PATHFINDER BANCORP INC
Form 10-Q
November 13, 2009

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

FORM 10-Q

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

For the quarterly period ending September 30, 2009

OR

[ ]TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from _______ to _______

Commission File Number: 000-23601

PATHFINDER BANCORP, INC.
(Exact Name of Company as Specified in its Charter)

FEDERAL (State or Other Jurisdiction of Incorporation or Organization)	16-1540137 (I.R.S. Employer Identification Number)

214 West First Street, Oswego, NY 13126
(Address of Principal Executive Office) (Zip Code)

(315) 343-0057
(Issuer's Telephone Number including area code)

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

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

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

Large accelerated filer* Accelerated filer* Non-accelerated filer* Smaller reporting company T
(Do not check if a smaller reporting company)

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

As of November 13, 2009, there were 2,484,832 shares outstanding of the Registrant’s Common Stock.

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PATHFINDER BANCORP, INC.

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PART I FINANCIAL INFORMATION
Item 1 – Consolidated Financial Statements

Pathfinder Bancorp, Inc.
Consolidated Statements of Condition
(Unaudited)

(In thousands, except share data)	September 30, 2009	December 31, 2008
ASSETS:		
Cash and due from banks	$12,199	$7,365
Interest earning deposits	12,080	313
Total cash and cash equivalents	24,279	7,678
Investment securities, at fair value	65,559	72,138
Federal Home Loan Bank stock, at cost	1,809	2,549
Loans	254,425	249,872
Less: Allowance for loan losses	2,960	2,472
Loans receivable, net	251,465	247,400
Premises and equipment, net	7,237	7,450
Accrued interest receivable	1,465	1,678
Foreclosed real estate	417	335
Goodwill	3,840	3,840
Bank owned life insurance	6,900	6,731
Other assets	2,011	2,961
Total assets	$364,982	$352,760
LIABILITIES AND SHAREHOLDERS' EQUITY:		
Deposits:		
Interest-bearing	$266,000	$243,288
Noninterest-bearing	26,618	26,150
Total deposits	292,618	269,438
Short-term borrowings	1,000	17,575
Long-term borrowings	33,000	34,400
Junior subordinated debentures	5,155	5,155
Other liabilities	4,778	6,697
Total liabilities	336,551	333,265
Shareholders' equity:		
Preferred stock, par value $0.01 per share; $1,000 liquidation preference; 1,000,000 shares authorized; 6,771 shares issued and outstanding as of September 30, 2009; 0 shares issued and outstanding as of December 31, 2008	6,071	-
Common stock, par value $0.01; authorized 10,000,000 shares; 2,972,119 and 2,484,832 shares issued and outstanding as of September 30, 2009 and December 31, 2008	30	30
Additional paid in capital	8,615	7,909
Retained earnings	22,126	21,198
Accumulated other comprehensive loss	(1,909)	(3,140)
Treasury stock, at cost; 487,287 shares	(6,502)	(6,502)
Total shareholders' equity	28,431	19,495
Total liabilities and shareholders' equity	$364,982	$352,760

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

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Pathfinder Bancorp, Inc.
Consolidated Statements of Operations
(Unaudited)

(In thousands, except per share data)	For the three months ended September 30, 2009	For the three months ended September 30, 2008
Interest and dividend income:		
Loans, including fees	$ 3,686	$ 3,755
Debt securities:		
Taxable	619	764
Tax-exempt	3	44
Dividends	81	91
Federal funds sold and interest earning deposits	2	5
Total interest income	4,391	4,659
Interest expense:		
Interest on deposits	1,020	1,320
Interest on short-term borrowings	7	103
Interest on long-term borrowings	365	455
Total interest expense	1,392	1,878
Net interest income	2,999	2,781
Provision for loan losses	247	270
Net interest income after provision for loan losses	2,752	2,511
Noninterest income:		
Service charges on deposit accounts	382	397
Earnings on bank owned life insurance	56	56
Loan servicing fees	64	67
Losses on impairment of investment securities	-	(1,834)
Net gains on sales of investment securities	231	26
Net gains (losses) on sales of loans and foreclosed real estate	15	(85)
Debit card interchange fees	69	71
Other charges, commissions & fees	155	127
Total noninterest income (loss)	972	(1,175)
Noninterest expense:		
Salaries and employee benefits	1,402	1,284
Building occupancy	312	331
Data processing expenses	322	335
Professional and other services	239	158
Regulatory assessments	218	16
Other expenses	371	338
Total noninterest expenses	2,864	2,462
Income (loss) before income taxes	860	(1,126)
Provision (benefit) for income taxes	293	(288)
Net income (loss)	$ 567	$ (838)
Preferred stock dividends and discount accretion	$ 25	$ -
Net income (loss) available to common shareholders	$ 542	$ (838)
Earnings (loss) per common share - basic	$ 0.22	$ (0.34)

Earnings (loss) per common share - diluted	$	0.22	$	(0.34)
Dividends per common share	$	0.03	$	0.1025

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

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Pathfinder Bancorp, Inc.
Consolidated Statements of Operations
(Unaudited)

(In thousands, except per share data)	For the nine months ended September 30, 2009	For the nine months ended September 30, 2008
Interest and dividend income:		
Loans, including fees	$ 10,999	$ 10,943
Debt securities:		
Taxable	2,001	2,219
Tax-exempt	16	126
Dividends	243	318
Federal funds sold and interest earning deposits	3	59
Total interest income	13,262	13,665
Interest expense:		
Interest on deposits	3,471	4,332
Interest on short-term borrowings	26	329
Interest on long-term borrowings	1,176	1,174
Total interest expense	4,673	5,835
Net interest income	8,589	7,830
Provision for loan losses	654	550
Net interest income after provision for loan losses	7,935	7,280
Noninterest income:		
Service charges on deposit accounts	1,099	1,131
Earnings on bank owned life insurance	169	179
Loan servicing fees	175	218
Losses on impairment of investment securities	(298)	(2,176)
Net gains on sales of investment securities	319	26
Net gains (losses) on sales of loans and foreclosed real estate	80	(79)
Debit card interchange fees	206	207
Other charges, commissions & fees	366	334
Total noninterest income (loss)	2,116	(160)
Noninterest expense:		
Salaries and employee benefits	4,151	3,863
Building occupancy	941	1,009
Data processing expenses	997	974
Professional and other services	654	580
Regulatory assessments	438	38
Other expenses	1,073	944
Total noninterest expenses	8,254	7,408
Income (loss) before income taxes	1,797	(288)

Provision (benefit) for income taxes		620		(82)
Net income (loss)	$	1,177	$	(206)
Preferred stock dividends and discount accretion	$	25	$	-
Net income (loss) available to common shareholders	$	1,152	$	(206)
Earnings (loss) per share - basic	$	0.46	$	(0.08)
Earnings (loss) per share - diluted	$	0.46	$	(0.08)
Dividends per share	$	0.09	$	0.3075

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

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Pathfinder Bancorp, Inc.
Consolidated Statements of Changes in Shareholders' Equity
Nine Months Ended September 30, 2009 and September 30, 2008
(Unaudited)

(In thousands, except share data)	Preferred Stock	Common Stock	Additional Paid in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Total
Balance, January 1, 2009	-	$ 30	$ 7,909	$ 21,198	$ (3,140)	$ (6,502)	$ 19,495
Comprehensive income:							
Net income				1,177			1,177
Other comprehensive income, net of tax:							
Unrealized holding gains on securities available for sale (net of $588 tax expense)					1,106		1,106
Retirement plan net losses and transition obligation recognized in plan expenses (net of $84 tax expense)					125		125
Total Comprehensive income							2,408
Preferred stock and common stock warrants issued	6,065		706				6,771
Preferred stock discount accretion	6			(6)			-
Preferred stock dividends				(19)			(19)
Common stock dividends declared ($0.09 per share)				(224)			(224)
Balance, September 30, 2009	$ 6,071	$ 30	$ 8,615	$ 22,126	$ (1,909)	$ (6,502)	$ 28,431
Balance, January 1, 2008	-	$ 30	$ 7,900	$ 21,734	$ (1,458)	$ (6,502)	$ 21,704
Cumulative effect of a change in accounting principle upon the change in defined employee benefit plans' measurement date under FASB ASC 715 (net of $8 tax expense)				(48)	13		(35)
Comprehensive loss:							
Net loss				(206)			(206)

Other comprehensive loss, net of tax:							
Unrealized holding losses on securities available for sale (net of $175 tax benefit)					(317)		(317)
Retirement plan losses and transition obligation not recognized in plan expenses (net of $26 tax expense)					38		38
Total Comprehensive loss							(485)
Stock options exercised			9				9
Dividends declared ($0.3075 per share)				(602)			(602)
Balance, September 30, 2008	-	$ 30	$ 7,909	$ 20,878	$ (1,724)	$ (6,502)	$ 20,591

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

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

(In thousands)	For the nine months ended September 30, 2009	For the nine months ended September 30, 2008
OPERATING ACTIVITIES		
Net income (loss)	$ 1,177	$ (206)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Provision for loan losses	654	550
Proceeds from sales of loans	9,322	-
Originations of loans held-for-sale	(9,210)	-
Realized losses (gains) on sales of:		
Foreclosed real estate	32	79
Loans	(112)	-
Available-for-sale investment securities	(319)	(26)
Impairment write-down on available-for-sale securities	298	2,176
Depreciation	493	529
Amortization of mortgage servicing rights	22	24
Earnings on bank owned life insurance	(169)	(179)
Net (accretion) amortization of premiums and discounts on investment securities	(84)	85
Decrease in accrued interest receivable	213	36
Net change in other assets and liabilities	(1,291)	63
Net cash provided by operating activities	1,026	3,131
INVESTING ACTIVITIES		
Purchase of investment securities available-for-sale	(21,379)	(31,730)
Net proceeds from the redemption of (purchase of) Federal Home Loan Bank stock	740	(654)
Proceeds from maturities and principal reductions of investment securities available-for-sale	15,999	15,402
Proceeds from sale of:		
Available-for-sale investment securities	13,758	3,494
Real estate acquired through foreclosure	265	773
Net increase in loans	(5,100)	(20,729)
Purchase of premises and equipment	(280)	(206)
Net cash provided by (used in) investing activities	4,003	(33,650)
FINANCING ACTIVITIES		
Net increase in demand deposits, NOW accounts, savings accounts, money market deposit accounts, MMDA accounts and escrow deposits	20,933	12,832
Net increase in time deposits	2,247	837
Net (repayments on) proceeds from short-term borrowings	(16,575)	3,355
Payments on long-term borrowings	(3,400)	(8,610)
Proceeds from long-term borrowings	2,000	24,000
	6,771	-

Proceeds from the issuance of preferred stock and common stock warrants				
Proceeds from exercise of stock options		-		9
Cash dividends paid		(404)		(440)
Net cash provided by financing activities		11,572		31,983
Increase in cash and cash equivalents		16,601		1,464
Cash and cash equivalents at beginning of period		7,678		10,213
Cash and cash equivalents at end of period	$	24,279	$	11,677
CASH PAID DURING THE PERIOD FOR:				
Interest	$	4,721	$	5,861
Income Taxes		521		160
NON-CASH INVESTING ACTIVITY				
Transfer of loans to foreclosed real estate		381		243

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

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Pathfinder Bancorp, Inc.
Note to Consolidated Financial Statements
(Unaudited)

(1) Basis of Presentation

The accompanying unaudited consolidated financial statements of Pathfinder Bancorp, Inc. and its wholly owned subsidiaries have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information, the instructions for Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes necessary for a complete presentation of consolidated financial position, results of operations, and cash flows in conformity with generally accepted accounting principles. In the opinion of management, all adjustments, consisting of normal recurring accruals, considered necessary for a fair presentation have been included. Certain amounts in the 2008 consolidated financial statements have been reclassified to conform to the current period presentation. These reclassifications had no effect on net income as previously reported. The Company has evaluated subsequent events and transactions occurring through the date of issuance of the financial data included herein, November 13, 2009.

The Company follows accounting standards set by the Financial Accounting Standards Board, commonly referred to as the "FASB". The FASB sets generally accepted accounting principals ("GAAP") that the Company follows. References to GAAP issued by the FASB in these footnotes are to the FASB Accounting Standards Codification, sometimes referred to as the Codification or ASC. The FASB finalized the Codification effective for periods ending on or after September 15, 2009.

The following material under the heading "Management's Discussion and Analysis of Financial Condition and Results of Operations" is written with the presumption that the users of the interim financial statements have read, or have access to, the Company's latest audited financial statements and notes thereto, together with Management's Discussion and Analysis of Financial Condition and Results of Operations as of December 31, 2008 and for the two year period then ended. Therefore, only material changes in financial condition and results of operations are discussed in the remainder of Part 1.

Operating results for the nine months ended September 30, 2009, are not necessarily indicative of the results that may be expected for the year ending December 31, 2009.

(2) Earnings per Share

Basic earnings per share has been computed by dividing net income by the weighted average number of common shares outstanding throughout the three months and nine months ended September 30, 2009 and 2008, using 2,484,832 and 2,484,364 weighted average common shares outstanding for the three month periods and 2,484,832 and 2,483,944 for the nine month periods, respectively. Diluted earnings per share for the three months and nine months ended September 30, 2009 and 2008, have been computed using 2,486,652 and 2,484,364 for the three month periods and 2,485,445 and 2,483,944 for the nine month periods, respectively. Diluted earnings per share gives effect to weighted average shares that would be outstanding assuming the exercise of issued stock options and warrants using the treasury stock method.

(3) Pension and Postretirement Benefits

On January 1, 2008, the Company recorded a $48,000 charge to retained earnings, representing the cumulative effect adjustment upon adopting the measurement date transition rule for the Company's pension plan and post retirement benefit plan. In accordance with FASB ASC 715-20-65, Compensation – Retirement Benefits, measurement date provisions, plan assets and obligations are to be measured as of the employer's balance sheet date. The Company previously measured its pension plan as of October 1 of each year. As a result of the measurement date provisions, the Company decreased its pension plan asset with a corresponding charge to retained earnings, representing the net periodic benefit cost for the period between the October 1, 2007 measurement date and January 1, 2008.

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The composition of net periodic pension plan costs for the three months and nine months ended September 30, is as follows:

(In thousands)	For the three months ended September 30, 2009	2008	For the nine months ended September 30, 2009	2008
Service cost	$57	$54	$171	$162
Interest cost	83	79	250	237
Expected return on plan assets	(68)	(112)	(204)	(335)
Amortization of net losses	65	16	194	49
Net periodic benefit cost	$137	$37	$411	$113

The composition of net periodic postretirement plan costs for the three months and nine months ended September 30, is as follows:

(In thousands)	For the three months ended September 30, 2009	2008	For the nine months ended September 30, 2009	2008
Service cost	$1	$1	$2	$2
Interest cost	5	5	16	16
Amortization of transition obligation	5	5	14	14
Amortization of net losses	-	-	1	-
Net periodic benefit cost	$11	$11	$33	$32

The Company made a non-recurring contribution to the defined benefit pension plan of $2,000,000 during the second quarter of 2009. The large contribution was made to reduce the overall plan funding shortfall and mitigate future anticipated pension expense increases.

(4) Comprehensive Income

Accounting principles generally accepted in the United States of America require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, and unrecognized gains and losses, prior service costs and transition assets or obligations for defined benefit pension and post-retirement plans are reported as a separate component of the shareholders' equity section of the consolidated statements of condition, such items, along with net income, are components of comprehensive income.

The components of other comprehensive income (loss) and related tax effects for the three and nine months ended September 30 are as follows:

(In thousands)	For the three months ended September 30, 2009	2008	For the nine months ended September 30, 2009	2008
Unrealized holding gains (losses) on securities available for sale:				
Unrealized holding gains (losses) arising during the period	$1,718	$(952)	$1,715	$(2,678)
	-	1,834	298	2,176

Reclassification adjustment for impairment charges included in net income				
Reclassification adjustment for net gains included in net income	(232)	(26)	(319)	(26)
Net unrealized gains (losses) on securities available for sale	1,486	856	1,694	(528)
Defined benefit pension and post retirement plans:				
Reclassification adjustment for amortization of benefit plans' net loss and transition obligation recognized in net periodic expense	70	21	210	63
Net change in defined benefit plan	70	21	210	63
Other comprehensive income (loss) before tax	1,556	877	1,904	(465)
Tax effect	(484)	(350)	(673)	186
Other comprehensive income (loss)	$1,072	$527	$1,231	$(279)

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The components of accumulated other comprehensive loss and related tax effects for the periods indicated are as follows:

(In thousands)	September 30, 2009	December 31, 2008
Unrealized gains (losses) on securities available for sale		
(net of tax expense 2009 - $384; net of tax benefit 2008 - $205)	$ 53	$ (1,053)
Net pension losses		
(net of tax benefit 2009 - $1,274; 2008 - $1,352)	(1,911)	(2,027)
Net post-retirement plan losses and transition obligation		
(net of tax benefit 2009 - $34; 2008 - $40)	(51)	(60)
	$ (1,909)	$ (3,140)

(5) Investment Securities

The amortized cost and estimated fair value of investment securities are summarized as follows:

	September 30, 2009			
(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Bond investment securities:				
US Treasury and agencies	$6,522	$47	$-	$6,569
State and political subdivisions	2,633	61	(5)	2,689
Corporate	8,822	314	(706)	8,430
Residential mortgage-backed	39,477	1,294	(43)	40,728
Total	57,454	1,716	(754)	58,416
Equity investment securities:				
Mutual funds	5,179	3	(525)	4,657
Common stock	313	-	(4)	309
Total	5,492	3	(529)	4,966
Other investments	2,177	-	-	2,177
Total investment securities	$65,123	$1,719	$(1,283)	$65,559

	December 31, 2008			
(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Bond investment securities:				
US Treasury and agencies	$9,126	$342	$-	$9,468
State and political subdivisions	5,020	23	(70)	4,973
Corporate	12,181	117	(1,472)	10,826
Residential mortgage-backed	39,478	707	(155)	40,030
Total	65,805	1,189	(1,697)	65,297
Equity investment securities:				
Mutual funds	5,179	-	(744)	4,435
Common stock	313	-	(6)	307
Total	5,492	-	(750)	4,742
Other investments	2,099	-	-	2,099

Total investment securities	$73,396	$1,189	$(2,447)	$72,138

The amortized cost and estimated fair value of debt investments at September 30, 2009 by contractual maturity are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without penalties.

(In thousands)	Amortized Cost	Estimated Fair Value
Due in one year or less	$ 863	$ 873
Due after one year through five years	10,576	10,809
Due after five years through ten years	1,509	1,599
Due after ten years	5,029	4,407
Residential mortgage-backed securities	39,477	40,728
Totals	$ 57,454	$ 58,416

The Company's investment securities' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, are as follows:

	September 30, 2009					
	Less than Twelve Months		Twelve Months or More		Total	
(In thousands)	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value
State and political subdivisions	$ (5)	$ 517	$ -	$ -	$ (5)	$ 517
Corporate	-	-	(706)	1,258	(706)	1,258
Residential mortgage-backed	(5)	3,027	(38)	1,362	(43)	4,389
Mutual funds	-	-	(525)	4,471	(525)	4,471
Common stock	-	-	(4)	24	(4)	24
	$ (10)	$ 3,544	$ (1,273)	$ 7,115	$ (1,283)	$ 10,659

	December 31, 2008					
	Less than Twelve Months		Twelve Months or More		Total	
(In thousands)	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value
State and political subdivisions	$ (70)	$ 2,134	$ -	$ -	$ (70)	$ 2,134
Corporate	(327)	5,349	(1,145)	2,805	(1,472)	8,154
Residential mortgage-backed	(150)	7,491	(5)	734	(155)	8,225
Mutual funds	(744)	4,251	-	-	(744)	4,251
Common stock	-	-	(6)	21	(6)	21
	$ (1,291)	$ 19,225	$ (1,156)	$ 3,560	$ (2,447)	$ 22,785

We conduct a formal review of investment securities on a quarterly basis for the presence of other-than-temporary impairment ("OTTI"). In the second quarter of 2009, we adopted the updated guidance in FASB ASC 320-10, Investments – Debt and Equity Securities, on determining OTTI on securities. We assess whether OTTI is present when the fair value of a debt security is less than its amortized cost basis at the balance sheet date. Under these circumstances, OTTI is considered to have occurred (1) if we intend to sell the security; (2) if it is "more likely than not" we will be required to sell the security before recovery of its amortized cost basis; or (3) the present value of expected cash flows is not sufficient to recover the entire amortized cost basis. The "more likely than not" criteria is a lower threshold than the "probable" criteria used under previous guidance. The guidance requires that credit-related OTTI is recognized in earnings while noncredit-related OTTI on securities not expected to be sold is recognized in other comprehensive income ("OCI"). Noncredit-related OTTI is based on other factors, including illiquidity. As required, presentation of OTTI should be made in the statement of income on a gross basis, including both the portion recognized in earnings as well as the portion recorded in OCI. Normally, the gross OTTI would then be offset by the amount of noncredit-related OTTI, showing the net as the impact on earnings. All OTTI charges have been credit-related in 2009, and therefore no offset was presented on the financial statements. Additional disclosures are also required by this guidance.

For debt security types discussed below, where no OTTI is considered necessary at September 30, 2009, we applied the criteria of FASB ASC 320-10-65, Investments – Debt and Equity Securities. That is, we do not intend to sell the securities and it is not "more likely than not" that we will be required to sell the securities before recovery of their amortized cost basis.

At September 30, 2009, two corporate securities were in unrealized loss positions. The two securities in the unrealized loss positions represent trust-preferred issuances from large money center financial institutions. The JP Morgan Chase floating rate trust-preferred security has a carrying value of $984,000 and a fair value of $678,000. The Bank of America

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floating rate trust-preferred security has a carrying value of $979,000 and a fair value of $580,000. The securities are rated A1 and Baa3, respectively, by Moody's. The securities are both floating rate notes that adjust quarterly to LIBOR. These securities reflect net unrealized losses due to the fact that current similar issuances are being originated at much higher spreads to LIBOR, as the market currently demands a greater pricing premium for the associated risk in the current economic environment. Management has performed a detailed credit analysis on the underlying companies and has concluded that each issue is not credit impaired thus, the securities are not deemed to be other-than-temporarily impaired. Due to the fact that each security has in excess of 17 years until final maturity, and management has determined that there is no related credit impairment, the associated pricing risk is managed similar to long-term, low yielding, 15 and 30 year fixed rate residential mortgages carried in the Company's loan portfolio. The risk is managed through the Company's extensive interest rate risk management procedures.

At September 30, 2009, five private label CMOs and two agency mortgage-backed securities are currently in unrealized loss positions. All seven of the above mentioned securities are currently rated AAA. These unrealized losses relate principally to changes in interest rates subsequent to the acquisition of the specific securities. None of the securities in this category had an unrealized loss that exceeded 7% of the carrying value of the security. Management reviewed the underlying mortgage collateral associated with its holdings in CMOs and agency MBS noting the underlying credit score information, loan-to-value information, and the concentration risk associated with the geographic area that the majority of the underlying mortgage collateral resides in. Based on the relatively high composite credit ratings and low average loan-to-value ratios identified, combined with the low collateral concentrations in the more troubled states, management deems that no other-than-temporary impairment is present.

In determining whether OTTI has occurred for equity securities, the Company considers the applicable factors described above and the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Management has determined that we have the intent and ability to retain the equity securities for a sufficient period of time to allow for recovery.

The Company presently holds in its investment portfolio a $2.8 million investment in a no-load mutual fund, which invests primarily in mortgage-related instruments. The fund holds mortgage-backed bonds and securities issued by government-sponsored mortgage entities and by private companies. The underlying assets are comprised of variable rate, adjustable rate and fixed-rate residential mortgage and home equity loans. As a result of the recent problems in the real estate and mortgage securities markets, the fair value of the fund has declined and, accordingly, the Company's recorded other-than-temporary impairment charges of 18% of the value during 2008. The value of the investment in the fund is still below its cost basis by approximately $286,000 as of September 30, 2009. The current fund value is not a compilation of the daily trading prices of the underlying securities, but rather is derived from matrix pricing in an illiquid market, thus it is more reflective of liquidation pricing than of the Fund's true fair value. Fund cash flows have been uninterrupted, as no individual security has experienced a default of contractual principal or interest payments. The Fund continues to reinvest excess cash flows into short-term federal agency backed mortgage-backed securities, thus improving the overall risk profile of the Fund. The overall value of the fund has continued to improve during 2009. As of October 31st, the unrealized loss associated with the Company's holdings in the fund has decreased to approximately $276,000, representing a 4% improvement since September 30, 2009 and a 25% improvement since June 30, 2009. Management has displayed the intent and ability to hold this security until its value improves. Given all these facts, it is management's opinion that additional other-than-temporary impairment is not present at this time.

In addition to the mutual fund backed by mortgage-related instruments, the Company also holds a $2.2 million investment in a mutual fund consisting of investment grade, dividend paying common stocks of large capitalization companies (companies with market capitalization in excess of $5 billion). Management recorded an other-than-temporary impairment charge of 24% of the Fund's value in 2008. The value of the investment in this fund is still below its cost basis by approximately $239,000 as of September 30, 2009. As of October 31st, the unrealized loss associated with the Company's holdings in the fund has slipped to approximately $241,000, however, the overall improvement in the value of the fund since June 30, 2009 still represents a 46% increase in the fund value. Management believes that the underlying investment grade securities represent equity positions in well-managed companies with a diverse cross section of various industries. Management has performed a review of each underlying holding comprising the Fund. The review and analysis indicates that there are no individually impaired holdings and there is no indication that the profitability of the individual companies is impaired beyond the current economic cycle. The Fund value is highly correlated to the overall stock market performance and management believes that the market will return to previous valuation levels over the next economic cycle. Management has the intent and ability to hold this security until its value improves. As such, the recent decline in fair value, since the previous write-down for impairment, is not considered to be other-than-temporary.

During the second quarter of 2009, the Company recorded an other than temporary impairment charge of $298,000 associated with its holdings in a senior unsecured note issued by CIT Group, Inc. (“CIT”). As current concerns grew relating to CIT’s ability to meet its current short-term obligations, combined with the belief that other government programs were not going to be made available to CIT, the Company concluded that the liquidation of its current holding at a loss was prudent, and the security was sold on July 16, 2009. The impairment charge recorded in the second quarter was based on the sale proceeds as compared to the amortized cost basis of the security.

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The following table presents a roll-forward of the amount related to credit losses recognized in earnings for the period ended September 30, 2009.

(In thousands)	Total
Beginning balance – January 1, 2009	$875
Initial credit impairment	298
Subsequent credit impairments	-
Reductions for amounts recognized in earnings due to intent or requirement to sell	-
Reductions for securities sold	(298)
Reductions for increases in cash flows expected to be collected	-
Ending balance - September 30, 2009	$875

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

(In thousands)	2009	2008
Available-for-sale securities:		
Realized gains	$327	$49
Realized losses	(8)	(23)
Other than temporary impairment	(298)	(2,176)
	$21	$(2,150)

As of September 30, 2009 and December 31, 2008, securities with an amortized cost of $50.6 million and $37.8 million, respectively, were pledged to collateralize certain deposit and borrowing arrangements.

Management has reviewed its loan and mortgage-backed securities portfolios and determined that, to the best of its knowledge, little or no exposure exists to sub-prime or other high-risk residential mortgages. The Company is not in the practice of investing in, or originating these types of investments or loans.

(6) Guarantees

The Company does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit written are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to customers. The Company generally holds collateral and/or personal guarantees supporting these commitments. The Company had $1.6 million of standby letters of credit as of September 30, 2009. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The current amount of the liability as of September 30, 2009, for guarantees under standby letters of credit issued is not material.

(7) Fair Value Measurements and Disclosures

FASB ASC Topic 820: Fair Value Measurements and Disclosures specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect our market assumptions. In accordance with FASB ASC Topic 820, these two types of inputs have created the following fair value hierarchy:

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Level 1 – Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

- Level 2 – Quoted prices for similar assets and liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are not active; and model-derived valuations in which all significant inputs and significant value drivers are observable in active markets.

- Level 3 – Model derived valuations in which one or more significant inputs or significant value drivers are unobservable.

An asset's or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

The Company used the following methods and significant assumptions to estimate fair value:

Investment securities: The fair values of securities available for sale are obtained from an independent third party and are based on quoted prices on nationally recognized exchange (Level 1), where available. If quoted prices are not available, fair values are measured by utilizing matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2). Management made no adjustment to the fair value quotes that were received from the independent third party pricing service.

Impaired loans: Impaired loans are those that are accounted for under FASB ASC 310-10-35, Receivables, in which the Company has measured impairment generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third party appraisals of the properties, or discounted cash flows based upon expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements. The fair value consists of loan balances less their valuation allowances as determined under FASB ASC 310-10-35, Receivables.

Foreclosed real estate: Properties acquired through foreclosure, or by deed in lieu of foreclosure, are recorded at their fair value less estimated disposal costs. Fair value is generally determined based upon independent third party appraisals of the properties, or discounted cash flows based upon expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements.

The following tables summarize assets measured at fair value on a recurring basis as of September 30, 2009 and December 31, 2008, segregated by the level of valuation inputs within the hierarchy utilized to measure fair value:

	At September 30, 2009			
(In thousands)	Level 1	Level 2	Level 3	Total Fair Value
Investment securities available for sale	$1,954	$63,605	$-	$65,559

	At December 31, 2008			
(In thousands)	Level 1	Level 2	Level 3	Total Fair Value
Investment securities available for sale	$1,918	$70,220	$-	$72,138

Certain assets and liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The following tables summarize assets measured at fair value on a nonrecurring basis as of September 30, 2009 and December 31, 2008, segregated by the level of valuation inputs within the hierarchy utilized to measure fair value:

	At September 30, 2009			
(In thousands)	Level 1	Level 2	Level 3	Total Fair Value
Impaired loans	$-	$-	$911	$911
Foreclosed real estate	-	-	417	417

	At December 31, 2008			
				Total Fair

(In thousands)	Level 1	Level 2	Level 3	Value
Impaired loans	$-	$-	$295	$295
Foreclosed real estate	-	-	335	335

FASB ASC Topic 825: Financial Instruments, requires disclosure of fair value information of financial instruments, whether or not recognized in the consolidated statement of condition, for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument.

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Management uses its best judgment in estimating the fair value of the Company's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts the Company could have realized in a sales transaction on the dates indicated. The estimated fair value amounts have been measured as of their respective year-ends, and have not been re-evaluated or updated for purposes of these financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each year-end.

The following information should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only provided for a limited portion of the Company's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Company's disclosures and those of other companies may not be meaningful. The Company, in estimating its fair value disclosures for financial instruments, used the following methods and assumptions:

Cash and cash equivalents – The carrying amounts of these assets approximate their fair value.

Investment securities – The fair values of securities available for sale are obtained from an independent third party and are based on quoted prices on nationally recognized exchange (Level 1), where available. If quoted prices are not available, fair values are measured by utilizing matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for specific securities, but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2). Management made no adjustment to the fair value quotes that were received from the independent third party pricing service.

Loans and mortgage loans held-for-sale – The fair values of portfolio loans, excluding impaired loans, are estimated using an option adjusted discounted cash flow model that discounts future cash flows using recent market interest rates, market volatility and credit spread assumptions.

Federal Home Loan Bank stock – The carrying amount of these assets approximates their fair value.

Mortgage servicing rights - The carrying amount of these assets approximates their fair value.

Accrued interest receivable and payable – The carrying amount of these assets approximates their fair value.

Deposit liabilities – The fair values disclosed for demand deposits (e.g., interest-bearing and noninterest-bearing checking, passbook savings and certain types of money management accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market on certificates of deposits to a schedule of aggregated expected monthly maturities on time deposits.

Borrowings – Fixed/variable term "bullet" structures are valued using a replacement cost of funds approach. These borrowings are discounted to the FHLBNY advance curve. Option structured borrowings' fair values are determined by the FHLB for borrowings that include a call or conversion option. If market pricing is not available from this source, current market indications from the FHLBNY are obtained and the borrowings are discounted to the FHLBNY advance curve less an appropriate spread to adjust for the option.

Junior subordinated debentures – Current economic conditions have rendered the market for this liability inactive. As such, we are unable to determine a good estimate of fair value. Since the rate paid on the debentures held is lower than what would be required to secure an interest in the same debt at year end, and we are unable to obtain a current fair value, we have disclosed that the carrying value approximates the fair value.

Off-balance sheet instruments – Fair values for the Company’s off-balance sheet instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties’ credit standing.

The carrying amounts and fair values of the Company's financial instruments as of September 30, 2009 and December 31, 2008 are presented in the following table:

	September 30, 2009		December 31, 2008	
(Dollars in thousands)	Carrying Amounts	Estimated Fair Values	Carrying Amounts	Estimated Fair Values
Financial assets:				
Cash and cash equivalents	$24,279	$24,279	$7,678	$7,678
Investment securities	65,559	65,559	72,138	72,138
Net loans	251,465	258,259	247,400	250,020
Federal Home Loan Bank stock	1,809	1,809	2,549	2,549
Accrued interest receivable	1,465	1,465	1,678	1,678
Mortgage servicing rights	68	68	15	15

	September 30, 2009		December 31, 2008	
(Dollars in thousands)	Carrying Amounts	Estimated Fair Values	Carrying Amounts	Estimated Fair Values
Financial liabilities:				
Deposits	$292,618	$294,632	$269,438	$272,207
Borrowed funds	34,000	35,485	51,975	53,777
Junior subordinated debentures	5,155	5,155	5,155	5,155
Accrued interest payable	165	165	211	211
Off-balance sheet instruments:				
Standby letters of credit	$-	$-	$-	$-
Commitments to extend credit	-	-	-	-

(8) Shareholders' Equity

Preferred Stock Issued to the United States Department of Treasury

In connection with the Emergency Economic Stabilization Act of 2008 (EESA), the U.S. Treasury Department (Treasury) initiated a Capital Purchase Program (CPP) which allows for qualifying financial institutions to issue preferred stock to the Treasury, subject to certain limitations and terms. The EESA was developed to attract broad participation by strong financial institutions, to stabilize the financial system and increase lending to benefit the national economy and citizens of the United States.

On September 11, 2009, the Company, entered into a Letter Agreement (the "Purchase Agreement"), with the United States Department of the Treasury ("Treasury Department") pursuant to which the Company has issued and sold to Treasury: (i) 6,771 shares of the Company's Fixed Rate Cumulative Perpetual Preferred Stock, Series A, par value $0.01 per share (the "Series A Preferred Stock"), having a liquidation amount per share equal to $1,000, for a total price of $6,771,000; and (ii) a Warrant (the "Warrant") to purchase 154,354 shares of the Company's common stock, par value $0.01 per share (the "Common Stock"), at an exercise price per share of $6.58. The Company contributed to Pathfinder Bank, its subsidiary, $5,500,000 or 81.23% of the proceeds of the sale of the Series A Preferred Stock.

The Series A Preferred Stock pays cumulative dividends at a rate of 5% per annum for the first five years and thereafter at a rate of 9% per annum. The Series A Preferred Stock is generally non-voting. Prior to September 11, 2012, and unless the Company has redeemed all of the Series A Preferred Stock or the Treasury Department has transferred all of the Series A Preferred Stock to a third party, the approval of the Treasury Department will be required for the Company to increase its common stock dividend or repurchase its common stock or other equity or capital securities, other than in certain circumstances specified in the Purchase Agreement.

Common Stock Warrant

The Warrant has a ten year term and is immediately exercisable. The Warrant provides for the adjustment of the exercise price and the number of shares of the Company’s common stock issuable upon exercise pursuant to customary anti-dilution provisions, such as upon stock splits or distributions of securities or other assets to holders of the Company’s common stock, and upon certain issuances of the Company’s common stock at or below a specified price relative to the then current market price of the Company’s common stock. If, on or prior to December 31, 2009, the Company receives aggregate gross cash proceeds of not less than the purchase price of the Series A Preferred Stock from one or more “qualified equity offerings,” the number of shares of common stock issuable pursuant to the Warrant will be reduced by one-half of the original number of shares, taking into account all adjustments. Pursuant to the Purchase Agreement, the Treasury Department has agreed not to exercise voting power with respect to any shares of common stock issued upon exercise of the Warrant.

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The Series A Preferred Stock and the Warrant were issued in a private placement exempt from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended. The $6.8 million of proceeds was allocated to the preferred stock and the warrant based on their relative fair values at issuance ($6.1 million was allocated to preferred stock and $706,000 to the warrants). The difference between the initial value allocated to the preferred stock of approximately $6.1 million and the liquidation value of $6.8 million, i.e., the preferred stock discount, will be charged to retained earnings over the first five years of the contract as an adjustment to the dividend yield using the effective yield method.

(9) New Accounting Pronouncements

In June 2009, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 168, "The FASB Accounting Standards Codification and the Hierarchy of Generally Accepted Accounting Principles, a replacement of FASB Statement No. 168," (SFAS 168). SFAS 168 establishes the FASB Accounting Standards Codification (Codification) as the source of authoritative generally accepted accounting principles (GAAP) for nongovernmental entities. The Codification does not change GAAP. Instead, it takes the thousands of individual pronouncements that currently comprise GAAP and reorganizes them into approximately 90 accounting Topics, and displays all Topics using a consistent structure. Contents in each Topic are further organized first by Subtopic, then Section and finally Paragraph. The Paragraph level is the only level that contains substantive content. Citing particular content in the Codification involves specifying the unique numeric path to the content through the Topic, Subtopic, Section and Paragraph structure. FASB suggests that all citations begin with "FASB ASC," where ASC stands for Accounting Standards Codification. Changes to the ASC subsequent to June 30, 2009 are referred to as Accounting Standards Updates (ASU).

In conjunction with the issuance of SFAS 168, the FASB also issued its first Accounting Standards Update No. 2009-1, "Topic 105 – Generally Accepted Accounting Principles" (ASU 2009-1) which includes SFAS 168 in its entirety as a transition to the ASC. ASU 2009-1 is effective for interim and annual periods ending after September 15, 2009. Its adoption will not have an impact on our financial position or results of operations, but will change the referencing system for accounting standards. In order to facilitate an effective and efficient transition to the new Codification, the disclosure and key presentation requirements may reference pre-Codification FASB literature for this quarter.

Certain of the following pronouncements were issued prior to the issuance of the ASC and adoption of the ASUs. For such pronouncements, citations to the applicable Codification Topic, Subtopic, and Section are provided where applicable in addition to the original standard type and number.

In December 2008, the FASB issued FASB Staff Position (FSP) FAS 132(R)-1 (FASB ASC 715-20-65), "Employers' Disclosures about Postretirement Benefit Plan Assets". This FSP provides guidance on an employer's disclosures about plan assets of a defined benefit pension or other postretirement plan. The objective of the FSP is to provide the users of the financial statements with an understanding of: (a) how investment allocation decisions are made, including the factors that are pertinent to an understanding of investment policies and strategies; (b) the major categories of plan assets; (c) the inputs and valuation techniques used to measure the fair value of plan assets; (d) the effect of fair value measurements using significant unobservable inputs (Level 3) on changes in plan assets for the period; and (e) significant concentrations of risk within plan assets. The disclosures about plan assets required by this FSP shall be provided for fiscal years ending after December 15, 2009. The new pronouncement will require the Company to provide additional disclosures related to its benefit plans.

In June 2009, the FASB issued SFAS No. 166 (not yet reflected in FASB ASC), Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140. This statement prescribes the information that a reporting entity must provide in its financial reports about a transfer of financial assets; the effects of a transfer on its financial position, financial performance and cash flows; and a transferor's continuing involvement in transferred financial assets. Specifically, among other aspects, SFAS 166 amends Statement of Financial Standard No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, or SFAS 140, by removing the concept of a qualifying special-purpose entity from SFAS 140 and removes the exception from applying FIN 46(R) to variable interest entities that are qualifying special-purpose entities. It also modifies the financial-components approach used in SFAS 140. SFAS 166 is effective for fiscal years beginning after November 15, 2009. We have not determined the effect that the adoption of SFAS 166 will have on our financial position or results of operations.

The FASB issued ASU 2009-5, "Fair Value Measurements and Disclosures (Topic 820) – Measuring Liabilities at Fair Value" in August 2009, to provide guidance when estimating the fair value of a liability. When a quoted price in an active market for the identical liability is not available, fair value should be measured using (a) the quoted price of an identical liability when traded as an asset; (b) quoted prices for similar liabilities or similar liabilities traded as assets; or (c) another valuation technique consistent with the principles of Topic 820 such as an income approach or a market approach. If a restriction exists that prevents the transfer of the liability, a separate adjustment related to the restriction is not required when estimating fair value. The ASU was effective October 1, 2009 and will not have a material impact on the Company's financial position.

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ASU 2009-12, “Fair Value Measurements and Disclosure (Topic 820) – Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent),” issued in September 2009, allows a company to measure the fair value of an investment that has no readily determinable fair market value on the basis of the investee’s net asset value per share as provided by the investee. This allowance assumes that the investee has calculated net asset value in accordance with the GAAP measurement principles of Topic 946 as of the reporting entity’s measurement date. Examples of such investments include investments in hedge funds, private equity funds, real estate funds and venture capital funds. The update also provides guidance on how the investment should be classified within the fair value hierarchy based on the value for which the investment can be redeemed. The amendment is effective for interim and annual periods after December 15, 2009 with early adoption permitted. The Company does not have investments in such entities and, therefore, there will be no impact to our financial statements.

In October 2009, ASU 2009-15, “Accounting for Own-Share Lending Arrangements in Contemplation of Convertible Debt Issuance or Other Financing” was issued to amend ASC Topic 470 and provides guidance for accounting and reporting for own-share lending arrangements issued in contemplation of a convertible debt issuance. At the date of issuance, a share-lending arrangement entered into on an entity’s own shares should be measured at fair value in accordance with Topic 820 and recognized as an issuance cost, with an offset to additional paid in capital. Loaned shares are excluded from basic and diluted earnings per share unless default of the share-lending arrangement occurs. The amendment also requires several disclosures including a description and the terms of the arrangement and the reason for entering into the arrangement. The effective dates of the amendment are dependent upon the date the share-lending arrangement was entered into and include retrospective application for arrangements outstanding as of the beginning of fiscal years beginning on or after December 15, 2009. The Company has no plans to issue convertible debt and, therefore, does not expect the update to have an impact on its financial statements.

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

General

Throughout Management's Discussion and Analysis ("MD&A") the term, "the Company", refers to the consolidated entity of Pathfinder Bancorp, Inc. Pathfinder Bank and Pathfinder Statutory Trust II are wholly owned subsidiaries of Pathfinder Bancorp, Inc.; however, Pathfinder Statutory Trust II is not consolidated for reporting purposes. Pathfinder Commercial Bank, Pathfinder REIT, Inc. and Whispering Oaks Development Corp. are wholly owned subsidiaries of Pathfinder Bank. At September 30, 2009, Pathfinder Bancorp, M.H.C, the Company's mutual holding company parent, whose activities are not included in the consolidated financial statements or the MD&A, held 63.7% of the Company's outstanding common stock and public shareholders held the remaining 36.3% of the common stock.

The following discussion reviews the Company's financial condition at September 30, 2009 and the results of operations for the three months and nine months ended September 30, 2009 and September 30, 2008.

Statement Regarding Forward-Looking Statements

When used in this quarterly report the words or phrases "will likely result", "are expected to", "will continue", "is anticipated" "estimate", "project" or similar expression are intended to identify "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements are subject to certain risks and uncertainties. By identifying these forward-looking statements for you in this manner, the Company is alerting you to the possibility that its actual results and financial condition may differ, possibly materially, from the anticipated results and financial condition indicated in these forward-looking statements. The Company wishes to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. The Company wishes to advise readers that various factors could affect the Company's financial performance and could cause the Company's actual results for future periods to differ materially from any opinions or statements expressed with respect to future periods in any current statements. Additionally, all statements in this document, including forward-looking statements, speak only as of the date they are made, and the Company undertakes no obligation to update any statement in light of new information or future events.

Application of Critical Accounting Policies

The Company's consolidated financial statements are prepared in accordance with accounting principles generally accepted in the United States and follow practices within the banking industry. Application of these principles requires management to make estimates, assumptions and judgments that affect the amounts reported in the financial statements and accompanying notes. These estimates, assumptions and judgments are based on information available as of the date of the financial statements; accordingly, as this information changes, the financial statements could reflect different estimates, assumptions and judgments. Certain policies inherently have a greater reliance on the use of estimates, assumptions and judgments and as such have a greater possibility of producing results that could be materially different than originally reported. Estimates, assumptions and judgments are necessary when assets and liabilities are required to be recorded at fair value or when an asset or liability needs to be recorded contingent upon a future event. Carrying assets and liabilities at fair value inherently results in more financial statement volatility. The fair values and information used to record valuation adjustments for certain assets and liabilities are based on quoted market prices or are provided by other third-party sources, when available. When third party information is not available, valuation adjustments are estimated in good faith by management.

The most significant accounting policies followed by the Company are presented in Note 1 to the consolidated financial statements included in the 2008 Annual Report on Form 10-K ("the Consolidated Financial Statements").

These policies, along with the disclosures presented in the other financial statement notes and in this discussion, provide information on how significant assets and liabilities are valued in the consolidated financial statements and how those values are determined. Based on the valuation techniques used and the sensitivity of financial statement amounts to the methods, assumptions and estimates underlying those amounts, management has identified the allowance for loan losses, deferred income taxes, pension obligations, the evaluation of investment securities for other than temporary impairment and the estimation of fair values for accounting and disclosure purposes to be the accounting areas that require the most subjective and complex judgments, and as such, could be the most subject to revision as new information becomes available.

The allowance for loan losses represents management's estimate of probable loan losses inherent in the loan portfolio. Determining the amount of the allowance for loan losses is considered a critical accounting estimate because it requires significant judgment and the use of estimates related to the amount and timing of expected future cash flows on impaired loans, estimated losses on pools of homogeneous loans based on historical loss experience, and consideration of current economic trends and conditions, all of which may be susceptible to significant change. The loan portfolio also represents the largest asset type on the consolidated statements of condition. Note 1 to the consolidated financial statements describes the methodology used to determine the allowance for loan losses, and a discussion of the factors driving changes in the amount of the allowance for loan losses is included in this report.

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Deferred income tax assets and liabilities are determined using the liability method. Under this method, the net deferred tax asset or liability is recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases as well as net operating and capital loss carry forwards. Deferred tax assets and liabilities are measured using enacted tax rates applied to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income tax expense in the period that includes the enactment date. To the extent that current available evidence about the future raises doubt about the likelihood of a deferred tax asset being realized, a valuation allowance is established. The judgment about the level of future taxable income, including that which is considered capital, is inherently subjective and is reviewed on a continual basis as regulatory and business factors change.

Pension and post-retirement benefit plan liabilities and expenses are based upon actuarial assumptions of future events, including fair value of plan assets, interest rates, rate of future compensation increases and the length of time the Company will have to provide those benefits. The assumptions used by management are discussed in Note 11 to the consolidated annual financial statements.

The Company carries all of its investments at fair value with any unrealized gains or losses reported net of tax as an adjustment to shareholders' equity, except for security impairment losses, which are charged to earnings. The Company's ability to fully realize the value of its investments in various securities, including corporate debt securities, is dependent on the underlying creditworthiness of the issuing organization. In evaluating the security portfolio for other-than-temporary impairment losses, management considers (1) if we intend to sell the security; (2) if it is “more likely than not” we will be required to sell the security before recovery of its amortized cost basis; or (3) the present value of expected cash flows is not sufficient to recover the entire amortized cost basis. Management continually analyzes the portfolio to determine if further impairment has occurred that may be deemed as other-than-temporary. Further charges are possible depending on future economic conditions.

The estimation of fair value is significant to several of our assets, including investment securities available for sale, intangible assets and foreclosed real estate, as well as the value of loan collateral when valuing loans. These are all recorded at either fair value or the lower of cost or fair value. Fair values are determined based on third party sources, when available. Furthermore, accounting principles generally accepted in the United States require disclosure of the fair value of financial instruments as a part of the notes to the consolidated financial statements. Fair values may be influenced by a number of factors, including market interest rates, prepayment speeds, discount rates and the shape of yield curves.

Fair values for securities available for sale are obtained from an independent third party pricing service. Where available, fair values are based on quoted prices on a nationally recognized securities exchange. If quoted prices are not available, fair values are measured using quoted market prices for similar benchmark securities. Management made no adjustments to the fair value quotes that were provided by the pricing source. The fair values of foreclosed real estate and the underlying collateral value of impaired loans are typically determined based on appraisals by third parties, less estimated costs to sell. If necessary, appraisals are updated to reflect changes in market conditions.

Overview

The Company's net income is primarily dependent on its net interest income, which is the difference between interest income earned on its investments in mortgage loans, investment securities and other loans, and its cost of funds consisting of interest accrued on deposits and borrowed funds. The Company's net income is also affected by its provision for loan losses, as well as by the amount of other income, including income from fees and service charges on deposit accounts, net gains and losses on sales and the impairment of securities, loans and foreclosed real estate, and other expenses such as salaries and employee benefits, building occupancy and equipment costs, data processing and income taxes. Earnings of the Company also are affected significantly by general economic and competitive conditions, particularly changes in market interest rates, government policies and actions of regulatory authorities, which events are beyond the control of the Company. In particular, the general level of market interest rates which tend to be highly cyclical have a significant impact on our earnings.

Net income available to common shareholders was $542,000, or $0.22 per basic and diluted common share, for the three months ended September 30, 2009, as compared to a net loss of $838,000, or $0.34 per basic and diluted common share, for the same period in 2008. For the nine months ended September 30, 2009, the Company reported net income available to common shareholders of $1,152,000, or $0.46 per basic and diluted common share as compared to a net loss of $206,000, or $0.08 per basic and diluted common share for the same period in 2008. During the second quarter of 2009, the Company recorded an investment security impairment charge of $197,000, net of tax benefits of $101,000. The 2008 net losses were the result of the Company recording impairment charges on investment security holdings totaling $1.3 million, net of the related tax benefits of $522,000, during the third quarter of 2008. In addition, during the second quarter of 2008, the Company recorded an investment security impairment charge of $205,000, net of tax benefits of $137,000.

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The Company has continued efforts to expand its lending and deposit relationships within the small business community. These efforts have helped the Company transform its statement of condition from one more concentrated in residential loans and retail deposits to a more diversified mix of residential, consumer, and commercial relationships. On an average balance basis, total commercial loans comprised 34.3% of the total gross loan portfolio for the nine months ended September 30, 2009 compared to 31.0% for the nine months ended September 30, 2008.

The Company sold approximately $13.4 million in investment portfolio holdings and $9.2 million of fixed rate residential real estate loans during the first nine months of the year. These efforts, combined with other deposit gathering efforts, were undertaken to improve the Company's overall liquidity position, reduce its reliance on wholesale borrowings, and to take advantage of beneficial pricing levels to generate gains from sale of the related assets. Short-term borrowings decreased $16.6 million, or 94%, when compared to December 31, 2008. Long-term borrowings decreased $1.4 million, or 4%, when compared to December 31, 2008.

Results of Operations

The return on average assets and return on average shareholders' equity were 0.63% and 10.09%, respectively, for the three months ended September 30, 2009, compared with a loss on average assets of (0.97)% and a loss on average shareholders' equity of (15.65)%, for the three months ended September 30, 2008. During the third quarter of 2009, when compared to the third quarter of 2008, net interest income increased $218,000, combined with a provision for loan losses that is less than the previous year by $23,000. Noninterest expense increased $402,000, which was primarily the result of increased pension plan expense to amortize losses recorded in the prior year, and the increase in FDIC regular and special assessment charges. The largest variance in operating results between the third quarter of 2009, when compared to the third quarter of 2008, is in noninterest income. In 2008, the Company's noninterest income was negatively impacted by impairment charges of $1,834,000 on available-for-sale securities. Sales of loans and foreclosed real estate also produced losses of $85,000 during the third quarter of 2008. In 2009, no such impairment charges were required. Sales of investments, loans and foreclosed real estate produced gains of $246,000. The provision for income tax expense was $293,000 for the third quarter of 2009, compared to a tax benefit of $288,000 in the same quarter last year.

The return on average assets and return on average shareholders' equity were 0.44% and 7.52%, respectively, for the nine months ended September 30, 2009, compared with a loss on average assets and a loss on average shareholders' equity of (0.08)% and (1.25)%, respectively, for the nine months ended September 30, 2008. During the nine month period ended September 30, 2009, when compared to the same period of 2008, net interest income increased $759,000, offset by a provision for loan losses that is greater than the previous year by $104,000. Noninterest expense increased $846,000, which was primarily the result of increased pension plan expense to amortize losses recorded in the prior year, and the increase in FDIC regular and special assessment charges. The largest variance in operating results between the nine months ended September 30, 2009, when compared to the same period in 2008, is in noninterest income. In 2008, the Company's noninterest income was negatively impacted by impairment charges of $2,176,000 on available-for-sale securities. Sales of loans and foreclosed real estate also produced losses of $79,000 during the nine month period of 2008. In 2009, impairment charges were $298,000. Sales of investments, loans and foreclosed real estate produced gains of $399,000. The provision for income tax expense was $620,000 for the nine months ended September 30, 2009, compared to a tax benefit of $82,000 in the same period last year.

Net Interest Income

Net interest income is the Company's primary source of operating income for payment of operating expenses and providing for loan losses. It is the amount by which interest earned on loans, interest-earning deposits and investment securities exceeds the interest paid on deposits and other interest-bearing liabilities. Changes in net interest income and net interest margin result from the interaction between the volume and composition of interest-earning assets, interest-bearing liabilities, related yields and associated funding costs.

Net interest income, on a tax-equivalent basis increased to $3.0 million for the three months ended September 30, 2009, from $2.8 million for the three months ended September 30, 2008. The Company's net interest margin increased 16 basis points to 3.66%, for the third quarter of 2009 when compared to the same quarter in 2008. Reductions in the Company’s current levels of earning asset yields, due to falling short-term interest rates, have been more than offset by efforts to reduce the cost of funds, and have resulted in improving the Company’s net interest margin. The increase in net interest income is attributable to a decrease of 72 basis points in the average cost of interest bearing liabilities, and was offset by a decrease of 49 basis points in the average yield earned on earning assets. Average interest-earning assets increased 2.4% to $329.2 million for the three months ended September 30, 2009, as compared to $321.4 million for the three months ended September 30, 2008. The increase in average earning assets is primarily attributable to a $13.8 million increase in average loans receivable, and a $9.3 million increase in average interest earning deposits, offset by a $15.3 million decrease in average investment securities. Average interest-bearing liabilities increased $8.8 million to $303.3 million from $294.5 million for the three months ended September 30, 2008. The increase in the average balance of interest-bearing liabilities resulted from a $25.5 million increase in average deposits offset by a $16.7 million decrease in average borrowings.

For the nine months ended September 30, 2009, net interest income, on a tax-equivalent basis, increased to $8.6 million from $7.9 million for the nine months ended September 30, 2008. Net interest margin increased 11 basis points, to 3.49% for the nine months ended September 30, 2009 from 3.38% for the nine months ended September 30, 2008. Average

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interest-earning assets increased 5.3% to $329.7 million for the nine months ended September 30, 2009 as compared to $313.2 million for the nine months ended September 30, 2008, and the yield on interest-earning assets decreased 48 basis points to 5.38% from 5.86% for the comparable period. The increase in average interest-earning assets was attributable to a $20.4 million increase in average loans receivable and a $4.4 million increase in average interest earning deposits, partially offset by a $8.3 million decrease in average investment securities. Average interest-bearing liabilities increased $15.9 million but the cost of funds decreased 65 basis points to 2.05% for the nine months ended September 30, 2009, from 2.70% for the same period in 2008. The increase in the average balance of interest-bearing liabilities resulted from a $20.7 million, or 8.6%, increase in average deposits offset by a $4.8 million, or 10.2%, decrease in average borrowings.

Interest Income

Total interest income, on a tax-equivalent basis, for the quarter ended September 30, 2009, decreased $294,000, or 6.3%, to $4.4 million from $4.7 million for the quarter ended September 30, 2008.

The average balance of loans increased $13.8 million to $251.3 million, with yields decreasing 47 basis points to 5.88% for the third quarter of 2009. Average residential real estate loans remained level at $133.0 million, although there was a decrease in the average yield to 5.54% from 5.70% in the comparable quarter of 2008. Average commercial real estate loans increased $9.6 million, while the average yield on those loans decreased to 6.89% from 7.37% from the period a year earlier. Average commercial loans increased $2.2 million and the average yield decreased 157 basis points, to 5.15% for the quarter ended September 30, 2009, from 6.72%, in the quarter ended September 30, 2008. The decrease in the average yield on commercial loans was primarily the result of new commercial loan origination activity taking place at yields lower than the average yield on the existing commercial loan portfolio, combined with the downward repricing of the existing adjustable rate commercial loan portfolio into the current, historically low, interest rate environment. Average consumer loans increased $2 million, or 8%, while the average yield decreased by 124 basis points.

Average investment securities (taxable and tax-exempt) for the quarter ended September 30, 2009, decreased by $15.3 million, with a decrease in tax-equivalent interest income from investments of $217,000, or 24%, when compared to the third quarter of 2008. The average tax-equivalent yield of the portfolio decreased 27 basis points, to 4.19% from 4.46%.

Total interest income, on a tax-equivalent basis, for the nine months ended September 30, 2009 decreased $472,000, or 3.4%, when compared to the nine months ended September 30, 2008.

Average loans increased $20.4 million, with average yields decreasing 50 basis points to 5.89% from 6.39% for the nine month period ended September 30, 2009 when compared with the same period in 2008. Average residential real estate loans increased $3.9 million, or 3%, and the average yield decreased 16 basis points from the comparable nine month period ended September 30, 2008. Average commercial real estate loans increased $9.9 million, while the average yield on those loans decreased to 6.88% from 7.38% from the period a year earlier. Average commercial loans increased $4.5 million and experienced a decrease in the average yield of 165 basis points, to 5.10% for the nine months ended September 30, 2009, from 6.75%, for the nine months ended September 30, 2008. The decrease in the average yield on commercial loans was the result of new commercial loan origination activity taking place at lower yields and variable rate loans pricing downwards. Average consumer loans increased $2.1 million, or 8.4%, while the average yield decreased by 130 basis points.

For the nine months ended September 30, 2009, tax-equivalent interest income from investment securities decreased $460,000, or 16.9%, compared to the same period in 2008. The average tax-equivalent yield of the portfolio decreased 32 basis points, to 4.21% from 4.53%. Moreover, there was a $8.3 million decrease in the average balance of investment securities, reflecting the sale of municipal investment portfolio holdings in the first quarter.

Interest Expense

Total interest expense decreased $486,000 for the three months ended September 30, 2009, compared to the same quarter in 2008, as the cost of funds decreased 72 basis points to 1.83% in 2009 from 2.55% in 2008. Although average deposits increased in 2009 over the third quarter of 2008, the associated cost of funds decreased sufficiently to lower the overall interest expense incurred. Average time deposits increased $10.6 million, but were offset by a 95 basis point reduction in the cost of funds. The average balance of money market demand accounts increased to $33.7 million at September 30, 2009 from $26.6 million at September 30, 2008 and was offset by a decrease in the cost of funds to 0.63% from 1.70%. The average balance of savings accounts increased $5.8 million between the two periods and was offset by a decrease in the cost of funds of 11 basis points. The average balances of other deposit categories showed smaller increases when comparing the third quarter averages between 2009 and 2008, but all categories had a reduction in the associated cost of funds.

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Interest expense on borrowings decreased by $186,000, or 33.3%, when compared to the same quarter in 2008, as a result of a decrease in average borrowings of $16.7 million and a 23 basis point decrease in the cost of funds. The decrease in cost is attributed to the cost of the junior subordinated debenture, down 225 basis points, which resulted from a reduction in its index rate based on 3-month LIBOR.

Total interest expense decreased $1.2 million for the nine months ended September 30, 2009, compared to the same period in 2008, as the average cost of funds decreased 65 basis points. Average time deposits increased $11.4 million, but were offset by a 83 basis point reduction in the cost of funds. The nine month average balance of money market demand accounts increased $5.0 million at September 30, 2009 from the prior year period and was offset by a decrease in the cost of funds to 0.75% from 2.06%. The average balances of other deposit categories showed smaller increases when comparing the nine month period results between 2009 and 2008, but all categories had a reduction in the associated interest expense as the result of a decrease in cost of funds of 63 basis points.

Interest expense on borrowings decreased by $303,000, or 20%, from the prior nine month period. The reduction in the average cost of borrowings to 3.76% from 4.23% in 2008, was combined with a decrease in average borrowings of $4.8 million.

Provision for Loan Losses

The provision for loan losses decreased $23,000 for the three month period, but increased $104,000 for the nine month period ended September 30, 2009, when compared to the same periods in 2008. The Company continues to provide for loan losses to reflect the growing loan portfolio and to reflect a loan portfolio composition that is more heavily weighted to commercial term and commercial real estate, which have higher inherent risk characteristics than a consumer real estate portfolio, as well as a general weakening in economic conditions. The Company's ratio of allowance for loan losses to period-end loans increased to 1.16% at September 30, 2009 as compared to 0.99% at December 31, 2008. Nonperforming loans to period end loans increased to 0.97% at September 30, 2009 from 0.93% at December 31, 2008. The increase in nonperforming loans is primarily the result of an increase in delinquency within the residential real estate loan portfolio. Management believes that the existing allowances provided on these loans are sufficient to cover anticipated losses.

Noninterest Income

The Company's noninterest income is primarily comprised of fees on deposit account balances and transactions, loan servicing, commissions, and net gains (losses) on securities, loans and foreclosed real estate.

The following table sets forth certain information on noninterest income for the quarters indicated:

	Three Months Ended September 30,			
(in thousands)	2009	2008	Change	
Service charges on deposit accounts	$382	$397	$(15)	-3.8%
Earnings on bank owned life insurance	56	56	-	0.0%
Loan servicing fees	64	67	(3)	-4.5%
Debit card interchange fees	69	71	(2)	-2.8%
Other charges, commissions and fees	155	127	28	22.0%
Noninterest income before gains (losses)	726	718	8	1.1%
Net gains (losses) on sales and impairment of investment securities	231	(1,808)	2,039	-112.8%
Net gains (losses) on sales of loans and foreclosed real estate	15	(85)	100	-117.6%
Total noninterest income (loss)	$972	$(1,175)	$2,147	-182.7%

	Nine Months Ended September 30,			
(in thousands)	2009	2008	Change	
Service charges on deposit accounts	$1,099	$1,131	$(32)	-2.8%
Earnings on bank owned life insurance	169	179	(10)	-5.6%
Loan servicing fees	175	218	(43)	-19.7%
Debit card interchange fees	206	207	(1)	-0.5%
Other charges, commissions and fees	366	334	32	9.6%
Noninterest income before gains (losses)	2,015	2,069	(54)	-2.6%