

PATHFINDER BANCORP INC
Form 10-Q
November 13, 2013

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

FORM 10-Q

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

For the quarterly period ended September 30, 2013

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

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 (Section 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 T NO *

Edgar Filing: PATHFINDER BANCORP INC - Form 10-Q

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.

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

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

As of November 8, 2013, there were 2,979,969 shares issued and 2,618,182 shares outstanding of the registrant’s common stock.

Table of Contents

PATHFINDER BANCORP, INC.
INDEX

PART I - FINANCIAL INFORMATION		PAGE NO.
Item 1.	Consolidated Financial Statements (Unaudited)	
	<u>Consolidated Statements of Condition</u>	<u>3</u>
	<u>Consolidated Statements of Income</u>	<u>4</u>
	<u>Consolidated Statements of Comprehensive Income (Loss)</u>	<u>5</u>
	<u>Consolidated Statements of Changes in Shareholders' Equity</u>	<u>6</u>
	<u>Consolidated Statements of Cash Flows</u>	<u>7</u>
	<u>Notes to Consolidated Financial Statements</u>	<u>8</u>
Item 2.	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations (Unaudited)</u>	<u>35</u>
-		
Item 3.	<u>Quantitative and Qualitative Disclosures About Market Risk</u>	48
Item 4.	<u>Controls and Procedures</u>	48
<u>PART II - OTHER INFORMATION</u>		49
Item 1.	Legal proceedings	
Item 1A.	Risk Factors	
Item 2.	Unregistered sales of equity securities and use of proceeds	
Item 3.	Defaults upon senior securities	
Item 4.	Mine Safety Disclosures	
Item 5.	Other information	
Item 6.	<u>Exhibits</u>	
<u>SIGNATURES</u>		50

Table of Contents

PART I - FINANCIAL INFORMATION

Item 1 – Consolidated Financial Statements

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

	September 30, 2013	December 31, 2012
(In thousands, except share data)		
ASSETS:		
Cash and due from banks	\$8,135	\$6,435
Interest earning deposits	3,659	2,230
Total cash and cash equivalents	11,794	8,665
Interest earning time deposits	1,500	2,000
Available-for-sale securities, at fair value	82,908	108,339
Held-to-maturity securities (fair value of \$32,495 and \$0, respectively)	32,495	-
Federal Home Loan Bank stock, at cost	2,913	1,929
Loans	338,074	333,748
Less: Allowance for loan losses	5,085	4,501
Loans receivable, net	332,989	329,247
Premises and equipment, net	10,183	10,108
Accrued interest receivable	1,806	1,717
Foreclosed real estate	301	426
Goodwill	3,840	3,840
Bank owned life insurance	8,216	8,046
Other assets	3,562	3,479
Total assets	\$492,507	\$477,796
LIABILITIES AND SHAREHOLDERS' EQUITY:		
Deposits:		
Interest-bearing	\$350,941	\$347,892
Noninterest-bearing	50,358	43,913
Total deposits	401,299	391,805
Short-term borrowings	24,000	9,000
Long-term borrowings	16,881	25,964
Junior subordinated debentures	5,155	5,155
Accrued interest payable	72	140
Other liabilities	4,345	4,985
Total liabilities	451,752	437,049
Shareholders' equity:		
Preferred stock - SBLF, par value \$0.01 per share; \$1,000 liquidation preference; 13,000 shares authorized; 13,000 shares issued and outstanding	13,000	13,000
Common stock, par value \$0.01; authorized 10,000,000 shares; 2,979,969 and 2,980,469 shares issued and 2,618,182 and 2,618,182 shares outstanding, respectively	30	30
Additional paid in capital	8,211	8,120
Retained earnings	28,314	26,685
Accumulated other comprehensive loss	(3,119)	(1,318)
Unearned ESOP	(853)	(936)

Edgar Filing: PATHFINDER BANCORP INC - Form 10-Q

Treasury stock, at cost; 361,787, and 362,287 shares respectively	(4,828)	(4,834)
Total shareholders' equity	40,755	40,747
Total liabilities and shareholders' equity	\$492,507	\$477,796

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

Table of Contents

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

	For the three months ended September 30, 2013	For the three months ended September 30, 2012	For the nine months ended September 30, 2013	For the nine months ended September 30, 2012
(In thousands, except per share data)				
Interest and dividend income:				
Loans, including fees	\$4,057	\$3,974	\$12,298	\$11,962
Debt securities:				
Taxable	399	439	1,181	1,386
Tax-exempt	189	190	569	535
Dividends	29	38	89	97
Interest earning time deposits	5	6	16	18
Federal funds sold and interest earning deposits	2	1	5	3
Total interest income	4,681	4,648	14,158	14,001
Interest expense:				
Interest on deposits	605	714	1,894	2,211
Interest on short-term borrowings	23	6	40	14
Interest on long-term borrowings	151	243	575	750
Total interest expense	779	963	2,509	2,975
Net interest income	3,902	3,685	11,649	11,026
Provision for loan losses	216	275	816	650
Net interest income after provision for loan losses	3,686	3,410	10,833	10,376
Noninterest income:				
Service charges on deposit accounts	313	285	856	838
Earnings and gain on bank owned life insurance	60	46	172	235
Loan servicing fees	30	51	112	159
Net gains on sales and redemptions of investment securities	17	18	116	179
Net gains on sales of loans and foreclosed real estate	36	6	487	31
Debit card interchange fees	114	105	341	308
Other charges, commissions & fees	134	150	400	423
Total noninterest income	704	661	2,484	2,173
Noninterest expense:				
Salaries and employee benefits	2,033	1,733	5,884	5,576
Building occupancy	382	348	1,109	1,077
Data processing	356	390	1,067	1,072
Professional and other services	178	174	502	473
Advertising	146	108	393	268
FDIC assessments	123	78	291	233
Audits and exams	61	73	184	184
Other expenses	388	274	1,343	1,106
Total noninterest expenses	3,667	3,178	10,773	9,989
Income before income taxes	723	893	2,544	2,560
Provision for income taxes	195	223	688	641
Net income	528	670	1,856	1,919

Edgar Filing: PATHFINDER BANCORP INC - Form 10-Q

Preferred stock dividends	-	113	-	367
Net income available to common shareholders	\$528	\$557	\$1,856	\$1,552
Earnings per common share - basic	\$0.21	\$0.22	\$0.74	\$0.62
Earnings per common share - diluted	\$0.20	\$0.22	\$0.73	\$0.62
Dividends per common share	\$0.03	\$0.03	\$0.09	\$0.09

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

Table of Contents

Pathfinder Bancorp, Inc.
Consolidated Statements of Comprehensive Income (Loss)
(Unaudited)

(In thousands)	For the three months ended September 30, 2013	For the three months ended September 30, 2012	For the Nine months ended September 30, 2013	For the Nine months ended September 30, 2012
Net Income	\$528	\$670	\$1,856	\$1,919
Other Comprehensive Income				
Retirement Plans:				
Retirement plan net losses recognized in plan expenses	95	78	286	318
Gain on pension plan curtailment net of additional plan losses not recognized in plan expenses	-	-	-	1,919
Retirement plan net losses recognized in plan expenses	95	78	286	2,237
Unrealized holding (losses) gains on financial derivative:				
Change in unrealized holding gains (losses) on financial derivative	(10	) (18	) 2	(53
Reclassification adjustment for interest expense included in net income	15	13	46	43
Net unrealized gain (loss) on financial derivative	5	(5	) 48	(10
Unrealized holding gains (losses) on available-for-sale securities:				
Unrealized holding (losses) gains arising during the period	1,401	939	(1,888	) 1,551
Reclassification adjustment for net gains included in net income	(17	) (18	) (116	) (179
Net unrealized gains (losses) on securities available-for-sale	1,384	921	(2,004	) 1,372
Unrealized loss on securities transferred to held-to-maturity	(1,332	) -	(1,332) -
Other comprehensive income (loss) , before tax	152	994	(3,002	) 3,599
Tax effect	(56	) (397	) 1,201	(1,440
Other comprehensive income (loss), net of tax	96	597	(1,801	) 2,159
Comprehensive Income	\$624	\$1,267	\$55	\$4,078
Tax Effect Allocated to Each Component of Other Comprehensive Income (Loss)				
Retirement plan net losses recognized in plan expenses	\$(38	) \$(31	) \$(115	) \$(127
Gain on pension plan curtailment net of additional plan losses not recognized in plan expenses	-	-	-	(768

Edgar Filing: PATHFINDER BANCORP INC - Form 10-Q

Change in unrealized holding gains (losses) on financial derivative	5	7	-	21
Reclassification adjustment for interest expense included in net income	(6	) (5	) (18	) (17
Unrealized holding (losses) gains arising during the period	(557	) (375	) 755	(620
Reclassification adjustment for net gains included in net income	7	7	46	71
Unrealized loss on securities transferred to held-to-maturity	533	-	533	-
Income tax effect related to other comprehensive income (loss)	\$(56	) \$(397	) \$1,201	\$(1,440

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

Table of Contents

PATHFINDER BANCORP, INC.
 CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
 Nine months ended September 30, 2013 and September 30, 2012

(In thousands, except share and per share data)	Preferred Stock	Common Stock	Additional Paid in Capital	Retained Earnings	Accumulated Other Com- prehensive Loss	Unearned ESOP	Treasury Stock	Total
Balance, January 1, 2013	\$13,000	\$30	\$ 8,120	\$26,685	\$ (1,318)	\$(936)	\$(4,834)	\$40,747
Net income	-	-	-	1,856	-	-	-	1,856
Other comprehensive loss, net of tax:	-	-	-	-	(1,801)	-	-	(1,801)
ESOP shares earned (9,375 shares)	-	-	38	-	-	83	-	121
Stock based compensation	-	-	59	-	-	-	-	59
Stock options exercised	-	-	(6)	-	-	-	6	-
Common stock dividends declared (\$0.09 per share)	-	-	-	(227)	-	-	-	(227)
Balance, September 30, 2013	\$13,000	\$30	\$ 8,211	\$28,314	\$ (3,119)	\$(853)	\$(4,828)	\$40,755
Balance, January 1, 2012	\$13,000	\$30	\$ 8,730	\$24,618	\$ (2,664)	\$(1,039)	\$(4,834)	\$37,841
Net income	-	-	-	1,919	-	-	-	1,919
Other comprehensive income, net of tax:	-	-	-	-	2,159	-	-	2,159
Purchase of CPP Warrants from Treasury	-	-	(706)	169	-	-	-	(537)

Edgar Filing: PATHFINDER BANCORP INC - Form 10-Q

Preferred stock dividends - SBLF	-	-	-	(367)	-	-	-	(367)
ESOP shares earned (8,520 shares)	-	-	6	-	-	75	-	81
Stock based compensation	-	-	68	-	-	-	-	68
Common stock dividends declared (\$0.09 per share)	-	-	-	(225)	-	-	-	(225)
Balance, September 30, 2012	\$13,000	\$30	\$ 8,098	\$26,114	\$ (505)	\$(964)	\$(4,834)	\$40,939

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

Table of Contents

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

(In thousands)	For the nine months ended September 30,	
	2013	2012
OPERATING ACTIVITIES		
Net income	\$1,856	\$1,919
Adjustments to reconcile net income to net cash flows from operating activities:		
Provision for loan losses	816	650
Proceeds from sales of loans	11,456	207
Originations of loans held-for-sale	(11,016)	(195)
Realized gains on sales and redemptions of:		
Real estate acquired through foreclosure	(47)	(19)
Loans	(440)	(12)
Available-for-sale investment securities	(116)	(179)
Depreciation	532	593
(Increase in) amortization of, mortgage servicing rights	(82)	6
Amortization of deferred loan costs	83	132
Earnings on bank owned life insurance	(170)	(198)
Realized gain on proceeds from bank owned life insurance	(2)	(37)
Net amortization of premiums and discounts on investment securities	567	851
Stock based compensation and ESOP expense	180	149
Net change in accrued interest receivable	(89)	(236)
Pension plan contribution	-	(2,600)
Net change in other assets and liabilities	927	734
Net cash flows from operating activities	4,455	1,765
INVESTING ACTIVITIES		
Purchase of investment securities available-for-sale	(34,861)	(44,429)
Net purchases of Federal Home Loan Bank stock	(984)	(382)
Proceeds from maturities of interest earning time deposits	500	-
Proceeds from maturities and principal reductions of investment securities available-for-sale	18,421	20,859
Proceeds from sales and redemptions of:		
Available-for-sale investment securities	5,589	10,353
Real estate acquired through foreclosure	324	331
Proceeds from bank owned life insurance	2	-
Net change in loans	(4,811)	(20,020)
Purchase of premises and equipment	(607)	(93)
Net cash flows from investing activities	(16,427)	(33,381)
FINANCING ACTIVITIES		
Net change in demand deposits, NOW accounts, savings accounts, money management deposit accounts, MMDA accounts and escrow deposits	21,953	17,698
Net change in time deposits and brokered deposits	(12,459)	10,011
Net change in short-term borrowings	15,000	9,000
Payments on long-term borrowings	(9,083)	(4,083)
Proceeds from long-term borrowings	-	4,000
Purchase of CPP warrants from the US Treasury	-	(537)
Cash dividends paid to preferred shareholder - SBLF	(83)	(392)

Edgar Filing: PATHFINDER BANCORP INC - Form 10-Q

Cash dividends paid to common shareholders	(227)	(225)
Net cash flows from financing activities	15,101	35,472
Change in cash and cash equivalents	3,129	3,856
Cash and cash equivalents at beginning of period	8,665	10,218
Cash and cash equivalents at end of period	\$11,794	\$14,074
CASH PAID DURING THE PERIOD FOR:		
Interest	\$2,577	\$2,991
Income taxes	668	3
NON-CASH INVESTING ACTIVITY		
Real estate acquired in exchange for loans	170	291
Transfer of available-for-sale securities to held-to-maturity	32,495	-

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

- 7 -

Table of Contents

Notes 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 condition, 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 2012 consolidated financial statements may have been reclassified to conform to the current period presentation. These reclassifications had no effect on net income or comprehensive income as previously reported.

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, 2012 and 2011 and for the two years 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 three and nine months ended September 30, 2013 are not necessarily indicative of the results that may be expected for the year ending December 31, 2013.

(2) New Accounting Pronouncements

In July 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2013-10 - Inclusion of the Fed Funds Effective Swap Rate (or Overnight Index Swap Rate) as a Benchmark Interest Rate for Hedge Accounting Purposes. Topic 815, Derivatives and Hedging, provides guidance on the risks that are permitted to be hedged in a fair value or cash flow hedge. Among those risks for financial assets and financial liabilities is the risk of changes in a hedged item's fair value or a hedged transaction's cash flows attributable to changes in the designated benchmark interest rate (referred to as interest rate risk). In the United States, currently only the interest rates on direct Treasury obligations of the U.S. government (UST) and, for practical reasons, the London Interbank Offered Rate (LIBOR) swap rate are considered benchmark interest rates. The amendments apply to all entities that elect to apply hedge accounting of the benchmark interest rate under Topic 815 and are effective prospectively for qualifying new or redesignated hedging relationships entered into on or after July 17, 2013. The adoption had no impact on our consolidated statements of condition, results of operations, or cash flows.

In July 2013, FASB issued ASU 2013-11 - Presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. FASB is issuing this amendment because Topic 740, Income Taxes, does not include explicit guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists. There is diversity in practice in the presentation of unrecognized tax benefits in those instances. Some entities present unrecognized tax benefits as a liability unless the unrecognized tax benefit is directly associated with a tax position taken in a tax year that results in, or that resulted in, the recognition of a net operating loss or tax credit carryforward for that year and the net operating loss or tax credit carryforward has not been utilized. Other entities present unrecognized tax benefits as a reduction of a deferred tax asset for a net operating loss or tax credit carryforward in certain circumstances. The objective of the amendments in this Update is to eliminate that diversity in practice. This Update applies to all entities

that have unrecognized tax benefits when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists at the reporting date. The amendments in this Update are effective for fiscal years, and interim periods within those years, beginning after December 15, 2013. The adoption of this amendment is not expected to have a material impact on the Company's consolidated statements of condition, results of operations, or cash flows.

Table of Contents

(3) Earnings per Common Share

Basic earnings per share are calculated by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the period. Net income available to common shareholders is net income less the total of preferred dividends declared. Diluted earnings per share include the potential dilutive effect that could occur upon the assumed exercise of issued stock options using the treasury stock method. Unallocated common shares held by the ESOP are not included in the weighted-average number of common shares outstanding for purposes of calculating earnings per common share until they are committed to be released to plan participants.

The following table sets forth the calculation of basic and diluted earnings per share:

(In thousands, except per share data)	Three months ended		Nine months ended	
	September 30,		September 30,	
	2013	2012	2013	2012
Basic Earnings Per Common Share				
Net income available to common shareholders	\$528	\$557	\$1,856	\$1,552
Weighted average common shares outstanding	2,518	2,505	2,515	2,503
Basic earnings per common share	\$0.21	\$0.22	\$0.74	\$0.62
Diluted Earnings Per Common Share				
Net income available to common shareholders	\$528	\$557	\$1,856	\$1,552
Weighted average common shares outstanding	2,518	2,505	2,515	2,503
Effect of assumed exercise of stock options	21	12	13	6
Effect of assumed exercise of stock warrants	-	-	-	4
Diluted weighted average common shares outstanding	2,539	2,517	2,528	2,513
Diluted earnings per common share	\$0.20	\$0.22	\$0.73	\$0.62

Table of Contents

(4) Investment Securities

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

(In thousands)	September 30, 2013			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
Available-for-Sale Portfolio				
Debt investment securities:				
US Treasury, agencies and GSEs	\$ 16,941	\$ 2	\$(330)	\$ 16,613
State and political subdivisions	6,319	142	(7)	6,454
Corporate	15,061	190	-	15,251
Residential mortgage-backed - US agency	41,208	630	(572)	41,266
Total	79,529	964	(909)	79,584
Equity investment securities:				
Mutual funds:				
Ultra short mortgage fund	1,286	12	-	1,298
Large cap equity fund	905	363	-	1,268
Other mutual funds	183	156	-	339
Common stock - financial services industry	402	17	-	419
Total	2,776	548	-	3,324
Total available-for-sale	\$82,305	\$1,512	\$(909)	\$82,908
Held-to-Maturity Portfolio				
Debt investment securities				
US Treasury, agencies and GSEs	\$ 1,868	\$-	\$-	\$ 1,868
State and political subdivisions	20,370	-	-	20,370
Corporate	3,747	-	-	3,747
Residential mortgage-backed - US agency	6,510	-	-	6,510
Total held-to-maturity	\$32,495	\$-	\$-	\$32,495

Table of Contents

Available-for-Sale Portfolio (In thousands)	December 31, 2012			Estimated Fair Value
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	
Debt investment securities:				
US Treasury, agencies and GSEs	\$6,175	\$16	\$(8)	\$6,183
State and political subdivisions	26,413	1,065	(7)	27,471
Corporate	22,942	468	(404)	23,006
Residential mortgage-backed - US agency	47,113	1,139	(1)	48,251
Residential mortgage-backed - private label	296	9	-	305
Total	102,939	2,697	(420)	105,216
Equity investment securities:				
Mutual funds:				
Ultra short mortgage fund	1,286	5	-	1,291
Large cap equity fund	905	176	-	1,081
Other mutual funds	183	136	-	319
Common stock - financial services industry	420	12	-	432
Total	2,794	329	-	3,123
Total investment securities	\$105,733	\$3,026	\$(420)	\$108,339

The Company elected to transfer 55 available-for-sale (“AFS”) securities with an aggregate fair value of \$32.5 million to a classification of held-to-maturity (“HTM”) on September 30, 2013. In accordance with FASB ASC 320-10-55-24, the transfer from AFS to HTM must be recorded at the fair value of the AFS securities at the time of transfer. The net unrealized holding loss of \$799,000, net of tax, at the date of transfer was retained in accumulated other comprehensive loss, with the associated pretax amount retained in the carrying value of the HTM securities. Such amounts will be amortized to interest income over the remaining life of the securities. The fair value of the transferred AFS securities became the book value of the HTM securities at September 30, 2013, with no unrealized gain or loss at this date. Future reporting periods, with potential changes in market value for these securities, would likely record an unrealized gain or loss for disclosure purposes.

The amortized cost and estimated fair value of debt investments at September 30, 2013 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.

	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
(In thousands)				
Due in one year or less	\$6,935	\$6,963	\$-	\$-
Due after one year through five years	26,696	26,827	-	-
Due after five years through ten years	4,517	4,355	11,171	11,171
Due after ten years	173	173	14,814	14,814
Sub-total	38,321	38,318	25,985	25,985
Residential mortgage-backed - US agency	41,208	41,266	6,510	6,510
Totals	\$79,529	\$79,584	\$32,495	\$32,495

Table of Contents

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:

	Less than Twelve Months			September 30, 2013 Twelve Months or More			Total		
	Number of Individual Securities	Unrealized Losses	Fair Value	Number of Individual Securities	Unrealized Losses	Fair Value	Number of Individual Securities	Unrealized Losses	Fair Value
(Dollars in thousands)									
Available-for-Sale									
US Treasury, agencies and GSE's	13	\$ (330)	\$ 14,588	-	\$ -	\$ -	13	\$ (330)	\$ 14,588
State and political subdivisions	10	(7)	1,660	-	-	-	10	(7)	1,660
Corporate	-	-	-	-	-	-	-	-	-
Residential mortgage-backed -									
US agency	24	(572)	22,963	-	-	-	24	(572)	22,963
Totals	47	\$ (909)	\$ 39,211	-	\$ -	\$ -	47	\$ (909)	\$ 39,211
Held-to-Maturity									
US Treasury, agencies and GSE's	-	\$ -	\$ -	-	\$ -	\$ -	-	\$ -	\$ -
State and political subdivisions	-	-	-	-	-	-	-	-	-
Corporate	-	-	-	-	-	-	-	-	-
Residential mortgage-backed -									
US agency	-	-	-	-	-	-	-	-	-
Totals	-	\$ -	\$ -	-	\$ -	\$ -	-	\$ -	\$ -

	Less than Twelve Months			December 31, 2012 Twelve Months or More			Total		
	Number of Individual Securities	Unrealized Losses	Fair Value	Number of Individual Securities	Unrealized Losses	Fair Value	Number of Individual Securities	Unrealized Losses	Fair Value
(Dollars in thousands)									
Available-for-Sale									
US Treasury, agencies and GSE's	1	\$ (8)	\$ 992	-	\$ -	\$ -	1	\$ (8)	\$ 992
State and political subdivisions	8	(7)	2,008	-	-	-	8	(7)	2,008
Corporate	2	(14)	974	2	(390)	1,580	4	(404)	2,554
Residential mortgage-backed -									
US agency	2	(1)	1,411	-	-	-	2	(1)	1,411

Totals	13	\$ (30)	\$ 5,385	2	\$ (390)	\$ 1,580	15	\$ (420)	\$ 6,965
--------	----	----------	----------	---	-----------	----------	----	-----------	----------

The Company conducts a formal review of investment securities on a quarterly basis for the presence of other-than-temporary impairment (“OTTI”). The Company assesses whether OTTI is present when the fair value of a debt security is less than its amortized cost basis at the statement of condition 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 anticipated to be sufficient to recover the entire amortized cost basis. The guidance requires that credit-related OTTI is recognized in earnings while non-credit-related OTTI on securities not expected to be sold is recognized in other comprehensive income (“OCI”). Non-credit-related OTTI is based on other factors, including illiquidity and changes in the general interest rate environment. Presentation of OTTI is made in the consolidated statement of income on a gross basis, including both the portion recognized in earnings as well as the portion recorded in OCI. The gross OTTI would then be offset by the amount of non-credit-related OTTI, showing the net as the impact on earnings.

The Company’s investment securities portfolio includes two corporate securities representing trust preferred issuances from large money center financial institutions. The securities have been in an unrealized loss position for more than 12 months. The securities are both floating rate notes that adjust quarterly to LIBOR (“London Interbank Offered Rate”). These securities are reflecting a net unrealized loss due to current similar offerings being originated at higher spreads to LIBOR, as the market currently demands a greater pricing premium for the associated risk. Management has performed a detailed credit analysis on the underlying companies and has concluded that neither issue is credit impaired. Due to the fact that each security has approximately 14 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 interest rate risk management procedures. The Company expects the present value of expected cash flows will be sufficient to recover the amortized cost basis. Thus, the securities are not deemed to be other-than-temporarily impaired.

Table of Contents

Management does not believe any individual unrealized loss in other securities within the portfolio as of September 30, 2013 represents OTTI. All related securities are rated A2 or better by Moody's and have been in an unrealized loss position for eight months or less with the exception of 2 municipal securities and 1 mortgage-backed security that have been in unrealized loss positions for 11 months and 10 months, respectively. The unrealized losses in the portfolio are primarily attributable to changes in interest rates. The Company does not intend to sell these securities, nor is it more likely than not that the Company will be required to sell these securities prior to the recovery of the amortized cost.

In determining whether OTTI has occurred for equity securities, the Company considers the applicable factors described above and the length of time the equity security's fair value has been below the carrying amount. All of the Company's equity securities had a fair value greater than the book value at September 30, 2013.

Gross realized gains on sales of securities for the indicated periods are detailed below:

(In thousands)	For the three months ended September 30,		For the nine months ended September 30,	
	2013	2012	2013	2012
Realized gains	\$17	\$30	\$121	\$191
Realized losses	-	(12)	(5)	(12)
	\$17	\$18	\$116	\$179

As of September 30, 2013 and December 31, 2012, securities with a fair value of \$57.4 million and \$46.0 million, respectively, were pledged to collateralize certain municipal deposit relationships. As of the same dates, securities with a fair value of \$23.2 million and \$37.8 million were pledged against certain borrowing arrangements. Total borrowings of \$0 and \$5.0 million were outstanding relating to the above noted collateralized borrowing arrangements as of September 30, 2013 and December 31, 2012, respectively.

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.

(5) Pension and Postretirement Benefits

The Company had a non-contributory defined benefit pension plan that covered substantially all employees. On May 14, 2012, the Company informed its employees of its decision to freeze participation and benefit accruals under the plan, primarily to reduce some of the volatility in earnings that can accompany the maintenance of a defined benefit plan. The freeze became effective June 30, 2012. Compensation earned by employees up to June 30, 2012 is used for purposes of calculating benefits under the plan but there will be no future benefit accruals after this date. Participants as of June 30, 2012, who continue to be employed by the Bank, will continue to earn vesting credit with respect to their frozen accrued benefits.

Table of Contents

Prior to being frozen, the plan provided defined benefits based on years of service and final average salary. Although the plan was frozen, the Company maintains the responsibility for funding the plan, and its funding practice is to contribute at least the minimum amount annually to meet minimum funding requirements. The funded status of the plan has and will continue to be affected by market conditions. The Company expects to continue to fund this plan on an as needed basis and does not foresee any issues or conditions that could negatively impact the payment of benefit obligations to plan participants. In addition, the Company provides certain health and life insurance benefits for eligible retired employees. The healthcare plan is contributory with participants' contributions adjusted annually; the life insurance plan is noncontributory. Employees with less than 14 years of service as of January 1, 1995, are not eligible for the health and life insurance retirement benefits.

The composition of net periodic pension plan and postretirement plan costs for the indicated periods is as follows:

(In thousands)	Pension Benefits		Postretirement Benefits		Pension Benefits		Postretirement Benefits	
	For the three months ended September 30,		For the three months ended September 30,		For the nine months ended September 30,		For the nine months ended September 30,	
	2013	2012	2013	2012	2013	2012	2013	2012
Service cost	\$-	\$-	\$-	\$-	\$-	\$166	\$-	\$-
Interest cost	95	93	4	4	284	305	13	13
Expected return on plan assets	(214)	(205)	-	-	(640)	(604)	-	-
Amortization of net losses	90	74	5	4	270	307	15	11
Net periodic plan (benefit) cost	\$(29)	\$(38)	\$9	\$8	\$(86)	\$174	\$28	\$24

The Company made a contribution in the amount of \$2.6 million to the defined benefit pension plan in January of 2012. The Company will evaluate the need for further contributions to the defined benefit pension plan during 2013, and has determined that no contribution was necessary during the nine months ended September 30, 2013. The prepaid pension asset is recorded in other assets on the statement of condition as of September 30, 2013.

Table of Contents

(6) Loans

Major classifications of loans at the indicated dates are as follows:

(In thousands)	September 30, 2013	December 31, 2012
Residential mortgage loans:		
1-4 family first-lien residential mortgages	\$ 165,363	\$ 173,955
Construction	1,694	2,655
Total residential mortgage loans	167,057	176,610
Commercial loans:		
Real estate	94,078	82,329
Lines of credit	13,701	13,748
Other commercial and industrial	33,037	31,477
Municipal	4,968	3,588
Total commercial loans	145,784	131,142
Consumer loans:		
Home equity and junior liens	20,917	22,073
Other consumer	4,009	3,469
Total consumer loans	24,926	25,542
Total loans	337,767	333,294
Net deferred loan costs	307	454
Less allowance for loan losses	(5,085)	(4,501)
Loans receivable, net	\$ 332,989	\$ 329,247

The Company originates residential mortgage, commercial, and consumer loans largely to customers throughout Oswego and Onondaga counties. Although the Company has a diversified loan portfolio, a substantial portion of its borrowers' abilities to honor their contracts is dependent upon the counties' employment and economic conditions.

As of September 30, 2013 and December 31, 2012, residential mortgage loans with a carrying value of \$111.9 million and \$58.6 million, respectively, have been pledged by the Company to the Federal Home Loan Bank of New York ("FHLBNY") under a blanket collateral agreement to secure the Company's line of credit and term borrowings.

Table of Contents

Loan Origination / Risk Management

The Company's lending policies and procedures are presented in Note 5 to the consolidated financial statements included in the 2012 Annual Report filed on Form 10-K on March 18, 2013, and have not changed.

To develop and document a systematic methodology for determining the allowance for loan losses, the Company has divided the loan portfolio into three portfolio segments, each with different risk characteristics but with similar methodologies for assessing risk. Each portfolio segment is broken down into loan classes where appropriate. Loan classes contain unique measurement attributes, risk characteristics, and methods for monitoring and assessing risk that are necessary to develop the allowance for loan losses. Unique characteristics such as borrower type, loan type, collateral type, and risk characteristics define each class. The following table illustrates the portfolio segments and classes for the Company's loan portfolio:

Portfolio Segment	Class
Residential Mortgages Loans	1-4 family first-lien residential mortgages Construction
Commercial Loans	Real estate Lines of credit Other commercial and industrial Municipal
Consumer Loans	Home equity and junior liens Other consumer

Table of Contents

The following tables present the classes of the loan portfolio, not including net deferred loan costs, summarized by the aggregate pass rating and the classified ratings of special mention, substandard and doubtful within the Company's internal risk rating system as of the dates indicated:

(In thousands)	As of September 30, 2013				Total
	Pass	Special Mention	Substandard	Doubtful	
Residential mortgage loans:					
1-4 family first-lien residential mortgages	\$ 159,005	\$ 1,293	\$ 5,050	\$ 15	\$ 165,363
Construction	1,694	-	-	-	1,694
Total residential mortgage loans	160,699	1,293	5,050	15	167,057
Commercial loans:					
Real estate	88,134	1,022	4,739	183	94,078
Lines of credit	12,154	476	1,071	-	13,701
Other commercial and industrial	31,348	432	982	275	33,037
Municipal	4,968	-	-	-	4,968
Total commercial loans	136,604	1,930	6,792	458	145,784
Consumer loans:					
Home equity and junior liens	19,357	473	1,004	83	20,917
Other consumer	3,890	31	66	22	4,009
Total consumer loans	23,247	504	1,070	105	24,926
Total loans	\$ 320,550	\$ 3,727	\$ 12,912	\$ 578	\$ 337,767

(In thousands)	As of December 31, 2012				Total
	Pass	Special Mention	Substandard	Doubtful	
Residential mortgage loans:					
1-4 family first-lien residential mortgages	\$ 166,801	\$ 1,323	\$ 5,831	\$ -	\$ 173,955
Construction	2,655	-	-	-	2,655
Total residential mortgage loans	169,456	1,323	5,831	-	176,610
Commercial loans:					
Real estate	76,719	1,685	3,925	-	82,329
Lines of credit	12,026	-	1,647	75	13,748
Other commercial and industrial	29,705	237	1,500	35	31,477
Municipal	3,588	-	-	-	3,588
Total commercial loans	122,038	1,922	7,072	110	131,142
Consumer loans:					
Home equity and junior liens	20,078	145	1,801	49	22,073
Other consumer	3,199	133	111	26	3,469
Total consumer loans	23,277	278	1,912	75	25,542
Total loans	\$ 314,771	\$ 3,523	\$ 14,815	\$ 185	\$ 333,294

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

Table of Contents

Nonaccrual and Past Due Loans

Loans are placed on nonaccrual when the contractual payment of principal and interest has become 90 days past due or management has serious doubts about further collectability of principal or interest, even though the loan may be currently performing.

Loans are considered past due if the required principal and interest payments have not been received within thirty days of the payment due date.

An age analysis of past due loans, segregated by portfolio segment and class of loans, as of September 30, 2013 and December 31, 2012, are detailed in the following tables:

(In thousands)	As of September 30, 2013					Total Loans Receivable
	30-59 Days Past Due	60-89 Days Past Due	90 Days and Over	Total Past Due	Current	
Residential mortgage loans:						
1-4 family first-lien residential mortgages	\$1,653	\$1,026	\$2,401	\$5,080	\$160,283	\$165,363
Construction	-	-	-	-	1,694	1,694
Total residential mortgage loans	1,653	1,026	2,401	5,080	161,977	167,057
Commercial loans:						
Real estate	917	1,082	2,336	4,335	89,743	94,078
Lines of credit	237	-	260	497	13,204	13,701
Other commercial and industrial	2,563	1,027	464	4,054	28,983	33,037
Municipal	-	-	-	-	4,968	4,968
Total commercial loans	3,717	2,109	3,060	8,886	136,898	145,784
Consumer loans:						
Home equity and junior liens	178	31	362	571	20,346	20,917
Other consumer	72	-	63	135	3,874	4,009
Total consumer loans	250	31	425	706	24,220	24,926
Total loans	\$5,620	\$3,166	\$5,886	\$14,672	\$323,095	\$337,767

(In thousands)	As of December 31, 2012					Total Loans Receivable
	30-59 Days Past Due	60-89 Days Past Due	90 Days and Over	Total Past Due	Current	
Residential mortgage loans:						
1-4 family first-lien residential mortgages	\$2,698	\$1,161	\$2,046	\$5,905	\$168,050	\$173,955
Construction	-	-	-	-	2,655	2,655
Total residential mortgage loans	2,698	1,161	2,046	5,905	170,705	176,610
Commercial loans:						
Real estate	1,706	1,833	1,794	5,333	76,996	82,329
Lines of credit	496	153	334	983	12,765	13,748
Other commercial and industrial	1,279	85	598	1,962	29,515	31,477
Municipal	-	-	-	-	3,588	3,588

Edgar Filing: PATHFINDER BANCORP INC - Form 10-Q

Total commercial loans	3,481	2,071	2,726	8,278	122,864	131,142
Consumer loans:						
Home equity and junior liens	207	405	730	1,342	20,731	22,073
Other consumer	26	42	46	114	3,355	3,469
Total consumer loans	233	447	776	1,456	24,086	25,542
Total loans	\$6,412	\$3,679	\$5,548	\$15,639	\$317,655	\$333,294

- 18 -

Table of Contents

Nonaccrual loans, segregated by class of loan, were as follows:

(In thousands)	September 30, 2013	December 31, 2012
Residential mortgage loans:		
1-4 family first-lien residential mortgages	\$2,401	\$2,046
	2,401	2,046
Commercial loans:		
Real estate	2,336	1,794
Lines of credit	260	334
Other commercial and industrial	464	598
	3,060	2,726
Consumer loans:		
Home equity and junior liens	362	730
Other consumer	63	46
	425	776
Total nonaccrual loans	\$5,886	\$5,548

There were no loans past due ninety days or more and still accruing interest at September 30, 2013 or December 31, 2012.

The Company is required to disclose certain activities related to Troubled Debt Restructurings (“TDR”s) in accordance with accounting guidance. Certain loans have been modified in a TDR where economic concessions have been granted to a borrower who is experiencing, or expected to experience, financial difficulties. These economic concessions could include a reduction in the loan interest rate, extension of payment terms, reduction of principal amortization, or other actions that it would not otherwise consider for a new loan with similar risk characteristics.

The Company is required to disclose new TDRs for each reporting period for which an income statement is being presented. The Company has determined that there was a new TDR with a recorded investment of \$404,000 in the nine month period ended September 30, 2013.

The modification made within the residential real estate loan class resulted in a pre-modification and post-modification recorded investment of \$400,000 and \$407,000, respectively. The post-modification recorded investment included late charges, accrued interest, and closing costs as a result of the restructuring. Economic concessions granted included a reduction in loan interest rate, extended payment terms, and an advance of additional monies for closing costs without an associated increase in collateral. The Company was required to establish a specific reserve against this loan of \$61,000, which was a component of the provision for loan losses in the third quarter of 2013.

There are five loans that have been in payment default during the nine month period ended September 30, 2013 which were modified during the preceding twelve month period. Two of these loans are commercial real estate loans that total to the amount of \$758,000, one is a commercial line of credit in the amount of \$85,000, one is a commercial loan in the amount of \$110,000 and another is a home equity loan in the amount of \$39,000.

When the Company modifies a loan within a portfolio segment, a potential impairment is analyzed either based on the present value of the expected future cash flows discounted at the interest rate of the original loan terms or the fair value of the collateral less costs to sell. If it is determined that the value of the loan is less than its recorded investment, then impairment is recognized as a component of the provision for loan losses, an associated increase to

the allowance for loan losses or as a charge-off to the allowance for loan losses in the current period.

- 19 -

Table of Contents

Impaired Loans

The following tables summarize impaired loan information by portfolio class at the indicated dates:

(In thousands)	September 30, 2013			December 31, 2012		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance recorded:						
1-4 family first-lien residential mortgages	\$578	\$578	\$-	\$844	\$844	\$-
Commercial real estate	1,981	1,981	-	1,554	1,571	-
Commercial lines of credit	282	297	-	358	370	-
Other commercial and industrial	286	286	-	657	801	-
Home equity and junior liens	299	299	-	380	380	-
Other consumer	-	-	-	-	-	-
With an allowance recorded:						
1-4 family first-lien residential mortgages	404	404	61	1,307	1,307	215
Commercial real estate	2,075	2,075	679	1,182	1,182	401
Commercial lines of credit	100	100	100	-	-	-
Other commercial and industrial	251	260	232	225	230	207
Home equity and junior liens	165	165	85	155	155	95
Other consumer	2	2	2	5	5	5
Total:						
1-4 family first-lien residential mortgages	982	982	61	2,151	2,151	215
Commercial real estate	4,056	4,056	679	2,736	2,753	401
Commercial lines of credit	382	397	100	358	370	-
Other commercial and industrial	537	546	232	882	1,031	207
Home equity and junior liens	464	464	85	535	535	95
Other consumer	2	2	2	5	5	5
Totals	\$6,423	\$6,447	\$1,159	\$6,667	\$6,845	\$923

The following table presents the average recorded investment in impaired loans for the periods indicated:

(In thousands)	For the three months ended		For the nine months ended	
	September 30,		September 30,	
	2013	2012	2013	2012
1-4 family first-lien residential mortgages	\$781	\$1,879	\$1,521	\$1,565
Commercial real estate	3,949	2,801	3,621	2,449
Commercial lines of credit	418	412	412	432
Other commercial and industrial	674	768	767	677
Home equity and junior liens	467	502	525	477
Other consumer	2	5	3	2

Edgar Filing: PATHFINDER BANCORP INC - Form 10-Q

Total	\$6,291	\$6,367	\$6,849	\$5,602
-------	---------	---------	---------	---------

- 20 -

Table of Contents

The following table presents the cash basis interest income recognized on impaired loans for the periods indicated:

(In thousands)	For the three months ended September 30,		For the nine months ended September 30,	
	2013	2012	2013	2012
1-4 family first-lien residential mortgages	\$10	\$34	\$23	\$80
Commercial real estate	79	-	151	60
Commercial lines of credit	2	(5	) 13	13
Other commercial and industrial	8	11	20	30
Home equity and junior liens	6	4	24	11
Other consumer	-	1	-	1
Total	\$105	\$45	\$231	\$195

Beginning with the second quarter of 2013, the Company categorized residential mortgage loans as impaired if the total related credit to the borrower exceeded the minimum threshold of \$300,000. The prior threshold was \$100,000.

Table of Contents

(7) Allowance for Loan Losses

Summarized in the tables below are changes in the allowance for loan losses for the indicated periods and information pertaining to the allocation of the allowance for loan losses, balances of the allowance for loan losses, loans receivable based on individual, and collective impairment evaluation by loan portfolio class. An allocation of a portion of the allowance to a given portfolio class does not limit the Company's ability to absorb losses in another portfolio class.

For the three months ended September 30, 2013

(In thousands)	1-4 family first-lien residential mortgage	Residential construction mortgage	Commercial real estate	Commercial lines of credit	Other commercial and industrial
Allowance for loan losses:					
Beginning Balance	\$585	\$-	\$2,055	\$418	\$1,045
Charge-offs	-	-	-	-	(14)
Recoveries	24	-	-	21	-
Provisions	25	-	295	(73)	(43)
Ending balance	\$634	\$-	\$2,350	\$366	\$988
Ending balance: related to loans individually evaluated for impairment	61	-	679	100	232
Ending balance: related to loans collectively evaluated for impairment	\$573	\$-	\$1,671	\$266	\$756
Loans receivables:					
Ending balance	\$165,363	\$1,694	\$94,078	\$13,701	\$33,037
Ending balance: individually evaluated for impairment	982	-	4,056	382	537
Ending balance: collectively evaluated for impairment	\$164,381	\$1,694	\$90,022	\$13,319	\$32,500

	Municipal	Home equity and junior liens	Other Consumer	Unallocated	Total
Allowance for loan losses:					
Beginning Balance	\$3	\$454	\$135	\$169	\$4,864
Charge-offs	-	-	(36)	-	(50)
Recoveries	-	-	10	-	55
Provisions	(1)	(9)	23	(1)	216
Ending balance	\$2	\$445	\$132	\$168	\$5,085
Ending balance: related to loans individually evaluated for impairment	-	85	2	-	1,159
Ending balance: related to loans collectively evaluated for impairment	\$2	\$360	\$130	\$168	\$3,926
Loans receivables:					
Ending balance	\$4,968	\$20,917	\$4,009		\$337,767

Edgar Filing: PATHFINDER BANCORP INC - Form 10-Q

Ending balance: individually evaluated for impairment	-	464	2	6,423
Ending balance: collectively evaluated for impairment	\$4,968	\$ 20,453	\$ 4,007	\$331,344

Table of Contents

For the nine months ended September 30, 2013

(In thousands)	1-4 family first-lien residential mortgage	Residential construction mortgage	Commercial real estate	Commercial lines of credit	Other commercial and industrial
Allowance for loan losses:					
Beginning Balance	\$811	\$-	\$1,748	\$440	\$750
Charge-offs	(104)	-	-	(49)	(29)
Recoveries	37	-	-	21	-
Provisions	(110)	-	602	(46)	267
Ending balance	\$634	\$-	\$2,350	\$366	\$988

	Municipal	Home equity and junior liens	Other consumer	Unallocated	Total
Allowance for loan losses:					
Beginning Balance	\$2	\$494	\$168	\$88	\$4,501
Charge-offs	-	(81)	(75)	-	(338)
Recoveries	-	13	35	-	106
Provisions	-	19	4	80	816
Ending balance	\$2	\$445	\$132	\$168	\$5,085

Table of Contents

For the three months ended September 30, 2012

(In thousands)	1-4 family first-lien residential mortgage	Residential construction mortgage	Commercial real estate	Commercial lines of credit	Other commercial and industrial
Allowance for loan losses:					
Beginning Balance	\$777	\$ -	\$ 1,587	\$ 398	\$698
Charge-offs	(61)	-	-	-	-
Recoveries	23	-	-	-	-
Provisions	27	-	200	12	112
Ending balance	\$766	\$ -	\$ 1,787	\$ 410	\$810
Ending balance: related to loans individually evaluated for impairment	208	-	489	-	269
Ending balance: related to loans collectively evaluated for impairment	\$558	\$ -	\$ 1,298	\$ 410	\$541
Loans receivables:					
Ending balance	\$169,062	\$ 2,587	\$ 79,770	\$ 13,471	\$27,509
Ending balance: individually evaluated for impairment	2,134	-	2,796	374	968
Ending balance: collectively evaluated for impairment	\$166,928	\$ 2,587	\$ 76,974	\$ 13,097	\$26,541
		Home equity and junior liens	Other Consumer	Unallocated	Total
Allowance for loan losses:					
Beginning Balance	\$2	\$ 501	\$ 131	\$ 119	\$4,213
Charge-offs	-	-	(30)	-	(91)
Recoveries	-	1	12	-	36
Provisions	-	(24)	65	(117)	275
Ending balance	\$2	\$ 478	\$ 178	\$ 2	\$4,433
Ending balance: related to loans individually evaluated for impairment	-	60	6	-	1,032
Ending balance: related to loans collectively evaluated for impairment	\$2	\$ 418	\$ 172	\$ 2	\$3,401
Loans receivables:					
Ending balance	\$5,063	\$ 22,580	\$ 3,627		\$323,669
Ending balance: individually evaluated for impairment	-	502	6		6,780
Ending balance: collectively evaluated for impairment	\$5,063	\$ 22,078	\$ 3,621		\$316,889

Table of Contents

For the nine months ended September 30, 2012

(In thousands)	1-4 family first-lien residential mortgage	Residential construction mortgage	Commercial real estate	Commercial lines of credit	Other commercial and industrial
Allowance for loan losses:					
Beginning Balance	\$664	\$-	\$1,346	\$463	\$649
Charge-offs	(96)	) -	(54)	) -	(89)
Recoveries	52	-	14	50	-
Provisions	146	-	481	(103)	) 250
Ending balance	\$766	\$-	\$1,787	\$410	\$810

	Municipal	Home equity and junior liens	Other Consumer	Unallocated	Total
Allowance for loan losses:					
Beginning Balance	\$2	\$501	\$162	\$193	\$3,980
Charge-offs	-	(8)	) (114)	) -	(361)
Recoveries	-	6	42	-	164
Provisions	-	(21)	) 88	(191)	) 650
Ending balance	\$2	\$478	\$178	\$2	\$4,433

Table of Contents

(8) 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 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 of issuance. 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 \$4.5 million of standby letters of credit outstanding as of September 30, 2013. 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 fair value of standby letters of credit was not significant to the Company's consolidated financial statements.

(9) Fair Value Measurements

Accounting guidance related to 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 the Company's market assumptions. These two types of inputs have created the following fair value hierarchy:

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.

In determining fair value, the Company utilizes valuation techniques that maximize the use of observable inputs, minimize the use of unobservable inputs, to the extent possible, and considers counterparty credit risk in its assessment of fair value.

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 where available (Level 1). 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.

Interest rate swap derivative: The fair value of the interest rate swap derivative is calculated based on a discounted cash flow model. All future floating cash flows are projected and both floating and fixed cash flows are discounted to the valuation date. The curve utilized for discounting and projecting is built by obtaining publicly available third

party market quotes for various swap maturity terms.

Impaired loans: Impaired loans are those loans 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 market value evaluations by third parties of the properties and/or estimates by management of working capital collateral or discounted cash flows based upon expected proceeds. These appraisals may include up to three approaches to value: the sales comparison approach, the income approach (for income-producing property), and the cost approach. Management modifies the appraised values, if needed, to take into account recent developments in the market or other factors, such as, changes in absorption rates or market conditions from the time of valuation and anticipated sales values considering management's plans for disposition. Such modifications to the appraised values could result in lower valuations of such collateral. Estimated costs to sell are based on current amounts of disposal costs for similar assets. These measurements are classified as Level 3 within the valuation hierarchy. Impaired loans are subject to nonrecurring fair value adjustment upon initial recognition or subsequent impairment. A portion of the allowance for loan losses is allocated to impaired loans if the value of such loans is deemed to be less than the unpaid balance.

Table of Contents

Foreclosed real estate: Fair values for foreclosed real estate are initially recorded based on market value evaluations by third parties, less costs to sell (“initial cost basis”). Any write-downs required when the related loan receivable is exchanged for the underlying real estate collateral at the time of transfer to foreclosed real estate are charged to the allowance for loan losses. Values are derived from appraisals, similar to impaired loans, of underlying collateral or discounted cash flow analysis. Subsequent to foreclosure, valuations are updated periodically and assets are marked to current fair value, not to exceed the initial cost basis. In the determination of fair value subsequent to foreclosure, management also considers other factors or recent developments, such as, changes in absorption rates and market conditions from the time of valuation and anticipated sales values considering management’s plans for disposition. Either change could result in adjustment to lower the property value estimates indicated in the appraisals. These measurements are classified as Level 3 within the fair value hierarchy.

The following tables summarize assets measured at fair value on a recurring basis as of the indicated dates, segregated by the level of valuation inputs within the hierarchy utilized to measure fair value:

(In thousands)	September 30, 2013			Total Fair Value
	Level 1	Level 2	Level 3	
Available-for-Sale Portfolio				
Debt investment securities:				
US Treasury, agencies and GSEs	\$-	\$16,613	\$-	\$16,613
State and political subdivisions	-	6,454	-	6,454
Corporate	-	15,251	-	15,251
Residential mortgage-backed - US agency	-	41,266	-	41,266
Residential mortgage-backed - private label	-	-	-	-
Equity investment securities:				
Mutual funds:				
Ultra short mortgage fund	1,298	-	-	1,298
Large cap equity fund	1,268	-	-	1,268
Other mutual funds	-	339	-	339
Common stock - financial services industry	38	381	-	419
Total available-for-sale securities	\$2,604	\$80,304	\$-	\$82,908
Interest rate swap derivative	\$-	\$(147)	\$-	\$(147)

Table of Contents

(In thousands)	December 31, 2012			Total Fair Value
	Level 1	Level 2	Level 3	
Available-for-sale portfolio				
Debt investment securities:				
US Treasury, agencies and GSEs	\$-	\$6,183	\$-	\$6,183
State and political subdivisions	-	27,471	-	27,471
Corporate	-	23,006	-	23,006
Residential mortgage-backed - US agency	-	48,251	-	48,251
Residential mortgage-backed - private label	-	305	-	305
Equity investment securities:				
Mutual funds:				
Ultra short mortgage fund	1,291	-	-	1,291
Large cap equity fund	1,081	-	-	1,081
Other mutual funds	-	319	-	319
Common stock - financial services industry	33	399	-	432
Total available-for-sale securities	\$2,405	\$105,934	\$-	\$108,339
Interest rate swap derivative	\$-	\$(195)	\$-	\$(195)

The Bank had the following assets measured at fair value on a nonrecurring basis as of September 30, 2013 and December 31, 2012:

(In thousands)	September 30, 2013			Total Fair Value
	Level 1	Level 2	Level 3	
Impaired loans	\$-	\$-	\$258	\$258
Foreclosed real estate	\$-	\$-	\$71	\$71

(In thousands)	December 31, 2012			Total Fair Value
	Level 1	Level 2	Level 3	
Impaired loans	\$-	\$-	\$1,951	\$1,951
Foreclosed real estate	\$-	\$-	\$301	\$301

The following table presents additional quantitative information about assets measured at fair value on a nonrecurring basis and for which Level 3 inputs were used to determine fair value at the indicated dates.

Quantitative Information about Level 3 Fair Value Measurements

	Valuation Techniques	Unobservable Input	Range (Weighted Avg.)
September 30, 2013			
Impaired loans	Appraisal of collateral (Sales Approach)	Appraisal Adjustments Costs to Sell	5% - 30% (15%) 6% - 50% (13%)

Edgar Filing: PATHFINDER BANCORP INC - Form 10-Q

Foreclosed real estate	Appraisal of collateral (Sales Approach)	Appraisal Adjustments Costs to Sell	15% - 15% (15%) 6% - 7% (6%)
------------------------	---	--	------------------------------------

- 28 -

Table of ContentsQuantitative Information about
Level 3 Fair Value Measurements

	Valuation Techniques	Unobservable Input	Range (Weighted Avg.)
December 31, 2012			
Impaired loans	Appraisal of collateral	Appraisal Adjustments	5% - 30% (21%)
	(Sales Approach)	Costs to Sell	6% - 15% (12%)
Foreclosed real estate	Appraisal of collateral	Appraisal Adjustments	15% - 15% (15%)
	(Sales Approach)	Costs to Sell	6% - 7% (6%)

As of June 30, 2013, junior subordinated debentures with a carrying value of \$5.2 million were transferred from a level 3 classification to a level 2 classification.

Required disclosures include 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.

The Company has various processes and controls in place to ensure that fair value is reasonably estimated. A model validation policy governs the use and control of valuation models used to estimate fair value. This policy requires review and approval of models by personnel who are independent of the front office, and periodic reassessments of models to ensure that they are continuing to perform as designed. In addition, detailed reviews of trading gains and losses are conducted by personnel who are independent of the front office. A price verification group, which is also independent of the front office, utilizes available market information including executed trades, market prices and market-observable valuation model inputs to ensure that fair values are reasonably estimated. The Company performs due diligence procedures over third-party pricing service providers in order to support their use in the valuation process. Where market information is not available to support internal valuations, independent reviews of the valuations are performed and any material exposures are escalated through a management review process.

While the Company believes its valuation methods are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

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

period-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 period-end.

- 29 -

Table of Contents

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 and are classified as Level 1.

Interest earning time deposits – The carrying amounts of these assets approximate their fair value and are classified as Level 1.

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 where available (Level 1). 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.

Federal Home Loan Bank stock – The carrying amount of these assets approximates their fair value and are classified as Level 2.

Net loans – For variable-rate loans that re-price frequently, fair value is based on carrying amounts. The fair value of other loans (for example, fixed-rate commercial real estate loans, mortgage loans, and commercial and industrial loans) is estimated using discounted cash flow analysis, based on interest rates currently being offered in the market for loans with similar terms to borrowers of similar credit quality. Loan value estimates include judgments based on expected prepayment rates. The measurement of the fair value of loans, including impaired loans, is classified within Level 3 of the fair value hierarchy.

Accrued interest receivable and payable – The carrying amount of these assets approximates their fair value and are classified as Level 1.

Deposits – 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) and are classified within Level 1 of the fair value hierarchy. 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. Measurements of the fair value of time deposits are classified within Level 2 of the fair value hierarchy.

Borrowings – Fixed/variable term “bullet” structures are valued using a replacement cost of funds approach. These borrowings are discounted to the FHLB 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 FHLB are obtained and the borrowings are discounted to the FHLB advance curve less an appropriate spread to adjust for the option. These measurements are classified as Level 2 within the fair value hierarchy.

Junior subordinated debentures – Current economic conditions have rendered the market for this liability inactive. As such, the Company was formerly unable to determine a good estimate of fair value, resulting in a Level 3 classification at December 31, 2012. As of June 30, 2013, the Company was able to secure a quote from its pricing

service based on a Discounted Cash Flow methodology which resulted in a Level 2 classification for this borrowing.

- 30 -

Interest rate swap derivative – The fair value of the interest rate swap derivative is obtained from a third party pricing agent and is calculated based on a discounted cash flow model. All future floating cash flows are projected and both floating and fixed cash flows are discounted to the valuation date. The curve utilized for discounting and projecting is built by obtaining publicly available third party market quotes for various swap maturity terms, and therefore is classified within Level 2 of the fair value hierarchy.

The carrying amounts and fair values of the Company's financial instruments as of the indicated dates are presented in the following table:

(Dollars In thousands)	Fair Value Hierarchy	September 30, 2013		December 31, 2012	
		Carrying Amounts	Estimated Fair Values	Carrying Amounts	Estimated Fair Values
Financial assets:					
Cash and cash equivalents	1	\$11,794	\$11,794	\$8,665	\$8,665
Interest earning time deposits	1	1,500	1,500	2,000	2,000
Investment securities - available-for-sale	1	2,604	2,604	2,405	2,405
Investment securities - available-for-sale	2	80,304	80,304	105,934	105,934
Investment securities - held-to-maturity	2	32,495	32,495	-	-
Federal Home Loan Bank stock	2	2,913	2,913	1,929	1,929
Net loans	3	332,989	341,241	329,247	341,389
Accrued interest receivable	1	1,806	1,806	1,717	1,717
Financial liabilities:					
Demand Deposits, Savings, NOW and MMDA	1	\$250,438	\$250,438	\$228,484	\$228,484
Time Deposits	2	150,861	151,579	163,321	165,491
Borrowings	2	40,881	41,373	34,964	36,054
Junior subordinated debentures	2	5,155	4,415	-	-
Junior subordinated debentures	3	-	-	5,155	5,155
Accrued interest payable	1	72	72	140	140
Interest rate swap derivative	2	147	147	195	195

(10) Interest Rate Derivatives

Derivative instruments are entered into primarily as a risk management tool of the Company. Financial derivatives are recorded at fair value as other assets and other liabilities. The accounting for changes in the fair value of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship. For a fair value hedge, changes in the fair value of the derivative instrument and changes in the fair value of the hedged asset or liability are recognized currently in earnings. For a cash flow hedge, changes in the fair value of the derivative instrument, to the extent that it is effective, are recorded in other comprehensive income and subsequently reclassified to earnings as the hedged transaction impacts net income. Any ineffective portion of a cash flow hedge is recognized currently in earnings. See Note 9 for further discussion of the fair value of the interest rate derivative.

The Company has \$5 million of floating rate trust preferred debt indexed to 3-month LIBOR. As a result, it is exposed to variability in cash flows related to changes in projected interest payments caused by changes in the benchmark interest rate. During the fourth quarter of fiscal 2009, the Company entered into an interest rate swap agreement, with a \$2.0 million notional amount, to convert a portion of the variable-rate junior subordinated debentures to a fixed rate for a term of approximately 7 years at a rate of 4.96%. The derivative is designated as a cash flow hedge. The hedging strategy ensures that changes in cash flows from the derivative will be highly effective at offsetting changes in interest expense from the hedged exposure.

The following table summarizes the fair value of the outstanding derivative and its presentation on the statements of condition:

(In thousands)		September 30, 2013	December 31, 2012
Cash flow hedge:			
	Other liabilities	\$147	\$195

The change in accumulated other comprehensive loss on a pretax basis and the impact on earnings from the interest rate swap that qualifies as a cash flow hedge for the periods indicated below were as follows:

(In thousands)	Three Months Ended September 30,	
	2013	2012
Balance as of June 30:	\$(152)	\$(205)
Amount of losses recognized in other comprehensive income	(10)	(18)
Amount of loss reclassified from other comprehensive income and recognized as interest expense	15	13
Balance as of September 30:	\$(147)	\$(210)

(In thousands)	Nine Months Ended September 30,	
	2013	2012
Balance as of December 31:	\$(195)	\$(200)
Amount of gains (losses) recognized in other comprehensive income	2	(53)
Amount of loss reclassified from other comprehensive income and recognized as interest expense	46	43
Balance as of September 30:	\$(147)	\$(210)

No amount of ineffectiveness has been included in earnings and the changes in fair value have been recorded in other comprehensive income. Some, or all, of the amount included in accumulated other comprehensive loss would be reclassified into current earnings should a portion of, or the entire hedge no longer be considered effective, but at this time, management expects the hedge to remain fully effective during the remaining term of the swap.

The Company posted cash of \$200,000 under arrangements to satisfy collateral requirements associated with the interest rate swap contract.

Table of Contents

(11) Accumulated Other Comprehensive Income (Loss)

Changes in the components of accumulated other comprehensive income (loss) ("AOCI"), net of tax, for the periods indicated are summarized in the table below.

	For the three months ended September 30, 2013				Total
	Retirement Plans	Unrealized Gains and Losses on Financial Derivative	Unrealized Gains and Losses on Available-for-Sale Securities	Unrealized Loss on Securities Transferred to Held-to-Maturity	
Beginning balance	\$(2,651)	\$(91)	\$ (473)	\$ -	\$(3,215)
Other comprehensive income (loss) before reclassifications	-	(5)	844	(799)	40
Amounts reclassified from AOCI	57	9	(10)	-	56
Ending balance	\$(2,594)	\$(87)	\$ 361	\$ (799)	\$(3,119)

	For the nine months ended September 30, 2013				Total
	Retirement Plans	Unrealized Gains and Losses on Financial Derivative	Unrealized Gains and Losses on Available-for-Sale Securities	Unrealized Loss on Securities Transferred to Held-to-Maturity	
Beginning balance	\$(2,765)	\$(117)	\$ 1,564	\$ -	\$(1,318)
Other comprehensive income (loss) before reclassifications	-	2	(1,133)	(799)	(1,930)
Amounts reclassified from AOCI	171	28	(70)	-	129
Ending balance	\$(2,594)	\$(87)	\$ 361	\$ (799)	\$(3,119)

	For the three months ended September 30, 2012				Total
	Retirement Plans	Unrealized Gains and Losses on Financial Derivative	Unrealized Gains and Losses on Available-for-Sale Securities	Unrealized Loss on Securities Transferred to Held-to-Maturity	
Beginning balance	\$(2,322)	\$(124)	\$ 1,344	\$ -	\$(1,102)
Other comprehensive income (loss) before reclassifications	-	(10)	563	-	553
Amounts reclassified from AOCI	47	8	(11)	-	44
Ending balance	\$(2,275)	\$(126)	\$ 1,896	\$ -	\$(505)

	For the nine months ended September 30, 2012				Total
	Retirement Plans	Unrealized Gains and Losses on Financial Derivative	Unrealized Gains and Losses on Available-for-Sale Securities	Unrealized Loss on Securities Transferred to Held-to-Maturity	
Beginning balance	\$(3,617)	\$(120)	\$ 1,073	\$ -	\$(2,664)
	1,151	(32)	931	-	2,050

Edgar Filing: PATHFINDER BANCORP INC - Form 10-Q

Other comprehensive income (loss) before reclassifications						
Amounts reclassified from AOCI	191	26	(108	)	-	109
Ending balance	\$(2,275	) \$(126	) \$	1,896	\$	-(505

- 33 -

Table of Contents

The following table presents the amounts reclassified out of each component of AOCI for the indicated period:

Details about AOCI components	For the three months ended September 30, 2013		For the nine months ended September 30, 2013	
	Amount Reclassified from AOCI1	Affected Line Item in the Statement of Income	Amount Reclassified from AOCI1	Affected Line Item in the Statement of Income
Unrealized holding gain on financial derivative: Reclassification adjustment for interest expense included in net income	\$(15)	Interest on long-term) borrowings	\$(46)	Interest on long-term) borrowings
	6	Provision for income taxes	18	Provision for income taxes
	\$(9)	) Net Income	\$(28)	) Net Income
Retirement plan items Retirement plan net losses recognized in plan expenses ²	\$(95)	Salaries and employee) benefits	\$(286)	Salaries and employee) benefits
	38	Provision for income taxes	115	Provision for income taxes
	\$(57)	) Net Income	\$(171)	) Net Income
Available-for-sale securities Realized gain on sale of securities	\$(17)	Net gains on sales and redemptions of investment) securities	\$(116)	Net gains on sales and redemptions of investment) securities
	7	Provision for income taxes	46	Provision for income taxes
	\$(10)	) Net Income	\$(70)	) Net Income

1 Amounts in parentheses indicates debits in net income.

2 These items are included in net periodic pension cost.

See Note 5 for additional information.

Table of Contents

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

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., Pathfinder Risk Management, Inc., and Whispering Oaks Development Corp. are wholly owned subsidiaries of Pathfinder Bank. At September 30, 2013, 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 60.5% of the Company's outstanding common stock and public shareholders, including shares held by the Employee Stock Ownership Plan ("ESOP"), held the remaining 39.5% of the outstanding common stock.

The following discussion reviews the Company's financial condition at September 30, 2013 and the results of operations for the three and nine months ended September 30, 2013 and 2012.

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 consolidated 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 annual audited consolidated financial statements included in the 2012 Annual Report filed with the Securities and Exchange

Commission on form 10-K on March 18, 2013 (“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. These areas could be the most subject to revision as new information becomes available.

- 35 -

Table of Contents

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 on 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 Company establishes a specific allowance for all commercial loans in excess of the total related credit threshold of \$100,000 and single borrower residential mortgage loans in excess of the total related credit threshold of \$300,000 identified as being impaired which are on nonaccrual and have been risk rated under the Company's risk rating system as substandard, doubtful, or loss. In addition, an accruing substandard loan could be identified as being impaired. The measurement of impaired loans is generally based upon the present value of future cash flows discounted at the historical effective interest rate, except that all collateral-dependent loans are measured for impairment based on the fair value of the collateral, less costs to sell. The majority of the Company's impaired loans are collateral-dependent. For all other loans and leases, the Company uses the general allocation methodology that establishes an allowance to estimate the probable incurred loss for each risk-rating category. The loan portfolio also represents the largest asset type on the consolidated statement 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.

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. This is attributable to the 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 affect 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. If 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. A valuation allowance of \$458,000 was maintained at September 30, 2013, as management believes it may not generate sufficient capital gains to offset its capital loss carry forward. The Company's effective tax rate differs from the statutory rate due primarily to non-taxable income from investment securities and bank owned life insurance.

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, and the length of time the Company will have to provide those benefits. The assumptions used by management are discussed in Note 12 to the consolidated annual financial statements.

The Company carries all of its available-for-sale investments at fair value with any unrealized gains or losses reported net of tax as an adjustment to shareholders' equity and included in accumulated other comprehensive income (loss), except for the credit-related portion of debt security impairment losses and other-than-temporary impairment ("OTTI") of equity securities 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 debt security (both available-for-sale and held-to-maturity) 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) if the present value of expected cash flows is not sufficient to recover the entire amortized cost basis. In determining whether OTTI has occurred for equity securities the Company considers the applicable factors described above and the length of time the equity security's fair value has been below the carrying amount. 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, the interest rate derivative, intangible assets, foreclosed real estate, and 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 on our available-for-sale securities may be influenced by a number of factors; including market interest rates, prepayment speeds, discount rates, and the shape of yield curves.

- 36 -

Table of Contents

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 evaluations by third parties, less estimated costs to sell. When necessary, appraisals are updated to reflect changes in market conditions.

Recent Events

As reported by the Company on its Form 10-K filed on March 29, 2012, the purchase of the 51% controlling interest in the Fitzgibbons Agency, pending the completion of the final stages of due diligence, was expected to close in the early part of the third quarter of 2012. The Company and the Fitzgibbons Agency are addressing the final elements of the transaction and are working to expedite a closing at the earliest possible time.

The Company elected to transfer 55 available-for-sale (“AFS”) securities with an aggregate fair value of \$32.5 million to a classification of held-to-maturity (“HTM”) on September 30, 2013. In accordance with FASB ASC 320-10-55-24, the transfer from AFS to HTM must be recorded at the fair value of the AFS securities at the time of transfer. The net unrealized holding loss of \$799,000, net of tax, at the date of transfer was retained in accumulated other comprehensive loss, with the associated pretax amount retained in the carrying value of the HTM securities. Such amounts will be amortized to interest income over the remaining life of the securities. The fair value of the transferred AFS securities became the book value of the HTM securities at September 30, 2013, with no unrealized gain or loss at this date. Future reporting periods, with potential changes in market value for these securities, would likely record an unrealized gain or loss for disclosure purposes.

Overview and Results of Operations

For the third quarter of 2013, net income was \$528,000 as compared to \$670,000 for the third quarter of 2012 due principally to a \$300,000 increase in personnel expenses reflecting wage increases and increased health insurance expenses. Partially offsetting the increase in personnel expenses was a \$59,000 decrease in the provision for loan loss.

For the first nine months of 2013, net income was \$1.9 million, unchanged from the same period in 2012. Net interest income increased \$623,000, noninterest income increased \$311,000, and the provision for loan losses decreased \$166,000 when compared to the prior year nine month period. These improvements to income were offset by increases in noninterest expense, reflecting higher personnel and advertising expenses.

The Company’s return on average assets and return on average equity for the third quarter of 2013 were 0.43% and 5.25%, respectively, as compared to 0.57% and 6.59% for the same prior year period. Return on average assets and return on average equity for the nine months of 2013 were 0.50% and 6.04%, respectively, as compared to 0.55% and 6.53% for the same prior year period.

Table of Contents

Average assets for the third quarter of 2013 were \$493.7 million, or 4.7% greater than the comparable prior year period. The increase was attributable to increases in commercial loans and commercial real estate loans and, to a lesser extent, tax-exempt securities. Average balances of commercial real estate loans increased \$19.5 million or 26.6% and commercial loans increased \$7.6 million or 17.2% between these same periods in direct support of the Company's initiative to diversify its portfolio and increase its penetration within the commercial segments. In contrast, average balances of real estate residential loans decreased \$1.9 million between these two time periods as a direct result of an \$8.8 million residential loan sale in May 2013. Average assets for the nine month period of 2013 were \$497.4 million, an increase of 7.1% over the comparable prior year period and a direct result of the Company's strategic growth initiatives.

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.

Edgar Filing: PATHFINDER BANCORP INC - Form 10-Q

The following table sets forth information concerning average interest-earning assets and interest-bearing liabilities and the yields and rates thereon for the periods indicated. Interest income and resultant yield information in the table is on a fully tax-equivalent basis using marginal federal income tax rates of 34%. Averages are computed on the daily average balance for each month in the period divided by the number of days in the period. Yields and amounts earned include loan fees. Nonaccrual loans have been included in interest-earning assets for purposes of these calculations.

(Dollars in thousands)	For the three months Ended September 30,							
	2013				2012			
	Average Balance	Interest	Average Yield / Cost		Average Balance	Interest	Average Yield / Cost	
Interest-earning assets:								
Real estate loans residential	\$ 168,660	\$ 1,889	4.48 %		\$ 170,595	\$ 2,041	4.79 %	
Real estate loans commercial	92,923	1,245	5.36 %		73,426	1,023	5.57 %	
Commercial loans	51,643	592	4.59 %		44,074	552	5.01 %	
Consumer loans	24,921	346	5.55 %		26,794	372	5.55 %	
Taxable investment securities	95,072	428	1.80 %		94,587	477	2.02 %	
Tax-exempt investment securities	25,650	287	4.48 %		25,106	288	4.59 %	
Interest-earning time deposit	1,500	5	1.33 %		2,000	6	1.20 %	
Interest-earning deposits	5,410	2	0.15 %		2,901	1	0.14 %	
Total interest-earning assets	465,779	4,794	4.12 %		439,483	4,760	4.33 %	
Noninterest-earning assets:								
Other assets	34,068				33,725			
Allowance for loan losses	(4,979)				(4,264)			
Net unrealized gains on available for sale securities	(1,188)				2,733			
Total assets	\$ 493,680				\$ 471,677			
Interest-bearing liabilities:								
NOW accounts	\$ 36,066	\$ 20	0.22 %		\$ 33,169	\$ 23	0.28 %	
Money management accounts	13,830	5	0.14 %		14,235	9	0.25 %	
MMDA accounts	76,374	86	0.45 %		74,380	102	0.55 %	
Savings and club accounts	69,435	13	0.07 %		65,793	13	0.08 %	
Time deposits	158,309	481	1.22 %		163,625	567	1.39 %	
Junior subordinated debentures	5,155	40	3.10 %		5,155	40	3.10 %	
Borrowings	40,452	134	1.33 %		29,999	209	2.77 %	
Total interest-bearing liabilities	399,621	779	0.78 %		386,356	963	1.00 %	
Noninterest-bearing liabilities:								
Demand deposits	49,355				40,914			
Other liabilities	4,480				3,766			
Total liabilities	453,456				431,036			
Shareholders' equity	40,224				40,641			
Total liabilities & shareholders' equity	\$ 493,680				\$ 471,677			
Net interest income		\$ 4,015				\$ 3,797		
Net interest rate spread			3.34 %				3.36 %	
Net interest margin			3.45 %				3.46 %	
Ratio of average interest-earning assets								
			116.56 %				113.75 %	

to average interest-bearing
liabilities

- 39 -

Edgar Filing: PATHFINDER BANCORP INC - Form 10-Q

(Dollars in thousands)	For the nine months Ended September 30,							
	2013		Average		2012		Average	
	Average	Interest	Yield /	Cost	Average	Interest	Yield /	Cost
	Balance				Balance			
Interest-earning assets:								
Real estate loans residential	\$ 173,705	\$ 5,925	4.55	%	\$ 166,731	\$ 6,168	4.93	%
Real estate loans commercial	87,489	3,523	5.37	%	70,500	3,093	5.85	%
Commercial loans	51,980	1,822	4.67	%	44,039	1,571	4.76	%
Consumer loans	25,167	1,064	5.64	%	27,403	1,160	5.64	%
Taxable investment securities	95,473	1,270	1.77	%	96,912	1,483	2.04	%
Tax-exempt investment securities								
Interest-earning time deposit	25,761	860	4.45	%	22,919	809	4.71	%
Interest-earning deposits	1,772	16	1.20	%	2,000	18	1.20	%
Total interest-earning assets	6,026	5	0.11	%	1,721	3	0.23	%
Total interest-earning assets	467,373	14,485	4.13	%	432,225	14,305	4.41	%
Noninterest-earning assets:								
Other assets	33,580				34,108			
Allowance for loan losses	(4,764)				(4,156)			
Net unrealized gains on available for sale securities								
Total assets	1,177				2,393			
Total assets	\$ 497,366				\$ 464,570			
Interest-bearing liabilities:								
NOW accounts	\$ 38,609	\$ 60	0.21	%	\$ 31,712	\$ 61	0.26	%
Money management accounts	14,214	21	0.20	%	14,522	35	0.32	%
MMDA accounts	79,544	269	0.45	%	77,597	325	0.56	%
Savings and club accounts	68,973	40	0.08	%	64,093	41	0.09	%
Time deposits	162,694	1,504	1.23	%	158,989	1,749	1.47	%
Junior subordinated debentures	5,155	121	3.13	%	5,155	127	3.28	%
Borrowings	34,774	494	1.89	%	29,455	637	2.88	%
Total interest-bearing liabilities	403,963	2,509	0.83	%	381,523	2,975	1.04	%
Noninterest-bearing liabilities:								
Demand deposits	48,323				39,990			
Other liabilities	4,134				3,897			
Total liabilities	456,420				425,410			
Shareholders' equity	40,946				39,160			
Total liabilities & shareholders' equity	\$ 497,366				\$ 464,570			
Net interest income		\$ 11,976				\$ 11,330		
Net interest rate spread			3.30	%			3.37	%
Net interest margin			3.42	%			3.50	%
Ratio of average interest-earning assets to average interest-bearing liabilities			115.70	%			113.29	%

Table of Contents

Net interest income, on a tax-equivalent basis, increased to \$4.0 million for the three months ended September 30, 2013, from \$3.8 million for the three months ended September 30, 2012. This was almost exclusively due to a decrease in interest expense on time deposits and borrowings as higher yielding liabilities in both segments saw their maturities replaced by lower balances and lower rates on time deposits and significantly lower rates on borrowings (Federal Home Loan Bank, or FHLB NY advances as the major component), despite higher balances. The most significant contributor to interest income was real estate commercial loans as seen by the increase in average balances. Net interest margin, however, contracted nominally to 3.45% from 3.46%, but on a linked quarter basis saw an improvement of 5 basis points as the impact of the above mentioned lower replacement costs of FHLB NY advances allowed the improvement in net interest margin.

As indicated in the three month table above and in the rate/volume analysis below, total interest income on a tax-equivalent basis increased \$34,000 due principally to an increase in average balances of both commercial loan products, partially offset by reductions in interest income from real estate residential loans due to the May 2013 residential loan sale. The yield on most classes of interest earning asset products decreased, with the most significant yield decrease reported in commercial real estate loans and residential real estate loans. For both of these products, yields decreased due to maturing loans and payoffs being replaced with those of lower rates reflecting current market conditions. Average balances of commercial real estate loans reported the largest relative increase among loan products but also recorded a lower yield as maturing term products within this segment were replaced by loans with lower current market rates.

Interest expense decreased \$184,000 between year over year third quarter periods, as indicated in the above three month table. The primary reason for the decline was lower rates paid on time deposits as higher cost maturing certificates of deposit were replaced with lower cost certificates of deposits at current market rates. Secondly, interest expense on borrowings (largely FHLB NY advances) declined as higher rate long term advances were replaced by advances of shorter duration and at current lower market rates despite greater average balances of borrowings.

Referencing the above nine month table and the rate/volume analysis below for the nine month period ended September 30, 2013 as compared to the same prior year period, net interest income improved \$646,000 driven primarily by the reduction in reduced interest expense from lower rates paid on certificates of deposit, reduced borrowing costs on replaced FHLB NY long term advances, and lower rates paid on money market deposit accounts. In addition, interest income increased due exclusively to an increase in average balances of commercial real estate and commercial loan products, despite lower yields recorded within each of these loan products. Additionally, higher average balances of tax-exempt securities also contributed to the improvement in interest income. The above mentioned residential loan sale caused the reduction in interest income from real estate residential loans.

Table of Contents

Rate/Volume Analysis

Net interest income can also be analyzed in terms of the impact of changing interest rates on interest-earning assets and interest-bearing liabilities and changes in the volume or amount of these assets and liabilities. The following table represents the extent to which changes in interest rates and changes in the volume of interest-earning assets and interest-bearing liabilities have affected the Company's interest income and interest expense during the periods indicated. Information is provided in each category with respect to: (i) changes attributable to changes in volume (change in volume multiplied by prior rate); (ii) changes attributable to changes in rate (changes in rate multiplied by prior volume); and (iii) total increase or decrease. Changes attributable to both rate and volume have been allocated ratably.

(In thousands)	Three Months Ended September 30 2013 vs. 2012			Nine Months Ended September 30 2013 vs. 2012		
	Volume	Rate	Increase/(Decrease) Due to Total Increase (Decrease)	Volume	Rate	Increase/(Decrease) Due to Total Increase (Decrease)
Interest Income:						
Real estate loans residential	\$(23)	\$(129)	\$(152)	\$362	\$(605)	\$(243)
Real estate loans commercial	467	(245)	222	825	(395)	430
Commercial loans	275	(235)	40	297	(46)	251
Consumer loans	(26)	-	(26)	(96)	-	(96)
Taxable investment securities	16	(64)	(48)	(22)	(191)	(213)
Tax-exempt investment securities	26	(27)	(1)	117	(66)	51
Interest-earning time deposits	(4)	3	(1)	(2)	-	(2)
Interest-earning deposits	1	0	1	5	(3)	2
Total interest income	732	(697)	34	1,486	(1,306)	180
Interest Expense:						
NOW accounts	10	(13)	(3)	16	(17)	(1)
Money management accounts	-	(4)	(4)	(1)	(13)	(14)
MMDA accounts	17	(33)	(16)	13	(69)	(56)
Savings and club accounts	3	(3)	-	4	(5)	(1)
Time deposits	(18)	(68)	(86)	64	(309)	(245)
Junior subordinated debentures	-	-	-	-	(6)	(6)
Borrowings	317	(392)	(75)	152	(295)	(143)
Total interest expense	329	(513)	(184)	248	(714)	(466)
Net change in net interest income	\$403	\$(184)	\$218	\$1,238	\$(592)	\$646

Provision for Loan Losses

The provision for loan losses represents management's estimate of the amount necessary to maintain the allowance for loan losses at an adequate level. The Company recorded \$216,000 in provision for loan losses for the three-month period ended September 30, 2013, as compared to \$275,000 for the three-month period ended September 30, 2012. This decrease was due primarily to the Company's quarterly review of the probable and estimable losses within the loan portfolio and the net recoveries of \$5,000 recorded in the third quarter of 2013 as compared to \$55,000 in net

charge-offs recorded in the same prior year period. For the nine month period ended September 30, 2013, the Company recorded a provision of \$816,000 as compared to \$650,000 in provision for loan losses recorded in the same 2012 nine month period. This increase stemmed from the need for a specific reserve from the addition of a large commercial relationship and net charge-offs of \$232,000 for the first nine months of 2013 as compared to \$197,000 for the same prior year period. The increase in net charge-offs principally resided in the residential mortgage loan and consumer loan segments.

Table of Contents

Delinquency trends improved across all product segments between December 31, 2012 and September 30, 2013. While the residential mortgage and consumer loan segments reported the largest improvements in total, the residential segment saw a shift in its past due loans towards the 90 day and over category. Delinquency trends are reviewed monthly and management continues to be proactive in working with our borrowers to minimize losses to the Bank. Management reviews trends in historical loss rates and environmental factors on a quarterly basis, in addition to assessing the specific allowance needs on impaired loans, and judges the current level of allowance for loan losses to be adequate to absorb the estimable and probable losses inherent in the loan portfolio.

Noninterest Income

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

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

(Dollars In thousands)	Three Months Ended September 30,				Nine Months Ended September 30,					
	2013	2012	Change		2013	2012	Change			
Service charges on deposit accounts	\$313	\$285	\$28	9.8	%	\$856	\$838	\$18	2.1	%
Earnings and gain on bank owned life insurance	60	46	14	30.4	%	172	235	(63)	)	-26.8 %
Loan servicing fees	30	51	(21)	-41.2	%	112	159	(47)	)	-29.6 %
Debit card interchange fees	114	105	9	8.6	%	341	308	33	10.7	%
Other charges, commissions and fees	134	150	(16)	-10.7	%	400	423	(23)	)	-5.4 %
Noninterest income before gains	651	637	14	2.2	%	1,881	1,963	(82)	)	-4.2 %
Net gains on sales and redemptions of investment securities	17	18	(1)	-5.6	%	116	179	(63)	)	-35.2 %
Net gains on sales of loans and foreclosed real estate	36	6	30	500.0	%	487	31	456	1471.0	%
Total noninterest income	\$704	\$661	\$43	6.5	%	\$2,484	\$2,173	\$311	14.3	%

As indicated above, noninterest income for the third quarter of 2013 increased when compared to the same prior year period due principally to service charges on deposit accounts from higher levels of commercial deposit balances as well as net gains on sales of loans and foreclosed real estate as the Company continues to sell longer term originated residential mortgages in an effort to minimize the Company's interest rate risk. When comparing the nine months ended September 30, 2013 with the same prior year period, the improvement in noninterest income was principally due to the residential loan portfolio sale that occurred in the second quarter of 2013, offset partially by reduced levels of sales and redemptions of the Company's available-for-sale investment securities and reduced levels of earnings and gain on bank owned life insurance. The latter was due to the recognition of a death benefit in 2012 from the passing of a former Company director.

Noninterest Expense

Edgar Filing: PATHFINDER BANCORP INC - Form 10-Q

The following table sets forth certain information on noninterest expense for the periods indicated:

(Dollars In thousands)	Three Months Ended September 30,					Nine Months Ended September 30,				
	2013	2012	Change			2013	2012	Change		
Salaries and employee benefits	\$2,033	\$1,733	\$300	17.3	%	\$5,884	\$5,576	\$308	5.5	%
Building occupancy	382	348	34	9.8	%	1,109	1,077	32	3.0	%
Data processing	356	390	(34)	-8.7	%	1,067	1,072	(5)	-0.5	%
Professional and other services	178	174	4	2.3	%	502	473	29	6.1	%
Advertising	146	108	38	35.2	%	393	268	125	46.6	%
FDIC assessments	123	78	45	57.7	%	291	233	58	24.9	%
Audits and exams	61	73	(12)	-16.4	%	184	184	-	0.0	%
Other expenses	388	274	114	41.6	%	1,343	1,106	237	21.4	%
Total noninterest expenses	\$3,667	\$3,178	\$489	15.4	%	\$10,773	\$9,989	\$784	7.8	%

Table of Contents

As indicated above, noninterest expense for the year over year third quarter period increased due principally to an increase in salary and employee benefits expenses reflecting normal wage increases and increased costs under the Company's self-insured health plan. Additionally, FDIC assessment expenses increased over the three month period in 2012 due to the increase in year over year assets and the related FICO charge accrual. Advertising expenses for the third quarter of 2013 increased over the comparable prior year period as the Company continues to increase its presence within the greater Syracuse marketplace. When comparing the nine month period ended September 30, 2013 with the same prior year period, noninterest expenses increased due principally to salary and employee benefit expenses, advertising expenses and other expenses. Other expenses include travel and training, office supplies, and nonrecurring expenses.

Income Tax Expense

Income tax expense decreased by \$28,000 for the quarter ended September 30, 2013 as compared to the same period in 2012 primarily due to a decrease in pretax income but offset by an increase in the effective tax rate to 27.0% as compared to 25.0% for the same prior year period. The effective tax rate increase principally reflects a smaller proportion of tax-exempt investments as a proportion of our taxable income in the third quarter of 2013 as compared to the third quarter of 2012. The Company has reduced its effective tax rate from the combined federal and state statutory rate of 38.7% primarily through the ownership of tax-exempt investment securities, bank owned life insurance, and other tax saving strategies. For the nine months ended September 30, 2013, income tax expense increased by \$47,000 over the same prior year period principally due to an increase in the effective tax rate to 27.0% as compared to 25.0% for the same prior year period.

Earnings per Share

Basic and diluted earnings per share were \$0.21 and \$0.20, respectively, in the third quarter of 2013 as compared to basic and diluted earnings per share of \$0.22 in the third quarter of 2012. This decrease was due to less net income available to common shareholders in the third quarter of 2013.

Basic and diluted earnings per share for the nine month period ended September 30, 2013 were \$0.74 and \$0.73, respectively, as compared to basic and diluted earnings per share of \$0.62 for the same prior year period. This increase was principally due to the lack of need for SBLF dividend payments through the third quarter of 2013 as positive updated lending information provided to the U.S. Treasury resulted in a credit to the Bank's benefit against the dividends due for the first nine months of 2013. Assuming our present lending activity continues, the amount of unused credit presently available would negate the need for any dividend payments in 2013.

Changes in Financial Condition

Assets

Total assets increased to \$492.5 million at September 30, 2013 as compared to \$477.8 million at December 31, 2012. This increase of \$14.7 million was largely due to increases in investment securities and, to a lesser extent, gross loans. Investment securities increased to \$115.4 million at September 30, 2013 from \$108.3 million at year end 2012. Gross loans increased \$4.3 million as the \$8.8 million decrease in loans from the above mentioned loan sale was offset primarily by a \$14.6 million net increase in commercial and municipal loans. The Company continues to diversify its loan product segments by increasing its relative proportion of commercial loan and commercial real estate loan products.

In the third quarter of 2013 the Company identified 55 available-for-sale securities with an estimated fair value of \$32.5 million that the Company estimated contained the largest degree of volatility during periods of interest rate changes. These securities reported a net unrealized loss position of \$1.3 million and were reclassified to

held-to-maturity (“HTM”) status at September 30, 2013. The after tax impact of this unrealized loss position was approximately \$799,000, and became frozen upon transfer with no impact on the Company’s income statement as a result of this transfer.

- 44 -

Table of Contents

Liabilities

Total liabilities increased to \$451.8 million at September 30, 2013, from \$437.0 million at December 31, 2012. Deposits increased \$9.5 million, with over two thirds of this increase in the form of demand deposit accounts as the Company was able to take advantage of competitive changes in the marketplace to improve deposit gathering across all markets and continue to increase its level of commercial and municipal demand deposits. Net borrowings increased \$5.9 million through short-term FHLBNY borrowings increasing by \$15.0 million, partially offset by long-term borrowings decreasing \$9.1 million as a result of maturing long term and higher rate FHLBNY advances.

Capital

Shareholders' equity was unchanged at \$40.8 million at September 30, 2013 and December 31, 2012. The increase in retained earnings between these two time periods through the generation of earnings less dividends declared was offset by the decrease in market value of available for sale securities, after tax, and the frozen unrealized loss of 55 available for sale securities, with a fair value of \$32.5 million, transferred to held to maturity status at September 30, 2013. The decrease in market value between these two time periods, caused by an increase in market interest rates, resulted in an increase to accumulated other comprehensive loss and its attendant decrease in shareholders' equity. This action eliminated any further reduction in shareholders' equity as a result of interest rate volatility on these 55 securities.

Capital adequacy is evaluated primarily by the use of ratios which measure capital against total assets, as well as against total assets that are weighted based on defined risk characteristics. The Company's goal is to maintain a strong capital position, consistent with the risk profile of its subsidiary banks that supports growth and expansion activities while at the same time exceeding regulatory standards. At September 30, 2013, Pathfinder Bank exceeded all regulatory required minimum capital ratios and met the regulatory definition of a "well-capitalized" institution, i.e. a leverage capital ratio exceeding 5%, a Tier 1 risk-based capital ratio exceeding 6%, and a total risk-based capital ratio exceeding 10%.

The Bank's actual capital amounts and ratios as of the indicated dates are presented in the following table.

(Dollars in thousands)	Actual		Minimum For Capital Adequacy Purposes		Minimum To Be "Well- Capitalized" Under Prompt Corrective Provisions		
	Amount	Ratio	Amount	Ratio	Amount	Ratio	
As of September 30, 2013:							
Total Core Capital (to Risk-Weighted Assets)	\$48,010	14.3	% \$27,117	8.0	% \$33,896	10.0	%
Tier 1 Capital (to Risk-Weighted Assets)	\$43,561	13.0	% \$13,558	4.0	% \$20,338	6.0	%
Tier 1 Capital (to Assets)	\$43,561	9.0	% \$19,387	4.0	% \$24,234	5.0	%
As of December 31, 2012:							
Total Core Capital (to Risk-Weighted Assets)	\$45,763	14.2	% \$25,808	8.0	% \$32,259	10.0	%
	\$41,574	12.9	% \$12,904	4.0	% \$19,356	6.0	%

Edgar Filing: PATHFINDER BANCORP INC - Form 10-Q

Tier 1 Capital (to Risk-Weighted Assets)									
Tier 1 Capital (to Assets)	\$41,574	8.8	%	\$18,831	4.0	%	\$23,539	5.0	%
As of December 31, 2011:									
Total Core Capital (to Risk-Weighted Assets)	\$43,670	14.9	%	\$23,386	8.0	%	\$29,233	10.0	%
Tier 1 Capital (to Risk-Weighted Assets)	\$39,917	13.7	%	\$11,693	4.0	%	\$17,540	6.0	%
Tier 1 Capital (to Average Assets)	\$39,917	9.4	%	\$17,041	4.0	%	\$21,301	5.0	%

(1) As of September 30, 2012, the Federal Financial Institutions Examination Council changed the computation for the Tier 1 Capital ratio as it applies to the Bank's designation as a savings association. The denominator has changed from using the average assets over the prior three months to the assets on the statement of condition as of the end of the September 30, 2012 and subsequent reporting quarters.

Table of Contents

Loan and Asset Quality and Allowance for Loan Losses

The following table represents information concerning the aggregate amount of non-performing assets at the indicated dates:

(Dollars In thousands)	September 30, 2013	December 31, 2012	September 30, 2012		
Nonaccrual loans:					
Commercial loans	\$3,060	\$2,726	\$2,342		
Consumer	425	776	775		
Residential mortgage loans	2,401	2,046	1,506		
Total nonaccrual loans	5,886	5,548	4,623		
Total nonperforming loans	5,886	5,548	4,623		
Foreclosed real estate	301	426	429		
Total nonperforming assets	\$6,187	\$5,974	\$5,052		
Troubled debt restructurings not included above	\$2,049	\$1,937	\$982		
Nonperforming loans to total loans	1.74	%	1.66	%	1.43
Nonperforming assets to total assets	1.26	%	1.25	%	1.05

Nonperforming assets include nonaccrual loans, troubled debt restructurings (“TDR”), and foreclosed real estate. Loans are considered modified in a TDR when, due to a borrower’s financial difficulties, the Company makes a concession(s) to the borrower that it would not otherwise consider. These modifications may include, among others, an extension of the term of the loan, and granting a period when interest-only payments can be made, with the principal payments made over the remaining term of the loan or at maturity. TDRs are included in the above table within the following categories of nonaccrual loans or TDRs not included above (the latter also known as accruing TDRs).

As indicated in the above table, total non-performing loans increased modestly at September 30, 2013, when compared to December 31, 2012. While significant improvement was recorded in the consumer and residential mortgage loan segments through reductions in nonperforming loans in these two product segments, this was more than offset by the increase in the commercial loan segments from the addition of one large commercial relationship to nonperforming status. This event contributed to the additional provision for loan losses required in the first nine months of 2013. Management continues to monitor and react to national and local economic trends as well as general portfolio conditions, which may impact the quality of the portfolio. Management believes that the current level of the allowance for loan losses, at \$5.1 million, adequately addresses the current level of risk within the loan portfolio.

Foreclosed real estate (“FRE”) balances decreased to \$301,000 at September 30, 2013, from \$426,000 at December 31, 2012 as the Company successfully reduced FRE properties from eight to five, in addition to writing down an existing property as new fair value information became available. Of the existing inventory of properties, two are commercial properties and the remaining three are 1-4 family residential properties.

The Company generally places a loan on nonaccrual status and ceases accruing interest when loan payment performance is deemed unsatisfactory and the loan is past due 90 days or more. There are no loans that are past due 90 days or more and still accruing interest. The Company considers a loan impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan.

The measurement of impaired loans is generally based upon the fair value of the collateral, with a portion of the impaired loans measured based upon the present value of future cash flows discounted at the historical effective interest rate. The Company used the fair value of collateral to measure impairment on commercial loans. At September 30, 2013 and December 31, 2012, the Company had \$6.4 million and \$6.7 million in loans, which were deemed to be impaired, having established specific reserves of \$1.2 million and \$923,000, respectively on these loans. Between these two time periods, the composition of impaired loans changed significantly as the decrease in the proportion of residential loans was partially offset by an increase in the proportion of commercial real estate loans.

Table of Contents

Management has identified potential problem loans totaling \$9.9 million as of September 30, 2013 as compared to \$11.7 million on December 31, 2012. These loans have been internally classified as special mention or substandard, yet are not currently considered impaired or in non-accrual status. Management has identified potential credit problems which may result in the borrowers not being able to comply with the current loan repayment terms and which may result in it being included in future impaired loan reporting. The reduction in potential problem loans resulted from the conversion of loans from potential problem loans to impaired loans and, to a lesser extent, the improvement in risk rating from loans previously classified as special mention. Management judges the current level of allowance for loan losses to be adequate to cover probable credit losses in the current loan portfolio. As a result, the ratio of the allowance to loan and lease losses to period-end loans at September 30, 2013 was 1.50% as compared to 1.35% at December 31, 2012. The increase reflects the nine month historical charge-off experience, the allowance for impaired loans, and the modest increase in gross loans reported in the first nine months of 2013.

Appraisals are obtained at the time a real estate secured loan is originated. For commercial real estate held as collateral, the property is inspected every two years. When evaluating our ability to collect from secondary sources, appraised values are adjusted to reflect the age of appraisal, the condition of the property, the current local real estate market, and cost to sell. Properties are re-appraised when our evaluation of the current property condition and the local real estate market suggests values may not be accurate.

In the normal course of business, Pathfinder Bank has sold residential mortgage loans and participation interests in commercial loans. As is typical in the industry, Pathfinder Bank makes certain representations and warranties to the buyer. Pathfinder Bank maintains a quality control program for closed loans and considers the risks and uncertainties associated with potential repurchase requirements to be minimal.

Liquidity

Liquidity management involves the Company's ability to generate cash or otherwise obtain funds at reasonable rates to support asset growth, meet deposit withdrawals, maintain reserve requirements, and otherwise operate the Company on an ongoing basis. The Company's primary sources of funds are deposits, borrowed funds, amortization and prepayment of loans and maturities of investment securities and other short-term investments, and earnings and funds provided from operations. While scheduled principal repayments on loans are a relatively predictable source of funds, deposit flows and loan prepayments are greatly influenced by general interest rates, economic conditions and competition. The Company manages the pricing of deposits to maintain a desired deposit composition and balance. In addition, the Company invests excess funds in short-term interest-earning and other assets, which provide liquidity to meet lending requirements.

The Company's liquidity has been enhanced by its ability to borrow from the Federal Home Loan Bank of New York, whose competitive advance programs and lines of credit provide the Company with a safe, reliable, and convenient source of funds. A significant decrease in deposits in the future could result in the Company having to seek other sources of funds for liquidity purposes. Such sources could include, but are not limited to, additional borrowings, brokered deposits, negotiated time deposits, the sale of "available-for-sale" investment securities, the sale of securitized loans, or the sale of whole loans. Such actions could result in higher interest expense costs and/or losses on the sale of securities or loans.

Through the first nine months of 2013, as indicated in the Consolidated Statement of Cash Flows, the Company reported net cash flows from financing activities of \$15.1 million generated by increased balances of demand, savings and money market deposit accounts. This was invested in available-for-sale investment securities of \$10.9 million, net, and loan generation of \$4.8 million. As a recurring source of liquidity, the Company's investment securities provided \$18.4 million in proceeds from maturities and principal reductions through the first nine months of 2013. Net cash provided by operating activities for this same period was \$4.5 million.

Table of Contents

The Company has a number of existing credit facilities available to it. At September 30, 2013, total credit available to the Company under the existing lines of credit is approximately \$147.6 million. At September 30, 2013, the Company has \$40.0 million outstanding on its existing lines of credit with \$107.6 million available.

The Asset Liability Management Committee of the Company is responsible for implementing the policies and guidelines for the maintenance of prudent levels of liquidity. As of September 30, 2013, management reported to the Board of Directors that the Company is in compliance with its liquidity policy guidelines.

Item 3 - Quantitative and Qualitative Disclosures About Market Risk

A smaller reporting company is not required to provide the information relating to this item.

Item 4 - Controls and Procedures

Under the supervision and with the participation of the Company's management, including our Chief Executive Officer and Chief Financial Officer, the Company has evaluated the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this quarterly report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures are effective to ensure that information required to be disclosed in the reports that the Company files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms. There has been no change in the Company's internal control over financial reporting during the most recent fiscal quarter that has materially affected, or is reasonable likely to materially affect, the Company's internal control over financial reporting.

Table of Contents

PART II - OTHER INFORMATION

Item 1 - Legal Proceedings

The Company is not currently a named party in a legal proceeding, the outcome of which would have a material and adverse effect on the financial condition or results of operations of the Company.

Item 1A – Risk Factors

A smaller reporting company is not required to provide the information relating to this item.

Item 2 – Unregistered Sales of Equity Securities and Use of Proceeds

None

Item 3 - Defaults Upon Senior Securities

None

Item 4 – Mine Safety Disclosures

Not applicable

Item 5 - Other Information

None

Item 6 - Exhibits

Exhibit

No.	Description
31.1	Rule 13a-14(a) / 15d-14(a) Certification of the Chief Executive Officer
31.2	Rule 13a-14(a) / 15d-14(a) Certification of the Chief Financial Officer
32.1	Section 1350 Certification of the Chief Executive Officer and Chief Financial Officer

