UNITY BANCORP INC /NJ/
Form 10-Q
November 10, 2009

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

FORM 10-Q

(Mark One)
(X) QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED September 30, 2009

OR

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

Commission file number 1-12431

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

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

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

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

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

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

The number of shares outstanding of each of the registrant's classes of common equity stock, as of November 1, 2009
common stock, no par value: 7,119,438 shares outstanding

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Part 1 - Consolidated Financial Information
Item 1 - Consolidated Financial Statements (Unaudited)

Unity Bancorp, Inc.
Consolidated Balance Sheets
(Unaudited)

(In thousands)	September 30, 2009	December 31, 2008	September 30, 2008
ASSETS			
Cash and due from banks	$ 17,035	$ 18,902	$ 21,987
Federal funds sold and interest-bearing deposits	48,853	15,529	29,356
Cash and cash equivalents	65,888	34,431	51,343
Securities:			
Available for sale	140,906	117,348	70,144
Held to maturity (fair value of $30,396, $30,088 and $27,063, respectively)	30,595	32,161	29,266
Total securities	171,501	149,509	99,410
Loans:			
SBA held for sale	21,364	22,181	19,863
SBA held to maturity	79,342	83,127	82,551
SBA 504	71,432	76,802	82,227
Commercial	298,019	308,165	311,988
Residential mortgage	124,313	133,110	128,216
Consumer	62,050	62,561	60,178
Total loans	656,520	685,946	685,023
Less: Allowance for loan losses	12,445	10,326	9,913
Net loans	644,075	675,620	675,110
Premises and equipment, net	11,911	12,580	12,475
Bank owned life insurance	5,946	5,780	5,727
Federal Home Loan Bank stock	4,677	4,857	5,307
Accrued interest receivable	4,230	4,712	4,364
Goodwill and other intangibles	1,563	1,574	1,577
Loan servicing asset	977	1,503	1,721
Other assets	11,921	7,744	7,049
Total Assets	$ 922,689	$ 898,310	$ 864,083
LIABILITIES AND SHAREHOLDERS' EQUITY			
Liabilities:			
Deposits:			
Noninterest-bearing demand deposits	$ 83,534	$ 74,090	$ 82,167
Interest-bearing demand deposits	92,401	87,046	87,587
Savings deposits	263,758	134,875	148,026
Time deposits, under $100,000	209,050	270,275	274,845
Time deposits, $100,000 and over	101,922	140,831	92,055
Total deposits	750,665	707,117	684,680
Borrowed funds	85,000	105,000	115,000
Subordinated debentures	15,465	15,465	15,465

Accrued interest payable	797	805	869
Accrued expenses and other liabilities	3,377	2,120	1,530
Total Liabilities	855,304	830,507	817,544
Commitments and contingencies	-	-	-
Shareholders' equity:			
Preferred stock, no par value, 500 shares authorized	18,418	18,064	-
Common stock, no par value, 12,500 shares authorized	55,351	55,179	52,453
Retained earnings (deficit)	(1,253)	1,085	591
Treasury stock at cost	(4,169)	(4,169)	(4,169)
Accumulated other comprehensive loss, net of tax	(962)	(2,356)	(2,336)
Total Shareholders' Equity	67,385	67,803	46,539
Total Liabilities and Shareholders' Equity	$ 922,689	$ 898,310	$ 864,083
Preferred shares	21	21	-
Issued common shares	7,544	7,544	7,535
Outstanding common shares	7,119	7,119	7,110

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

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Unity Bancorp
Consolidated Statements of Operations
(Unaudited)

(In thousands, except per share amounts)	For the three months ended September 30, 2009	2008	For the nine months ended September 30, 2009	2008
INTEREST INCOME				
Federal funds sold and interest-bearing deposits	$32	$ 113	$78	$ 404
Federal Home Loan Bank stock	101	58	219	234
Securities:				
Available for sale	1,482	907	4,670	2,714
Held to maturity	389	381	1,167	1,216
Total securities	1,871	1,288	5,837	3,930
Loans:				
SBA	1,498	2,043	4,668	6,399
SBA 504	1,147	1,424	3,663	4,134
Commercial	4,973	5,453	15,040	16,145
Residential mortgage	1,772	1,720	5,419	4,008
Consumer	791	866	2,383	2,613
Total loan interest income	10,181	11,506	31,173	33,299
Total interest income	12,185	12,965	37,307	37,867
INTEREST EXPENSE				
Interest-bearing demand deposits	264	404	801	1,120
Savings deposits	1,032	774	2,588	3,041
Time deposits	2,950	3,553	10,084	9,779
Borrowed funds and subordinated debentures	1,081	1,152	3,344	3,372
Total interest expense	5,327	5,883	16,817	17,312
Net interest income	6,858	7,082	20,490	20,555
Provision for loan losses	3,000	2,100	6,000	3,200
Net interest income after provision for loan losses	3,858	4,982	14,490	17,355
NONINTEREST INCOME (LOSS)				
Service charges on deposit accounts	373	381	1,038	1,042
Service and loan fee income	398	334	946	936
Bank owned life insurance	56	53	166	157
Gain on sale of mortgage loans	71	-	184	21
Gain on sale of SBA loans held for sale, net	-	215	29	1,208
Total other-than-temporary impairment charge on securities	-	(946)	(2,555)	(1,201)
Portion of loss recognized in other comprehensive income (before taxes)	-	-	806	-
Net other-than temporary impairment charge recognized in earnings	-	(946)	(1,749)	(1,201)
Net security gains (losses)	158	(512)	675	(393)
Other income	106	131	316	369
Total noninterest income (loss)	1,162	(344)	1,605	2,139
NONINTEREST EXPENSE				
Compensation and benefits	2,909	2,948	8,386	9,148
Occupancy	595	688	1,929	2,102

Processing and communications		531			554	1,554		1,668
Furniture and equipment		414			423	1,381		1,224
Professional services		274			285	780		626
Loan collection costs		315			206	694		446
Deposit insurance		351			117	1,361		291
Advertising		147			158	373		299
Other expenses		574			400	1,411		1,362
Total noninterest expense		6,110			5,779	17,869		17,166
Income (loss) before provision for income taxes		(1,090	)		(1,141)	(1,774)		2,328
Provision (benefit) for income taxes		(343	)		(139)	(559)		982
Net (loss) income		(747	)		(1,002)	(1,215)		1,346
Preferred stock dividends and discount accretion		372			-	1,123		-
Income available (loss attributable) to common shareholders	$	(1,119	)	$	(1,002)	$(2,338)	$	1,346
Net income (loss) per common share - Basic	$	(0.16	)	$	(0.14)	$(0.33)	$	0.19
- Diluted		(0.16	)		(0.14)	(0.33)		0.19
Weighted average common shares outstanding - Basic		7,119			7,107	7,119		7,091
- Diluted		7,119			7,107	7,119		7,268

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

Unity Bancorp, Inc.
Consolidated Statements of Changes in Shareholders' Equity
For the nine months ended September 30, 2009 and 2008
(Unaudited)

(In thousands)	Preferred Stock	Common Stock Shares	Common Stock Amount	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
Balance, December 31, 2007	$	7,063	$ 49,447	$ 2,472	$ (4,169)	$ (490)	$ 47,260
Comprehensive income:							
Net income				1,346			1,346
Unrealized losses on securities, net of tax						(1,727)	(1,727)
Unrealized losses on cash flow hedge derivatives, net of tax						(119)	(119)
Total comprehensive loss							(500)
Dividends on common stock ($.10 per share)				(692)			(692)
5% stock dividend, including cash-in-lieu			2,532	(2,535)			(3)
Issuance of common stock:							
Stock issued, including related tax benefits		34	240				240
Stock-based compensation		13	234				234
Balance, September 30, 2008	$	7,110	$ 52,453	$ 591	$ (4,169)	$ (2,336)	$ 46,539

(In thousands)	Preferred Stock	Common Stock Shares	Common Stock Amount	Retained Earnings (Deficit)	Treasury Stock	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
Balance, December 31, 2008	$ 18,064	7,119	$ 55,179	$ 1,085	$ (4,169)	$ (2,356)	$ 67,803
Comprehensive income:							

Net loss				(1,215)			(1,215)
Noncredit unrealized losses on held to maturity debt securities, net of tax						(532)	(532)
Unrealized gains on securities, net of tax						1,841	1,841
Unrealized gains on cash flow hedge derivatives, net of tax						85	85
Total comprehensive income							179
Accretion of discount on preferred stock	354			(354)			-
Dividends on preferred stock (5% annually)				(769)			(769)
Issuance of common stock:							
Stock issued, including related tax benefits			(51)				(51)
Stock-based compensation			223				223
Balance, September 30, 2009	$ 18,418	7,119	$ 55,351	$ (1,253)	$ (4,169)	$ (962)	$ 67,385

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

Unity Bancorp, Inc.
Consolidated Statements of Cash Flows
(Unaudited)

(In thousands)	For the nine months ended September 30, 2009	September 30, 2008
OPERATING ACTIVITIES:		
Net (loss) income	$ (1,215)	$ 1,346
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Provision for loan losses	6,000	3,200
Net amortization of purchase premiums and discounts on securities	327	55
Depreciation and amortization	1,115	626
Deferred income tax benefit	(2,091)	(1,515)
Other-than-temporary impairment charges on securities	1,749	1,201
Net security (gains) losses	(675)	393
Stock compensation expense	223	234
Gain on sale of SBA loans held for sale, net	(29)	(1,208)
Gain on sale of mortgage loans	(184)	(21)
Loss on disposal of fixed assets	-	28
Origination of mortgage loans held for sale	(15,700)	(1,739)
Origination of SBA loans held for sale	(1,910)	(25,846)
Proceeds from the sale of mortgage loans held for sale, net	15,884	1,760
Proceeds from the sale of SBA loans held for sale, net	867	26,041
Net change in other assets and liabilities	1,960	110
Net cash provided by operating activities	6,321	4,665
INVESTING ACTIVITIES		
Purchases of securities held to maturity	(4,036)	(2,782)
Purchases of securities available for sale	(87,708)	(30,337)
Purchases of Federal Home Loan Bank stock, at cost	(8,469)	(1,362)
Maturities and principal payments on securities held to maturity	4,096	9,098
Maturities and principal payments on securities available for sale	39,665	15,757
Proceeds from sales of securities available for sale	26,048	3,696
Proceeds from the redemption of Federal Home Loan Bank stock	8,649	450
Proceeds from the sale of other real estate owned	1,171	353
Net decrease (increase) in loans	23,245	(96,066)
Proceeds from the sale of premises and equipment	-	263
Purchases of premises and equipment	(305)	(1,326)
Net cash provided by (used in) investing activities	2,356	(102,257)

FINANCING ACTIVITIES				
Net increase in deposits		43,548		83,412
Proceeds from new borrowings		22,000		35,000
Repayments of borrowings		(42,000)		(5,000)
Proceeds from the issuance of common stock		(51)		240
Cash dividends paid on preferred stock		(717)		-
Cash dividends paid on common stock		-		(1,028)
Net cash provided by financing activities		22,780		112,623
Increase in cash and cash equivalents		31,457		15,031
Cash and cash equivalents at beginning of period		34,431		36,312
Cash and cash equivalents at end of period	$	65,888	$	51,343
SUPPLEMENTAL DISCLOSURES				
Cash:				
Interest paid	$	16,825	$	17,078
Income taxes paid		1,035		1,391
Noncash investing activities:				
Transfer of AFS securities to HTM securities		-		1,860
Transfer of AFS SBA loans to HTM SBA loans		1,890		5,790
Transfer of loans to other real estate owned		3,242		565

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

Unity Bancorp, Inc.
Notes to the Consolidated Financial Statements (Unaudited)
September 30, 2009

NOTE 1. Significant Accounting Policies

The accompanying consolidated financial statements include the accounts of Unity Bancorp, Inc. (the "Parent Company") and its wholly-owned subsidiary, Unity Bank (the "Bank" or when consolidated with the Parent Company, the "Company"), and reflect all adjustments and disclosures which are generally routine and recurring in nature, and in the opinion of management, necessary for a fair presentation of interim results. Unity Investment Services, Inc., a wholly-owned subsidiary of the Bank, is used to hold part of the Bank’s investment portfolio. Unity Participation Company, Inc., a wholly-owned subsidiary of the Bank, is used to hold part of the Bank’s loan portfolio. All significant inter-company balances and transactions have been eliminated in consolidation. Certain reclassifications have been made to prior period amounts to conform to the current year presentation. The financial information has been prepared in accordance with U.S. generally accepted accounting principles and has not been audited. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the dates of the statements of financial condition and revenues and expenses during the reporting periods. Actual results could differ from those estimates. The Company has evaluated subsequent events for potential recognition and/or disclosure through November 10, 2009, the date the consolidated financial statements included in this Quarterly Report on Form 10-Q were issued.

Estimates that are particularly susceptible to significant changes relate to the determination of the allowance for loan losses. Management believes that the allowance for loan losses is adequate. While management uses available information to recognize losses on loans, future additions to the allowance for loan losses may be necessary based on changes in economic conditions. The interim unaudited consolidated financial statements included herein have been prepared in accordance with instructions for Form 10-Q and the rules and regulations of the Securities and Exchange Commission (“SEC”). The results of operations for the nine months ended September 30, 2009 are not necessarily indicative of the results which may be expected for the entire year. As used in this Form 10-Q, “we” and “us” and “our” refer to Unity Bancorp, Inc., and its consolidated subsidiary, Unity Bank, depending on the context. Interim financial statements should be read in conjunction with the Company’s consolidated financial statements and notes thereto for the year ended December 31, 2008, included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2008.

Accounting Standards Codification

The Financial Accounting Standards Board’s ("FASB") Accounting Standards Codification ("ASC") became effective on July 1, 2009. At that date, the ASC became FASB’s officially recognized source of authoritative U.S. generally accepted accounting principles ("GAAP") applicable to all public and non-public non-governmental entities, superseding existing FASB, American Institute of Certified Public Accountants ("AICPA"), Emerging Issues Task Force ("EITF") and related literature. Rules and interpretive releases of the SEC under the authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. All other accounting literature is considered non-authoritative. The switch to the ASC affects the way companies refer to U.S. GAAP in financial statements and accounting policies. Citing particular content in the ASC involves specifying the unique numeric path to the content through the Topic, Subtopic, Section and Paragraph structure.

Stock Transactions

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

Stock Option Plans

The Company's incentive and nonqualified option plans permit the Board to set vesting requirements. Grants issued to date generally vest over 3 years and must be exercised within 10 years of the date of the grant. The exercise price of each option is the market price on the date of grant. As of September 30, 2009, 1,520,529 shares have been reserved for issuance upon the exercise of options, 833,612 option grants are outstanding, and 572,271 option grants have been exercised, forfeited or expired, leaving 114,646 shares available for grant.

The Company did not grant any options during the three months and nine months ended September 30, 2009. Comparatively, 5,000 and 47,263 options were granted during the three months and nine months ended September 30, 2008, respectively. The fair value of the options granted during 2008 was estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2008	2009	2008
Number of shares granted	-	5,000	-	47,263
Weighted average exercise price	$ -	6.12	$ -	$ 7.44
Weighted average fair value	$ -	1.42	$ -	$ 1.58
Expected life	-	3.99	-	3.82
Expected volatility	-%	34.14	- %	31.33%
Risk-free interest rate	-%	3.15	- %	2.51%
Dividend yield	-%	3.27	- %	2.59%

Transactions under the Company's stock option plans during the nine months ended September 30, 2009 are summarized as follows:

	Number of Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Life (in years)	Aggregate Intrinsic Value
Outstanding at December 31, 2008	872,274	$ 5.94		
Options expired	(37,395)	8.02		
Options forfeited	(1,267)	5.38		
Outstanding at September 30, 2009	833,612	$ 5.85	4.4	$ 360,793
Exercisable at September 30, 2009	656,762	$ 5.82	3.3	$ 331,993

FASB ASC Topic 718, "Compensation - Stock Compensation," requires an entity to recognize the fair value of equity awards as compensation expense over the period during which an employee is required to provide service in exchange for such an award (vesting period). Compensation expense related to stock options totaled $43 thousand and $38 thousand for the three months ended September 30, 2009 and 2008, respectively. The related income tax benefit was approximately $18 thousand and $16 thousand for each of the three months ended September 30, 2009 and 2008, respectively. Compensation expense related to stock options totaled $115 thousand and $105 thousand for the nine months ended September 30, 2009 and 2008, respectively. The related income tax benefit was approximately $54 thousand and $45 thousand for each of the nine months ended September 30, 2009 and 2008, respectively. As of

September 30, 2009, there was approximately $185 thousand of unrecognized compensation cost related to nonvested, share-based compensation arrangements granted under the Company's stock incentive plans. This cost is expected to be recognized over a weighted-average period of 1.7 years.

There were no options exercised during the three months and nine months ended September 30, 2009 or the three months ended September 30, 2008; consequently, no intrinsic value was realized. During the nine months ended September 30, 2008, there were 536 shares exercised with a related intrinsic value (spread between the market value and exercise price) of $1 thousand.

Restricted Stock Awards

Restricted stock awards granted to date vest over a period of 4 years and are recognized as compensation to the recipient over the vesting period. The awards are recorded at fair market value and amortized into salary expense on a straight line basis over the vesting period. There were no restricted stock awards granted during the three months and nine months ended September 30, 2009. There were 1,500 restricted share awards with an average grant date fair value of $6.12 and 14,100 restricted share awards with an average grant date fair value of $7.43 granted during the three months and nine months ended September 30, 2008, respectively.

Compensation expense related to the restricted stock awards totaled $46 thousand and $45 thousand for the three months ended September 30, 2009 and 2008, respectively. Compensation expense related to the restricted stock awards totaled $108 thousand and $129 thousand for the nine months ended September 30, 2009 and 2008, respectively. As of September 30, 2009 there was approximately $182 thousand of unrecognized compensation cost related to nonvested restricted stock awards granted under the Company's stock incentive plans. The cost is expected to be recognized over a weighted average period of 1.8 years.

As of September 30, 2009, 121,551 shares of restricted stock were reserved for issuance, of which 44,508 shares are available for grant.

The following table summarizes nonvested restricted stock award activity for the nine months ended September 30, 2009:

	Shares	Average Grant Date Fair Value
Nonvested restricted stock at December 31, 2008	50,424	$ 9.76
Granted	-	-
Vested	(15,418)	11.30
Forfeited	-	-
Nonvested restricted stock at September 30, 2009	35,006	$ 9.08

Income Taxes

The Company accounts for income taxes according to the asset and liability method. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax basis. Deferred tax assets and liabilities are measured using the enacted tax rates applicable to taxable income for the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Valuation reserves are established against certain deferred tax assets when it is more likely than not that the deferred tax assets will not be realized. Increases or decreases in the valuation reserve are charged or credited to the income tax provision.

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

Derivative Instruments and Hedging Activities

The Company uses derivative instruments, such as interest rate swaps, to manage interest rate risk. The Company recognizes all derivative instruments at fair value as either assets or liabilities in other assets or other liabilities. The accounting for changes in the fair value of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as an accounting hedge, the gain or loss is recognized in trading noninterest income. As of September 30, 2009, all of the Company's derivative instruments qualified as hedging instruments.

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

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

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

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

Loans Held To Maturity and Loans Held For Sale

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

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

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

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

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

The Company evaluates its loans for impairment. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. The Company has defined impaired loans to be all troubled debt restructurings and nonaccrual loans. Impairment of a loan is measured based on the present value of expected future cash flows, net of estimated costs to sell, discounted at the loan’s effective interest rate. Impairment can also be measured based on a loan’s observable market price or the fair value of collateral, net of estimated costs to sell, if the loan is collateral dependent. If the measure of the impaired loan is less than the recorded investment in the loan, the Company establishes a valuation allowance, or adjusts existing valuation allowances, with a corresponding charge or credit to the provision for loan losses.

Loans held for sale are SBA loans and are reflected at the lower of aggregate cost or market value.

The Company originates loans to customers under an SBA program that generally provides for SBA guarantees up to 90 percent of each loan. In the past, the Company generally sold the guaranteed portion of its SBA loans to a third party and retained the servicing, holding the nonguaranteed portion in its portfolio. However, during the third quarter of 2007, the Company announced a change in its strategy to retain more SBA loans in its portfolio due to lower premiums received on the sale of these loans. During late 2008, the Company withdrew from SBA lending as a primary line of business, but continues to offer SBA loan products as an additional credit product to its customers. If sales of SBA loans do occur, the premium received on the sale and the present value of future cash flows of the servicing asset are recognized in income.

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

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

Allowance for Loan Losses

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

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

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

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

NOTE 2. Litigation

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

NOTE 3. Earnings per share

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

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

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

	Three Months ended September 30,		Nine Months ended September 30,	
(In thousands, except per share data)	2009	2008	2009	2008
Net income (loss)	$ (747)	$ (1,002)	$ (1,215)	$ 1,346
Less: Preferred stock dividends and discount accretion	372	-	1,123	-
Net income available (loss attributable) to common shareholders	$ (1,119)	$ (1,002)	$ (2,338)	$ 1,346
Weighted-average common shares outstanding (basic)	7,119	7,107	7,119	7,091
Plus: Effect of dilutive securities	-	-	-	177
Weighted-average common shares outstanding (diluted)	7,119	7,107	7,119	7,268
Net income (loss) per common share:				
Basic	$ (0.16)	$ (0.14)	$ (0.33)	$ 0.19
Diluted	(0.16)	(0.14)	(0.33)	0.19
Stock options and common stock warrants excluded from the earnings per share computation as their effect would have been anti-dilutive	1,385	405	1,405	387

The number of anti-dilutive stock options and common stock warrants for the three and nine months ended September 30, 2009 include the issuance of common stock warrants to the U.S. Department of Treasury under the Capital Purchase Program in December 2008.

NOTE 4. Income Taxes

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

The Company did not recognize or accrue any interest or penalties related to income taxes during the three month and nine month periods ended September 30, 2009 and 2008. The Company does not have an accrual for uncertain tax positions as of September 30, 2009, as deductions taken and benefits accrued are based on widely understood administrative practices and procedures and are based on clear and unambiguous tax law. The tax years 2005-2008 remain open to examination by the major taxing jurisdictions to which the Company is subject.

NOTE 5. Other Comprehensive Income (Loss)

(In thousands)	For the three months ended September 30, 2009	2008	For the nine months ended September 30, 2009	2008
Net income (loss)	$(747)	$(1,002)	$(1,215)	$1,346
Unrealized gains (losses) on available for sale securities	492	(882)	1,401	(1,362)
Noncredit unrealized losses on HTM debt securities	-	-	(806)	-
Unrealized gains (losses) on cash flow hedge derivatives	(48)	(153)	137	(192)
Income tax (expense) benefit	796	453	662	(292)
Total comprehensive income (loss)	$493	$(1,584)	$179	$(500)

NOTE 6. Fair Value

Fair Value Measurement

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

Level 1 Inputs

Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Generally, this includes debt and equity securities and derivative contracts that are traded in an active exchange market (i.e. New York Stock Exchange), as well as certain US Treasury and US Government and agency mortgage-backed securities that are highly liquid and are actively traded in over-the-counter markets.

Level 2 Inputs

Quoted prices for similar assets or liabilities in active markets.

Quoted prices for identical or similar assets or liabilities.

Inputs other than quoted prices that are observable, either directly or indirectly, for the term of the asset or liability (e.g., interest rates, yield curves, credit risks, prepayment speeds or volatilities) or "market corroborated inputs."

Generally, this includes US Government and agency mortgage-backed securities, corporate debt securities, derivative contracts and loans held for sale.

Level 3 Inputs

Prices or valuation techniques that require inputs that are both unobservable (i.e. supported by little or no market activity) and that are significant to the fair value of the assets or liabilities.

These assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which the determination of fair value requires significant management judgment or estimation.

Fair Value on a Recurring Basis

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

Available for Sale Securities Portfolio -

The fair value of available for sale securities is the market value based on quoted market prices, when available, or market prices provided by recognized broker dealers (Level 1). If listed prices or quotes are not available, fair value is based upon quoted market prices for similar or identical assets or other observable inputs (Level 2) or externally developed models that use unobservable inputs due to limited or no market activity of the instrument (Level 3).

SBA Servicing Rights –

SBA servicing rights do not trade in an active, open market with readily observable prices. The Company estimates the fair value of SBA servicing rights using discounted cash flow models incorporating numerous assumptions from the perspective of a market participant including market discount rates and prepayment speeds. The fair value of SBA servicing rights as of September 30, 2009 was determined using a discount rate of 15 percent, constant prepayment rates of 15 to 18 CPR, and interest strip multiples ranging from 2.08 to 3.80, depending on each individual credit. Due to the nature of the valuation inputs, SBA servicing rights are classified as Level 3 assets.

Interest rate swap agreements -

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

There were no changes in the inputs or methodologies used to determine fair value during the quarter ended September 30, 2009 as compared to the quarters ended December 31, 2008 and September 30, 2008. The tables below present the balances of assets and liabilities measured at fair value on a recurring basis as of September 30, 2009 and December 31, 2008.

	As of September 30, 2009			
(In thousands)	Level 1	Level 2	Level 3	Total
Financial Assets:				
Securities available for sale:				
U.S. government sponsored entities	$9,992	$ 2,709	$ -	$ 12,701
State and political subdivisions	-	3,027	-	3,027
Residential mortgage-backed securities	4,761	114,734	-	119,495
Commercial mortgage-backed securities	-	4,691	-	4,691
Collateralized debt obligations	-	388	-	388
Other equities	19	585	-	604
Total securities available for sale	14,772	126,134	-	140,906
SBA servicing assets	-	-	977	977
Financial Liabilities:				
Interest rate swap agreements	-	877	-	877

(In thousands)	As of December 31, 2008 Level 1	Level 2	Level 3	Total
Financial Assets:				
Securities available for sale:				
U.S. government sponsored entities	$ -	$ 4,156	$ -	$ 4,156
State and political subdivisions	-	2,718	-	2,718
Residential mortgage-backed securities	38,899	70,680	-	109,579
Commercial mortgage-backed securities	-	-	-	-
Collateralized debt obligations	-	318	-	318
Other equities	16	561	-	577
Total securities available for sale	38,915	78,433	-	117,348
SBA servicing assets	-	-	1,503	1,503
Financial Liabilities:				
Interest rate swap agreements	-	1,013	-	1,013

The changes in Level 3 assets and liabilities measured at fair value on a recurring basis as of September 30, 2009 and 2008 are summarized as follows:

(In thousands)	As of September 30, 2009 SBA Servicing Asset
Beginning balance December 31, 2008	$ 1,503
Total net gains (losses) included in:	
Net income	-
Other comprehensive income	-
Purchases, sales, issuances and settlements, net	(526)
Transfers in and/or out of Level 3	-
Ending balance September 30, 2009	$ 977

As of September 30, 2008

(In thousands)	Securities Available for Sale	SBA Servicing Asset
Beginning balance December 31, 2007	$ 2,711	$ 2,056
Total net gains (losses) included in:		
Net income	-	-
Other comprehensive income	(851)	-
Purchases, sales, issuances and settlements, net	-	(335)
Transfers in and/or out of Level 3	(1,860)	-
Ending balance September 30, 2008	$ -	$ 1,721

There were no gains and losses (realized and unrealized) included in earnings for Level 3 assets and liabilities held at September 30, 2009 or September 30, 2008.

Fair Value on a Nonrecurring Basis

Certain assets and liabilities are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The following table presents the assets and liabilities carried on the balance sheet by caption and by level within the hierarchy (as described above) as of September 30, 2009 and December 31, 2008.

As of September 30, 2009 (In thousands)	Level 1	Level 2	Level 3	Total	Total Fair Value Loss during 9 months ended September 30, 2009
Financial Assets:					
SBA loans held for sale	$ -	$ 22,387	$ -	$ 22,387	$ -
Other real estate owned ("OREO")	-	-	2,774	2,774	150
Impaired loans	$-	$ -	$ 21,627	$ 21,627	$ 651

As of December 31, 2008 (In thousands)	Level 1	Level 2	Level 3	Total	Total Fair Value Loss during 12 months ended December 31, 2008
Financial Assets:					

SBA loans held for sale	$ -	$ 22,733	$ -	$ 22,733	$ -
Impaired loans	$-	$ -	$ 13,118	$ 13,118	$ 585

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SBA Loans – Held for Sale -

The fair value of SBA loans held for sale was determined using a market approach that includes significant other observable inputs (Level 2 Inputs). The Level 2 fair values were estimated using quoted prices for similar assets in active markets.

OREO -

The fair value was determined using appraisals, which may be discounted based on management's review and changes in market conditions (Level 3 Inputs).

Impaired Loans -

The fair value of impaired collateral dependent loans is derived in accordance with FASB ASC Topic 310, "Receivables." Fair value is determined based on the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. The valuation allowance for impaired loans is included in the allowance for loan losses in the consolidated balance sheets. The valuation allowance for impaired loans at September 30, 2009 was $1.6 million as compared to $726 thousand at September 30, 2008. During the nine months ended September 30, 2009, the valuation allowance for impaired loans increased $651 thousand from $957 thousand at December 31, 2008. During the nine months ended September 30, 2008, the valuation allowance for impaired loans increased $354 thousand from $372 thousand at December 31, 2007.

Fair Value of Financial Instruments

FASB ASC Topic 825, "Financial Instruments," requires the disclosure of the estimated fair value of certain financial instruments, including those financial instruments for which the Company did not elect the fair value option. These estimated fair values as of September 30, 2009 and December 31, 2008 have been determined using available market information and appropriate valuation methodologies. Considerable judgment is required to interpret market data to develop estimates of fair value. The estimates presented are not necessarily indicative of amounts the Company could realize in a current market exchange. The use of alternative market assumptions and estimation methodologies could have had a material effect on these estimates of fair value. The following methods and assumptions were used to estimate the fair value of other financial instruments for which it is practicable to estimate that value:

Cash and Cash Equivalents

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

Securities

The fair value of securities is determined in the manner previously discussed above.

Loans

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

Federal Home Loan Bank Stock

Federal Home Loan Bank stock is carried at cost.

Deposit Liabilities

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

Borrowed Funds & Subordinated Debentures

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

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

Standby Letters of Credit

At September 30, 2009, the Bank had standby letters of credit outstanding of $6.4 million, as compared to $4.5 million at December 31, 2008. The fair value of these commitments is nominal.

The table below presents the estimated fair values of the Company's financial instruments as of September 30, 2009 and December 31, 2008:

	September 30, 2009		December 31, 2008	
(In thousands)	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and cash equivalents	$ 65,888	$ 65,888	$ 34,431	$ 34,431
Securities available for sale	140,906	140,906	117,348	117,348
Securities held to maturity	30,595	30,396	32,161	30,088
Loans, net of allowance for possible loan losses	644,075	648,133	675,620	696,966
Federal Home Loan Bank stock	4,677	4,677	4,857	4,857
SBA servicing assets	977	977	1,503	1,503
Accrued interest receivable	4,230	4,230	4,712	4,712
Financial liabilities:				
Deposits	750,665	740,540	707,117	706,475
Borrowed funds and subordinated debentures	100,465	113,967	120,465	130,217
Accrued interest payable	797	797	805	805
Interest rate swap agreements	877	877	1,013	1,013

Note 7. Securities

The following table provides the major components of securities available for sale and held to maturity at amortized cost and estimated fair value at September 30, 2009 and December 31, 2008:

	September 30, 2009				December 31, 2008			
(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Securities available for sale:								
US Government sponsored entities	$ 12,676	$ 26	$ (1)	$ 12,701	$ 4,132	$ 27	$ (3)	$ 4,156
State and political subdivisions	2,946	81	-	3,027	2,946	-	(228)	2,718
Residential mortgage-backed securities	118,847	1,784	(1,136)	119,495	109,630	992	(1,043)	109,579
Commercial mortgage-backed securities	4,652	50	(11)	4,691	-	-	-	-
Collateralized debt obligations	976	-	(588)	388	975	-	(657)	318
Other equities	626	4	(26)	604	639	-	(62)	577
Total securities available for sale	$ 140,723	$ 1,945	$ (1,762)	$ 140,906	$ 118,322	$ 1,019	$ (1,993)	$ 117,348
Securities held to maturity:								
US Government sponsored entities	$ 2,000	$ 93	$ -	$ 2,093	$ 2,000	$ 119	$ -	$ 2,119
State and political subdivisions	3,156	46	(28)	3,174	3,157	-	(251)	2,906
Residential mortgage-backed securities	20,912	433	(881)	20,464	25,450	193	(880)	24,763
Commercial mortgage-backed securities	4,420	217	-	4,637	-	-	-	-
Collateralized debt obligations	107	-	(79)	28	1,554	-	(1,254)	300
Total securities held to maturity	$ 30,595	$ 789	$ (988)	$ 30,396	$ 32,161	$ 312	$ (2,385)	$ 30,088

The table below provides the remaining contractual maturities and yields of securities within the investment portfolios. The carrying value of securities at September 30, 2009 is primarily distributed by contractual maturity. Mortgage-backed securities and other securities, which may have principal prepayment provisions, are distributed based on contractual maturity. Expected maturities will differ materially from contractual maturities as a result of early prepayments and calls. The total weighted average yield excludes equity securities.

Within one year	After one year through five years	After five years through ten years	After ten years	Total carrying

(In thousands)	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield	Amount	Yield
Available for sale at fair value:										
US Government sponsored entities	$ -	-%	$ 587	3.78%	$ 9,099	3.34%	$ 3,015	5.39%	$ 12,701	3.85%
State and political subdivisions	-	-	-	-	286	3.82	2,741	3.91	3,027	3.91
Residential mortgage-backed securities	-	-	1,794	3.68	16,299	4.36	101,402	4.52	119,495	4.49
Commercial mortgage-backed securities	-	-	-	-	-	-	4,691	6.50	4,691	6.50
Collateralized debt obligations	-	-	-	-	-	-	388	1.07	388	1.07
Other equities	-	-	-	-	-	-	604	4.14	604	4.14
Total securities available for sale	$ -	-%	$ 2,381	3.70%	$ 25,684	3.95%	$ 112,841	4.60%	$ 140,906	4.49%
Held to maturity at cost:										
US Government sponsored entities	$ -	-%	$ 2,000	5.00%	$ -	-%	$ -	-%	$ 2,000	5.00%
State and political subdivisions	-	-	-	-	-	-	3,156	4.46	3,156	4.46
Residential mortgage-backed securities	-	-	1,225	4.37	5,725	4.75	13,962	5.28	20,912	5.08
Commercial mortgage-backed securities	-	-	-	-	-	-	4,420	5.49	4,420	5.49
Collateralized debt obligations	-	-	-	-	-	-	107	-	107	-
Total securities held to maturity	$ -	-%	$ 3,225	4.76%	$ 5,725	4.75%	$ 21,645	5.18%	$ 30,595	5.05%

The fair value of securities with unrealized losses by length of time that the individual securities have been in a continuous unrealized loss position at September 30, 2009 and December 31, 2008 are as follows:

	Total Number in	Less than 12 months		Greater than 12 months		Total	
(In thousands)	Loss Position	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss	Estimated Fair Value	Unrealized Loss
September 30, 2009							
U.S. Government sponsored entities	4	$ 89	$ (1)	$ 10	$ -	$ 99	$ (1)
State and political subdivisions	2	-	-	1,032	(28)	1,032	(28)
Residential mortgage-backed securities	35	18,876	(400)	10,120	(1,617)	28,996	(2,017)
	1	1,985	(11)	-	-	1,985	(11)

Commercial mortgage-backed securities													
Collateralized debt obligations	3		15		(9)		417		(658)		432		(667)
Other equities	2		-		-		534		(26)		534		(26)
Total temporarily impaired investments	47	$	20,965	$	(421)	$	12,113	$	(2,329)	$	33,078	$	(2,750)
December 31, 2008													
U.S. Government sponsored entities	3	$	2,110	$	(3)	$	11	$	-	$	2,121	$	(3)
State and political subdivisions	18		5,624		(479)		-		-		5,624		(479)
Residential mortgage-backed securities	59		32,113		(1,024)		11,668		(899)		43,781		(1,923)
Commercial mortgage-backed securities	-		-		-		-		-		-		-
Collateralized debt obligations	3		-		-		618		(1,911)		618		(1,911)
Other equities	4		82		(34)		472		(28)		554		(62)
Total temporarily impaired investments	87	$	39,929	$	(1,540)	$	12,769	$	(2,838)	$	52,698	$	(4,378)

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concern warrants such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent of the Company to not sell the investment and whether it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost which, in some cases, may extend to maturity, and for equity securities, the Company's ability and intent to hold the security for a period of time that allows for recovery in value. The unrealized losses in each of these categories are discussed in the paragraphs that follow:

U.S. Government sponsored entities and state and political subdivision securities: The unrealized losses on investments in securities were caused by the increase in interest rate spreads. The contractual terms of these investments do not permit the issuer to settle the securities at a price less than the par value of the investment. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be at maturity, the Company does not consider these investments to be other-than-temporarily impaired as of September 30, 2009.

Residential and commercial mortgage-backed securities: The unrealized losses on investments in mortgage-backed securities were caused by interest rate increases. The majority of contractual cash flows of these securities are guaranteed by Fannie Mae, Ginnie Mae and the Federal Home Loan Mortgage Corporation. It is expected that the securities would not be settled at a price significantly less than the par value of the investment. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be at maturity, the Company does not consider these investments to be other-than-temporarily impaired as of September 30, 2009.

Collateral debt obligations: The unrealized losses on collateral debt obligations were caused by increases in interest rate spreads. The contractual terms of the bonds do not allow the securities to be settled at a price less than the par value of the investments. The decline in face value is attributed to changes in interest rates and the current liquidity in the credit markets and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be at maturity, the Company does not consider these investments to be other-than-temporarily impaired as of September 30, 2009.

Other equity securities: Included in this category is stock of other financial institutions. The unrealized losses on other equity securities are caused by decreases in the market prices of the shares. The Company has the ability and intent to hold these shares until a market price recovery; therefore these investments are not considered other-than-temporarily impaired as of September 30, 2009.

Other-Than-Temporarily Impaired Debt Securities

We assess whether we intend to sell or it is more likely than not that we will be required to sell a security before recovery of its amortized cost basis less any current-period credit losses. For debt securities that are considered other-than-temporarily impaired and that we do not intend to sell and will not be required to sell prior to recovery of our amortized cost basis, we separate the amount of the impairment into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings and is the difference between the security’s amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security’s fair value and the present value of future expected cash flows is due to factors that are not credit related and is recognized in other comprehensive income.

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

We have a process in place to identify debt securities that could potentially have a credit impairment that is other than temporary. This process involves monitoring late payments, pricing levels, downgrades by rating agencies, key financial ratios, financial statements, revenue forecasts and cash flow projections as indicators of credit issues. On a quarterly basis, we review all securities to determine whether an other-than-temporary decline in value exists and whether losses should be recognized. We consider relevant facts and circumstances in evaluating whether a credit or interest rate-related impairment of a security is other than temporary. Relevant facts and circumstances considered include: (1) the extent and length of time the fair value has been below cost; (2) the reasons for the decline in value; (3) the financial position and access to capital of the issuer, including the current and future impact of any specific events and (4) for fixed maturity securities, our intent to sell a security or whether it is more likely than not we will be required to sell the security before the recovery of its amortized cost which, in some cases, may extend to maturity and for equity securities, our ability and intent to hold the security for a period of time that allows for the recovery in value.

During 2009, the Company recognized $1.7 million of credit related other-than-temporary impairment losses on two held to maturity securities due to the deterioration in the underlying collateral. These two pooled trust preferred securities which had a cost basis of $3.0 million had been previously written down $306 thousand in December of 2008. The remaining book value of the trust preferred securities is approximately $912 thousand. In estimating the present value of the expected cash flows on the two collateralized debt obligations which were other-than-temporarily impaired as of September 30, 2009, the following assumptions were made:

- Moderate conditional repayment rates ("CRR") were used due to the lack of new trust preferred issuances and the poor conditions of the financial industry. A CRR of 2 percent was used for performing issuers and 0 percent for nonperformers.

- Conditional default rates ("CDR") have been established based on the financial condition of the underlying trust preferred issuers in the pools. These ranged from 0.75 percent to 3.50 percent for performing issuers. Nonperforming issues were stated at 100 percent CDR.

- Expected loss severities of 95 percent were assumed (i.e. recoveries occur in only 5 percent of defaulted securities) for all performing issuers and ranged from 80.25 percent to 87.46 percent for nonperforming issues.

- Internal rates of return ("IRR") are the pre-tax yields used to discount the future cash flow stream expected from the collateral cash flows. The IRR used was 17 percent.

The following table presents a roll-forward of the credit loss component of the amortized cost of debt securities that we have written down for OTTI and the credit component of the loss that is recognized in earnings. The beginning balance represents the credit loss component for debt securities for which OTTI occurred prior to January 1, 2009. OTTI recognized in earnings subsequent to 2009 for credit-impaired debt securities is presented as additions in two components based upon whether the current period is the first time the debt security was credit-impaired (initial credit impairment) or is not the first time the debt security was credit impaired (subsequent credit impairments). The credit loss component is reduced if we sell, intend to sell or believe we will be required to sell previously credit-impaired debt securities. Additionally, the credit loss component is reduced if we receive cash flows in excess of what we expected to receive over the remaining life of the credit-impaired debt security, the security matures or is fully written down. Changes in the credit loss component of credit-impaired debt securities were as follows for the period ended September 30, 2009:

Beginning balance – January 1, 2009	$ 306
Initial credit impairment	1,749
Subsequent credit impairments	-
Reductions for amounts recognized in earnings due to intent or requirement to sell	-
Reductions for securities sold	-
Reductions for increases in cash flows expected to be collected	-
Ending balance - September 30, 2009	$ 2,055

Gross realized gains (losses) on sales of securities and other-than-temporary impairment charges for the nine months ended September 30, 2009 are detailed below:

Available-for-sale securities:	
Realized gains	$ 675
Realized (losses)	-
Other than temporary impairment	-
	$ 675
Held-to-maturity securities:	$ -
Realized gains	-
Realized (losses)	-
Other than temporary impairment	(1,749)
	$ (1,749)

Note 8. Allowance for Loan Losses

The allowance for loan losses is based on estimates. Ultimate losses may vary from current estimates. These estimates are reviewed periodically and, as adjustments become known, they are reflected in operations in the periods in which they become known.

The following is a reconciled summary of the allowance for loan losses for the nine months ended September 30, 2009 and 2008:

Allowance for Loan Loss Activity	Three months ended September 30,		Nine months ended September 30,	
(In thousands)	2009	2008	2009	2008
Balance, beginning of period	$ 10,665	$ 8,945	$ 10,326	$ 8,383
Provision charged to expense	3,000	2,100	6,000	3,200
	13,665	11,045	16,326	11,583
Charge-offs	1,258	1,201	4,147	1,861
Recoveries	38	69	266	191
Net charge-offs	1,220	1,132	3,881	1,670
Balance, end of period	$ 12,445	$ 9,913	$ 12,445	$ 9,913

Note 9. New Accounting Pronouncements

As discussed in Note 1, "Significant Accounting Policies", on July 1, 2009, the Accounting Standards Codification became FASB's officially recognized source of authoritative U.S. generally accepted accounting principles applicable to all public and non-public non-governmental entities, superseding existing FASB, AICPA, EITF and related literature. Rules and interpretive releases of the SEC under the authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. All other accounting literature is considered non-authoritative. The switch to the ASC affects the way companies refer to U.S. GAAP in financial statements and accounting policies. Citing particular content in the ASC involves specifying the unique numeric path to the content through the Topic, Subtopic, Section and Paragraph structure.

FASB ASC Topic 260, "Earnings Per Share." On January 1, 2009, the Company adopted new authoritative accounting guidance under FASB ASC Topic 260, "Earnings Per Share," which provides that unvested share based payment awards that contain nonforfeitable rights to dividends or dividend equivalents are considered participating securities. As such they should be included in the computation of basic EPS using the two class method. At September 30, 2009 the Company had 35,006 shares of nonvested restricted stock which were considered participating securities under this guidance. Adoption of this new authoritative guidance did not have a material effect on the Company's EPS calculation.

FASB ASC Topic 320, "Investments - Debt and Equity Securities." New authoritative accounting guidance under ASC Topic 320, "Investments - Debt and Equity Securities," (i) changes existing guidance for determining whether an impairment is other than temporary to debt securities and (ii) replaces the existing requirement that the entity's management assert it has both the intent and ability to hold an impaired security until recovery with a requirement that management assert: (a) it does not have the intent to sell the security; and (b) it is more likely than not it will not have to sell the security before recovery of its cost basis. Under ASC Topic 320, declines in the fair value of held-to-maturity and available-for-sale debt securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of the impairment related to other factors is recognized in other comprehensive income. The Company adopted the provisions of the new authoritative accounting guidance under ASC Topic 320 during the first quarter of 2009. Adoption of the new guidance did not significantly impact the Company's financial statements.

FASB ASC Topic 815, "Derivatives and Hedging." New authoritative accounting guidance under ASC Topic 815, "Derivatives and Hedging," amends prior guidance to amend and expand the disclosure requirements for derivatives and hedging activities to provide greater transparency about (i) how and why an entity uses derivative instruments, (ii) how derivative instruments and related hedge items are accounted for under ASC Topic 815, and (iii) how derivative instruments and related hedged items affect an entity's financial position, results of operations and cash flows. To meet those objectives, the new authoritative accounting guidance requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of gains and losses on derivative instruments and disclosures about credit-risk-related contingent features in derivative agreements. The new authoritative accounting guidance under ASC Topic 815 became effective for the Company on January 1, 2009 and is reflected in these financial statements.

FASB ASC Topic 820, “Fair Value Measurements and Disclosures.” New authoritative accounting guidance under ASC Topic 820,”Fair Value Measurements and Disclosures,” affirms that the objective of fair value when the market for an asset is not active is the price that would be received to sell the asset in an orderly transaction, and clarifies and includes additional factors for determining whether there has been a significant decrease in market activity for an asset when the market for that asset is not active. ASC Topic 820 requires an entity to base its conclusion about whether a transaction was not orderly on the weight of the evidence. The new accounting guidance amended prior guidance to expand certain disclosure requirements. The Company adopted the new authoritative accounting guidance under ASC Topic 820 during the first quarter of 2009. Adoption of the new guidance did not significantly impact the Company’s financial statements.

Further new authoritative accounting guidance (Accounting Standards Update No. 2009-5) under ASC Topic 820 provides guidance for measuring the fair value of a liability in circumstances in which a quoted price in an active market for the identical liability is not available. In such instances, a reporting entity is required to measure fair value utilizing a valuation technique that uses (i) the quoted price of the identical liability when traded as an asset, (ii) quoted prices for similar liabilities or similar liabilities when traded as assets, or (iii) another valuation technique that is consistent with the existing principles of ASC Topic 820, such as an income approach or market approach. The new authoritative accounting guidance also clarifies that when estimating the fair value of a liability, a reporting entity is not required to include a separate input or adjustment to other inputs relating to the existence of a restriction that prevents the transfer of the liability. The forgoing new authoritative accounting guidance under ASC Topic 820 will be effective for the Company’s financial statements beginning October 1, 2009 and is not expected to have a significant impact on the Company’s financial statements.

FASB ASC Topic 825 “Financial Instruments.” New authoritative accounting guidance under ASC Topic 825,”Financial Instruments,” requires an entity to provide disclosures about the fair value of financial instruments in interim financial information and amends prior guidance to require those disclosures in summarized financial information at interim reporting periods. The new interim disclosures required under Topic 825 are included in Note 6 - Fair Value.

FASB ASC Topic 855, “Subsequent Events.” New authoritative accounting guidance under ASC Topic 855, “Subsequent Events,” establishes general standards of accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued or available to be issued. ASC Topic 855 defines (i) the period after the balance sheet date during which a reporting entity’s management should evaluate events or transactions that may occur for potential recognition or disclosure in the financial statements, (ii) the circumstances under which an entity should recognize events or transactions occurring after the balance sheet date in its financial statements, and (iii) the disclosures an entity should make about events or transactions that occurred after the balance sheet date. The new authoritative accounting guidance under ASC Topic 855 became effective for the Company’s financial statements for periods ending after June 15, 2009 and did not have a significant impact on the Company’s financial statements.

FASB ASC Topic 860, “Transfers and Servicing.” New authoritative accounting guidance under ASC Topic 860, “Transfers and Servicing,” amends prior accounting guidance to enhance reporting about transfers of financial assets, including securitizations, and where companies have continuing exposure to the risks related to transferred financial assets. The new authoritative accounting guidance eliminates the concept of a “qualifying special-purpose entity” and changes the requirements for derecognizing financial assets. The new authoritative accounting guidance also requires additional disclosures about all continuing involvements with transferred financial assets including information about gains and losses resulting from transfers during the period. The new authoritative accounting guidance under ASC Topic 860 will be effective January 1, 2010 and is not expected to have a significant impact on the Corporation’s financial statements; however it will defer the gains of SBA 7(a) loans, if any, for a 90-day period after the sale of the loan.

ITEM 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of financial condition and results of operations should be read in conjunction with the 2008 consolidated audited financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2008. When necessary, reclassifications have been made to prior period data throughout the following discussion and analysis for purposes of comparability. This Quarterly Report on Form 10-Q contains certain “forward looking statements” within the meaning of the Private Securities Litigation Reform Act of 1995, which may be identified by the use of such words as “believe”, “expect”, “anticipate”, “should”, “planned”, “estimated” “potential”. Examples of forward looking statements include, but are not limited to, estimates with respect to the financial condition, results of operations and business of Unity Bancorp, Inc. that are subject to various factors which could cause actual results to differ materially from these estimates. These factors include, in addition to those items contained in the Company’s Annual Report on Form 10-K under Item IA-Risk Factors, as updated by our subsequent Quarterly Reports on Form 10-Q, the following: changes in general, economic, and market conditions, legislative and regulatory conditions, or the development of an interest rate environment that adversely affects Unity Bancorp, Inc.’s interest-rate spread or other income anticipated from operations and investments.

Overview

Unity Bancorp, Inc., (the “Parent Company”), is incorporated in New Jersey and is registered as a bank holding company under the Bank Holding Company Act of 1956, as amended. Its wholly-owned subsidiary, Unity Bank (the “Bank” or, when consolidated with the Parent Company, the “Company”) was granted a charter by the New Jersey Department of Banking and Insurance and commenced operations on September 13, 1991. The Bank provides a full range of commercial and retail banking services through 16 branch offices located in Hunterdon, Somerset, Middlesex, Union and Warren counties in New Jersey, and Northampton County in Pennsylvania. These services include the acceptance of demand, savings, and time deposits and the extension of consumer, real estate, Small Business Administration and other commercial credits. Unity Investment Services, Inc., a wholly-owned subsidiary of the Bank, is used to hold part of the Bank’s investment portfolio. Unity Participation Company, Inc., a wholly-owned subsidiary of the Bank is used for holding and administering certain loan participations.

Unity (NJ) Statutory Trust II is a statutory business trust and wholly owned subsidiary of Unity Bancorp, Inc. On July 24, 2006, the Trust issued $10.0 million of trust preferred securities to investors. Unity (NJ) Statutory Trust III is a statutory business trust and wholly owned subsidiary of Unity Bancorp, Inc. On December 19, 2006, the Trust issued $5.0 million of trust preferred securities to investors. These floating rate securities are treated as subordinated debentures on the Company’s financial statements. However, they qualify as Tier I Capital for regulatory capital compliance purposes, subject to certain limitations. The Company does not consolidate the accounts and related activity of any of its business trust subsidiaries.

Earnings Summary

Beginning in 2008, we have seen unprecedented financial, credit and capital market stress. Factors such as lack of liquidity in the credit markets, financial institution failures, asset “fair market” value write-downs, capital adequacy and credit quality concerns resulted in a lack of confidence by the markets in the financial industry. Consumer sentiment remains low, consumer spending contracted, housing values declined, the stock market remained volatile, and unemployment remained at approximately 10 percent.

The plight of the financial, credit and capital markets carried over into 2009 and will likely persist into the first half of 2010. Corporate layoffs, hiring freezes and bankruptcies persist and capital spending plans have been postponed. Individual's uncertainties regarding the labor market have re-prioritized their spending habits and have curbed discretionary spending. The majority of the financial sector continues to trade at a discount to book value due to credit concerns and negative publicity by the news media. Secondary markets for many types of financial assets, including the guaranteed portion of SBA loans, remain very restrictive. Despite this challenging operating environment, the Company believes that it is well-positioned.

Our performance during the third quarter of 2009 included the following accomplishments:

- Total assets exceeded $922 million,
- Market share expansion continued as total deposits increased 9.6 percent from one year ago, and
- The Company remained well-capitalized.

For the three months ended September 30, 2009, the Company reported a net loss of $747 thousand, a reduction of $255 thousand from the net loss of $1.0 million reported for the same period of 2008. Net loss attributable to common shareholders, which includes the impact of dividends and accretion of discount on the Company's outstanding preferred stock, was $1.1 million for the three months ended September 30, 2009. The Company had no outstanding preferred stock until the fourth quarter of 2008. For the nine months ended September 30, 2009, the Company reported a net loss of $1.2 million, a decrease of $2.6 million from net income of $1.3 million reported for the same period of 2008. Net loss attributable to common shareholders, which includes the impact of dividends and accretion of discount on the Company's outstanding preferred stock, was $2.3 million for the nine months ended September 30, 2009.

Our results reflect:

- An increased provision for loan losses in response to increased credit risk due to continued weakness in the economy,
- A lower level of noninterest income due to significantly reduced net gains on SBA loan sales and a $1.7 million other-than-temporary impairment charge on securities, and
- Higher operating expenses due to increased FDIC insurance rates and a special assessment in the second quarter.

The earnings (loss) per share and return (loss) on average common equity ratios shown below are calculated on net income (loss) available to common shareholders.

	Three Months ended September 30,		Nine Months ended September 30,	
(In thousands, except per share data)	2009	2008	2009	2008
Net Income (Loss) per Common share:				
Basic	$ (0.16)	$ (0.14)	$ (0.33)	$ 0.19
Diluted	(0.16)	(0.14)	(0.33)	0.19
Return (loss) on average assets	(0.33)%	(0.47)%	(0.18)%	0.22%
Return (loss) on average common equity	(9.14)%	(8.45)%	(6.38)%	3.77%
Efficiency ratio	77.72%	70.51%	77.12%	70.68%

Net Interest Income

The primary source of income for the Company is net interest income, the difference between the interest earned on earning assets such as investments and loans, and the interest paid on deposits and borrowings. Factors that impact the Company’s net interest income include the interest rate environment, the volume and mix of interest-earning assets and interest-bearing liabilities, and the competitive nature of the Company’s market place.

Since September 30, 2008, the Federal Open Market Committee has lowered interest rates 175 basis points in an attempt to stimulate economic activity. These actions have resulted in a Fed Funds target rate of 0.25 percent and a Prime rate of 3.25 percent. These interest rate levels in turn have generated lower yields on earning assets as well as lower funding costs for financial institutions.

For the three months ended September 30, 2009, tax-equivalent interest income decreased $780 thousand or 6.0 percent to $12.2 million compared to the same period a year ago. This decrease was driven by lower yields on interest-earning assets, partially offset by a higher volume of these assets.

- Of the $780 thousand decrease in interest income on a tax-equivalent basis, $2.5 million can be attributed to the reduced yields on interest-earning assets, partially offset by a $1.7 million increase due to a higher volume of earning assets.
- The yield on interest-earning assets decreased 81 basis points to 5.64 percent for the quarter-ended September 30, 2009 due to the lower overall interest rate environment compared to 2008. Yields on all loan products fell during the period, with the largest declines in the SBA and SBA 504 loan portfolios, repricing 215 and 109 basis points lower, respectively.
- The average volume of interest-earning assets increased $59.7 million to $862.1 million in the third quarter of 2009 compared to $802.4 million for the third quarter of 2008. This was due primarily to a $58.9 million increase in average securities and an $8.8 million increase in federal funds sold and interest-bearing deposits, partially offset by a decrease in total average loans of $8.3 million. As loan demand began to subside with the economic downturn, excess liquidity was invested in the securities portfolio as a favorable alternative to federal funds sold. The Company anticipates the slowdown in SBA and commercial lending will continue for the remainder of 2009.

Total interest expense was $5.3 million for the third quarter of 2009, a decrease of $556 thousand or 9.5 percent compared to the same period in 2008. This decrease was primarily driven by the decline in the overall interest rate environment in 2009, partially offset by a large increase in average savings deposits.

- Of the $556 thousand decrease in interest expense in the third quarter of 2009, $814 thousand was attributed to the lower rates paid on interest-bearing liabilities, partially offset by a $258 thousand increase due to a higher volume of interest-bearing liabilities.
- The average cost of interest-bearing liabilities decreased 48 basis points to 2.80 percent, primarily due to the repricing of deposits in a lower interest rate environment and the migration of customer deposits from higher priced time deposits to savings accounts. The cost of interest-bearing deposits decreased 53 basis points to 2.59 percent for the third quarter of 2009 as all product lines repriced lower. The cost of borrowed funds and subordinated debentures increased 7 basis points to 4.21 percent due to the use of low cost overnight line of credit funding in the third quarter of 2008, but not in the third quarter of 2009.
- Interest-bearing liabilities averaged $751.7 million in the third quarter of 2009, an increase of $37.6 million, or 5.3 percent, compared to the prior year's quarter. The increase in interest-bearing liabilities was a result of increases in interest-bearing demand deposits and savings deposits, offset in part by a decline in time deposits and borrowed funds. The largest increase was due to savings deposits, which increased $77.7 million or 48.1 percent from the third quarter of 2008 to the third quarter of 2009. Average borrowed funds and subordinated debentures decreased $10.2 million to $100.5 million in 2009 compared to $110.7 million in 2008 due to the maturity of a $10.0 million repurchase agreement in 2009 and no overnight line of credit as of September 30, 2009.

During the quarter-ended September 30, 2009, tax-equivalent net interest income decreased $224 thousand compared to the same period in 2008. Net interest margin decreased 38 basis points to 3.17 percent for 2009 compared to 3.55 percent in 2008. The net interest spread was 2.84 percent, a 33 basis point decrease from 3.17 percent in 2008. The net interest margin and net interest spread are expected to expand in the fourth quarter of 2009 as higher cost time deposits reprice in the current low rate environment and more customers shift from time deposits to the Loyalty savings product.

For the nine months ended September 30, 2009, tax-equivalent interest income decreased $595 thousand or 1.6 percent to $37.4 million. This decrease was driven by lower yields on interest-earning assets, partially offset by a higher volume of these assets.

- Of the $595 thousand decrease in interest income on a tax-equivalent basis, $4.9 million can be attributed to reduced yields on interest-earning assets, partially offset by a $4.3 million increase due to a higher volume of earning assets.
- The yield on interest-earning assets decreased 83 basis points to 5.81 percent for the nine months ended September 30, 2009 due to the lower overall interest rate environment compared to 2008. Yields on all loan products fell during the period, with the largest declines in SBA, SBA 504 and consumer loan portfolios repricing 245, 94 and 86 basis points lower, respectively.
- The average volume of interest-earning assets increased $96.8 million to $860.3 million for the first nine months of 2009 compared to $763.5 million for the comparable period in 2008. This was due primarily to a $61.1 million increase in average securities and a $38.7 million increase in average loans across all product lines except commercial, which declined $4.9 million, partially offset by a $3.9 million decrease in federal funds sold and interest-bearing deposits. As loan demand began to subside with the economic downturn, excess liquidity was invested in the securities portfolio as a favorable alternative to federal funds sold. The majority of the increase in average loans was in the residential mortgage portfolio, which increased $36.1 million or 40.3 percent during the period. Growth in the SBA and SBA 504 portfolios slowed during the period, accounting for only 9.3 percent of the overall increase in average loans. This slowdown is expected to continue for the remainder of 2009.

Total interest expense was $16.8 million for the nine months ended September 30, 2009, a decrease of $495 thousand or 2.9 percent compared to the same period in 2008. This decrease was driven by the decline in the overall interest rate environment in 2009, partially offset by a large increase in average interest-bearing deposits.

- Of the $495 thousand decrease in interest expense, $3.3 million was attributed to the lower rates paid on interest-bearing liabilities, partially offset by a $2.8 million increase due to a higher volume of interest-bearing liabilities.
- The average cost of interest-bearing liabilities decreased 45 basis points to 2.98 percent, primarily due to the repricing of deposits and borrowings in a lower interest rate environment. The cost of interest-bearing deposits decreased 46 basis points to 2.83 percent for the first nine months of 2009 as all product lines repriced lower. The cost of borrowed funds and subordinated debentures decreased 41 basis points to 3.79 percent due to the use of low cost overnight line of credit funding during the first and second quarters of 2009.
- Interest-bearing liabilities averaged $752.3 million for the nine months ended September 30, 2009, an increase of $78.3 million, or 11.6 percent, compared to the same period in the prior year. The increase in interest-bearing liabilities was a result of increases in all major interest-bearing categories. Average borrowed funds and subordinated debentures increased $9.1 million to $116.4 million in 2009 compared to $107.3 million in 2008 as these funding sources provided favorable pricing compared to alternate sources of funds as market rates fell.

During the nine months ended September 30, 2009, tax-equivalent net interest income decreased $100 thousand or 0.5 percent. Net interest margin decreased 41 basis points to 3.20 percent for 2009 compared to 3.61 percent in 2008. The net interest spread was 2.83 percent, a 38 basis point decrease from 3.21 percent in 2008. The net interest margin and net interest spread are expected to expand in the fourth quarter of 2009 as higher cost time deposits reprice in the current low rate environment and more customers shift from time deposits to the Loyalty savings product.

Unity Bancorp, Inc.
Consolidated Average Balance Sheets with Resultant Interest and Rates
(Unaudited)
(Tax-equivalent basis, dollars in thousands)

	Three Months Ended					
	September 30, 2009			September 30, 2008		
	Average Balance	Interest	Rate/Yield	Average Balance	Interest	Rate/ Yield
Assets						
Interest-earning assets:						
Federal funds sold and interest-bearing deposits with banks	$ 32,940	$ 32	0.39%	$ 24,118	$ 113	1.86%
Federal Home Loan Bank stock	4,677	101	8.57	4,415	58	5.23
Securities:						
Available for sale	131,360	1,495	4.55	72,658	920	5.06
Held to maturity	31,418	407	5.18	31,209	399	5.11
Total securities (a)	162,778	1,902	4.67	103,867	1,319	5.08
Loans, net of unearned discount:						
SBA loans	102,691	1,498	5.83	102,383	2,043	7.98
SBA 504 loans	71,764	1,147	6.34	76,288	1,424	7.43
Commercial loans	301,010	4,973	6.55	317,338	5,453	6.84
Residential mortgage loans	123,786	1,772	5.73	114,058	1,720	6.03
Consumer loans	62,459	791	5.02	59,933	866	5.75
Total loans (a),(b)	661,710	10,181	6.12	670,000	11,506	6.84
Total interest-earning assets	$ 862,105	$ 12,216	5.64%	$ 802,400	$ 12,996	6.45%
Noninterest-earning assets:						
Cash and due from banks	18,502			19,166		
Allowance for loan losses	(11,478)			(9,092)		
Other assets	34,355			32,229		
Total noninterest-earning assets	41,379			42,303		
Total Assets	$ 903,484			$ 844,703		
Liabilities and Shareholders' Equity						
Interest-bearing deposits:						
Interest-bearing checking	$ 88,284	$ 264	1.19%	$ 87,903	$ 404	1.83%

Savings deposits	239,427	1,032	1.71	161,707	774	1.90
Time deposits	323,484	2,950	3.62	353,743	3,553	4.00
Total interest-bearing deposits	651,195	4,246	2.59	603,353	4,731	3.12
Borrowed funds and subordinated debentures	100,465	1,081	4.21	110,684	1,152	4.14
Total interest-bearing liabilities	751,660	5,327	2.80	714,037	5,883	3.28
Noninterest-bearing liabilities:						
Demand deposits	79,965			81,157		
Other liabilities	4,945			2,321		
Total noninterest-bearing liabilities	84,910			83,478		
Shareholders' equity	66,914			47,188		
Total Liabilities and Shareholders' Equity	$ 903,484			$ 844,703		
Net interest spread		$ 6,889	2.84%		$ 7,113	3.17%
Tax-equivalent basis adjustment		(31)			(31)	
Net interest income		$ 6,858			$ 7,082	
Net interest margin			3.17%			3.55%

(a) Yields related to securities and loans exempt from federal income taxes are stated on a fully tax-equivalent basis. They are reduced by the nondeductible portion of interest expense, assuming a federal tax rate of 34 percent.
(b) The loan averages are stated net of unearned income, and the averages include loans on which the accrual of interest has been discontinued.

Unity Bancorp, Inc.
Consolidated Average Balance Sheets with Resultant Interest and Rates
(Unaudited)
(Tax-equivalent basis, dollars in thousands)

	Nine Months Ended					
	September 30, 2009			September 30, 2008		
	Average Balance	Interest	Rate/Yield	Average Balance	Interest	Rate/Yield
Assets						
Interest-earning assets:						