complexity of its investment portfolio.

Our determination as to the classification of our investments are subject to review by our regulatory agencies. We regularly review our investment portfolio to determine whether any investments require classification in accordance with applicable regulations. Our review of our investment portfolio at December 31, 2012 indicated six private-label asset-backed securities that we considered to be below investment grade, as the issuer did not have an adequate capacity to meet its financial commitments over the projected life of the investment or the risk of default by the obligor was possible, resulting in an expectation that the Bank would not receive the full and timely repayment of principal and interest as expected. These six securities had an amortized cost of $4.5 million and fair value of $4.7 million. The NRSRO ratings on these securities ranged from BB+ to D. All six securities were classified as "Substandard." These securities were also evaluated for other-than-temporary impairment as noted in the Other than Temporary Impairment section of Part II, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and we concluded that an additional $102,000 of other-than-temporary impairment needed to be recorded for one private-label asset-backed security during the year ended December 31, 2012.

The following table presents the composition of our securities portfolio in dollar amount of each investment type at the dates indicated.

	At December 31,					
	2012		2011		2010	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(Dollars in thousands)					
Securities available for sale:						
U.S. Treasury bonds	$ 12,896	$ 15,195	$ 12,935	$ 15,078	$ 8,961	$ 9,104
Municipal bonds	51,666	56,264	49,561	53,676	47,995	45,746
Mortgage-backed securities:						
Collateralized mortgage obligations -private label	92	94	133	129	305	304
Collateralized mortgage obligations -government sponsored entities	57,574	58,167	59,669	60,771	71,864	73,396
Government National Mortgage Association	2,607	2,896	3,141	3,349	2,461	2,407
Federal Home Loan Mortgage Association	15,232	16,272	19,612	20,570	10,545	10,866
Federal Home Loan Mortgage Corporation	5,708	6,194	5,246	5,766	5,817	6,207
Asset-backed securities-private label	4,514	4,117	5,459	4,632	6,586	5,650
Asset-backed securities-government sponsored entities	150	163	173	189	237	237

Equity securities	22	6	22	5	22	7
Total available for sale	$ 150,461	$ 159,368	$ 155,951	$ 164,165	$ 154,793	$ 153,924

At December 31, 2012, we did not have any non-U.S. Government and Government agency securities that exceeded 10.0% of equity.

Investment Securities Portfolio, Maturities and Yields. The following table sets forth the scheduled maturities, amortized cost and weighted average yields for our investment portfolio, with the exception of equity securities, at December 31, 2012. Due to repayments of the underlying loans, the average life maturities of mortgage-backed and asset-backed securities generally are substantially less than the final maturities. The weighted average yield does not include the impact of a tax-equivalent adjustment for bank qualified municipals.