

TF FINANCIAL CORP  
Form 10-Q  
November 14, 2012

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

FORM 10-Q

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

For the period ended September 30, 2012

- 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: 0-24168

TF FINANCIAL CORPORATION  
(Exact Name of Registrant as Specified in Its Charter)

Pennsylvania  
(State or Other Jurisdiction of Incorporation  
or Organization)

74-2705050  
(I.R.S. Employer Identification No.)

3 Penns Trail, Newtown, Pennsylvania  
(Address of Principal Executive Offices)

18940  
(Zip Code)

Registrant's telephone number, including area code: (215) 579-4000

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES  NO

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

Large accelerated filer

Accelerated filer

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Non-accelerated filer   
(Do not check if a smaller reporting  
company)

Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of the latest practicable date: November 13, 2012

| Class                        | Outstanding      |
|------------------------------|------------------|
| \$.10 par value common stock | 2,838,493 shares |
|                              |                  |
|                              |                  |

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Exhibits

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| 31.1 | <u>Certification of CEO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002</u> |
| 31.2 | <u>Certification of CFO pursuant of Section 302 of the Sarbanes-Oxley Act of 2002</u> |
| 32.  | <u>Certification pursuant of Section 906 of the Sarbanes-Oxley Act of 2002</u>        |

The following Exhibits are being furnished as part of this report:

|         |  |
|---------|--|
| 101.INS | XBRL Instance Document                                 |
| 101.SCH | XBRL Taxonomy Extension Schema Document                |
| 101.CAL | XBRL Taxonomy Extension Calculation Linkbase Document  |
| 101.LAB | XBRL Taxonomy Extension Label Linkbase Document        |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |
| 101.DEF | XBRL Taxonomy Definition Linkbase Document             |



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## TF FINANCIAL CORPORATION AND SUBSIDIARIES

PART I-CONSOLIDATED FINANCIAL INFORMATION  
ITEM 1. CONSOLIDATED FINANCIAL STATEMENTSCONSOLIDATED BALANCE SHEETS  
(Unaudited)

|  | September 30,<br>2012 | At<br>(in thousands) | December 31,<br>2011 |
|--|-----------------------|----------------------|----------------------|
| <b>ASSETS</b>  |                       |                      |                      |
| Cash and cash equivalents  | \$ 3,712              |                      | \$ 14,928            |
| Investment securities  |                       |                      |                      |
| Available for sale   | 106,957               |                      | 114,503              |
| Held to maturity (fair value of \$2,418 and \$2,928 as of<br>September 30, 2012 and December 31, 2011, respectively)   | 2,079                 |                      | 2,588                |
| Loans receivable, net  | 533,978               |                      | 494,125              |
| Loans receivable, held for sale  | 860                   |                      | 488                  |
| Federal Home Loan Bank ("FHLB") stock—at cost  | 6,249                 |                      | 7,657                |
| Accrued interest receivable  | 2,605                 |                      | 2,610                |
| Premises and equipment, net  | 6,294                 |                      | 6,559                |
| Goodwill   | 4,324                 |                      | 4,324                |
| Bank owned life insurance  | 18,962                |                      | 18,506               |
| Other assets   | 11,036                |                      | 15,641               |
| <b>TOTAL ASSETS</b>  | <b>\$ 697,056</b>     |                      | <b>\$ 681,929</b>    |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>  |                       |                      |                      |
| <b>Liabilities</b>   |                       |                      |                      |
| Deposits   | \$ 533,273            |                      | \$ 551,288           |
| Advances from the FHLB   | 75,156                |                      | 46,908               |
| Advances from borrowers for taxes and insurance  | 1,817                 |                      | 2,322                |
| Accrued interest payable   | 943                   |                      | 1,375                |
| Other liabilities  | 3,902                 |                      | 2,628                |
| <b>Total liabilities</b>   | <b>615,091</b>        |                      | <b>604,521</b>       |
| <b>Stockholders' equity</b>  |                       |                      |                      |
| Preferred stock, no par value; 2,000,000 shares authorized at<br>September 30, 2012 and December 31, 2011, none issued   | —                     |                      | —                    |
| Common stock, \$0.10 par value; 10,000,000 shares authorized,<br>5,290,000 shares issued, 2,836,946 and 2,831,874 shares<br>outstanding at September 30, 2012 and December 31, 2011,<br>respectively, net of shares in treasury of 2,453,054 and<br>2,458,126, respectively. | 529                   |                      | 529                  |
| Additional paid-in capital   | 54,293                |                      | 54,118               |
| Unearned ESOP shares   | (1,004 )              |                      | (1,097 )             |
| Treasury stock—at cost   | (50,928 )             |                      | (51,032 )            |
| Retained earnings  | 77,614                |                      | 74,144               |
| Accumulated other comprehensive income   | 1,461                 |                      | 746                  |
| <b>Total stockholders' equity</b>  | <b>81,965</b>         |                      | <b>77,408</b>        |

|  |            |            |
|--|------------|------------|
| TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY | \$ 697,056 | \$ 681,929 |
|--|------------|------------|

The accompanying notes are an integral part of these statements

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## TF FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME  
(Unaudited)

|  | For the three months<br>ended<br>September 30, |                | For the nine months<br>ended<br>September 30, |                |
|--|--|----------------|---|----------------|
|  | 2012   | 2011           | 2012  | 2011           |
|  | (in thousands, except per share data)          |                |   |                |
| Interest income  |  |                |   |                |
| Loans, including fees  | \$6,436  | \$6,667        | \$18,864                                      | \$19,946       |
| Investment securities  |  |                |   |                |
| Fully taxable  | 544  | 879            | 1,840   | 2,648          |
| Exempt from federal taxes                                      | 415  | 362            | 1,280   | 1,080          |
| Interest-bearing deposits and other                            | —  | —              | 2   | 1              |
| <b>TOTAL INTEREST INCOME</b>                                   | <b>7,395</b>                                   | <b>7,908</b>   | <b>21,986</b>                                 | <b>23,675</b>  |
| Interest expense   |  |                |   |                |
| Deposits   | 803  | 1,430          | 2,795   | 4,328          |
| Borrowings   | 338  | 473            | 1,094   | 1,537          |
| <b>TOTAL INTEREST EXPENSE</b>                                  | <b>1,141</b>                                   | <b>1,903</b>   | <b>3,889</b>                                  | <b>5,865</b>   |
| <b>NET INTEREST INCOME</b>                                     | <b>6,254</b>                                   | <b>6,005</b>   | <b>18,097</b>                                 | <b>17,810</b>  |
| Provision for loan losses                                      | 750  | 528            | 1,750   | 2,878          |
| <b>NET INTEREST INCOME AFTER PROVISION<br/>FOR LOAN LOSSES</b> | <b>5,504</b>                                   | <b>5,477</b>   | <b>16,347</b>                                 | <b>14,932</b>  |
| Non-interest income  |  |                |   |                |
| Service fees, charges and other operating income               | 380  | 298            | 1,237   | 1,242          |
| Bank owned life insurance                                      | 152  | 160            | 456   | 481            |
| Gain on sale of investments                                    | —  | —              | —   | 210            |
| Gain on sale of loans  | 382  | 125            | 920   | 292            |
| Gain on disposition of premises and equipment                  | —  | —              | 277   | —              |
| <b>TOTAL NON-INTEREST INCOME</b>                               | <b>914</b>                                     | <b>583</b>     | <b>2,890</b>                                  | <b>2,225</b>   |
| Non-interest expense   |  |                |   |                |
| Compensation and benefits                                      | 2,651  | 2,584          | 8,222   | 7,952          |
| Occupancy and equipment  | 686  | 699            | 2,068   | 2,253          |
| Federal deposit insurance premiums                             | 146  | 142            | 447   | 526            |
| Professional fees  | 349  | 263            | 874   | 1,065          |
| Marketing and advertising                                      | 76   | 88             | 267   | 257            |
| Foreclosed real estate expense                                 | 78   | 317            | 705   | 497            |
| Other operating  | 480  | 573            | 1,588   | 1,702          |
| <b>TOTAL NON-INTEREST EXPENSE</b>                              | <b>4,466</b>                                   | <b>4,666</b>   | <b>14,171</b>                                 | <b>14,252</b>  |
| <b>INCOME BEFORE INCOME TAXES</b>                              | <b>1,952</b>                                   | <b>1,394</b>   | <b>5,066</b>                                  | <b>2,905</b>   |
| Income tax expense   | 479  | 314            | 1,189   | 508            |
| <b>NET INCOME</b>  | <b>\$1,473</b>                                 | <b>\$1,080</b> | <b>\$3,877</b>                                | <b>\$2,397</b> |
| Earnings per share—basic                                       | \$0.54   | \$0.40         | \$1.42  | \$0.89         |
| Earnings per share—diluted                                     | \$0.54   | \$0.40         | \$1.42  | \$0.89         |
| Dividends paid per share                                       | \$0.05   | \$0.05         | \$0.15  | \$0.15         |
| Weighted average shares outstanding:                           |  |                |   |                |
| Basic  | 2,729  | 2,704          | 2,724   | 2,701          |

|         |       |       |       |       |
|---------|-------|-------|-------|-------|
| Diluted | 2,732 | 2,705 | 2,727 | 2,702 |
|---------|-------|-------|-------|-------|

The accompanying notes are an integral part of these statements



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TF FINANCIAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
(Unaudited)

|  | For the three months<br>ended<br>September 30, |         | For the nine months<br>ended<br>September 30, |         |
|--|--|---------|---|---------|
|  | 2012   | 2011    | 2012  | 2011    |
| (in thousands)   |  |         |   |         |
| Net income   | \$1,473  | \$1,080 | \$3,877                                       | \$2,397 |
| Other comprehensive income:                                  |  |         |   |         |
| Investment securities available for sale:                    |  |         |   |         |
| Unrealized holding gains                                     | 544  | 1,524   | 870   | 2,884   |
| Tax effect   | (185 )   | (518 )  | (296 )  | (980 )  |
| Reclassification adjustment for gains realized in net income | —  | —       | —   | (210 )  |
| Tax effect   | —  | —       | —   | 71      |
| Net of tax amount  | 359  | 1,006   | 574   | 1,765   |
| Pension plan benefit adjustment:                             |  |         |   |         |
| Related to actuarial losses and prior service cost           | 71   | 30      | 214   | 88      |
| Tax effect   | (24 )  | (11 )   | (73 )   | (30 )   |
| Net of tax amount  | 47   | 19      | 141   | 58      |
| Total other comprehensive income                             | 406  | 1,025   | 715   | 1,823   |
| Comprehensive income   | \$1,879  | \$2,105 | \$4,592                                       | \$4,220 |

The accompanying notes are an integral part of these statements

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## TF FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)For the nine months  
ended September 30,  
2012                  2011  
(in thousands)

## OPERATING ACTIVITIES

|   |              |              |
|---|--------------|--------------|
| Net income  | \$3,877      | \$2,397      |
| Adjustments to reconcile net income to net cash provided by operating activities: |              |              |
| Amortization and impairment adjustment of mortgage loan servicing rights          | 304          | 296          |
| Premiums and discounts on investment securities, net                              | 181          | 87           |
| Premiums and discounts on mortgage-backed securities, net                         | 229          | 128          |
| Deferred loan origination costs, net  | 132          | 122          |
| Provision for loan losses   | 1,750        | 2,878        |
| Depreciation of premises and equipment  | 573          | 647          |
| Increase in value of bank owned life insurance                                    | (456 )       | (481 )       |
| Stock based compensation  | 366          | 262          |
| Proceeds from sale of loans originated for sale                                   | 39,656       | 15,748       |
| Origination of loans held for sale  | (39,512 )    | (17,156 )    |
| Loss on foreclosed real estate  | 425          | 254          |
| Gain on :   |              |              |
| Sale of investments   | —            | (210 )       |
| Sale of loans held for sale   | (920 )       | (292 )       |
| Disposition of premises and equipment   | (277 )       | —            |
| Decrease in:  |              |              |
| Accrued interest receivable   | 5            | 158          |
| Other assets  | 644          | 900          |
| (Decrease) increase in:   |              |              |
| Accrued interest payable  | (432 )       | (477 )       |
| Other liabilities   | 944          | 533          |
| <b>NET CASH PROVIDED BY OPERATING ACTIVITIES</b>                                  | <b>7,489</b> | <b>5,794</b> |

## INVESTING ACTIVITIES

|  |            |           |
|--|------------|-----------|
| Loan originations  | (110,383 ) | (76,036 ) |
| Loan principal payments  | 65,723     | 68,123    |
| Proceeds from sale of foreclosed real estate                               | 6,736      | 724       |
| Proceeds from disposition of premises and equipment                        | 356        | —         |
| Principal repayments on mortgage-backed securities held to maturity        | 506        | 482       |
| Principal repayments on mortgage-backed securities available for sale      | 20,489     | 20,990    |
| Proceeds from maturities and redemptions of investments available for sale | 5,300      | 3,860     |
| Proceeds from sale of investment securities available for sale             | —          | 3,534     |
| Purchase of investment securities available for sale                       | (4,260 )   | (4,112 )  |
| Purchase of mortgage-backed securities available for sale                  | (13,520 )  | (16,596 ) |
| Purchase of premises and equipment   | (387 )     | (508 )    |
| Redemption of FHLB stock   | 1,408      | 1,341     |

|   |           |       |
|---|-----------|-------|
| Proceeds from sale of mortgage backed securities available for sale | —         | 1,518 |
| NET CASH (USED)/PROVIDED BY INVESTING ACTIVITIES                    | (28,032 ) | 3,320 |

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## TF FINANCIAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS  
(Unaudited)

|   | For the nine months ended<br>September 30, |                 |
|---|--|-----------------|
|   | 2012                                       | 2011            |
|   | (in thousands)                             |                 |
| <b>FINANCING ACTIVITIES</b>                                     |  |                 |
| Net (decrease)/increase in deposits                             | (18,015 )                                  | 1,543           |
| Net increase in short-term FHLB borrowings                      | 14,304                                     | 10,884          |
| Proceeds of long-term FHLB borrowings                           | 32,197                                     | 6,573           |
| Repayment of long-term FHLB borrowings                          | (18,253 )                                  | (19,944 )       |
| Net decrease in advances from borrowers for taxes and insurance | (505 )                                     | (733 )          |
| Exercise of stock options                                       | 7  | —               |
| Tax benefit arising from exercise of stock options              | (1 )                                       | —               |
| Common stock dividends paid                                     | (407 )                                     | (399 )          |
| <b>NET CASH PROVIDED/(USED) BY FINANCING ACTIVITIES</b>         | <b>9,327</b>                               | <b>(2,076 )</b> |
| <b>NET (DECREASE)/INCREASE IN CASH AND CASH EQUIVALENTS</b>     | <b>(11,216 )</b>                           | <b>7,038</b>    |
| Cash and cash equivalents at beginning of period                | 14,928                                     | 7,437           |
| Cash and cash equivalents at end of period                      | \$3,712                                    | \$14,475        |
| Supplemental disclosure of cash flow information                |  |                 |
| Cash paid for:  |  |                 |
| Interest on deposits and borrowings                             | \$4,321                                    | \$6,342         |
| Income taxes  | \$375                                      | \$300           |
| Non-cash transactions:  |  |                 |
| Capitalization of mortgage servicing rights                     | \$404                                      | \$136           |
| Transfers from loans to foreclosed real estate                  | \$2,925                                    | \$2,405         |

The accompanying notes are an integral part of these statements

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TF FINANCIAL CORPORATION AND SUBSIDIARIES  
NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1—PRINCIPLES OF CONSOLIDATION

The consolidated financial statements as of September 30, 2012 (unaudited) and December 31, 2011 and for the three and nine-month periods ended September 30, 2012 and 2011 (unaudited) include the accounts of TF Financial Corporation (the “Company”) and its wholly owned subsidiaries: 3rd Fed Bank (the “Bank”), Penns Trail Development Corporation, and TF Investments Corporation, which was merged into the Company during 2011. The accompanying consolidated balance sheet at December 31, 2011, has been derived from the audited consolidated balance sheet but does not include all of the information and notes required by accounting principles generally accepted in the United States of America (“US GAAP”) for complete financial statements. The Company’s business is conducted principally through the Bank. All significant intercompany accounts and transactions have been eliminated in consolidation.

NOTE 2—BASIS OF PRESENTATION

The accompanying unaudited consolidated financial statements were prepared in accordance with the instructions for Form 10-Q and, therefore, do not include all of the disclosures or footnotes required by US GAAP. In the opinion of management, all adjustments, consisting of normal recurring accruals, necessary for fair presentation of the consolidated financial statements have been included. The results of operations for the period ended September 30, 2012 are not necessarily indicative of the results which may be expected for the entire fiscal year or any other period. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company’s Annual Report on Form 10-K for the fiscal year ended December 31, 2011.

NOTE 3—CONTINGENCIES

The Company, from time to time, is a party to routine litigation that arises in the normal course of business. In the opinion of management, the resolution of this litigation, if any, would not have a material adverse effect on the Company’s consolidated financial position or results of operations.

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## NOTE 4—EARNINGS PER SHARE

The following tables illustrate the reconciliation of the numerators and denominators of the basic and diluted earnings per share computations (dollars in thousands, except share and per share data):

|  | For the three months ended September 30,<br>2012 |  |                     |
|--|--|--|---------------------|
|  | Income<br>(numerator)                            | Weighted<br>average<br>shares<br>(denominator) | Per share<br>Amount |
| <b>Basic earnings per share</b>  |  |  |                     |
| Income available to common stockholders                                    | \$1,473  | 2,728,534                                      | \$0.54              |
| Effect of dilutive securities  |  |  |                     |
| Stock options and grants   | —  | 3,119  | —                   |
| <b>Diluted earnings per share</b>  |  |  |                     |
| Income available to common stockholders plus effect of dilutive securities | \$1,473  | 2,731,653                                      | \$0.54              |
| <br>   |  |  |                     |
|  | For the nine months ended September 30,<br>2012  |  |                     |
|  | Income<br>(numerator)                            | Weighted<br>average<br>shares<br>(denominator) | Per share<br>Amount |
| <b>Basic earnings per share</b>  |  |  |                     |
| Income available to common stockholders                                    | \$3,877  | 2,723,703                                      | \$1.42              |
| Effect of dilutive securities  |  |  |                     |
| Stock options and grants   | —  | 3,668  | —                   |
| <b>Diluted earnings per share</b>  |  |  |                     |
| Income available to common stockholders plus effect of dilutive securities | \$3,877  | 2,727,371                                      | \$1.42              |

There were 65,337 options to purchase shares of common stock with exercise prices ranging from \$23.53 to \$32.51 per share which were outstanding during the three and nine months ended September 30, 2012 that were not included in the computation of diluted earnings per share because the options' exercise prices were greater than the average market price of the common shares.

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|  | For the three months ended September 30,<br>2011 |  |                     |
|--|--|--|---------------------|
|  | Income<br>(numerator)                            | Weighted<br>average<br>shares<br>(denominator) | Per share<br>Amount |
| Basic earnings per share   |  |  |                     |
| Income available to common stockholders                                    | \$1,080  | 2,704,350                                      | \$0.40              |
| Effect of dilutive securities  |  |  |                     |
| Stock options and grants   | —  | 818  | —                   |
| Diluted earnings per share   |  |  |                     |
| Income available to common stockholders plus effect of dilutive securities | \$1,080  | 2,705,168                                      | \$0.40              |

|  | For the nine months ended September 30,<br>2011 |  |                     |
|--|---|--|---------------------|
|  | Income<br>(numerator)                           | Weighted<br>average<br>shares<br>(denominator) | Per share<br>Amount |
| Basic earnings per share   |   |  |                     |
| Income available to common stockholders                                    | \$2,397   | 2,700,845                                      | \$0.89              |
| Effect of dilutive securities  |   |  |                     |
| Stock options and grants   | —   | 716  | —                   |
| Diluted earnings per share   |   |  |                     |
| Income available to common stockholders plus effect of dilutive securities | \$2,397   | 2,701,561                                      | \$0.89              |

There were 64,407 options to purchase shares of common stock with exercise prices ranging from \$24.12 to \$32.51 per share which were outstanding during the three and nine months ended September 30, 2011 that were not included in the computation of diluted earnings per share because the options' exercise prices were greater than the average market price of the common shares.

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## NOTE 5—INVESTMENT SECURITIES

The amortized cost, gross unrealized gains and losses, and fair value of the Company's investment securities are summarized as follows:

|   | Amortized<br>cost | At September 30, 2012<br>Gross unrealized gains<br>Gross unrealized losses<br>(in thousands) |         | Fair<br>value |
|---|-------------------|--|---------|---------------|
| Available for sale  |                   |  |         |               |
| State and political subdivisions  | \$53,060          | \$4,513  | \$—     | \$57,573      |
| Residential mortgage-backed securities issued by quasi-governmental agencies                | 43,349            | 1,696  | (1 )    | 45,044        |
| Residential mortgage-backed securities privately issued                                     | 4,149             | 191  | —       | 4,340         |
| Total investment securities available for sale  | 100,558           | 6,400  | (1 )    | 106,957       |
| Held to maturity  |                   |  |         |               |
| Residential mortgage-backed securities issued by quasi-governmental agencies                | 2,079             | 339  | —       | 2,418         |
| Total investment securities   | \$102,637         | \$6,739  | \$(1 )  | \$109,375     |
| At December 31, 2011<br>Gross unrealized gains<br>Gross unrealized losses<br>(in thousands) |                   |  |         |               |
| Available for sale  |                   |  |         |               |
| U.S. Government and federal agencies  | \$2,995           | \$35   | \$—     | \$3,030       |
| State and political subdivisions  | 51,287            | 3,804  | —       | 55,091        |
| Residential mortgage-backed securities issued by quasi-governmental agencies                | 45,969            | 1,525  | —       | 47,494        |
| Residential mortgage-backed securities privately issued                                     | 8,723             | 195  | (30 )   | 8,888         |
| Total investment securities available for sale  | 108,974           | 5,559  | (30 )   | 114,503       |
| Held to maturity  |                   |  |         |               |
| Residential mortgage-backed securities issued by quasi-governmental agencies                | 2,588             | 340  | —       | 2,928         |
| Total investment securities   | \$111,562         | \$5,899  | \$(30 ) | \$117,431     |

There were no sales of investment securities during the three and nine months ended September 30, 2012. There were no sales of investment securities during the three months ended September 30, 2011. Gross realized gains were \$210,000 for the nine months ended September 30, 2011. These gains resulted from proceeds from the sale of investment and mortgage-backed securities of \$5.1 million.



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The amortized cost and fair value of investment and mortgage-backed securities, by contractual maturity, are shown below.

|   | At September 30, 2012                   |               |                                       |               |
|---|---|---------------|---------------------------------------|---------------|
|   | Available for sale<br>Amortized<br>cost | Fair<br>value | Held to maturity<br>Amortized<br>cost | Fair<br>value |
|   | (in thousands)                          |               |                                       |               |
| Investment securities                           |   |               |                                       |               |
| Due in one year or less                         | \$1,070                                 | \$1,084       | \$—                                   | \$—           |
| Due after one year through five years           | 7,732                                   | 8,139         | —                                     | —             |
| Due after five years through ten years          | 24,136                                  | 25,880        | —                                     | —             |
| Due after ten years                             | 20,122                                  | 22,470        | —                                     | —             |
|   | 53,060                                  | 57,573        | —                                     | —             |
| Mortgage-backed securities                      | 47,498                                  | 49,384        | 2,079                                 | 2,418         |
| Total investment and mortgage-backed securities | \$100,558                               | \$106,957     | \$2,079                               | \$2,418       |

The table below indicates the length of time individual securities have been in a continuous unrealized loss position at September 30, 2012:

| Description of<br>Securities  | Number<br>of<br>Securities | Fair<br>Value | Less than<br>12 months | 12 months<br>or longer |                    | Total<br>Fair<br>Value | Unrealized<br>Loss |
|---|----------------------------|---------------|------------------------|------------------------|--------------------|------------------------|--------------------|
|   |                            |               | Unrealized<br>Loss     | Fair<br>Value          | Unrealized<br>Loss |                        |                    |
| (dollars in thousands)  |                            |               |                        |                        |                    |                        |                    |
| Residential<br>mortgage-<br>backed<br>securities<br>issued by<br>quasi-<br>governmental<br>agencies | 1                          | \$263         | \$(1 )                 | \$—                    | \$—                | \$263                  | \$(1 )             |
| Total temporarily<br>impaired<br>securities   | 1                          | \$263         | \$(1 )                 | \$—                    | \$—                | \$263                  | \$(1 )             |

The table below indicates the length of time individual securities have been in a continuous unrealized loss position at December 31, 2011:

| Description of<br>Securities | Number<br>of<br>Securities | Fair<br>Value | Less than<br>12 months | 12 months<br>or longer |                    | Total<br>Fair<br>Value | Unrealized<br>Loss |
|------------------------------|----------------------------|---------------|------------------------|------------------------|--------------------|------------------------|--------------------|
|                              |                            |               | Unrealized<br>Loss     | Fair<br>Value          | Unrealized<br>Loss |                        |                    |
| (dollars in thousands)       |                            |               |                        |                        |                    |                        |                    |
| Residential<br>mortgage-     | 2                          | \$3,442       | \$(30 )                | \$—                    | \$—                | \$3,442                | \$(30 )            |

|                                       |   |         |         |     |     |         |         |  |
|---------------------------------------|---|---------|---------|-----|-----|---------|---------|--|
| backed securities privately issued    |   |         |         |     |     |         |         |  |
| Total temporarily impaired securities | 2 | \$3,442 | \$(30 ) | \$— | \$— | \$3,442 | \$(30 ) |  |

On a quarterly basis, temporarily impaired securities are evaluated to determine whether such impairment is an other-than-temporary impairment (“OTTI”). The Company has performed this evaluation and has determined that the unrealized losses at September 30, 2012 and December 31, 2011, respectively, are not considered other-than-temporary but are the result of changes in interest rates, and are therefore reflected in other comprehensive income.

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## NOTE 6—LOANS RECEIVABLE

Loans receivable are summarized as follows:

|  | September 30,<br>2012 | At<br>December 31,<br>2011 |
|--|-----------------------|----------------------------|
|  | (in thousands)        |                            |
| Held for investment:   |                       |                            |
| Residential  |                       |                            |
| Residential mortgages  | \$ 320,883            | \$ 277,824                 |
| Commercial   |                       |                            |
| Real estate-commercial                                       | 109,379               | 110,743                    |
| Real estate-residential                                      | 22,502                | 25,801                     |
| Real estate-multi-family                                     | 19,433                | 19,906                     |
| Construction loans   | 19,094                | 16,336                     |
| Commercial and industrial loans                              | 4,316                 | 4,414                      |
| Total commercial loans                                       | 174,724               | 177,200                    |
| Consumer   |                       |                            |
| Home equity and second mortgage                              | 41,751                | 44,165                     |
| Other consumer   | 1,925                 | 1,971                      |
| Total consumer loans   | 43,676                | 46,136                     |
| Total loans  | 539,283               | 501,160                    |
| Net deferred loan origination costs and unamortized premiums | 1,467                 | 1,065                      |
| Less allowance for loan losses                               | (6,772 )              | (8,100 )                   |
| Total loans receivable                                       | \$ 533,978            | \$ 494,125                 |
| Held for sale:   |                       |                            |
| Residential  |                       |                            |
| Residential mortgages  | \$ 860                | \$ 488                     |

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The following table presents the composition of the commercial loan portfolio by credit quality indicators:

## Commercial credit exposure-credit risk profile by internally assigned grade

|                                 | At September 30, 2012 |                    |                               |          | Total     |
|---------------------------------|-----------------------|--------------------|-------------------------------|----------|-----------|
|                                 | Pass                  | Special<br>mention | Substandard<br>(in thousands) | Doubtful |           |
| Real estate-commercial          | \$96,008              | \$4,221            | \$ 9,150                      | \$—      | \$109,379 |
| Real estate-residential         | 19,419                | 1,023              | 2,060                         | —        | 22,502    |
| Real estate-multi-family        | 13,526                | 2,532              | 3,375                         | —        | 19,433    |
| Construction loans              | 7,360                 | 5,398              | 6,336                         | —        | 19,094    |
| Commercial and industrial loans | 4,233                 | 83                 | —                             | —        | 4,316     |
| Total                           | \$140,546             | \$13,257           | \$ 20,921                     | \$—      | \$174,724 |

|                                 | At December 31, 2011 |                    |                               |          | Total     |
|---------------------------------|----------------------|--------------------|-------------------------------|----------|-----------|
|                                 | Pass                 | Special<br>mention | Substandard<br>(in thousands) | Doubtful |           |
| Real estate-commercial          | \$95,719             | \$6,189            | \$8,835                       | \$—      | \$110,743 |
| Real estate-residential         | 21,447               | 2,891              | 1,463                         | —        | 25,801    |
| Real estate-multi-family        | 12,753               | 3,768              | 3,385                         | —        | 19,906    |
| Construction loans              | 4,452                | 4,312              | 7,572                         | —        | 16,336    |
| Commercial and industrial loans | 4,139                | 100                | 175                           | —        | 4,414     |
| Total                           | \$138,510            | \$17,260           | \$21,430                      | \$—      | \$177,200 |

In order to assess and monitor the credit risk associated with commercial loans, the Company employs a risk rating methodology whereby each commercial loan is initially assigned a risk grade. At least annually, all risk ratings are reviewed in light of information received such as tax returns, rent rolls, cash flow statements, appraisals, and any other information which may affect the then current risk rating, which is adjusted upward or downward as needed. At the end of each quarter the risk ratings are summarized and become a component of the evaluation of the allowance for loan losses. The Company's risk rating definitions mirror those promulgated by banking regulators and are as follows:

**Pass:** A good quality loan is characterized by satisfactory liquidity; reasonable debt capacity and coverage; acceptable management in all critical positions and normal operating results for its peer group. The Company has grades 1 through 6 within the Pass category which reflect the increasing amount of attention paid to the individual loan because of, among other things, trends in debt service coverage, management weaknesses, or collateral values.

**Special mention:** A loan that has potential weaknesses that deserves management's close attention. Although the loan is currently protected, if left uncorrected, potential weaknesses may result in the deterioration of the loan's repayment prospects or in the borrower's future credit position. Potential weaknesses include: weakening financial condition; an unrealistic repayment program; inadequate sources of funds; lack of adequate collateral; credit information; or documentation. There is currently the capacity to meet interest and principal payments, but further adverse business, financial, or economic conditions may impair the borrower's capacity or willingness to pay interest and repay principal.

**Substandard:** A loan that is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged. Although no loss of principal or interest is presently apparent, there is the distinct possibility

that a partial loss of interest and/or principal will be sustained if the deficiencies are not corrected. There is a current identifiable vulnerability to default and the dependence upon favorable business, financial, or economic conditions to meet timely payment of interest and repayment of principal.

Doubtful: A loan which has all the weaknesses inherent in a substandard asset with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable

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and improbable. The possibility of loss is extremely high, but because of certain important and reasonable specific pending factors which may work to strengthen the asset, classification as an estimated loss is deferred until a more exact status is determined. Pending factors include: proposed merger, acquisition, liquidation, capital injection, perfecting liens on additional collateral, and refinancing plans.

Loss: Loans which are considered uncollectible and have been charged off. The Company has charged-off all loans classified as loss.

Loans classified as special mention, substandard or doubtful are evaluated for potential impairment. All impaired loans are placed on non-accrual status and are classified as substandard or doubtful.

The following table presents the composition of the residential mortgage and consumer loan portfolios by credit quality indicators:

## Mortgage and consumer credit exposure-credit risk profile by payment activity

|                                 | At September 30, 2012 |                |           |
|---------------------------------|-----------------------|----------------|-----------|
|                                 | Performing            | Non-performing | Total     |
|                                 | (in thousands)        |                |           |
| Residential mortgages           | \$318,761             | \$ 2,122       | \$320,883 |
| Home equity and second mortgage | 41,547                | 204            | 41,751    |
| Other consumer                  | 1,925                 | —              | 1,925     |
| Total                           | \$362,233             | \$ 2,326       | \$364,559 |

|                                 | At December 31, 2011 |                |           |
|---------------------------------|----------------------|----------------|-----------|
|                                 | Performing           | Non-performing | Total     |
|                                 | (in thousands)       |                |           |
| Residential mortgages           | \$272,322            | \$ 5,502       | \$277,824 |
| Home equity and second mortgage | 43,888               | 277            | 44,165    |
| Other consumer                  | 1,970                | 1              | 1,971     |
| Total                           | \$318,180            | \$ 5,780       | \$323,960 |

In order to assess and monitor the credit risk associated with residential mortgage loans and consumer loans which include second mortgage loans and home equity secured lines of credit, the Company relies upon the payment status of the loan. Residential mortgage and other consumer loans 90 days or more past due are placed on non-accrual status and evaluated for impairment.

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The following table presents by class non-performing loans including impaired loans and loan balances 90 days or more past due for which the accrual of interest has been discontinued:

|  | September 30,<br>2012 | At<br>December 31,<br>2011 |
|--|-----------------------|----------------------------|
|  | (in thousands)        |                            |
| Residential  |                       |                            |
| Residential mortgages  | \$ 2,122              | \$ 5,502                   |
| Commercial   |                       |                            |
| Real estate-commercial   | 1,116                 | 2,711                      |
| Real estate-residential  | 839                   | —                          |
| Construction loans   | 6,119                 | 4,044                      |
| Commercial and industrial loans  | —                     | 6                          |
| Consumer   |                       |                            |
| Home equity and second mortgage  | 204                   | 277                        |
| Other consumer   | —                     | 1                          |
| Total non-performing loans   | \$ 10,400             | \$ 12,541                  |
| Total loans past due 90 days as to interest or principal and accruing interest | \$ —                  | \$ —                       |

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The following tables present loans individually evaluated for impairment by class:

|                                 | At September 30, 2012 |                          |                                  |                             |                            |
|---------------------------------|-----------------------|--------------------------|----------------------------------|-----------------------------|----------------------------|
|                                 | Recorded investment   | Unpaid principal balance | Related allowance (in thousands) | Average recorded investment | Interest income recognized |
| With an allowance recorded:     |                       |                          |                                  |                             |                            |
| Residential                     |                       |                          |                                  |                             |                            |
| Residential mortgages           | \$2,236               | \$2,331                  | \$295                            | \$2,042                     | \$—                        |
| Commercial                      |                       |                          |                                  |                             |                            |
| Real estate-commercial          | 565                   | 1,497                    | 185                              | 734                         | —                          |
| Real estate-residential         | 719                   | 838                      | 57                               | 360                         | —                          |
| Construction loans              | 3,118                 | 3,815                    | 329                              | 3,321                       | —                          |
| Commercial and industrial loans | —                     | —                        | —                                | 3                           | —                          |
|                                 | 6,638                 | 8,481                    | 866                              | 6,460                       | —                          |
| With no allowance recorded:     |                       |                          |                                  |                             |                            |
| Residential                     |                       |                          |                                  |                             |                            |
| Residential mortgages           | —                     | —                        | —                                | 1,030                       | —                          |
| Commercial                      |                       |                          |                                  |                             |                            |
| Real estate-commercial          | 551                   | 551                      | —                                | 1,089                       | —                          |
| Real estate-residential         | 120                   | 121                      | —                                | 337                         | —                          |
| Construction loans              | 3,001                 | 3,258                    | —                                | 2,399                       | —                          |
|                                 | 3,672                 | 3,930                    | —                                | 4,855                       | —                          |
| Total                           | \$10,310              | \$12,411                 | \$866                            | \$11,315                    | \$—                        |

  

|                                 | At December 31, 2011 |                          |                                  |                             |                            |
|---------------------------------|----------------------|--------------------------|----------------------------------|-----------------------------|----------------------------|
|                                 | Recorded investment  | Unpaid principal balance | Related allowance (in thousands) | Average recorded investment | Interest income recognized |
| With an allowance recorded:     |                      |                          |                                  |                             |                            |
| Residential                     |                      |                          |                                  |                             |                            |
| Residential mortgages           | \$1,252              | \$1,252                  | \$388                            | \$751                       | \$—                        |
| Commercial                      |                      |                          |                                  |                             |                            |
| Real estate-commercial          | 1,497                | 1,497                    | 877                              | 3,581                       | —                          |
| Real estate-residential         | —                    | —                        | —                                | 497                         | —                          |
| Construction loans              | 3,816                | 3,816                    | 1,035                            | 4,143                       | —                          |
| Commercial and industrial loans | 6                    | 6                        | 3                                | 72                          | —                          |
|                                 | 6,571                | 6,571                    | 2,303                            | 9,044                       | —                          |
| With no allowance recorded:     |                      |                          |                                  |                             |                            |
| Residential                     |                      |                          |                                  |                             |                            |
| Residential mortgages           | 2,381                | 2,381                    | —                                | 1,497                       | —                          |
| Commercial                      |                      |                          |                                  |                             |                            |
| Real estate-commercial          | 1,214                | 1,214                    | —                                | 1,270                       | —                          |
| Real estate-residential         | —                    | —                        | —                                | 459                         | —                          |
| Construction loans              | 228                  | 228                      | —                                | 1,642                       | —                          |
| Commercial and industrial loans | —                    | —                        | —                                | —                           | —                          |
|                                 | 3,823                | 3,823                    | —                                | 4,868                       | —                          |



|       |          |          |         |          |     |
|-------|----------|----------|---------|----------|-----|
| Total | \$10,394 | \$10,394 | \$2,303 | \$13,912 | \$— |
|-------|----------|----------|---------|----------|-----|

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The following tables present the contractual aging of delinquent loans by class:

| At September 30, 2012           |                  |                           |                           |   |                   |                  |  |
|---------------------------------|------------------|---------------------------|---------------------------|---|-------------------|------------------|--|
|                                 | Current          | 30-59<br>Days<br>past due | 60-89<br>Days<br>past due | Loans<br>past due<br>90 days<br>or more<br>(in thousands) | Total<br>past due | Total<br>loans   | Recorded<br>investment<br>over 90<br>days<br>and<br>accruing<br>interest |
| Residential                     |                  |                           |                           |   |                   |                  |  |
| Residential mortgages           | \$317,534        | \$1,098                   | \$129                     | \$2,122   | \$3,349           | \$320,883        | \$—  |
| Commercial                      |                  |                           |                           |   |                   |                  |  |
| Real estate-commercial          | 108,263          | —                         | —                         | 1,116   | 1,116             | 109,379          | —  |
| Real estate-residential         | 21,663           | —                         | —                         | 839   | 839               | 22,502           | —  |
| Real estate-multi-family        | 19,433           | —                         | —                         | —   | —                 | 19,433           | —  |
| Construction loans              | 12,975           | —                         | —                         | 6,119   | 6,119             | 19,094           | —  |
| Commercial and industrial       |                  |                           |                           |   |                   |                  |  |
| loans                           | 4,309            | 7                         | —                         | —   | 7                 | 4,316            | —  |
| Consumer                        |                  |                           |                           |   |                   |                  |  |
| Home equity and second mortgage |                  |                           |                           |   |                   |                  |  |
| Home equity and second mortgage | 41,321           | 126                       | 100                       | 204   | 430               | 41,751           | —  |
| Other consumer                  | 1,917            | —                         | 8                         | —   | 8                 | 1,925            | —  |
| <b>Total</b>                    | <b>\$527,415</b> | <b>\$1,231</b>            | <b>\$237</b>              | <b>\$10,400</b>   | <b>\$11,868</b>   | <b>\$539,283</b> | <b>\$—</b>   |

| At December 31, 2011   |           |                           |                           |   |                   |                |  |
|------------------------|-----------|---------------------------|---------------------------|---|-------------------|----------------|--|
|                        | Current   | 30-59<br>Days<br>past due | 60-89<br>Days<br>past due | Loans<br>past due<br>90 days<br>or more<br>(in thousands) | Total<br>past due | Total<br>loans | Recorded<br>investment<br>over 90<br>days<br>and<br>accruing<br>interest |
| Residential            |           |                           |                           |   |                   |                |  |
| Residential mortgages  | \$273,231 | \$98                      | \$153                     | \$4,342   | \$4,593           | \$277,824      | \$—  |
| Commercial             |           |                           |                           |   |                   |                |  |
| Real estate-commercial | 108,382   | —                         | —                         | 2,361   | 2,361             | 110,743        | —  |

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|  |           |       |         |          |          |           |     |
|--|-----------|-------|---------|----------|----------|-----------|-----|
| Real estate-residential                  | 25,489    | 312   | —       | —        | 312      | 25,801    | —   |
| Real estate-multi-family                 | 19,906    | —     | —       | —        | —        | 19,906    | —   |
| Construction loans                       | 9,151     | —     | 3,141   | 4,044    | 7,185    | 16,336    | —   |
| Commercial and industrial loans          | 4,408     | —     | —       | 6        | 6        | 4,414     | —   |
| Consumer Home equity and second mortgage | 43,712    | 165   | 11      | 277      | 453      | 44,165    | —   |
| Other consumer                           | 1,956     | 6     | 8       | 1        | 15       | 1,971     | —   |
| Total                                    | \$486,235 | \$581 | \$3,313 | \$11,031 | \$14,925 | \$501,160 | \$— |

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Activity in the allowance for loan losses for the three and nine months ended September 30, 2012 is summarized as follows:

|                                 | Balance<br>July 1, 2012 | Provision | Charge-offs<br>(in thousands) | Recoveries | Balance<br>September 30,<br>2012 |
|---------------------------------|-------------------------|-----------|-------------------------------|------------|----------------------------------|
| Residential                     |                         |           |                               |            |                                  |
| Residential mortgages           | \$ 1,620                | \$ 373    | \$ (126 )                     | \$ 46      | \$ 1,913                         |
| Commercial                      |                         |           |                               |            |                                  |
| Real estate-commercial          | 1,913                   | 100       | (18 )                         | —          | 1,995                            |
| Real estate-residential         | 699                     | (52 )     | (1 )                          | —          | 646                              |
| Real estate-multi-family        | 284                     | (34 )     | —                             | —          | 250                              |
| Construction loans              | 1,002                   | 166       | (31 )                         | —          | 1,137                            |
| Commercial and industrial loans | 137                     | (41 )     | —                             | 9          | 105                              |
| Consumer                        |                         |           |                               |            |                                  |
| Home equity and second mortgage | 265                     | (25 )     | (11 )                         | —          | 229                              |
| Other consumer                  | 12                      | 8         | (9 )                          | —          | 11                               |
| Unallocated                     | 231                     | 255       | —                             | —          | 486                              |
| Total                           | \$ 6,163                | \$ 750    | \$ (196 )                     | \$ 55      | \$ 6,772                         |

|                                 | Balance<br>January 1,<br>2012 | Provision | Charge-offs<br>(in thousands) | Recoveries | Balance<br>September<br>30,2012 |
|---------------------------------|-------------------------------|-----------|-------------------------------|------------|---------------------------------|
| Residential                     |                               |           |                               |            |                                 |
| Residential mortgages           | \$ 2,194                      | \$ 365    | \$ (702 )                     | \$ 56      | \$ 1,913                        |
| Commercial                      |                               |           |                               |            |                                 |
| Real estate-commercial          | 2,819                         | 108       | (932 )                        | —          | 1,995                           |
| Real estate-residential         | 464                           | 600       | (418 )                        | —          | 646                             |
| Real estate-multi-family        | 358                           | (108 )    | —                             | —          | 250                             |
| Construction loans              | 1,260                         | 768       | (891 )                        | —          | 1,137                           |
| Commercial and industrial loans | 138                           | 106       | (156 )                        | 17         | 105                             |
| Consumer                        |                               |           |                               |            |                                 |
| Home equity and second mortgage | 448                           | (187 )    | (32 )                         | —          | 229                             |
| Other consumer                  | 22                            | 9         | (23 )                         | 3          | 11                              |
| Unallocated                     | 397                           | 89        | —                             | —          | 486                             |
| Total                           | \$ 8,100                      | \$ 1,750  | \$ (3,154 )                   | \$ 76      | \$ 6,772                        |

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Activity in the allowance for loan losses for the three and nine months ended September 30, 2011 is summarized as follows:

|                                    | Balance<br>July 1, 2011 | Provision | Charge-offs<br>(in thousands) | Recoveries | Balance<br>September 30,<br>2011 |
|------------------------------------|-------------------------|-----------|-------------------------------|------------|----------------------------------|
| Residential                        |                         |           |                               |            |                                  |
| Residential mortgages              | \$ 1,693                | \$ 12     | \$ (48 )                      | \$ 2       | \$ 1,659                         |
| Commercial                         |                         |           |                               |            |                                  |
| Real estate-commercial             | 2,828                   | 1,236     | —                             | —          | 4,064                            |
| Real estate-residential            | 419                     | 135       | —                             | —          | 554                              |
| Real estate-multi-family           | 336                     | 98        | —                             | —          | 434                              |
| Construction loans                 | 2,662                   | (678 )    | —                             | —          | 1,984                            |
| Commercial and industrial loans    | 216                     | 20        | —                             | —          | 236                              |
| Consumer                           |                         |           |                               |            |                                  |
| Home equity and second<br>mortgage | 482                     | (14 )     | —                             | —          | 468                              |
| Other consumer                     | 22                      | 1         | (5 )                          | 1          | 19                               |
| Unallocated                        | 450                     | (282 )    | —                             | —          | 168                              |
| Total                              | \$ 9,108                | \$ 528    | \$ (53 )                      | \$ 3       | \$ 9,586                         |

|                                    | Balance<br>January 1,<br>2011 | Provision | Charge-offs<br>(in thousands) | Recoveries | Balance<br>September 30,<br>2011 |
|------------------------------------|-------------------------------|-----------|-------------------------------|------------|----------------------------------|
| Residential                        |                               |           |                               |            |                                  |
| Residential mortgages              | \$ 1,839                      | \$ (10 )  | \$ (172 )                     | \$ 2       | \$ 1,659                         |
| Commercial                         |                               |           |                               |            |                                  |
| Real estate-commercial             | 3,281                         | 783       | —                             | —          | 4,064                            |
| Real estate-residential            | 534                           | 749       | (729 )                        | —          | 554                              |
| Real estate-multi-family           | 399                           | 337       | (302 )                        | —          | 434                              |
| Construction loans                 | 1,363                         | 775       | (155 )                        | 1          | 1,984                            |
| Commercial and industrial loans    | 77                            | 197       | (44 )                         | 6          | 236                              |
| Consumer                           |                               |           |                               |            |                                  |
| Home equity and second<br>mortgage | 607                           | 82        | (221 )                        | —          | 468                              |
| Other consumer                     | 16                            | 9         | (12 )                         | 6          | 19                               |
| Unallocated                        | 212                           | (44 )     | —                             | —          | 168                              |
| Total                              | \$ 8,328                      | \$ 2,878  | \$ (1,635 )                   | \$ 15      | \$ 9,586                         |

Despite the above allocation, the allowance for credit losses is general in nature and is available to absorb losses from any portfolio segment.

Loans receivable include certain loans that have been modified as Troubled Debt Restructurings (“TDRs”), where economic concessions have been granted to borrowers experiencing financial difficulties. The objective for granting the concessions is to maximize the recovery of the investment in the loan and may include reductions in the interest rate, payment extensions, forgiveness of interest or principal, forbearance or other actions. TDRs are classified as

nonperforming at the time of restructuring and typically

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return to performing status after considering the borrower's positive repayment performance for a reasonable period of time, usually six months.

Loans modified in a TDR are evaluated individually for impairment based on the present value of expected cash flows or the fair value of the underlying collateral less selling costs for collateral dependent loans. If the value of the modified loan is less than the recorded investment in the loan, impairment is recognized through an increase to the allowance for loan losses. In periods subsequent to modification, TDRs are evaluated for possible additional impairment.

|                      | For the three months ended<br>September 30, 2012 |                                       |                                       | For the nine months ended<br>September 30, 2012 |                                       |                                       |
|----------------------|--|---------------------------------------|---------------------------------------|---|---------------------------------------|---------------------------------------|
|                      | Pre-Modification                                 | Post<br>Modification                  |                                       | Pre-Modification                                | Post<br>Modification                  |                                       |
|                      | Number<br>of<br>Contracts<br>(in thousands)      | Outstanding<br>Recorded<br>Investment | Outstanding<br>Recorded<br>Investment | Number<br>of<br>Contracts<br>(in thousands)     | Outstanding<br>Recorded<br>Investment | Outstanding<br>Recorded<br>Investment |
| Residential          |  |                                       |                                       |   |                                       |                                       |
| Residential mortgage | -  | \$ -                                  | \$ -                                  | 1   | \$ 852                                | \$ 814                                |
| Total                | -  | \$ -                                  | \$ -                                  | 1   | \$ 852                                | \$ 814                                |

For the Bank, restructuring of loans is usually either an extension of the maturity date or a temporary reduction or moratorium on the payment terms. No modifications involved any reduction in principal balance.

During the first quarter of 2012, a TDR totaling \$167,000 which had been previously identified as in default of its modified terms was repaid and a \$40,000 loss was charged to the allowance for loan losses.

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The following tables present the ending balance of the allowance for loan losses and ending loan balance by portfolio and by class based on impairment method as of September 30, 2012:

| Allowance                       | Evaluated for impairment |                                | Total   |
|---------------------------------|--------------------------|--------------------------------|---------|
|                                 | Individually             | Collectively<br>(in thousands) |         |
| Residential                     |                          |                                |         |
| Residential mortgages           | \$295                    | \$1,618                        | \$1,913 |
| Commercial                      |                          |                                |         |
| Real estate-commercial          | 185                      | 1,810                          | 1,995   |
| Real estate-residential         | 57                       | 589                            | 646     |
| Real estate-multi-family        | —                        | 250                            | 250     |
| Construction loans              | 329                      | 808                            | 1,137   |
| Commercial and industrial loans | —                        | 105                            | 105     |
| Consumer                        |                          |                                |         |
| Home equity and second mortgage | —                        | 229                            | 229     |
| Other consumer                  | —                        | 11                             | 11      |
| Unallocated                     | —                        | 486                            | 486     |
| Total                           | \$866                    | \$5,906                        | \$6,772 |

| Loan balance                    | Evaluated for impairment |                                | Total     |
|---------------------------------|--------------------------|--------------------------------|-----------|
|                                 | Individually             | Collectively<br>(in thousands) |           |
| Residential                     |                          |                                |           |
| Residential mortgages           | \$2,236                  | \$318,647                      | \$320,883 |
| Commercial                      |                          |                                |           |
| Real estate-commercial          | 1,116                    | 108,263                        | 109,379   |
| Real estate-residential         | 839                      | 21,663                         | 22,502    |
| Real estate-multi-family        | —                        | 19,433                         | 19,433    |
| Construction loans              | 6,119                    | 12,975                         | 19,094    |
| Commercial and industrial loans | —                        | 4,316                          | 4,316     |
| Consumer                        |                          |                                |           |
| Home equity and second mortgage | —                        | 41,751                         | 41,751    |
| Other consumer                  | —                        | 1,925                          | 1,925     |
| Total                           | \$10,310                 | \$528,973                      | \$539,283 |



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The following tables present the ending balance of the allowance for loan losses and ending loan balance by portfolio and by class based on impairment method as of December 31, 2011:

| Allowance                       | Evaluated for impairment |                                | Total   |
|---------------------------------|--------------------------|--------------------------------|---------|
|                                 | Individually             | Collectively<br>(in thousands) |         |
| Residential                     |                          |                                |         |
| Residential mortgages           | \$388                    | \$1,806                        | \$2,194 |
| Commercial                      |                          |                                |         |
| Real estate-commercial          | 877                      | 1,475                          | 2,352   |
| Real estate-residential         | —                        | 369                            | 369     |
| Real estate-multi-family        | —                        | 350                            | 350     |
| Construction loans              | 1,035                    | 795                            | 1,830   |
| Commercial and industrial loans | 3                        | 135                            | 138     |
| Consumer                        |                          |                                |         |
| Home equity and second mortgage | —                        | 448                            | 448     |
| Other consumer                  | —                        | 22                             | 22      |
| Unallocated                     | —                        | 397                            | 397     |
| Total                           | \$2,303                  | \$5,797                        | \$8,100 |

| Loan balance                    | Evaluated for impairment |                                | Total     |
|---------------------------------|--------------------------|--------------------------------|-----------|
|                                 | Individually             | Collectively<br>(in thousands) |           |
| Residential                     |                          |                                |           |
| Residential mortgages           | \$3,633                  | \$274,191                      | \$277,824 |
| Commercial                      |                          |                                |           |
| Real estate-commercial          | 2,711                    | 108,032                        | 110,743   |
| Real estate-residential         | —                        | 25,801                         | 25,801    |
| Real estate-multi-family        | —                        | 19,906                         | 19,906    |
| Construction loans              | 4,044                    | 12,292                         | 16,336    |
| Commercial and industrial loans | 6                        | 4,408                          | 4,414     |
| Consumer                        |                          |                                |           |
| Home equity and second mortgage | —                        | 44,165                         | 44,165    |
| Other consumer                  | —                        | 1,971                          | 1,971     |
| Total                           | \$10,394                 | \$490,766                      | \$501,160 |

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## NOTE 7—FAIR VALUE MEASUREMENTS AND FAIR VALUE OF FINANCIAL INSTRUMENTS

The following tables present information about the Company's financial instruments measured at fair value as of September 30, 2012 and December 31, 2011. Fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement hierarchy has been established for inputs in valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). Determination of the appropriate level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement for the instrument or security.

The fair value hierarchy levels are summarized below:

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2 inputs are inputs that are observable for the asset or liability, either directly or indirectly.
- Level 3 inputs are unobservable and contain assumptions of the party assessing the fair value of the asset or liability.

Assets measured at fair value on a recurring basis, segregated by fair value hierarchy level are summarized below:

|  | Fair value hierarchy levels |            |         | Balance as of<br>September 30,<br>2012 |
|--|-----------------------------|------------|---------|--|
|  | Level 1                     | Level 2    | Level 3 |  |
|  | (in thousands)              |            |         |  |
| Assets   |                             |            |         |  |
| Investment securities available for sale                                     |                             |            |         |  |
| State and political subdivisions   | \$ —                        | \$ 57,573  | \$ —    | \$ 57,573                              |
| Residential mortgage-backed securities issued by quasi-governmental agencies | —                           | 45,044     | —       | 45,044                                 |
| Residential real estate mortgage-backed securities privately issued          | —                           | 4,340      | —       | 4,340                                  |
| Total investment securities available for sale                               | \$ —                        | \$ 106,957 | \$ —    | \$ 106,957                             |
| Loans available for sale   |                             |            |         |  |
| Residential mortgages  | \$ —                        | \$ 860     | \$ —    | \$ 860                                 |

|  | Fair value hierarchy levels |          |         | Balance as of<br>December<br>31, 2011 |
|--|-----------------------------|----------|---------|---------------------------------------|
|  | Level 1                     | Level 2  | Level 3 |                                       |
|  | (in thousands)              |          |         |                                       |
| Assets   |                             |          |         |                                       |
| Investment securities available for sale                                     |                             |          |         |                                       |
| U.S. Government and federal agencies   | \$ —                        | \$ 3,030 | \$ —    | \$ 3,030                              |
| State and political subdivisions   | —                           | 55,091   | —       | 55,091                                |
| Residential mortgage-backed securities issued by quasi-governmental agencies | —                           | 47,494   | —       | 47,494                                |
| Residential real estate mortgage-backed securities privately issued          | —                           | 8,888    | —       | 8,888                                 |

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|  |      |            |      |            |
|--|------|------------|------|------------|
| Total investment securities available for sale | \$ — | \$ 114,503 | \$ — | \$ 114,503 |
| Loans available for sale                       |      |            |      |            |
| Residential mortgages                          | \$ — | \$ 488     | \$ — | \$ 488     |

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Investment securities available for sale and mortgage-backed securities available for sale are valued primarily by a third party pricing agent. U.S. Government and federal agency and corporate debt securities are primarily priced through a multi-dimensional relational model, a Level 2 hierarchy, which incorporates dealer quotes and other market information including, defined sector breakdown, benchmark yields, base spread, yield to maturity, and corporate actions. State and political subdivision securities are also valued within the Level 2 hierarchy using inputs with a series of matrices that reflect benchmark yields, ratings updates, and spread adjustments. Mortgage-backed securities include Government National Mortgage Association (“GNMA”), Federal Home Loan Mortgage Corporation (“FHLMC”) and Federal National Mortgage Association (“FNMA”) certificates and privately issued real estate mortgage investment conduits which are valued under a Level 2 hierarchy using a matrix correlation to benchmark yields, spread analysis, and prepayment speeds.

Assets measured at fair value on a nonrecurring basis segregated by fair value hierarchy level at September 30, 2012 are summarized below:

|  | Fair value hierarchy levels |         |          | Balance as of<br>September 30,<br>2012 |
|--|-----------------------------|---------|----------|--|
|  | Level 1                     | Level 2 | Level 3  |  |
|  | (in thousands)              |         |          |  |
| Assets                                   |                             |         |          |  |
| Impaired loans                           | \$ —                        | \$ —    | \$ 9,444 | \$ 9,444                               |
| Real estate acquired through foreclosure | —                           | —       | 7,619    | 7,619                                  |
| Mortgage servicing rights                | —                           | 864     | —        | 864                                    |

The following table presents additional quantitative information about assets measured at fair value on a nonrecurring basis and for which the Bank has utilized Level 3 inputs to determine fair value at September 30, 2012:

| Description                              | Fair value estimate<br>(in thousands) | Valuation technique     | Unobservable Input   | Range of inputs |
|--|---------------------------------------|-------------------------|--|-----------------|
| Impaired loans                           | \$9,444                               | Appraisal of collateral | Discount rate to reflect current market conditions and ultimate recoverability | 5%-15 %         |
| Real estate acquired through foreclosure | 7,619                                 | Appraisal of collateral | Discount rate to reflect current market conditions and liquidation expenses    | 5%-20 %         |

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The fair value of impaired loans and real estate acquired through foreclosure is generally determined through independent appraisals of the underlying collateral, which generally include level 3 inputs which are not identifiable. Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses. The range and weighted average of liquidation expenses are presented as a percent of the appraised value.

Assets measured at fair value on a nonrecurring basis segregated by fair value hierarchy level at December 31, 2011 are summarized below:

|  | Fair value hierarchy levels |         |                | Balance as of<br>December 31,<br>2011 |
|--|-----------------------------|---------|----------------|---------------------------------------|
|  | Level 1                     | Level 2 | Level 3        |                                       |
|  |                             |         | (in thousands) |                                       |
| Assets                                   |                             |         |                |                                       |
| Impaired loans                           | \$ —                        | \$ —    | \$ 8,091       | \$ 8,091                              |
| Real estate acquired through foreclosure | —                           | —       | 11,730         | 11,730                                |
| Mortgage servicing rights                | —                           | 763     | —              | 763                                   |

Impaired loans are evaluated and valued at the time the loan is identified as impaired, at the lower of the recorded investment in the loan or fair value. Real estate acquired through foreclosure is initially valued at the lower of the recorded investment in the loan or fair value at foreclosure less costs to sell and subsequently adjusted for further decreases in market value, if necessary. Fair value is determined by using the value of the collateral securing the loans and is therefore classified as a Level 3 hierarchy. The value of the real estate securing impaired loans and real estate acquired through foreclosure is based on appraisals prepared by qualified independent licensed appraisers contracted by the Company to perform the assessment.

The Company initially recognizes and measures servicing assets based on the fair value of the servicing right at the time the loan is sold. The Company uses the amortized cost method for subsequent measurement of its servicing assets and evaluates the recorded value for impairment quarterly. The Company retains a qualified valuation service to calculate the amortized cost and to determine the fair value of the mortgage servicing rights. The valuation service utilizes discounted cash flow analyses, adjusted for prepayment speeds, market discount rates and conditions existing in the secondary servicing market. Hence, the fair value of mortgage servicing rights is deemed a Level 2 hierarchy. The amortized cost basis of the Company's mortgage servicing rights was \$1.2 million and \$1.0 million at September 30, 2012 and December 31, 2011, respectively. The fair value of the mortgage servicing rights was \$864,000 and \$763,000 at September 30, 2012 and December 31, 2011, respectively, and was included in other assets in the consolidated balance sheets.

In addition to financial instruments recorded at fair value in the Company's financial statements, disclosure of the estimated fair value of all of an entity's assets and liabilities considered to be financial instruments is also required. For the Bank, as for most financial institutions, the majority of its assets and liabilities are considered financial instruments. However, many such instruments lack an available trading market as characterized by a willing buyer and willing seller engaging in an exchange transaction. Also, it is the Company's general practice and intent to hold its financial instruments to maturity or available for sale and to not engage in trading or significant sales activities. For fair value disclosure purposes, the Company substantially utilized the established fair value measurement hierarchy.

Changes in the assumptions or methodologies used to estimate fair values may materially affect the estimated amounts. In addition, there may not be reasonable comparability between entities due to the wide range of permitted assumptions and methodologies in the absence of active markets. This lack of uniformity gives rise to a high degree of

subjectivity in estimating financial instrument fair values.

Fair values have been estimated using data which management considered the best available, as generally provided by estimation methodologies deemed suitable for the pertinent category of financial instrument. The recorded carrying amounts and fair values segregated by fair value hierarchy level at September 30, 2012 are summarized below:

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|                                    | Carrying<br>value | Fair<br>value | Fair value hierarchy levels |         |           |
|------------------------------------|-------------------|---------------|-----------------------------|---------|-----------|
|                                    |                   |               | Level 1<br>(in thousands)   | Level 2 | Level 3   |
| <b>Assets</b>                      |                   |               |                             |         |           |
| Cash and cash equivalents          | \$3,712           | \$3,712       | \$3,712                     | \$—     | \$—       |
| Investment securities              | 57,573            | 57,573        | —                           | 57,573  | —         |
| Mortgage-backed securities         | 51,463            | 51,802        | —                           | 51,802  | —         |
| Loans receivable                   | 534,838           | 552,583       | —                           | 860     | 551,723   |
| <b>Liabilities</b>                 |                   |               |                             |         |           |
| Deposits with stated maturities    | \$152,011         | \$153,834     | \$—                         | \$—     | \$153,834 |
| Borrowings with stated maturities  | 75,156            | 75,816        | —                           | —       | 75,816    |
| Deposits with no stated maturities | 381,262           | 381,262       | 381,262                     | —       | —         |

The recorded carrying amounts and fair values at December 31, 2011 are summarized below:

|                                    | At December 31, 2011                |               |
|------------------------------------|-------------------------------------|---------------|
|                                    | Carrying<br>value<br>(in thousands) | Fair<br>value |
| <b>Assets</b>                      |                                     |               |
| Cash and cash equivalents          | \$14,928                            | \$14,928      |
| Investment securities              | 58,121                              | 58,121        |
| Mortgage-backed securities         | 58,970                              | 59,310        |
| Loans receivable                   | 494,613                             | 516,359       |
| <b>Liabilities</b>                 |                                     |               |
| Deposits with stated maturities    | \$181,074                           | \$183,306     |
| Borrowings with stated maturities  | 46,908                              | 48,092        |
| Deposits with no stated maturities | 370,214                             | 370,214       |

The fair value of cash and cash equivalents equals historical book value. The fair value of investment and mortgage-backed securities is described and presented under fair value measurement guidelines as discussed earlier.

The fair value of loans receivable has been estimated using the present value of cash flows, discounted at the approximate current market rates, and giving consideration to estimated prepayment risk but not adjusted for credit risk. Loans receivable also includes loans receivable held for sale.

The fair value of deposits and borrowings with stated maturities has been estimated using the present value of cash flows, discounted at rates approximating current market rates for similar liabilities. Fair value of deposits and borrowings with floating interest rates is generally presumed to approximate the recorded carrying amounts.

The fair value of deposits with no stated maturities is generally presumed to approximate the carrying amount (the amount payable on demand). The fair value of deposits with floating interest rates is generally presumed to approximate the recorded carrying amounts.

The Bank's remaining assets and liabilities are not considered financial instruments. No disclosure of the relationship value of the Bank's depositors or customers is required.



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## NOTE 8—STOCK-BASED COMPENSATION

The Company has stock benefit plans that allow the Company to grant options and restricted stock to employees and directors. The awards, which have a term of up to 10 years when issued, vest over a three to five year period. The exercise price of each award equals the market price of the Company's stock on the date of the grant. At September 30, 2012, there was \$29,000 of total unrecognized compensation cost, net of estimated forfeitures, related to non-vested awards under the Company's stock option plan. That cost is expected to be recognized over a weighted average period of 6.7 months. Option activity under the Company's stock option plan as of September 30, 2012 was as follows:

|   |           | At September 30, 2012 |             |           |
|---|-----------|-----------------------|-------------|-----------|
|   | Number of | Weighted              | Weighted    | Aggregate |
|   | shares    | average               | average     | intrinsic |
|   |           | exercise              | remaining   | value     |
|   |           | price per             | contractual | (\$000)   |
|   |           | share                 | term (in    |           |
|   |           |                       | years)      |           |
| Outstanding at January 1, 2012            | 109,765   | \$24.41               |             |           |
| Options granted                           | —         | —                     |             |           |
| Options exercised                         | (315 )    | 19.67                 |             |           |
| Options forfeited                         | (776 )    | 28.75                 |             |           |
| Options expired                           | (257 )    | 28.25                 |             |           |
| Outstanding at September 30, 2012         | 108,417   | \$24.39               | 1.85        | \$178     |
| Options exercisable at September 30, 2012 | 91,177    | \$25.28               | 1.62        | \$107     |

The aggregate intrinsic value in the table above represents the total pre-tax intrinsic value (the difference between the Company's closing stock price on the last trading day of the third quarter and the exercise price, multiplied by the number of in-the-money options).

The aggregate intrinsic value and cash receipts of options exercised are as follows:

|  | For the nine months<br>ended<br>September 30,<br>2012      2011<br>(in thousands) |     |
|--|---|-----|
| Options Exercised                              |   |     |
| Aggregate intrinsic value of options exercised | \$6   | \$— |
| Cash receipts from options exercised           | 7   | —   |

In July 2011, the Company issued stock of the Company as payment for director fees as permitted by the 2011 Director Stock Compensation Plan, the cost associated with these grants is included as a component of stock-based compensation.

The following tables provide information regarding the Company's stock-based compensation expense:

| For the three months<br>ended<br>September 30,<br>2012      2011 |  |
|--|--|
|--|--|

(in thousands)

|  |       |      |
|--|-------|------|
| Stock-based compensation expense               |       |      |
| Director fees                                  | \$38  | \$34 |
| Stock grant expense                            | —     | 3    |
| Stock option expense                           | 6     | 8    |
| Employee Stock Ownership Plan ("ESOP") expense | 68    | 53   |
| Total stock-based compensation expense         | \$112 | \$98 |

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|  | For the nine months<br>ended<br>September 30,<br>2012          2011<br>(in thousands) |        |
|--|---|--------|
| Stock-based compensation expense               |   |        |
| Director fees                                  | \$ 112  | \$ 34  |
| Stock grant expense                            | —   | 9      |
| Stock option expense                           | 20  | 24     |
| Employee Stock Ownership Plan ("ESOP") expense | 210   | 168    |
| Total stock-based compensation expense         | \$ 342  | \$ 235 |

The Bank reports ESOP expense in an amount equal to the fair value of shares released from the ESOP to employees less dividends received on the allocated shares in the plan used for debt service. Dividends on allocated shares used to reduce ESOP expense totaled \$8,000 and \$9,000 for the three months ended September 30, 2012 and 2011, respectively. Stock-based compensation expense related to stock options resulted in a tax benefit of \$2,000 for the three months ended September 30, 2012 and 2011.

Dividends on allocated shares used to reduce ESOP expense totaled \$24,000 and \$27,000 for the nine months ended September 30, 2012 and 2011, respectively. Stock-based compensation expense related to stock options resulted in a tax benefit of \$7,000 and \$9,000 for the nine months ended September 30, 2012 and 2011, respectively.

## NOTE 9—EMPLOYEE BENEFIT PLANS

Net periodic defined benefit pension cost included the following:

|   | For the three months<br>ended<br>September 30,<br>2012          2011<br>(in thousands) |        |
|---|--|--------|
| Components of net periodic benefit cost |  |        |
| Service cost                            | \$ 184   | \$ 141 |
| Interest cost                           | 90   | 82     |
| Expected return on plan assets          | (161 )   | (156 ) |
| Recognized net actuarial loss           | 71   | 30     |
| Net periodic benefit cost               | \$ 184   | \$ 97  |

|   | For the nine months<br>ended<br>September 30,<br>2012          2011<br>(in thousands) |        |
|---|---|--------|
| Components of net periodic benefit cost |   |        |
| Service cost                            | \$ 552  | \$ 424 |
| Interest cost                           | 270   | 246    |
| Expected return on plan assets          | (483 )  | (466 ) |
| Amortization of prior service cost      | 2   | —      |

|                               |       |       |
|-------------------------------|-------|-------|
| Recognized net actuarial loss | 212   | 88    |
| Net periodic benefit cost     | \$553 | \$292 |

There were no employer contributions for the nine months ended September 30, 2012 and 2011.

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TF FINANCIAL CORPORATION AND SUBSIDIARIES

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS  
(Unaudited)

GENERAL

The Company may from time to time make written or oral "forward-looking statements", including statements contained in the Company's filings with the Securities and Exchange Commission (including this Quarterly Report on Form 10-Q and the exhibits hereto), in its reports to stockholders and in other communications by the Company, which are made in good faith by the Company pursuant to the "Safe Harbor" Provisions of the Private Securities Litigation Reform Act of 1995.

These forward-looking statements involve risks and uncertainties, such as statements of the Company's plans, objectives, expectations, estimates and intentions that are subject to change based on various important factors (some of which are beyond the Company's control). The following factors, among others, could cause the Company's financial performance to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements: the strength of the United States economy in general and the strength of the local economies in which the Company conducts operations; the effects of, and changes in, trade, monetary and fiscal policies and laws, including interest rate policies of the Board of Governors of the Federal Reserve System, inflation, interest rate, market and monetary fluctuations; the timely development of and acceptance of new products and services of the Company and the perceived overall value of these products and services by users, including the features, pricing and quality compared to competitors' products and services; the willingness of users to substitute competitors' products and services for the Company's products and services; the success of the Company in gaining regulatory approval of its products and services, when required; the impact of changes in financial services' laws and regulations (including laws concerning taxes, banking, securities and insurance); technological changes, acquisitions; changes in consumer spending and saving habits; and the success of the Company at managing the risks involved in the foregoing.

The Company cautions that the foregoing list of important factors is not exclusive. The Company does not undertake to update any forward-looking statement, whether written or oral, that may be made from time to time by or on behalf of the Company.

Financial Condition

The Company's total assets at September 30, 2012 and December 31, 2011 were \$697.1 million and \$681.9 million, respectively, representing an increase of \$15.2 million during the nine-month period. Loans receivable, net increased by \$39.9 million during the first nine months of 2012. Originations of consumer and single-family residential mortgage loans totaling \$98.2 million and originations of commercial loans totaling \$12.1 million were partially offset by principal repayments of \$65.7 million. The Company increased the allowance for loan losses by \$1.8 million and transferred \$2.9 million from loans to real estate acquired through foreclosure. Loans receivable held for sale increased \$400,000 primarily because originations of loans for sale in the secondary market of \$39.7 million exceeded proceeds of \$39.5 million from loan sales. Investment securities decreased by \$8.1 million due to principal repayments and maturities totaling \$26.3 million and net premium amortization of \$361,000 which were offset by security purchases of \$17.8 million and an increase in the fair value of available for sale securities of \$870,000. Largely as a result of the increase in the loan portfolio, cash and cash equivalents decreased by \$11.2 million during the first nine months of 2012. The decrease in other assets was mainly due to the sale of foreclosed real estate.

Total liabilities increased by \$10.6 million during the first nine months of 2012. Advances from the FHLB increased by \$28.2 million, the result of new long term fixed rate advances of \$32.2 million and an increase in the outstanding balance of the line of credit of \$14.3 million, offset by scheduled amortization and maturities of \$18.3 million. Deposit balances decreased \$18.0 million during the period with checking and savings accounts increasing by \$12.7 million while money market accounts decreased \$1.7 million. Retail certificates of deposit (“CDs”) decreased \$29.1 million during the first nine months of 2012, largely due to the maturity of CDs which had been originated during periods of higher market interest rates, and were converted into other non-CD products or were withdrawn from the Bank.

Total consolidated stockholders’ equity of the Company was \$82.0 million or 11.8% of total assets at September 30, 2012. At September 30, 2012, there were approximately 102,000 shares available for repurchase under the previously announced share repurchase plan.

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## Asset Quality

Non-performing assets include real estate owned, which is carried at estimated fair value less costs to sell and non-performing loans. Non-performing loans include loan balances 90 days or more past due and impaired loans for which the accrual of interest has been discontinued. The following table sets forth information regarding the Company's non-performing assets:

| Non-Performing Assets  | September 30, | At                     |      | September 30, |
|--|---------------|------------------------|------|---------------|
|  | 2012          | December 31,           | 2011 | 2011          |
|  |               | (Dollars in thousands) |      |               |
| Loans receivable, net:   |               |                        |      |               |
| Residential  |               |                        |      |               |
| Residential mortgages  | \$ 2,122      | \$ 5,502               |      | \$ 5,144      |
| Commercial   |               |                        |      |               |
| Real estate-commercial   | 1,116         | 2,711                  |      | 5,317         |
| Real estate-residential  | 839           | —                      |      | —             |
| Construction loans   | 6,119         | 4,044                  |      | 6,205         |
| Commercial and industrial loans  | —             | 6                      |      | 160           |
| Consumer   |               |                        |      |               |
| Home equity and second mortgage  | 204           | 277                    |      | 277           |
| Other consumer   | —             | 1                      |      | —             |
| Total non-performing loans   | 10,400        | 12,541                 |      | 17,103        |
| Real estate owned  | 7,619         | 11,730                 |      | 8,909         |
| Total non-performing assets  | \$ 18,019     | \$ 24,271              |      | \$ 26,012     |
| Total loans 90 days or more past due as to interest or principal and accruing interest | \$ —          | \$ —                   |      | \$ —          |
| Ratio of non-performing loans to gross loans   | 1.92          | 2.49                   | %    | 3.32          |
| Ratio of non-performing loans to total assets  | 1.49          | 1.84                   | %    | 2.46          |
| Ratio of total non-performing assets to total assets                                   | 2.59          | 3.56                   | %    | 3.74          |

Non-performing commercial real estate loans include a loan with an unpaid principal balance of \$1.5 million secured by two contiguous parcels of commercial real estate and a lien on the guarantor's personal residence. The Bank has recorded a partial charge-off of \$932,000 from the allowance for loan losses, equal to the difference between the loan balance and the fair value based upon a recent appraisal. The Bank has initiated foreclosure proceedings and the borrower has filed for bankruptcy protection under Chapter 11 of the U.S. Bankruptcy Code. Additionally, \$185,000 of the allowance for loan losses has been allocated to this loan for potential acquisition or selling costs related to the properties.

Non-performing construction loans include a loan with an unpaid principal balance of \$1.8 million secured by five contiguous lots approved for construction of commercial and residential buildings. The Bank recorded a partial charge-off of \$432,000 from the allowance for loan losses equal to the difference between the loan balance and a recent appraisal. In addition, \$300,000 of the allowance for loan losses has been allocated to this loan for potential acquisition or selling costs related to the properties. The borrower is attempting to sell the properties and apply the proceeds toward the outstanding loan balance.

Non-performing construction loans also include two loans, with a combined balance of \$2.0 million secured by a parcel of land. The Bank has recorded a partial charge-off of \$202,000 from the allowance for loan losses equal to the difference between the recorded investment and a recent appraisal. The borrower is attempting to sell the property and intends to apply the sale proceeds to the outstanding loan balance. Additionally, \$29,000 of the allowance for loan losses has been allocated to this loan for potential acquisition or selling costs related to the property.

Non-performing construction loans also include a participation in a commercial construction project with a principal balance due to the Bank of \$3.1 million. The Bank has recorded a partial charge-off of \$198,000 from the allowance for loan losses equal to the difference between the recorded investment and a recent appraisal.



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Foreclosed property at September 30, 2012 consisted of seven parcels of real estate with a combined carrying value of \$7.6 million. During the first nine months of 2012, the Bank foreclosed on six mortgages secured by a residential property valued at \$2.9 million in the aggregate which resulted in a charge to the allowance of \$163,000. Also, the Bank sold 43 properties acquired through foreclosure with an aggregate book value of \$7.0 million. All foreclosed properties are listed or are in the process of being listed with real estate agents for sale in a timely manner. Foreclosed real estate is included in other assets in the consolidated balance sheet.

### Allowance for Loan Losses

The Bank provides valuation allowances for estimated losses from uncollectible loans. The allowance is increased by provisions charged to expense and reduced by net charge-offs. On a quarterly basis, the Company prepares an allowance for loan losses (ALLL) analysis. In the analysis, the loan portfolio is segmented into groups of homogeneous loans that share similar risk characteristics: commercial loans secured by non-residential or non-owner occupied residential real estate, construction, commercial and industrial loans, single family residential, and consumer which is predominately real estate secured junior liens and home equity lines of credit. Each segment is assigned reserve factors based on quantitative and qualitative measurements. In addition, the Bank reviews its internally classified loans, its loans classified for regulatory purposes, delinquent loans, and other relevant information in order to isolate loans for further scrutiny as potentially impaired loans.

Quantitative factors include an actual expected loss factor based on historical loss experience over a relevant look-back period. Quantitative factors also include the Bank's actual risk ratings for the commercial loan segments as determined in accordance with loan review and loan grading policies and procedures, and additional factors as determined by management to be representative of additional risk due to the loan's geographic location, type, and other attributes. These quantitative factors are adjusted if necessary, up or down, based on actual experience and an evaluation of the qualitative factors.

Qualitative factors are based upon: (1) changes in lending policies and procedures, including but not limited to changes in underwriting standards and collection, charge-off, and recovery practices not considered elsewhere in estimating credit losses; (2) changes in international, national, regional, and local economic and business conditions and developments that affect the collectability of the portfolio, including the condition of various market segments; (3) changes in the nature and volume of the portfolio and in the terms of loans; (4) changes in the experience, ability, and depth of lending management and other relevant staff; (5) changes in the volume and severity of past due loans, the volume of nonaccrual loans, and the volume and severity of adversely classified or graded loans; (6) changes in the quality of the loan review system; (7) changes in the value of underlying collateral for collateral dependent loans; (8) the existence and effect of any concentration of credit, and changes in the level of such concentrations; and (9) the effect of other external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the existing loan portfolio.

Potentially impaired loans selected for individual evaluation are reviewed in accordance with US GAAP which governs the accounting for impaired assets, as well as regulatory guidance regarding treatment of troubled, collateral-dependent loans. Each potentially impaired loan is evaluated using all available information such as recent appraisals, whether the loan is currently on accrual or non-accrual status, discounted cash flow analyses, guarantor financial strength, the value of additional collateral, and the loan's and borrower's past performance to determine whether in management's best judgment it is probable that the Bank will be unable to collect all contractual interest and principal in accordance with the loan's terms. Loans deemed not to be impaired are assigned a reserve factor based upon the segment from which they were selected.

Loans deemed impaired are evaluated to determine the estimated fair value of the collateral, and a portion of the ALLL will be allocated to the deficiency. Troubled collateral-dependent real estate secured loans are valued using the

appraised value of the collateral, and a portion of the ALLL will be allocated to these loans based on the difference between the loan amount and the appraised value. If such amounts are judged by management to be permanent, they will be charged-off. In addition, if foreclosure is probable, a portion of the ALLL will be allocated to the estimated additional costs to acquire and the estimated costs to sell. Upon completion of the foreclosure process, these amounts will be charged-off.

The ALLL needed as a result of the foregoing evaluation is compared with the unadjusted amount, and an adjustment is made by means of a provision to the allowance for loan losses. Recognizing the inherently imprecise nature of the loss estimates and the large number of assumptions needed in order to perform the analysis, the required reserve may be less than the actual level of reserves at the end of any evaluation period, and thus there may be an unallocated portion of the ALLL. Management adjusts the unallocated portion to an amount which management considers reasonable under the circumstances.

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## RESULTS OF OPERATIONS FOR THE THREE MONTHS ENDED SEPTEMBER 30, 2012 AND 2011

Net Income. The Company recorded net income of \$1.5 million, or \$0.54 per diluted share, for the three months ended September 30, 2012 as compared to net income of \$1.1 million, or \$0.40 per diluted share, for the three months ended September 30, 2011.

## Average Balance Sheet

The following table sets forth information (dollars in thousands) relating to the Company's average balance sheet and reflects the average yield on assets and average cost of liabilities for the periods indicated. Yields and costs are computed by dividing income or expense by the average daily balance of interest-earning assets or interest-bearing liabilities, respectively, for the three-month periods indicated.

|  | Three Months Ended September 30, |                  |                     |                    |                  |                     | Average<br>yld/cost |   |
|--|----------------------------------|------------------|---------------------|--------------------|------------------|---------------------|---------------------|---|
|  | Average<br>balance               | 2012<br>Interest | Average<br>yld/cost | Average<br>balance | 2011<br>Interest | Average<br>yld/cost |                     |   |
| <b>ASSETS</b>  |                                  |                  |                     |                    |                  |                     |                     |   |
| Interest-earning assets:   |                                  |                  |                     |                    |                  |                     |                     |   |
| Loans receivable(1)  | \$527,195                        | \$6,436          | 4.86                | %                  | \$502,574        | \$6,667             | 5.26                | % |
| Mortgage-backed securities   | 55,820                           | 453              | 3.23                | %                  | 66,283           | 702                 | 4.20                | % |
| Investment securities(2)   | 64,304                           | 699              | 4.32                | %                  | 67,662           | 705                 | 4.13                | % |
| Other interest-earning assets(3)   | 393                              | —                | *                   | %                  | 3,237            | —                   | *                   | % |
| Total interest-earning assets  | 647,712                          | 7,588            | 4.66                | %                  | 639,756          | 8,074               | 5.01                | % |
| Non interest-earning assets  | 46,168                           |                  |                     |                    | 53,907           |                     |                     |   |
| Total assets   | \$693,880                        |                  |                     |                    | \$693,663        |                     |                     |   |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                      |                                  |                  |                     |                    |                  |                     |                     |   |
| Interest-bearing liabilities:  |                                  |                  |                     |                    |                  |                     |                     |   |
| Deposits   | \$538,637                        | \$803            | 0.59                | %                  | \$555,713        | \$1,430             | 1.02                | % |
| Borrowings from the FHLB   | 66,740                           | 338              | 2.01                | %                  | 54,709           | 473                 | 3.43                | % |
| Total interest-bearing liabilities   | 605,377                          | 1,141            | 0.75                | %                  | 610,422          | 1,903               | 1.24                | % |
| Non interest-bearing liabilities   | 7,179                            |                  |                     |                    | 7,075            |                     |                     |   |
| Total liabilities  | 612,556                          |                  |                     |                    | 617,497          |                     |                     |   |
| Stockholders' equity   | 81,324                           |                  |                     |                    | 76,166           |                     |                     |   |
| Total liabilities and stockholders' equity                                       | \$693,880                        |                  |                     |                    | \$693,663        |                     |                     |   |
| Net interest income-tax equivalent basis   |                                  | 6,447            |                     |                    |                  | 6,171               |                     |   |
| Interest rate spread(4)-tax equivalent basis                                     |                                  |                  | 3.91                | %                  |                  |                     | 3.77                | % |
| Net yield on interest-earning assets(5)-tax equivalent basis                     |                                  |                  | 3.96                | %                  |                  |                     | 3.83                | % |
| Ratio of average interest-earning assets to average interest-bearing liabilities |                                  |                  | 106.99              | %                  |                  |                     | 104.81              | % |
| Less: tax-equivalent interest adjustments  |                                  | (193)            |                     |                    |                  | (166)               |                     |   |
| Net interest income  |                                  | \$6,254          |                     |                    |                  | \$6,005             |                     |   |
| Interest rate spread(4)  |                                  |                  | 3.79                | %                  |                  |                     | 3.67                | % |

|   |      |   |      |   |
|---|------|---|------|---|
| Net yield on interest-earning assets(5) | 3.84 | % | 3.72 | % |
|---|------|---|------|---|

- (1) ) Non-performing loans have been included in the appropriate average loan balance category, but interest on non-performing loans has not been included for purposes of determining interest income.
- (2) ) Tax equivalent adjustments to interest on investment securities were \$193,000 and \$166,000 for the quarters ended September 30, 2012 and 2011, respectively. Tax equivalent interest income is based upon a marginal effective tax rate of 34%.
- (3) ) Includes interest-bearing deposits in other banks.  
Interest rate spread represents the difference between the average yield on interest-earning assets and the
- (4) ) average cost of interest-bearing liabilities.  
Net yield on interest-earning assets represents net interest income as a percentage of average
- (5) ) interest-earning assets.
- \* Is less than \$500 for period indicated.

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## Rate/Volume Analysis

The following table presents, for the periods indicated, the change in interest income and interest expense (dollars in thousands) attributed to (i) changes in volume (changes in the weighted average balance of the total interest earning asset and interest bearing liability portfolios multiplied by the prior year rate), and (ii) changes in rate (changes in rate multiplied by prior year volume). Changes attributable to the combined impact of volume and rate have been allocated proportionately based on the absolute value of changes due to volume and changes due to rate.

|                                    | For the three months ended September 30, 2012 vs 2011 |           |         |
|------------------------------------|---|-----------|---------|
|                                    | Volume  | Rate      | Net     |
| Interest income:                   |   |           |         |
| Loans receivable, net              | \$1,496   | \$(1,727) | \$(231) |
| Mortgage-backed securities         | (101)   | (148)     | (249)   |
| Investment securities (1)          | (137)   | 131       | (6)     |
| Other interest-earning assets      | —   | —         | —       |
| Total interest-earning assets      | 1,258   | (1,744)   | (486)   |
| Interest expense:                  |   |           |         |
| Deposits                           | (43)  | (584)     | (627)   |
| Borrowings from the FHLB           | 491   | (626)     | (135)   |
| Total interest-bearing liabilities | 448   | (1,210)   | (762)   |
| Net change in net interest income  | \$810   | \$(534)   | \$276   |

(1) Tax equivalent adjustments to interest on investment securities were \$193,000 and \$166,000 for the quarters ended September 30, 2012 and 2011, respectively. Tax equivalent interest income is based upon a marginal effective tax rate of 34%.

**Total Interest Income.** Total interest income, on a taxable equivalent basis, decreased by \$486,000, or 6.0%, to \$7.6 million for the quarter ended September 30, 2012 compared with the third quarter of 2011. Interest income from loans receivable decreased by \$231,000, the result of a decrease in the average yield on loans of 40 basis points netted against the effect of a \$24.6 million increase in the average balance of loans outstanding. The decrease in the yield was caused by the combined effect of a large number of higher rate loans being prepaid, and new loans added to the portfolio with a lower yield than the existing portfolio loans that matured or refinanced. Interest income from mortgage-backed securities was lower in the 2012 quarter in comparison to the same period of 2011 mainly because the yield associated with principal repayments was higher than the yield on mortgage-backed securities purchased in the intervening period.

**Total Interest Expense.** Total interest expense decreased by \$762,000 to \$1.1 million during the three-month period ended September 30, 2012 as compared with the same period in 2011. The average interest rates paid on the Bank's deposits was 43 basis points lower in 2012 due to the maturity of certificates of deposit with higher interest rates than current market rates offered on the products into which the maturing CDs were renewed or reinvested, and a favorable change in the deposit mix and pricing. Interest expense associated with borrowings from the FHLB decreased \$135,000 between the third quarter of 2012 and the same quarter of 2011. During the intervening period, the Bank increased its average outstanding borrowings by \$12.0 million, which included increases in long-term and short-term advances with rates lower than the maturing advances, which resulted in a decrease in the cost of borrowed funds of 142 basis points.

Non-Interest Income. Total non-interest income was \$914,000 for the third quarter of 2012 compared with \$583,000 for the same period in 2011. Gain on the sale of loans was \$257,000 higher during the third quarter of 2012 as a result of a higher level of residential loan sales activity in the quarter.

Non-Interest Expense. Total non-interest expense decreased by \$200,000 to \$4.5 million for the three months ended September 30, 2012 compared to the same period in 2011. Foreclosed real estate expense decreased \$239,000 in the 2012 quarter as compared to the same period in 2011 mainly due to net losses totaling \$254,000 in 2011 that resulted from valuation adjustments and

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disposition of real estate acquired through foreclosure. Other operating expenses were \$93,000 lower in the third quarter of 2012 due to a decrease of \$40,000 in loan servicing expense and a \$27,000 decrease in supervisory examination costs due to the Bank's conversion to a state charter during the first quarter of 2012. Compensation and benefit expense increased by \$67,000, mainly due to the increased costs associated with the defined benefit plan which increased \$87,000 between the two quarters. Professional fees increased \$86,000 between the two periods as costs were higher during 2012 due to an increase in consulting services.

Income Tax Expense. The Company's effective tax rate was 24.5% for the quarter ended September 30, 2012 compared to 22.5% for the quarter ended September 30, 2011. These effective tax rates are lower than the Company's marginal tax rate of 34% largely due to the tax-exempt income associated with the Company's investments in tax-exempt municipal bonds and bank owned life insurance.

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## RESULTS OF OPERATIONS FOR THE NINE MONTHS ENDED SEPTEMBER 30, 2012 AND 2011

Net Income. The Company recorded net income of \$3.9 million, or \$1.42 per diluted share, for the nine months ended September 30, 2012 as compared to net income of \$2.4 million, or \$0.89 per diluted share, for the nine months ended September 30, 2011.

## Average Balance Sheet

The following table sets forth information (dollars in thousands) relating to the Company's average balance sheet and reflects the average yield on assets and average cost of liabilities for the periods indicated. Yields and costs are computed by dividing income or expense by the average daily balance of interest-earning assets or interest-bearing liabilities, respectively, for the nine-month periods indicated.

|  | Nine Months Ended September 30, |                  |                     |   |                    |                  | Average<br>yld/cost |   |
|--|---------------------------------|------------------|---------------------|---|--------------------|------------------|---------------------|---|
|  | Average<br>balance              | 2012<br>Interest | Average<br>yld/cost |   | Average<br>balance | 2011<br>Interest |                     |   |
| <b>ASSETS</b>  |                                 |                  |                     |   |                    |                  |                     |   |
| Interest-earning assets:   |                                 |                  |                     |   |                    |                  |                     |   |
| Loans receivable(1)  | \$507,521                       | \$18,864         | 4.96                | % | \$501,052          | \$19,946         | 5.32                | % |
| Mortgage-backed securities   | 59,776                          | 1,556            | 3.48                | % | 65,541             | 2,068            | 4.22                | % |
| Investment securities(2)   | 66,498                          | 2,154            | 4.33                | % | 67,714             | 2,155            | 4.25                | % |
| Other interest-earning assets(3)   | 5,676                           | 2                | 0.05                | % | 4,970              | 1                | 0.03                | % |
| Total interest-earning assets  | 639,471                         | 22,576           | 4.72                | % | 639,277            | 24,170           | 5.05                | % |
| Non interest-earning assets  | 48,345                          |                  |                     |   | 49,759             |                  |                     |   |
| Total assets   | \$687,816                       |                  |                     |   | \$689,036          |                  |                     |   |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                                      |                                 |                  |                     |   |                    |                  |                     |   |
| Interest-bearing liabilities:  |                                 |                  |                     |   |                    |                  |                     |   |
| Deposits   | \$547,700                       | \$2,795          | 0.68                | % | \$549,364          | \$4,328          | 1.05                | % |
| Borrowings from the FHLB   | 53,685                          | 1,094            | 2.72                | % | 57,688             | 1,537            | 3.56                | % |
| Total interest-bearing liabilities   | 601,385                         | 3,889            | 0.86                | % | 607,052            | 5,865            | 1.29                | % |
| Non interest-bearing liabilities   | 6,732                           |                  |                     |   | 6,867              |                  |                     |   |
| Total liabilities  | 608,117                         |                  |                     |   | 613,919            |                  |                     |   |
| Stockholders' equity   | 79,699                          |                  |                     |   | 75,117             |                  |                     |   |
| Total liabilities and stockholders' equity                                       | \$687,816                       |                  |                     |   | \$689,036          |                  |                     |   |
| Net interest income-tax equivalent basis   |                                 | 18,687           |                     |   |                    | 18,305           |                     |   |
| Interest rate spread(4)-tax equivalent basis                                     |                                 |                  | 3.86                | % |                    |                  | 3.76                | % |
| Net yield on interest-earning assets(5)-tax equivalent basis                     |                                 |                  | 3.90                | % |                    |                  | 3.83                | % |
| Ratio of average interest-earning assets to average interest-bearing liabilities |                                 |                  | 106.33              | % |                    |                  | 105.31              | % |
| Less: tax-equivalent interest adjustments  |                                 | (590)            |                     |   |                    | (495)            |                     |   |
| Net interest income  |                                 | \$18,097         |                     |   |                    | \$17,810         |                     |   |
| Interest rate spread(4)  |                                 |                  | 3.73                | % |                    |                  | 3.66                | % |



|   |      |   |      |   |
|---|------|---|------|---|
| Net yield on interest-earning assets(5) | 3.78 | % | 3.72 | % |
|---|------|---|------|---|

- (1) ) Non-performing loans have been included in the appropriate average loan balance category, but interest on non-performing loans has not been included for purposes of determining interest income.
- (2) ) Tax equivalent adjustments to interest on investment securities were \$590,000 and \$495,000 for the nine months ended September 30, 2012 and 2011, respectively. Tax equivalent interest income is based upon a marginal effective tax rate of 34%.
- (3) ) Includes interest-bearing deposits in other banks.  
Interest rate spread represents the difference between the average yield on interest-earning assets and the
- (4) ) average cost of interest-bearing liabilities.  
Net yield on interest-earning assets represents net interest income as a percentage of average
- (5) ) interest-earning assets.

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## Rate/Volume Analysis

The following table presents, for the periods indicated, the change in interest income and interest expense (dollars in thousands) attributed to (i) changes in volume (changes in the weighted average balance of the total interest earning asset and interest bearing liability portfolios multiplied by the prior year rate), and (ii) changes in rate (changes in rate multiplied by prior year volume). Changes attributable to the combined impact of volume and rate have been allocated proportionately based on the absolute value of changes due to volume and changes due to rate.

|                                    | For the nine months ended September 30, 2012 vs 2011 |           |           |
|------------------------------------|--|-----------|-----------|
|                                    | Volume   | Rate      | Net       |
| Interest income:                   |  |           |           |
| Loans receivable, net              | \$403  | \$(1,485) | \$(1,082) |
| Mortgage-backed securities         | (171)  | (341)     | (512)     |
| Investment securities (1)          | (51)   | 50        | (1)       |
| Other interest-earning assets      | —  | 1         | 1         |
| Total interest-earning assets      | 181  | (1,775)   | (1,594)   |
| Interest expense:                  |  |           |           |
| Deposits                           | (13)   | (1,520)   | (1,533)   |
| Borrowings from the FHLB           | (101)  | (342)     | (443)     |
| Total interest-bearing liabilities | (114)  | (1,862)   | (1,976)   |
| Net change in net interest income  | \$295  | \$87      | \$382     |

- (1) Tax equivalent adjustments to interest on investment securities were \$590,000 and \$495,000 for the nine months ended September 30, 2012 and 2011, respectively. Tax equivalent interest income is based upon a marginal effective tax rate of 34%.

**Total Interest Income.** Total interest income, on a taxable equivalent basis, decreased by \$1.6 million or 6.6% to \$22.6 million for the nine months ended September 30, 2012 compared with the first nine months of 2011. Interest income from loans receivable decreased by \$1.1 million, the result of a decrease in the average yield on loans of 36 basis points. The decrease in the yield was due to the combined effect of a large number of higher rate loans being prepaid, and new loans added to the portfolio with a lower yield than the existing portfolio loans that matured or refinanced. Interest income from mortgage-backed securities was lower in the first nine months of 2012 in comparison to the same period of 2011 mainly because the yield associated with repayments was higher than the yield on newly purchased mortgage-backed securities and to a lesser extent, a decrease in the average balance of these securities during the period.

**Total Interest Expense.** Total interest expense decreased by \$2.0 million to \$3.9 million during the nine-month period ended September 30, 2012 as compared with the same period in 2011. The average interest rates paid on the Bank's deposits was 37 basis points lower in the 2012 period due to the maturity of certificates of deposit with higher interest rates than current market rates offered on the products into which the maturing CDs were renewed or reinvested, and a favorable change in the deposit mix and pricing. Interest expense associated with borrowings from the FHLB decreased \$443,000 during the first nine months of 2012 as compared to the first nine months of 2011. During the intervening period, the Bank reduced its average outstanding borrowings from the FHLB by \$4.0 million, as a result of the maturity of higher rate borrowings, which resulted in a decrease in the cost of funds of the remaining

outstanding borrowings of 84 basis points.

**Non-Interest Income.** Total non-interest income was \$2.9 million for the first nine months of 2012 compared with \$2.2 million for the same period in 2011. During the first nine months of 2012, gains on the sale of loans increased by \$628,000 as a result of a higher level of residential loan sales activity in the period. The disposition of a branch property to a local municipality resulted in a gain of \$264,000 in 2012. The 2011 period had included gains on the sale of investment securities of \$210,000 and there were no such gains in 2012.

**Non-Interest Expense.** Total non-interest expense decreased by \$81,000 to \$14.2 million for the nine months ended September 30, 2012 compared to the same period in 2011. Foreclosed real estate expense increased \$208,000 in 2012 mainly due to

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valuation adjustments to the book value of real estate acquired through foreclosure and net losses from the sale of such assets of \$425,000. During 2011, valuation adjustments to the book value of real estate acquired through foreclosure net of gains from the sale of such assets had totaled \$254,000. Employee compensation and benefits increased by \$270,000, the combined result of annual salary increases and the increased costs associated with the defined benefit plan which increased \$261,000 between the two periods. In contrast, professional fees decreased \$191,000 between the two periods as legal and professional costs were incurred during 2011 in connection with the Company's reincorporation in Pennsylvania, the cost of distributing a 5% stock dividend in the first quarter of 2011 and the implementation of the Company's directors' stock compensation plan. In addition, the Company's professional fees associated with non performing loans and foreclosures were higher in 2011. Occupancy and equipment costs decreased \$185,000, which was mainly the result of a substantial reduction of costs associated with facility snow removal during 2012. FDIC insurance premiums decreased by \$79,000 between the two periods due to a change in the method of premium assessment. During the first quarter of 2011, premium assessments were based solely on deposit balances whereas under the new rules, the deposit insurance assessment base is the Bank's average total assets less its average tangible equity.

**Income Tax Expense.** The Company's effective tax rate was 23.5% for the nine months ended September 30, 2012 compared to 17.5% for the nine months ended September 30, 2011. These effective tax rates are lower than the Company's marginal tax rate of 34% largely due to the tax-exempt income associated with the Company's investments in tax-exempt municipal bonds and bank owned life insurance.

## LIQUIDITY AND CAPITAL RESOURCES

### Liquidity

The Bank's liquidity is a measure of its ability to fund loans, and pay withdrawals of deposits, and other cash outflows in an efficient, cost-effective manner. The Bank's short-term sources of liquidity include maturities, repayment and sales of assets, excess cash and cash equivalents, new deposits, brokered deposits, other borrowings, and new borrowings from the Federal Home Loan Bank and the Federal Reserve Bank. There has been no material adverse change during the nine-month period ended September 30, 2012 in the ability of the Bank and its subsidiaries to fund their operations.

At September 30, 2012, the Bank had commitments outstanding under letters of credit of \$807,000, commitments to originate loans of \$29.7 million, and commitments to fund undisbursed balances of closed loans and unused lines of credit of \$46.8 million. At September 30, 2012, the Bank had \$3.3 million in outstanding commitments to sell loans. There has been no material change during the nine months ended September 30, 2012 in any of the Bank's other contractual obligations or commitments to make future payments.

The Company's primary sources of liquidity are dividends from the Bank, principal and interest payments received from a loan made to the Bank's ESOP, and tax benefits arising from the use of the Company's tax deductions by other members of its consolidated group pursuant to a tax sharing agreement. The Company is dependent upon these sources and cash on hand which totaled approximately \$2.3 million at September 30, 2012 in order to fund its operations and pay the dividend to its shareholders. There has been no material adverse change in the ability of the Company to fund its operations during the nine-month period ended September 30, 2012.

### Capital Requirements

The Bank was in compliance with all of its capital requirements as of September 30, 2012.

## CRITICAL ACCOUNTING POLICIES

Certain critical accounting policies of the Company require the use of significant judgment and accounting estimates in the preparation of the consolidated financial statements and related data of the Company. These accounting estimates require management to make assumptions about matters that are highly uncertain at the time the accounting estimate is made. Management believes that the most critical accounting policy requiring the use of accounting estimates and judgment is the determination of the allowance for loan losses. If the financial position of a significant number of debtors or the value of the collateral securing the loans should deteriorate more than the Company has estimated, the present allowance for loan losses may be insufficient and additional provisions for loan losses may be required. The allowance for loan losses was approximately \$6.8 million at September 30, 2012.

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ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

As a “smaller reporting company” as defined by Item 10 of Regulation S-K, the Company is not required to provide the information required by this item.

ITEM 4. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Based on their evaluation of the Company’s disclosure controls and procedures (as defined in Rules 13a-15(e) under the Securities Exchange Act of 1934 (the “Exchange Act”)), the Company’s principal executive officer and principal financial officer have concluded that as of the end of the period covered by this Quarterly Report on Form 10-Q such disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in the reports it files and submits pursuant to the rules and forms of the SEC is accumulated and communicated to the Company’s management including the principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosures.

Changes in Internal Controls over Financial Reporting

During the quarter under report, there was no change in the Company’s internal control over financial reporting that has materially affected, or is reasonably likely to materially affect, the Company’s internal control over financial reporting.

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TF FINANCIAL CORPORATION AND SUBSIDIARIES

PART II-OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS

Neither the Company nor its subsidiaries are involved in any pending legal proceedings, other than routine legal matters occurring in the ordinary course of business that in the aggregate involve amounts which are believed by management to be immaterial to the consolidated financial condition or results of operations of the Company.

ITEM 1A. RISK FACTORS

As a “smaller reporting company” as defined by Item 10 of Regulation S-K, the Company is not required to provide the information required by this item.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

None.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES

Not applicable.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable

ITEM 5. OTHER INFORMATION

None.

ITEM 6. EXHIBITS

|     |          |   |
|-----|----------|---|
| (a) | Exhibits |   |
|     | 31.1     | Certification of CEO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
|     | 31.2     | Certification of CFO pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
|     | 32.      | Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.        |
|     | 101.INS  | XBRL Instance Document  |
|     | 101.SCH  | XBRL Taxonomy Extension Schema Document   |
|     | 101.CAL  | XBRL Taxonomy Extension Calculation Linkbase Document                           |
|     | 101.LAB  |   |

|         |  |
|---------|--|
|         | XBRL Taxonomy Extension Label Linkbase Document        |
| 101.PRE | XBRL Taxonomy Extension Presentation Linkbase Document |
| 101.DEF | XBRL Taxonomy Definition Linkbase Document             |



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TF FINANCIAL CORPORATION

SIGNATURES

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

Date: November 13, 2012

/s/ Kent C. Lufkin  
Kent C. Lufkin  
President and CEO  
(Principal Executive Officer)

Date: November 13, 2012

/s/ Dennis R. Stewart  
Dennis R. Stewart  
Executive Vice President and Chief  
Financial Officer  
(Principal Financial & Accounting Officer)