

BERKSHIRE BANCORP INC /DE/

Form 10-Q

August 14, 2013

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

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

For the quarterly period ended June 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: 0-13649

**BERKSHIRE BANCORP INC.**

(Exact Name of Registrant as Specified in Its Charter)

**Delaware**

**94-2563513**

(State or Other Jurisdiction of (I.R.S. Employer

Incorporation or Organization) Identification No.)

**160 Broadway, New York, New York 10038**  
(Address of Principal Executive Offices) (Zip Code)

Registrant's Telephone Number, Including Area Code: (212) 791-5362

**N/A**  
(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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

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

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

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

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

As of August 9, 2013, there were 14,416,198 outstanding shares of the issuer's Common Stock, \$.10 par value.

## BERKSHIRE BANCORP INC. AND SUBSIDIARIES

### FORWARD-LOOKING STATEMENTS

**Forward-Looking Statements.** *Statements in this Quarterly Report on Form 10-Q that are not based on historical fact may be "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. Words such as "believe", "may", "will", "expect", "estimate", "anticipate", "continue" or similar terms identify forward-looking statements. A wide variety of factors could cause the actual results and experiences of Berkshire Bancorp Inc. (the "Company") to differ materially from the results expressed or implied by the Company's forward-looking statements. Some of the risks and uncertainties that may affect operations, performance, results of the Company's business, the interest rate sensitivity of its assets and liabilities, and the adequacy of its loan loss allowance, include, but are not limited to: (i) deterioration in local, regional, national or global economic conditions which could result, among other things, in an increase in loan delinquencies, a decrease in property values, or a change in the housing turnover rate; (ii) changes in market interest rates or changes in the speed at which market interest rates change; (iii) changes in laws and regulations affecting the financial services industry; (iv) changes in competition; (v) changes in consumer preferences; (vi) changes in banking technology; (vii) ability to maintain key members of management; (viii) possible disruptions in the Company's operations at its banking facilities; (ix) cost of compliance with new corporate governance requirements, rules and regulations; and other factors referred to in this Quarterly Report and in Item 1A, "Risk Factors", of the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2012.*

*Certain information customarily disclosed by financial institutions, such as estimates of interest rate sensitivity and the adequacy of the loan loss allowance, are inherently forward-looking statements because, by their nature, they represent attempts to estimate what will occur in the future.*

*The Company cautions readers not to place undue reliance upon any forward-looking statement contained in this Quarterly Report. Forward-looking statements speak only as of the date they were made and the Company assumes no obligation to update or revise any such statements upon any change in applicable circumstances.*

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES**

**QUARTERLY REPORT ON FORM 10-Q**

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**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(Dollars in Thousands, Except Share Data)**

	June 30, 2013 (unaudited)	December 31, 2012
<b>ASSETS</b>		
Cash and due from banks <b>(including restricted cash Of \$4,711 and \$4,083, respectively)</b>	\$ 8,009	\$ 8,637
Interest bearing deposits	96,203	140,517
Total cash and cash equivalents	104,212	149,154
Investment Securities:		
Available-for-sale, at fair value	354,935	355,114
Federal Home Loan Bank of New York stock	722	887
Held-to-maturity, fair value of \$266 in 2013 and \$283 in 2012	264	275
Total investment securities	355,921	356,276
Loans, net of unearned income	305,876	295,165
Less: allowance for loan losses	(10,387 )	(11,008 )
Net loans	295,489	284,157
Accrued interest receivable	2,928	3,099
Premises and equipment, net	7,086	7,113
Real Estate Owned	-	225
Deferred Tax Asset, net	19,834	16,392
Other assets	4,371	11,629
Total assets	\$ 789,841	\$ 828,045
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Deposits:		
Non-interest bearing	\$ 89,824	\$ 84,163
Interest bearing	518,143	558,307
Total deposits	607,967	642,470
Securities sold under agreements to repurchase	45,000	45,000
Borrowings	-	1,539
Accrued interest payable	1,925	1,699
Other liabilities	4,411	3,031
Total liabilities	659,303	693,739
Commitments and Contingencies		
Stockholders' equity		
Preferred stock - \$.01 Par value:		
2,000,000 shares authorized - none issued	—	—
Common stock - \$.10 par value	1,442	1,441
Authorized — 25,000,000 shares		
Issued — 14,416,198 shares		

Outstanding —

June 30, 2013, 14,416,198 shares

December 31, 2012, 14,416,198 shares

Additional paid-in capital	143,903	143,903
Accumulated Deficit	(6,035 )	(8,061 )
Accumulated other comprehensive loss, net	(8,772 )	(2,977 )
Total stockholders' equity	130,538	134,306
Total liabilities and stockholders' equity	\$ 789,841	\$ 828,045

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

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF INCOME****(Dollars In Thousands, Except Per Share Data)****(unaudited)**

	For The Three Months Ended June 30,		For The Six Months Ended June 30,	
	2013	2012	2013	2012
<b>INTEREST INCOME</b>				
Loans, including related fees	\$ 4,249	\$ 4,882	\$ 8,476	\$ 9,787
Investment securities	2,093	2,288	4,278	4,737
Federal Home Loan Bank of New York stock	8	12	19	-
Interest bearing deposits	90	125	184	184
Total interest income	6,440	7,307	12,957	14,708
<b>INTEREST EXPENSE</b>				
Deposits	949	1,174	1,907	2,400
Securities sold under agreements to repurchase	384	447	764	891
Interest expense on borrowings	2	144	10	341
Total interest expense	1,335	1,765	2,681	3,632
Net interest income	5,105	5,542	10,276	11,076
<b>PROVISION FOR LOAN LOSSES</b>	(298 )	—	(601 )	—
Net interest income after provision for loan losses	5,403	5,542	10,877	11,076
<b>NON-INTEREST INCOME</b>				
Service charges on deposit accounts	73	148	197	234
Investment securities gains (losses)	292	(112 )	313	108
Other income	94	85	476	302
Total non-interest income	459	121	986	644
<b>NON-INTEREST EXPENSE</b>				
Salaries and employee benefits	2,893	2,380	5,595	4,860
Net occupancy expense	708	577	1,301	1,161
Equipment expense	89	88	178	166
FDIC assessment	(3 )	300	297	600
Data processing expense	107	112	234	224
Other	653	696	1,304	1,332
Total non-interest expense	4,447	4,153	8,909	8,343
Income before provision for taxes	1,415	1,510	2,953	3,377
Provision (benefit) for income taxes	538	(1,834 )	1,126	(2,103 )
Net income	\$ 877	\$ 3,344	\$ 1,828	\$ 5,480
Dividends on preferred stock	-	-	-	-
Income allocated to common stockholders	\$ 877	\$ 3,344	\$ 1,828	\$ 5,480
Net income per common share:				



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Basic	\$ 0.06	\$ 0.23	\$ 0.13	\$ 0.38
Diluted	\$ 0.06	\$ 0.23	\$ 0.13	\$ 0.38
Number of shares used to compute net income per common share:				
Basic	14,416	14,416	14,416	14,416
Diluted	14,416	14,416	14,416	14,416

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

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME****(in thousands)****(unaudited)**

	For The Six Months Ended June 30,	
	2013	2012
Net Income	\$ 1,828	\$ 5,480
Other comprehensive income, net of tax:		
Unrealized gains(losses) on available- for-sale securities, net of taxes of \$4,596 and \$3,673, in 2013 and 2012, respectively	(5,623 )	5,509
Less: Reclassification adjustment for realized gains (losses) included in net earnings, net of taxes of \$141 and \$43, in 2013 and 2012, respectively	172	65
Other comprehensive income (loss)	\$ (5,795 )	\$ 5,444
Comprehensive income(loss)	\$ (3,967 )	\$ 10,924

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

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY****For The Six Months Ended June 30, 2013 and 2012**

(Dollars In Thousands, Except Share Data)

(Unaudited)

	Common Shares	Preferred Shares	Common Stock Par Value	Preferred Stock Par Value	Additional paid-in capital	Accumulated other comprehensive (loss), net	Retained Earnings/ Accumulated deficit	Treasury stock	Total stockholders' equity
Balance at December 31, 2011	\$ 14,443	—	\$ 1,444	\$ —	\$ 143,900	\$ (10,517 )	\$ (19,299 )	\$ —	\$ 115,528
Net income							5,480		5,480
Other comprehensive income net of taxes						5,444			5,444
Adjustment	(27 )		(2 )		3				1
Balance at June 30, 2012	\$ 14,416	—	\$ 1,442	\$ —	\$ 143,903	\$ (5,073 )	\$ (13,819 )	\$ —	\$ 126,453
Balance at December 31, 2012	\$ 14,416	—	\$ 1,441	\$ —	\$ 143,903	\$ (2,977 )	\$ (8,061 )	\$ —	\$ 134,306
Net income							1,828		1,828
Other comprehensive income net of taxes						(5,795 )			(5,795 )
Adjustment			1				198		199
Balance at June 30, 2013	14,416	—	\$ 1,442	\$ —	\$ 143,903	\$ (8,772 )	\$ (6,035 )	\$ —	\$ 130,538

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

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****CONSOLIDATED STATEMENTS OF CASH FLOWS****(in thousands)****(unaudited)**

	For The Six Months Ended	
	June 30,	2012
	2013	2012
Cash flows from operating activities:		
Net income	\$ 1,828	\$ 5,480
Adjustments to reconcile net income to net cash provided by (used in) operating activities:		
Realized (gains) on investment securities	(313 )	(108 )
Net amortization of premiums of investment securities	896	1,313
Depreciation and amortization	262	252
Provision for loan losses	(601 )	-
(Increase) decrease in accrued interest receivable	171	245
(Increase) decrease in other real estate owned	225	—
(Increase) decrease in other assets	8,411	(7,264 )
(Decrease) increase in accrued interest payable and other liabilities	1,606	(4,587 )
Net cash provided by (used in) operating activities	12,485	(4,669 )
Cash flows from investing activities:		
Investment securities available for sale		
Purchases	(245,393 )	(228,191 )
Sales, maturities and calls	234,799	254,097
Investment securities held to maturity	—	—
Payments	11	12
Decrease in FHLB NY stock	165	—
Net decrease in loans	(10,731 )	(3,279 )
Purchases of premises and equipment	(236 )	(99 )
Net cash provided by (used in) investing activities	(21,385 )	22,540
Cash flows from financing activities:		
Net increase/(decrease) in non interest bearing deposits	5,661	1,644
Net increase/(decrease) in interest bearing deposits	(40,164 )	20,281
Repayment of borrowings	(1,539 )	(2,344 )
Net cash provided by (used in) financing activities	(36,042 )	19,581
Net increase/(decrease) in cash and cash equivalents	(44,942 )	37,452
Cash and cash equivalents at beginning of period	149,154	101,036
Cash and cash equivalents at end of period	\$ 104,212	\$ 138,488

Supplemental disclosure of cash flow information:

Cash used to pay interest	\$ 2,455	\$ 8,504
Cash used to pay income taxes, net of refunds	\$ 453	\$ 78

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

## **BERKSHIRE BANCORP INC. AND SUBSIDIARIES**

### **Notes to Consolidated Financial Statements**

**June 30, 2013 and 2012**

**(unaudited)**

#### **Note 1. General**

Berkshire Bancorp Inc., a Delaware corporation, is a bank holding company registered under the Bank Holding Company Act of 1956. References herein to "Berkshire", the "Company" or "we" and similar pronouns, shall be deemed to refer to Berkshire Bancorp Inc. and its wholly-owned consolidated subsidiaries unless the context otherwise requires. Berkshire's principal activity is the ownership and management of its indirect wholly-owned subsidiary, The Berkshire Bank (the "Bank"), a New York State chartered commercial bank. The Bank is owned through Berkshire's wholly-owned subsidiary, Greater American Finance Group, Inc. ("GAFG").

The accompanying consolidated financial statements of Berkshire Bancorp Inc. and subsidiaries include the accounts of the parent company, Berkshire Bancorp Inc., and its wholly-owned subsidiaries: The Berkshire Bank, GAFG and East 39, LLC.

We have prepared the accompanying consolidated financial statements pursuant to the rules and regulations of the Securities and Exchange Commission (the "SEC") for interim financial reporting. These consolidated financial statements, including the notes thereto, are unaudited and, in our opinion, include all adjustments, consisting of normal recurring adjustments and accruals, necessary for a fair presentation of our consolidated balance sheets, operating results, and cash flows for the periods presented. Operating results for the periods presented are not necessarily indicative of the results that may be expected for the remaining quarters of fiscal 2013 due to a variety of factors. Certain information and footnote disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States ("GAAP") have been omitted in accordance with the rules and regulations of the SEC. These consolidated financial statements should be read in conjunction with the audited consolidated financial statements and accompanying notes included in the Company's 2012 Annual Report on Form 10-K.

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (continued)****(unaudited)****Note 2. Earnings Per Share**

Basic earnings per common share is calculated by dividing income available to common stockholders by the weighted average common stock outstanding, excluding stock options from the calculation. As of and for the three and six-months ended June 30, 2013 and 2012, there were no potential dilutive shares. The following tables present the Company's calculation of income per common share:

	For The Three Months Ended June 30, 2013		Per share amount	2012		Per share amount
	Income (numerator)	Shares (denominator)		Income (numerator)	Shares (denominator)	
	(In thousands, except per share data)					
Basic earnings per common share						
Net income	\$ 877			\$3,344		
Net income available to common stockholders	\$ 877	14,416	\$ 0.06	\$3,344	14,416	\$ 0.23

	For The Six Months Ended June 30, 2013		Per share amount	2012		Per share amount
	Income (numerator)	Shares (denominator)		Income (numerator)	Shares (denominator)	
	(In thousands, except per share data)					
Basic earnings per common share						
Net income	\$ 1,828			\$5,480		
Net income available to common stockholders	\$ 1,828	14,416	\$ 0.13	\$5,480	14,416	\$ 0.38

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (continued)**

**(unaudited)**

**Note 3. Income Taxes**

The income tax provision (benefit) for the three months and six months ended June 30, 2013 was \$538 and \$1,126, respectively and the income tax provision (benefit) from three months and six months ended June 30, 2012 was (\$1,834) and \$(2,103), respectively.

The effective tax rate for the three month and six month period ended June 30, 2013 was 38.02 and 38.13 percent. The Company's effective tax rate differs from the statutory rate primarily due to benefit related to the dividends received deduction.

During the three and six months ended June 30, 2012, the Company recorded an income tax benefit of \$1.8 million and \$2.1 million, respectively. In 2012, the Company released its valuation allowance on the deferred tax asset for its remaining net operating loss carry forwards. The release during the three and six-month periods ended June 30, 2012 was due to additional current earnings and the expectation that the Company will recognize the remaining benefit of the net operating loss carry forwards. The valuation allowance release was the primary driver of the tax benefits recorded during the three and six months ended June 30, 2012.

There were no significant uncertain tax positions requiring additional recognition in its financial statements as of June 30, 2013 and the Company does not believe that there will be any material changes in its unrecognized tax positions over the next twelve months. In addition, there were no accruals for interest or penalties during the three months and six months ended June 30, 2013.



**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (continued)****(unaudited)****Note 4. Loan Portfolio**

The following table sets forth information concerning the Company's loan portfolio by type of loan at the dates indicated:

	June 30, 2013		December 31, 2012		
	Amount	% of Total	Amount	% of Total	
	(Dollars in thousands)				
Commercial and Industrial and Finance Leases	\$23,066	7.5 %	\$23,184	7.8 %	
Secured by Real Estate:					
Residential	81,990	26.8	84,207	28.5	
Multi family	13,872	4.5	14,491	4.9	
Commercial Real Estate and Construction	186,898	61.0	172,973	58.5	
Consumer	566	0.2	899	0.3	
Total loans	306,392	100.0%	295,754	100.0 %	
Deferred loan fees	(516 )		(589 )		
Allowance for loan losses	(10,387 )		(11,008 )		
Loans, net	\$295,489		\$284,157		

The Bank had \$0.9 million of non-accrual loans as of June 30, 2013 and December 31, 2012, and no loans delinquent more than ninety days and still accruing interest at both June 30, 2013 and December 31, 2012. The Bank did not foreclose on any loans during the six months ended June 30, 2013. The Bank had one foreclosed real estate property, with a carrying value of \$225,000 in the year ended December 31, 2012 which was sold during the first quarter of 2013. The Bank classified the non-accrual loans as impaired loans at both June 30, 2013 and December 31, 2012. However, no specific reserves for impaired loans was made because the collateral underlying the impaired loans was deemed to be sufficient to cover any loss in the event of a default. Therefore, the allowance for loan loss is includable in the calculation of regulatory capital up to a maximum of 1.25% of risk-weighted assets or approximately \$4.8 million and \$4.6 million at June 30, 2013 and December 31, 2012, respectively.

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (continued)****(unaudited)****Note 4. - (continued)**

Average impaired loans for the three and six months ended June 30, 2013 and 2012 were approximately \$7.5 million and \$25.6 million, respectively. Interest income that would have been recognized had these loans performed in accordance with their contractual terms was approximately \$4,000 and \$8,000 for the three months ended June 30, 2013 and 2012, respectively, and \$9,000 and \$17,000 for the six months ended June 30, 2013 and 2012, respectively.

The following table sets forth information concerning activity in the Company's allowance for loan losses for the indicated periods.

	For The Three Months Ended		For The Six Months Ended	
	June 30, 2013	June 30, 2012	June 30, 2013	June 30, 2012
	(In thousands)			
Balance at beginning of period	\$ 10,705	\$ 17,720	\$ 11,008	\$ 17,720
Provision charged to operations	(298 )	-	(601 )	-
Loans charged-off	(20 )	(2 )	(20 )	(2 )
Recoveries	-	-	-	-
Balance at end of period	\$ 10,387	\$ 17,718	\$ 10,387	\$ 17,718

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (continued)**

**(unaudited)**

**Note 4. - (continued)**

**Allowance for Credit Losses and Recorded Investment in Financing Receivables**

The qualitative factors are determined based on the various risk characteristics of each loan class. Relevant risk characteristics are as follows:

**Commercial and industrial loans** - Loans in this class are made to businesses. Generally these loans are secured by assets of the business and repayment is expected from the cash flows of the business. A weakened economy, and resultant decreased consumer and/or business spending will have an adverse effect on the credit quality in this loan class.

**Commercial real estate** - Loans in this class include non-owner occupied income-producing investment properties and owner-occupied real estate used for business purposes. The underlying properties are generally located largely in our primary market area. The cash flows of the income producing investment properties are adversely impacted by a downturn in the economy as evidenced by increased vacancy rates, which in turn, will have an effect on credit quality. In the case of owner-occupied real estate used for business purposes a weakened economy and resultant decreased consumer and/or business spending will have an adverse effect on credit quality.

**Construction loans** - Loans in this class primarily include land loans to local individuals, contractors and developers for developing the land for sale or for the purpose of making improvements thereon. Repayment is derived from sale of the lots/units including any pre-sold units. Credit risk is affected by market conditions, time to sell at an adequate price and cost overruns. To a lesser extent this class includes commercial development projects we finance which in most cases have an interest-only phase during construction and then convert to permanent financing. Credit risk is affected by cost overruns, market conditions and the availability of permanent financing, to the extent such permanent financing is not being provided by us.

**Residential real estate** - Loans in this class are made to and secured by owner-occupied residential real estate and repayment is dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment rates and housing prices, will have an adverse effect on the credit quality in this loan class. The Company generally does not originate loans with a loan-to-value ratio greater than 80 percent and does not grant subprime loans.

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (continued)**

**(unaudited)**

**Note 4. - (continued)**

**Multi-Family real estate** - Loans in this class are made to and secured by owner-occupied residential real estate and repayment is dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment rates and housing prices, will have an effect on the credit quality in this loan class. The Company generally does not originate loans with a loan-to-value ratio greater than 80 percent and does not grant subprime loans.

**Consumer loans** - Loans in this class may be either secured or unsecured and repayment is dependent on the credit quality of the individual borrower and, if applicable, sale of the collateral securing the loan (such as automobile or other secured assets). Therefore the overall health of the economy, including unemployment rates and housing prices, will have an effect on the credit quality in this loan class.

**Financing Leases** - Loans in this class may be either secured or unsecured and repayment is dependent on the credit quality of the individual borrower and, if applicable, sale of the collateral securing the loan (such as equipment or other secured assets). Therefore the overall health of the economy, including unemployment rates and housing prices, will have an effect on the credit quality in this loan class.

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (continued)****(unaudited)****Note 4. - (continued)****Allowance for Credit Losses and Recorded Investment in Loans****For the Six Months Ended June 30, 2013****(In thousands)**

	Commercial & Industrial	Commercial Real Estate	Construction	Multi Family	Residential Real Estate	Consumer	Finance Leases	Unallocated	Total
Allowance for credit losses:									
Beginning balance	\$ 989	\$ 6,309	\$ 1,441	\$ 326	\$ 1,529	\$ 15	\$ 62	\$ 337	\$ 11,008
Charge-offs	-	-	-	-	(20 )	-	-	-	(20 )
Recoveries	-	-	-	-	-	-	-	-	-
Provision	(21 )	215	65	(49 )	(432 )	(5 )	(37 )	(337 )	(601 )
Ending balance	\$ 968	\$ 6,524	\$ 1,506	\$ 277	\$ 1,077	\$ 10	\$ 25	\$ -	\$ 10,387
Ending balance: individually evaluated for impairment	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Ending balance: collectively evaluated for impairment	\$ 968	\$ 6,524	\$ 1,506	\$ 277	\$ 1,077	\$ 10	\$ 25	\$ -	\$ 10,387
Financing Receivables:									
Ending balance	\$ 22,123	\$ 161,756	\$ 25,142	\$ 13,872	\$ 81,990	\$ 566	\$ 943	\$ 0	\$ 306,392
Ending balance: individually evaluated for impairment	\$ 0	\$ 1,250	\$ 0	\$ 0	\$ 6,224	\$ 0	\$ 0	\$ 0	\$ 7,474
	\$ 22,123	\$ 160,506	\$ 25,142	\$ 13,872	\$ 75,766	\$ 566	\$ 943	\$ 0	\$ 298,918

Ending balance:  
collectively  
evaluated for  
impairment

Among the loans reviewed for impairment, \$0.8 million of residential loans and \$1.2 million of commercial real estate loans were identified as troubled debt restructurings ("TDRs"). TDRs are the result of an economic concession being granted to borrowers experiencing financial difficulties. Certain TDRs are classified as nonperforming at the time of restructuring and may only return to performing status after considering the borrower's sustained repayment performance under the revised payment terms for a reasonable period, generally six months. We evaluated all of the impaired loans by analyzing the collateral value and by evaluating the discounted cash flow. Based on the nature of the modifications no impairment was required.

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (continued)****(unaudited)****Note 4. - (continued)****Allowance for Credit Losses and Recorded Investment in Loans****For the Year Ended December 31, 2012****(In thousands)**

	Commercial & Industrial	Commercial Real Estate	Construction	Multi Family	Residential Real Estate	Consumer	Finance Leases	Unallocated	Total
Allowance for credit losses:									
Beginning balance	\$ 950	\$ 7,857	\$ 609	\$ 411	\$ 6,490	\$ 53	\$ 126	\$ 1,224	\$ 17,720
Charge-offs	(2 )	-	-	-	(50 )	-	-	-	(52 )
Recoveries	33	-	-	-	-	-	-	-	33
Provision	8	(1,548 )	832	(85 )	(4,911 )	(38 )	(64 )	(887 )	(6,693 )
Ending balance	\$ 989	\$ 6,309	\$ 1,441	\$ 326	\$ 1,529	\$ 15	\$ 62	\$ 337	\$ 11,008
Ending balance: individually evaluated for impairment	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0
Ending balance: collectively evaluated for impairment	\$ 989	\$ 6,309	\$ 1,441	\$ 326	\$ 1,529	\$ 15	\$ 62	\$ 337	\$ 11,008
Financing Receivables:									
Ending balance	\$ 21,814	\$ 149,184	\$ 23,789	\$ 14,491	\$ 84,207	\$ 899	\$ 1,370	\$ 0	\$ 295,754
Ending balance: individually evaluated for impairment	\$ 0	\$ 1,277	\$ 0	\$ 0	\$ 7,596	\$ 13	\$ 0	\$ 0	\$ 8,886



Ending balance:

collectively evaluated for impairment	\$ 21,814	\$ 147,907	\$ 23,789	\$ 14,491	\$ 76,611	\$ 886	\$ 1,370	\$ 0	\$ 286,868
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Among the loans reviewed for impairment, \$2.4 million of residential loans and \$1.3 million of commercial real estate loans were identified as troubled debt restructurings ("TDRs"). TDRs are the result of an economic concession being granted to borrowers experiencing financial difficulties. Certain TDRs are classified as nonperforming at the time of restructuring and may only return to performing status after considering the borrower's sustained repayment performance under the revised payment terms for a reasonable period, generally six months. We evaluated all of the impaired loans by analyzing the collateral value and by evaluating the discounted cash flow. Based on the nature of the modifications no impairment was required.

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (continued)****(unaudited)****Note 4. - (continued)****Age Analysis of Past Due Loans****As of June 30, 2013****(In thousands)**

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans	Recorded Loans > 90 Days and Accruing
Commercial & industrial	\$ 20	\$	— \$ —	\$ 20	\$22,103	\$22,123	\$ —
Construction	—	—	—	—	25,142	25,142	—
Commercial real estate	—	—	—	—	161,756	161,756	—
Consumer	—	—	—	—	440	440	—
Overdrafts	—	—	—	—	126	126	—
Residential - prime	329	—	882	1,211	80,779	81,990	—
Residential - multi family	—	—	—	—	13,872	13,872	—
Finance leases	—	—	—	—	943	943	—
Total	\$ 349	\$	— \$ 882	\$ 1,231	\$305,161	\$306,392	\$ —

**Age Analysis of Past Due Loans****As of December 31, 2012****(In thousands)**

	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans	Recorded Loans > 90 Days and Accruing
Commercial & industrial	\$ —	\$ —	\$ —	\$ —	\$21,814	\$21,814	\$ —
Construction	—	—	—	—	23,789	23,789	—
Commercial real estate	7,181	—	—	7,181	142,003	149,184	—
Consumer	50	—	—	50	665	715	—
Overdrafts	—	—	—	—	184	184	—
Residential - prime	6,081	373	861	7,315	76,892	84,207	—
Residential - multi family	—	—	—	—	14,491	14,491	—
Finance leases	—	—	—	—	1,370	1,370	—
Total	\$ 13,312	\$ 373	\$ 861	\$ 14,546	\$281,208	\$295,754	\$ —

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (continued)****(unaudited)****Note 4. - (continued)****Impaired Loans****For the Six Months Ended June 30, 2013****(In thousands)**

	Recorded Loan	Unpaid Principal Balance	Related Allowance	Average Recorded Loan	Interest Income Recognized	Interest Income Foregone
With no related allowance recorded:						
Commercial & industrial	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Construction	—	—	—	—	—	—
Commercial real estate	1,250	1,250	—	1,262	42	—
Consumer	—	—	—	—	—	—
Residential - prime	6,224	6,224	—	6,260	202	8
Residential - multi family	—	—	—	—	—	—
Finance leases	—	—	—	—	—	—
<b>Total</b>	<b>\$ 7,474</b>	<b>\$ 7,474</b>	<b>\$ —</b>	<b>\$ 7,522</b>	<b>\$ 244</b>	<b>\$ 8</b>
Commercial	1,250	1,250	—	1,262	42	—
Consumer	—	—	—	—	0	—
Residential	6,224	6,224	—	6,260	202	8

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (continued)****(unaudited)****Note 4. - (continued)****Impaired Loans****For the Year Ended December 31, 2012****(In thousands)**

	Recorded Loan	Unpaid Principal Balance	Related Allowance	Average Recorded Loan	Interest Income Recognized	Interest Income Foregone
With no related allowance recorded:						
Commercial & industrial	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Construction	—	—	—	—	—	—
Commercial real estate	1,277	1,277	—	1,307	87	—
Consumer	13	13	—	15	—	—
Residential - prime	7,596	7,596	—	7,640	355	6
Residential - multi family	—	—	—	—	—	—
Finance leases	—	—	—	—	—	—
<b>Total</b>	<b>\$ 8,886</b>	<b>\$ 8,886</b>	<b>\$ —</b>	<b>\$ 8,962</b>	<b>\$ 442</b>	<b>\$ 6</b>
Commercial	1,277	1,277	—	1,307	87	—
Consumer	13	13	—	15	—	—
Residential	7,596	7,596	—	7,640	355	6
Finance leases	—	—	—	—	—	—

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (continued)****(unaudited)****Note 4. - (continued)****Loans on Nonaccrual Status****As of**

	June 30, 2013	December 31, 2012
	(In thousands)	
Commercial & industrial	\$—	\$ —
Construction	—	—
Commercial real estate	—	—
Consumer	—	—
Residential	882	861
Residential - multi family	—	—
Finance leases	—	—
Total	\$882	\$ 861

The Company utilizes a grade risk rating system for the loan portfolio.

On a quarterly basis, or more often if needed, the Company formally reviews the ratings on all classified commercial and industrial, commercial real estate and construction loans. Semi-annually, the Company engages an independent third-party to review a significant portion of loans within these segments. Management uses the results of these reviews as part of its periodic review process.

**Credit Exposure****Credit Risk Profile by Internally Assigned Grades****As of June 30, 2013**

**(In thousands)**

	Commercial & Industrial	Commercial Real Estate Construction	Commercial Real Estate Other
Grade:			
Pass	\$ 20,215	\$ 15,512	\$ 142,681
Watch	1,700	—	9,582
Special Mention	103	—	5,533
Substandard	105	9,630	3,960
Total	\$ 22,123	\$ 25,142	\$ 161,756

	Residential	Multi Family	Finance Leases
Grade:			
Pass	\$ 80,820	\$ 13,872	\$ —
Watch	1,091	—	—
Special Mention	—	—	943
Substandard	79	—	—
Total	\$ 81,990	\$ 13,872	\$ 943

	Consumer Overdrafts	Consumer Other
Performing	\$ 126	\$ 440
Nonperforming	—	—
Total	\$ 126	\$ 440

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (continued)****(unaudited)****Note 4. - (continued)****Credit Exposure****Credit Risk Profile by Internally Assigned Grades****As of December 31, 2012****(In thousands)**

	Commercial & Industrial	Commercial Real Estate Construction	Commercial Real Estate Other
Grade:			
Pass	\$ 21,679	\$ 23,789	\$ 115,548
Watch	—	—	8,226
Special Mention	—	—	5,970
Substandard	135	—	19,441
Total	\$ 21,814	\$ 23,789	\$ 149,184

	Residential	Multi Family
Grade:		
Pass	\$ 76,097	\$ 14,491
Watch	716	—
Special Mention	1,086	—
Substandard	6,308	—
Total	\$ 84,207	\$ 14,491

	Consumer Overdrafts	Consumer Other	Finance Leases
Performing	\$ 184	\$ 715	\$ 1,370
Nonperforming	—	—	—
Total	\$ 184	\$ 715	\$ 1,370





**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (continued)****(unaudited)****Note 4. - (continued)**

Loan Modifications  
(Dollars in Thousands)

Troubled Debt Restructuring	As of June 30, 2013		Post-Modification Outstanding Recorded Loans	Non- Accrual Basis	Loan Balance
	Number of Loans	Pre-Modification Outstanding Recorded Loans			
Residential Real Estate	5	\$ 1,048	\$ 1,008	2	\$ 803
Commercial Real Estate	3	1,354	1,250	0	0
	8	\$ 2,402	\$ 2,258	2	\$ 803

Troubled Debt Restructuring	As of December 31, 2012		Post-Modification Outstanding Recorded Loans	Non- Accrual Basis	Loan Balance
	Number of Loans	Pre-Modification Outstanding Recorded Loans			
Residential Real Estate	7	\$ 2,177	\$ 2,101	0	\$ 0
Commercial Real Estate	3	1,354	1,276	0	0
	10	\$ 3,531	\$ 3,377	0	\$ 0

The loans restructured as noted above were restructured by extending maturity dates or reducing interest rates. No loans were restructured into two notes nor are there any commitments to extend additional funds on any TDRs. Any material loans deemed to be TDRs are individually evaluated for impairment with any loss recognized in the allowance for loan losses.

The following table shows our recorded investment for loans classified as TDR that are performing according to their restructured terms :

As of June 30,

(Dollars in thousands)	2013		2012	
	Number of contracts	Recorded investments	Numbers of contracts	Recorded investments
Multi-family residential	—	\$ —	—	\$ —
Commercial real estate	3	1,250	3	1,315
One-to-four family – residential	5	1,008	7	2,134
Construction	—	—	—	—
Commercial business and others	—	—	—	—
Total Performing TDRs	8	\$ 2,258	10	\$ 3,449

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (continued)****(unaudited)****Note 5. Investment Securities**

The following is a summary of held to maturity investment securities:

	June 30, 2013			
	Amortized Cost	Gross unrealized gains	Gross unrealized losses	Fair value
	(In thousands)			
U.S. Government Agencies	\$264	\$ 2	\$ -	\$ 266

	December 31, 2012			
	Amortized Cost	Gross unrealized gains	Gross unrealized losses	Fair value
	(In thousands)			
U.S. Government Agencies	\$275	\$ 8	\$ -	\$ 283

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (continued)****(unaudited)****Note 5. - (continued)**

The following is a summary of available-for-sale investment securities:

	June 30, 2013			
	Amortized Cost	Gross unrealized gains	Gross unrealized losses	Fair value
	(In thousands)			
U.S. Treasury Notes	\$39,859	\$—	\$(1,149)	) \$38,710
U.S. Government Agencies	140,011	—	(8,008)	) 132,003
Mortgage-backed securities	129,074	725	(1,849)	) 127,950
Corporate notes	8,459	56	(10)	) 8,505
Auction rate securities	53,000	—	(5,355)	) 47,645
Marketable equity Securities and other	122	—	—	) 122
Totals	\$370,525	\$781	\$(16,371)	) \$354,935

  

	December 31, 2012			
	Amortized Cost	Gross unrealized gains	Gross unrealized losses	Fair value
	(In thousands)			
U.S. Treasury Notes	\$24,868	\$19	\$(37)	) \$24,850
U.S. Government Agencies	141,653	367	(151)	) 141,869
Mortgage-backed securities	127,507	2,343	(255)	) 129,595
Corporate notes	10,386	106	(3)	) 10,489
Auction rate securities	56,000	—	(7,815)	) 48,185
Marketable equity Securities and other	126	—	—	) 126
Totals	\$360,540	\$2,835	\$(8,261)	) \$355,114

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (continued)**

**(unaudited)**

**Note 5. - (continued)**

Management uses a multi-factor approach to determine whether each investment security in an unrealized loss position is other-than-temporarily impaired ("OTTI"). An unrealized loss position exists when the current fair value of an investment is less than its amortized cost basis. The valuation factors utilized by management incorporate the ideas and concepts outlined in relevant accounting guidance. These include such factors as:

\*The length of time and the extent to which the market value has been less than cost;

\*The financial condition of the issuer of the security as well as the near and long-term prospect for the issuer;

\*The rating of the security by a national rating agency;

\*Historical volatility and movement in the fair market value of the security; and

\*Adverse conditions relative to the security, issuer or industry.

The following table shows the outstanding auction rate securities at June 30, 2013 and December 31, 2012:

	June 30, 2013		December 31, 2012	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In thousands)			
Preferred Shares of Money Center Banks	\$53,000	\$47,645	\$56,000	\$48,185
Totals	\$53,000	\$47,645	\$56,000	\$48,185

In accordance with ASC 320-10, Investment - Debt and Equity Securities, management's impairment analysis for the corporate and auction rate securities that were in a loss position as of June 30, 2013 began with management's

determination that it had the intent to hold these securities for sufficient time to recover the cost basis. Management also concluded that it was unlikely that it would be required to sell any of the securities before recovery of the cost basis.

At June 30, 2013 and December 31, 2012, the amortized cost of our auction rate securities was \$ 53.0 million and \$56.0 million, respectively. The fair value of the auction rate securities was \$47.6 million and \$48.2 million at June 30, 2013 and December 31, 2012, respectively.

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (continued)**

**(unaudited)**

**Note 5. - (continued)**

The fair value of the auction rate securities is determined by management valuing the underlying security. The auction rate securities allow for conversion to the underlying preferred security after two failed auctions. As of June 30, 2013, there have been more than two failed auctions for all outstanding auction rate securities. It is our intention to continue to hold these securities and not convert to the underlying preferred securities. We also perform a discounted cash flow analysis, but we considered the market value of the underlying preferred shares to be more objective and relevant in pricing auction rate securities.

In determining whether there is OTTI, management considers the factors noted above. The financial performance indicators we review include, but are not limited to, net earnings, change in liquidity, and change in cash from operating activities, and, for money center banks, the regulatory capital ratios and the allowance for loan losses to the nonperforming loans. Through June 30, 2013, the auction rate securities have continued to pay interest at the highest rate as stipulated in the original prospectus.

At June 30, 2013, we had 6 auction rate securities with an aggregate fair market value of \$33.0 million which were below investment grade. At December 31, 2012, we had four auction rate securities with an aggregate fair market value of \$30.6 million which were below investment grade.

Based upon our methodology for determining the fair value of the auction rate securities, we concluded that as of June 30, 2013, the unrealized loss for the auction rate securities is due to the market interest volatility, the continued illiquidity of the auction rate markets, and uncertainty in the financial markets as there has not been a deterioration in the credit quality of the 5/6 issuers of the auction rate securities or a downgrade of additional auction rate securities from investment grade. It is not more likely than not that the Company would be required to sell the auction rate securities prior to recovery of the unrealized loss, nor does the Company intend to sell the security at the present time.

There has been one credit rating downgrade on our auction rate securities subsequent to December 31, 2012.





**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (continued)****(unaudited)****Note 5. - (continued)**

The Company has investments in certain debt securities that have unrealized losses or may be otherwise impaired, but an OTTI has not been recognized in the financial statements as management believes the decline is due to the credit markets coupled with the interest rate environment.

The following table indicates the length of time individual securities that we consider temporarily impaired have been in a continuous unrealized loss position at June 30, 2013 (in thousands):

Description of Securities	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
U.S. Treasury Notes	\$38,710	\$ 1,149	\$—	\$ —	\$38,710	\$ 1,149
U.S. Government Agencies	119,353	7,519	12,650	489	132,003	8,008
Mortgage-backed securities	66,563	1,295	40,291	554	106,854	1,849
Corporate Notes	1,078	9	630	1	1,708	10
Auction rate securities	47,645	5,355	—	—	47,645	5,355
Total temporarily impaired securities	\$273,349	\$ 15,327	\$53,571	\$ 1,044	\$326,920	\$ 16,371

The Company had a total of 152 debt securities with a fair market value of \$326.9 million which were temporarily impaired at June 30, 2013. The total unrealized loss on these securities was \$16.4 million, which is attributable to the market interest volatility, the continued illiquidity of the debt markets, and uncertainty in the financial markets. The unrealized loss on our debt securities is comprised of a loss of \$5.4 million on eight auction rate securities which have declined in value due to auction failures beginning in February 2008 and a loss of \$11.0 million on other debt securities. It is not more likely than not that we would sell the securities before maturity, and we have the intent to hold all of these securities to maturity and will not be required to sell these securities, due to our ratio of cash and cash equivalents of approximately 13.2% of total assets at June 30, 2013. Therefore, the unrealized losses associated with these securities are not considered to be other than temporary.

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (continued)****(unaudited)****Note 5. - (continued)**

The amortized cost and fair value of investment securities available for sale and held to maturity, by contractual maturity, at June 30, 2013 are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	June 30, 2013		Held to Maturity	
	Available for Sale Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In thousands)			
Due in one year or less	\$2,704	\$2,719	-	-
Due after one through five years	36,563	36,118	-	-
Due after five through ten years	66,983	64,390	245	246
Due after ten years	211,153	203,941	19	20
Auction rate securities	53,000	47,645	-	-
Marketable equity securities and other	122	122	-	-
Totals	\$370,525	\$354,935	\$ 264	\$ 266

Gross gains realized on the sales of available-for-sale securities for the six months ended June 30, 2013, and 2012 were \$444,000 and \$785,000 respectively. Gross losses were \$131,000 and \$677,000 for the six months ended June 30, 2013 and 2012, respectively.

At both June 30, 2013 and December 31, 2012, securities sold under agreements to repurchase with a book value of \$45.0 million were outstanding. The book value of the securities pledged for these repurchase agreements was \$52.0 million and \$55.9 million, respectively. As of June 30, 2013 and December 31, 2012, the Company owns investment securities in one issuer where the carrying value exceeded 10% of shareholders' equity.



**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (continued)****(unaudited)****Note 6. Deposits**

The following table summarizes the composition of the average balances of major deposit categories:

	<b>Six Months Ended</b>		<b>Twelve Months Ended</b>	
	<b>June 30, 2013</b>		<b>December 31, 2012</b>	
	<b>Average</b>	<b>Average</b>	<b>Average</b>	<b>Average</b>
	<b>Amount</b>	<b>Yield</b>	<b>Amount</b>	<b>Yield</b>
	<b>(Dollars in thousands)</b>			
Demand deposits	\$81,025	—	\$ 74,630	—
NOW and money market	39,739	0.42 %	27,536	0.29 %
Savings deposits	167,364	0.20 %	201,251	0.18
Time deposits	330,782	0.98 %	357,706	1.13
Total deposits	\$618,910	0.62 %	\$ 661,123	0.68 %

The following table provides the Weighted Average rate for each of the deposit categories:

<b>(Dollars in thousands)</b>	<b>As of June 30,</b>		<b>2012</b>	
	<b>2013</b>	<b>Weighted</b>	<b>Balance</b>	<b>Weighted</b>
	<b>Balance</b>	<b>Ave Rate</b>	<b>Balance</b>	<b>Ave Rate</b>
Interest-bearing deposits:				
Certificate of deposit accounts	\$321,624	0.96 %	\$366,232	1.19 %
Savings accounts	155,953	0.20 %	210,271	0.16 %
Money Market accounts	8,908	0.17 %	7,986	0.20 %
NOW accounts	29,187	0.53 %	18,495	0.25 %
Total interest-bearing demand deposits	515,672		602,984	
Non-interest bearing deposits	89,824		76,039	
Total due to depositors	605,496		679,023	
Mortgagors' escrow deposits	2,471		2,197	

Total Deposits	\$607,967	\$681,220
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**Note 7. Comprehensive Income (Loss)**

The Company follows the provisions of FASB ASC 220, Comprehensive Income("ASC 220"), which includes net income as well as certain other items which result in a change to equity during the period. The following table presents the components of comprehensive income (loss):

	For The Six Months Ended June 30,					
	2013			2012		
	Before tax amount	Tax (expense) benefit	Net of tax amount	Before tax amount	Tax (expense) benefit	Net of tax amount
	(In thousands)					
Unrealized gains (losses) on investment securities:						
Unrealized holding gains (losses) arising During period	\$ (10,219)	\$ 4,596	\$ (5,623 )	\$ 9,182	\$ (3,673 )	\$ 5,509
Less reclassification adjustment for gains (losses) realized in net income	313	(141 )	172	108	(43 )	65
Unrealized gain (loss) on investment securities	(10,532)	4,737	(5,795)	9,074	(3,630 )	5,444
Other comprehensive Income (loss), net	\$ (10,532)	\$ 4,737	\$ (5,795)	\$ 9,074	\$ (3,630 )	\$ 5,444

## **BERKSHIRE BANCORP INC. AND SUBSIDIARIES**

### **Notes to Consolidated Financial Statements (continued)**

**(unaudited)**

#### **Note 8. Fair Value of Financial Instruments**

FASB ASC 820, "Fair Value Measurements and Disclosure" ("ASC 820"), defines fair value, establishes a framework for measuring fair value, and expands disclosure about fair value. ASC 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability (an exit price) in an orderly transaction between market participants on the measurement date. ASC 820 also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value. A financial instrument's level within the fair value hierarchy is based on the lowest level of input significant to the fair value measurement. There have been no material changes in valuation techniques as a result of the adoption of ASC 820.

Level 1 - Quoted prices (unadjusted) in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date.

Level 2 - Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities in active markets; quoted prices in markets that are not active for identical or similar assets or liabilities; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities.

Level 3 - Unobservable inputs that are supported by little or no market activity and significant to the fair value of the assets or liabilities that are developed using the reporting entities' estimates and assumptions, which reflect those that market participants would use.

The Company is required to disclose the estimated fair value of its assets and liabilities considered to be financial instruments. For the Company, as for most financial institutions, the majority of its assets and liabilities are considered financial instruments. However, many such instruments lack an available trading market, as characterized by a willing buyer and seller engaging in an exchange transaction. Also, it is the Company's general practice and intent to hold its financial instruments to maturity and not to engage in trading or sales activities, except for certain loans. Therefore, the Company had to use significant estimations and present value calculations to prepare this disclosure.



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

Estimated fair values have been determined by the Company using the best available data and an estimation methodology suitable for each category of financial instruments. The estimation methodologies used, the estimated fair values, and recorded book balances at June 30, 2013 and December 31, 2012 are outlined below.

**BERKSHIRE BANCORP INC. AND SUBSIDIARIES****Notes to Consolidated Financial Statements (continued)****(unaudited)****Note 8. - (continued)**

	June 30, 2013		December 31, 2012	
	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
	(In thousands)			
Investment securities	\$ 355,199	\$ 355,201	\$ 355,389	\$ 355,397
Loans, net of unearned income	305,876	312,108	295,165	305,123
Time Deposits	321,624	322,660	337,492	338,723
Other Deposits	286,343	286,343	304,978	304,978
Repurchase Agreements	45,000	45,502	45,000	46,138
Borrowings	—	—	1,539	1,548

The following table sets forth the fair value hierarchy for financial instruments measured at fair value at June 30, 2013 and December 31, 2012:

(In thousands)	Quoted Prices in Active Markets for Identical Assets (Level 1)		Significant Other Observable Inputs (Level 2)		Significant Other Unobservable Inputs (Level 3)		Total carried at fair value	
	June 30, 2013	December 31, 2012	June 30, 2013	December 31, 2012	June 30, 2013	December 31, 2012	June 30, 2013	December 31, 2012
	Assets:							
Investment Securities	45,501	\$ 21,234	261,224	\$ 285,978	48,210	\$ 48,185	354,935	\$ 355,397
Loans, net of Unearned Income	—	—	—	—	312,108	305,123	312,108	305,123
Time Deposits	—	—	322,660	338,723	—	—	322,660	338,723
Other Deposits	—	—	286,432	304,978	—	—	286,432	304,978
Repurchase Agreements	—	—	45,502	46,138	—	—	45,502	46,138

Borrowings	—	—	0	1,548	—	—	0	1,548
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For cash and cash equivalents, the recorded book values of \$104.2 million and \$149.2 million at June 30, 2013 and December 31, 2012, respectively, approximates fair value because of the relatively short term between the origination of the instrument and its expected realization. Therefore, the Company believes the measurement of fair value of cash and cash equivalents is derived from Level 1 inputs.

The estimated fair values of investment securities are based on quoted market prices (Level 1 inputs), if available. Estimated fair values are based on quoted market prices of comparable instruments if quoted market prices are not available (Level 2 inputs). Estimated fair values are also determined using unobservable inputs that are supported by little or no market values and significant assumptions and estimates (Level 3 inputs).

The net loan portfolio at June 30, 2013 and December 31, 2012 has been valued using a present value discounted cash flow where market prices were not available. The discount rate used in these calculations is the estimated current market rate adjusted for credit risk. The Company believes the fair value of portfolio loans is derived from Level 3 inputs.

The estimated fair values of demand deposits (i.e. interest (checking) and non-interest bearing demand accounts, savings and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e. their carrying amounts). The fair value of such deposits is derived from Level 2 inputs. The fair value of time deposits have been valued using net present value discounted cash flow and is derived from Level 2 inputs.

The fair value of commitments to extend credit is estimated based upon the amount of unamortized deferred loan commitment fees. The fair value of letters of credit is based upon the amount of unearned fees plus the estimated cost to terminate letters of credit. Fair values of unrecognized financial instruments, including commitments to extend credit, and the fair value of letters of credit are considered immaterial. As such, no disclosures are made on the fair value of commitments.

The fair value of interest rate caps, included in borrowings, are based upon the estimated amount the Company would receive or pay to terminate the contracts or agreements, taking into account current interest rates and, when appropriate, the current creditworthiness of the counterparties. The aggregate fair value for the interest rate caps were zero at both June 30, 2013 and December 31, 2012.

The fair value of borrowings and repurchase agreements approximates the carrying value due to the re-pricing of the debt. The Company measures the fair value of borrowings and repurchase agreements using Level 2 inputs.



**BERKSHIRE BANCORP INC. AND SUBSIDIARIES**

**Notes to Consolidated Financial Statements (continued)**

**(unaudited)**

**Note 8. - (continued)**

**Assets and Liabilities Measured at Fair Value on a Recurring and Non Recurring Basis**

A description of the valuation methodologies used for financial instruments measured at fair value on a recurring basis, as well as the classification of the instruments pursuant to the valuation hierarchy, are as follows:

**Securities Available for Sale**

When quoted market prices are available in an active market, securities are classified within Level 1 of the fair value hierarchy. If quoted market prices are not available or accessible, then fair values are estimated using pricing models, matrix pricing, or discounted cash flow models. The fair values of securities estimated using pricing models or matrix pricing are generally classified within Level 2 of the fair value hierarchy. When discounted cash flow models are used there is omitted activity or less transparency around inputs to the valuation and securities are classified within Level 3 of the fair value hierarchy.

Level 1 securities generally include equity securities valued based on quoted market prices in active markets. Level 2 instruments include U.S. government agency obligations, state and municipal bonds, mortgage-backed securities, collateralized mortgage obligations and corporate bonds. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things. Level 3 securities available for sale consist of instruments that are not readily marketable and may only be redeemed with the issuer at par such as Federal Home Loan Bank stock. These securities are valued at par value.

Assets measured at fair value on a recurring and nonrecurring basis at June 30, 2013 and at December 31, 2012 are summarized below.



	At June 30, 2013			
	Fair Value Measurement Using			
	<b>Quoted</b>			
	<b>Prices</b>			
	<b>in</b>			
	<b>Significant</b>			
	<b>Active</b>	<b>Other</b>	<b>Significant</b>	
	<b>Markets</b>	<b>Observable</b>	<b>Unobservable</b>	<b>Total</b>
	<b>for</b>	<b>Inputs</b>	<b>Inputs</b>	
	<b>Identical</b>	<b>(Level 2)</b>	<b>(Level 3)</b>	
	<b>Assets/Liabilities</b>			
	<b>(Level 1)</b>			
	<b>(Dollars in thousands)</b>			
Assets				
Impaired Loans (1)	\$—	\$—	\$ 7,474	\$7,474
Investment securities available for sale: (2)				
U.S. Treasury Notes	38,710	—	—	38,710
U.S. Government Agencies	—	132,003	—	132,003
Mortgage-backed securities	—	127,950	—	127,950
Corporate notes	6,791	1,149	565	8,505
Auction rate securities	—	—	47,645	47,645
Marketable equity securities and other	—	122	—	122
Total Investment securities available for sale	\$45,501	\$ 261,224	\$ 48,210	\$354,935
Total assets	\$45,501	\$ 261,224	\$ 55,684	\$362,409

(1) Non-recurring basis-impaired loans represent carrying amount as no write downs were taken to date.

(2) Recurring basis.

The above table includes \$15.6 million in net unrealized losses on the Company's available for sale securities. The Company has reviewed its investment portfolio at June 30, 2013, and determined that the unrealized losses are temporary.



	At December 31, 2012 Fair Value Measurement Using <b>Quoted Prices in</b>			
	<b>Significant</b>			
	<b>Active Markets</b>	<b>Other Observable Inputs (Level 2)</b>	<b>Significant Unobservable Inputs (Level 3)</b>	<b>Total</b>
	<b>for Identical Assets/Liabilities (Level 1)</b>			
	<b>(Dollars in thousands)</b>			
Assets				
Impaired Loans (1)	\$ —	\$ —	\$ 8,886	\$8,886
Investment securities available for sale: (2)				
U.S. Treasury Notes	\$14,846	\$ 10,004	\$ —	\$24,850
U.S. Government Agencies	—	141,869	—	141,869
Mortgage-backed securities	—	129,595	—	129,595
Corporate notes	6,388	4,101	—	10,489
Municipal securities				
Auction rate securities	—	—	48,185	48,185
Marketable equity securities and other	—	126	—	126
Total Investment securities available for sale	\$21,234	\$ 285,695	\$ 48,185	\$355,114
Total assets	\$21,234	\$ 285,695	\$ 57,071	\$364,000

(1) Non-recurring basis-impaired loans represent carrying amount as no write downs were taken to date.

(2) Recurring basis.

The above table includes \$5.4 million in net unrealized losses on the Company's available for sale securities. The Company has reviewed its investment portfolio at December 31, 2012, and determined that the unrealized losses are temporary.

#### **Assets and Liabilities Measured at Fair Value on a Recurring Basis Using Significant Unobservable Inputs (Level 3)**

The following table presents a reconciliation for assets measured at fair value on a recurring basis for which the Company has utilized significant unobservable inputs (Level 3).

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(Dollars in thousands)	Investment Securities Available for Sale	
	For the six months ended June 30,	
	2013	2012
Balance, January 1,	\$ 48,185	\$ 44,495
Included in other comprehensive income	2,460	9,118
Redemptions and sales	(3,000)	(7,500)
Balance, June 30,	\$ 47,645	\$ 46,113

The amount of total gains (losses) for the period included in earnings attributable to the change in unrealized gains or losses relating to assets still held at June 30, 2013

	\$ —	\$ —
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In accordance with FASB Accounting Standards Update (“ASU”) No. 2011-04, the Bank establishes valuation processes and procedures to ensure that the valuation techniques for investments that are categorized within Level 3 of the fair value hierarchy are fair, consistent and verifiable.

The Bank periodically tests its valuation of Level 3 investments through performing Discounted Cash Flow analysis of the investments by comparing the results of the discounted cash flow to the values obtained from valuation of the underlying collateral of the Auction Rate Securities. The following table presents additional information in accordance with ASU 2011-04 about the valuation processes utilized in measuring assets and liabilities at fair value using significant unobservable inputs (Level 3):

Assets (at Fair Value)	Fair Value at June 30, 2013 (in thousands)	Valuation Technique	Unobservable Inputs	Range of Preferred Share Pricing
Auction Rate Securities	\$ 47,645	Market Prices	Underlying Collateral	\$21.17 to \$24.04

### Note 9. Related Party Transactions

In accordance with banking regulations, the Bank, from time to time, enters into lending transactions in the ordinary course of business with directors, executive officers, principal stockholders and affiliates of such persons on the same terms as those prevailing for comparable transactions with other borrowers. The following table summarizes the activity in loans to related parties. (In thousands)

Balance at 12/31/12	\$4,900
New Loans	—
Repayments	(164 )
Balance at 6/30/13	\$4,736

Aggregate deposits from related parties at June 30, 2013 and December 31, 2012 amounted to approximately \$55.3 million and \$61.5 million, respectively. At both June 30, 2013 and December 31, there were no related party overdrawn deposit accounts reclassified to loans.

#### NOTE 10. Capital Adequacy

Quantitative measures established by regulations to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets, and of Tier I capital to average assets. Management believes that, as of June 30, 2013, the Bank meets all capital adequacy requirements to which it is subject.

As of June 30, 2013, the Bank met all regulatory requirements for classification as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based and Tier I leverage ratios as set forth in the following table. There are no conditions or events since that date that management believes have changed the institution's category.

The following table sets forth the actual and required regulatory capital amounts and ratios of the Company and the Bank as of June 30, 2013 (dollars in thousands):

	Actual		For capital		To be well	
			adequacy purposes		capitalized under	
	Amount	Ratio	Amount	Ratio	prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
June 30, 2013						
Total Capital (to Risk-Weighted Assets)						
Company	\$ 141,914	36.96 %	30,721	≥8.0 %	—	N/A
Bank	\$ 132,232	35.00 %	30,221	≥8.0 %	37,776	≥10.0 %
Tier I Capital (to Risk-Weighted Assets)						
Company	\$ 137,045	35.69 %	15,360	≥4.0 %	—	N/A
Bank	\$ 127,440	33.74 %	15,110	≥4.0 %	22,665	≥6.0 %
Tier I Capital (to Average Assets)						
Company	\$ 137,045	16.92 %	32,402	≥4.0 %	—	N/A
Bank	\$ 127,440	15.86 %	32,137	≥4.0 %	40,172	≥5.0 %



## **Note 11. New Accounting Pronouncements**

In December 2011, the FASB issued ASU No. 2011-11, which amends Topic 210, "Balance Sheet," to require an entity to disclose both gross and net information about financial instruments, such as sales and repurchase agreements and reverse sale and repurchase agreements and securities borrowing/lending arrangements, and derivative instruments that are eligible for offset in the statement of financial position and/or subject to a master netting arrangement or similar agreement. ASU 2011-11 is effective for annual and interim periods beginning on January 1, 2013, and did not have a material effect on the consolidated statements of operations or financial condition.

In February 2013, the FASB issued ASU No. 2013-02, which amends the authoritative accounting guidance under ASC Topic 220 "Comprehensive Income." The amendments do not change the current requirements for reporting net income or other comprehensive income in financial statements. However, the amendments require an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. In addition, an entity is required to present, either on the face of the statement where net income is presented or in the notes, significant amounts reclassified out of accumulated other comprehensive income by the respective line items of net income but only if the amount reclassified is required under U.S. GAAP to be reclassified to net income in its entirety in the same reporting period. For other amounts that are not required under U.S. GAAP to be reclassified in their entirety to net income, an entity is required to cross-reference to other disclosures required under U.S. GAAP that provide additional detail about those amounts. The amendments in this update are effective prospectively for reporting periods beginning after December 15, 2013. Early adoption is permitted. Adoption of this update is not expected to have a material effect on the Company's consolidated results of operation or financial condition.

## **ITEM 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.**

### **Executive Summary**

We are a Delaware corporation organized in March 1979, and a bank holding company registered under the Bank Holding Company Act of 1956. We acquired The Berkshire Bank (the "Bank"), our indirect wholly-owned subsidiary in March 1999. The Bank was organized in 1987 as a New York State chartered commercial bank. Our principal activity is the ownership and management of the Bank. Our activities are primarily funded by cash on hand, rental income, income from our portfolio of investment securities, and dividends, if any, received from the Bank. Our common stock is traded on the NASDAQ Stock Market under the symbol "BERK."

The Bank's principal business consists of gathering deposits from the general public and investing those deposits together with funds generated from ongoing operations and borrowings, primarily in residential and commercial loans,

debt obligations issued by the U.S. Government and its agencies, debt obligations of business corporations, and mortgage-backed securities. The Bank operates from seven deposit-taking offices in New York City, four deposit-taking offices in Orange and Sullivan Counties, New York, and one deposit-taking office in Teaneck, New Jersey. The Bank's revenues are derived principally from interest on loans, and interest and dividends on investments in the securities portfolio. The Bank's primary regulator at the state level is the New York State Department of Financial Services (the "DFS"), while at the federal level its primary regulator is the Federal Deposit Insurance Corporation (the "FDIC"). Deposits are insured to the maximum allowable amount by the FDIC. The Bank is a member of the Federal Home Loan Bank system. The Company, as a bank holding company, is regulated by the Federal Reserve Bank of New York.



The May 14, 2009 Memorandum of Understanding entered into between the Board of Directors of The Berkshire Bank, the Federal Deposit Insurance Corporation (FDIC) and the New York State Banking Department (NYSBD) was replaced on January 31, 2013 with a revised Memorandum of Understanding (MOU) between the Board of Directors of The Berkshire Bank, the Federal Deposit Insurance Corporation and the New York State Department of Financial Services (NYSDFS).

The MOU requires that a committee of the board of directors ("Compliance Committee") of at least three directors be established to ensure compliance with the MOU. The Compliance Committee meets monthly and presents a monthly written status report to the Board of the Bank on actions to ensure compliance with the MOU. In addition, a quarterly progress report is submitted to the FDIC and NYSDFS 30 days after each quarter end covering each provision of the MOU. We believe that the Bank is in full compliance with all of the provisions of the January 31, 2013 MOU.

Our results of operations depend primarily on net interest income, which is the difference between the income earned on our interest-earning assets and the cost of our interest-bearing liabilities. Net interest income is the result of our interest rate margin, which is the difference between the average yield earned on interest-earning assets and the average cost of interest-bearing liabilities, adjusted for the difference in the average balance of interest-earning assets as compared to the average balance of interest-bearing liabilities. We also generate non-interest income from loan fees, service charges on deposit accounts, mortgage servicing fees and other fees, dividends on Federal Home Loan Bank of New York ("FHLB-NY") stock, and net gains and losses on sales of securities and loans. Our operating expenses consist principally of employee compensation and benefits, occupancy and equipment costs, other general and administrative expenses, and income tax expense. Our results of operations also can be significantly affected by our periodic provision for loan losses and specific provision for losses on loans.

Our investment policy, approved by the Board of Directors, is designed primarily to manage the interest rate sensitivity of our overall assets and liabilities, to generate a favorable return without incurring undue interest rate and credit risk, to complement our lending activities, and to provide and maintain liquidity. In establishing our investment strategies, we consider our business and growth strategies, the economic environment, our interest rate risk exposure, our interest rate sensitivity "gap" position, the types of securities to be held, and other factors. We primarily classify our investment securities as available for sale.

During the first and second quarter of 2013, upon reviewing its historical experience of defaults in its portfolio and the current loan and housing environment, the Bank reduced its loan loss provision by \$303 thousand and \$298 thousand, respectively. No net provisions were made in the first or second quarters of 2013.

Net income, before the provision for income taxes, for the three and six months ended June 30, 2013 was \$1.4 million and \$3.0 million, respectively, compared to net income, before the benefit for income taxes, for the three and six months ended June 30, 2012 of \$1.5 million and \$3.4 million, respectively.

Net income allocated to common stockholders, after the provision for income taxes, was \$0.7 million and \$1.7 million for the three and six months ended June 30, 2013, respectively, compared to \$3.3 million and \$5.5 million for the three and six months ended June 30, 2012, respectively.

The following discussion and analysis is intended to provide a better understanding of the consolidated financial condition and results of operations of Berkshire Bancorp Inc. and subsidiaries. All references to earnings per share, unless stated otherwise, refer to earnings per diluted share. References to Notes herein are references to the "Notes to Consolidated Financial Statements" of the Company located in Item 1 herein.

## Critical Accounting Policies, Judgments, and Estimates

The accounting and reporting policies of the Company conform with accounting principles generally accepted in the United States of America ("GAAP") and general practices within the financial services industry. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and the accompanying notes. Actual results could differ from those estimates.

The Company considers that the determination of the allowance for loan losses involves a higher degree of judgment and complexity than any of its other significant accounting policies. The allowance for loan losses is calculated with the objective of maintaining a reserve level believed by management to be sufficient to absorb estimated credit losses. Management's determination of the adequacy of the allowance is based on periodic evaluations of the loan portfolio and other relevant factors. However, this evaluation is inherently subjective as it requires material estimates, including, among others, expected default probabilities, loss given default, the amounts and timing of expected future cash flows on impaired loans, mortgages, and general amounts for historical loss experience. The process also considers economic conditions, uncertainties in estimating losses, and inherent risks in the loan portfolio. All of these factors may be susceptible to significant change. To the extent actual outcomes differ from management estimates, additional provisions for loan losses may be required that would adversely impact earnings in future periods. See "Provision for Loan Losses" below in this Item 2 for further discussion of the allowance for loan losses.

The Company recognizes deferred tax assets and liabilities for the future tax effects of temporary differences, net operating loss carryforwards, and tax credits. Deferred tax assets are subject to management's judgment based upon available evidence that future realization is more likely than not. If management determines that the Company may be unable to realize all or part of net deferred tax assets in the future, a direct charge to income tax expense may be required to reduce the recorded value of the net deferred tax asset to the expected realizable amount.

The Company conducts a periodic review and evaluation of its securities portfolio, taking into account the severity and duration of each unrealized loss, as well as management's intent and ability to hold the security until the unrealized loss is substantially eliminated, in order to determine if a decline in market value of any security below its carrying value is either temporary or other than temporary. Unrealized losses on held-to-maturity securities that are deemed temporary are disclosed but not recognized. Unrealized losses on debt or equity securities available-for-sale that are deemed temporary are excluded from net income and reported net of deferred taxes as other comprehensive income or loss. All unrealized losses that are deemed other than temporary on either available-for-sale or held-to-maturity securities are recognized immediately as a reduction of the carrying amount of the security, with a charge recorded in the Company's consolidated statements of operations.

The following table presents the total dollar amount of interest income from average interest-earning assets and the resultant yields, as well as the interest expense on average interest-bearing liabilities, expressed in both dollars and

rates.

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	For The Three Months Ended June 30, 2013			2012		
	<b>Average Balance</b>	<b>Interest and Dividends</b>	<b>Average Yield/Rate</b>	<b>Average Balance</b>	<b>Interest and Dividends</b>	<b>Average Yield/Rate</b>
(Dollars in Thousands)						
<b>INTEREST-EARNING ASSETS:</b>						
Loans (1)	\$297,735	\$ 4,249	5.71 %	\$322,629	\$ 4,882	6.05 %
Investment securities	358,997	2,093	2.33	419,466	2,300	2.19
Other (2)(5)	131,854	98	0.30	108,948	125	0.46
Total interest-earning assets	788,586	6,440	3.27	851,043	7,307	3.43
Non-interest-earning assets	22,024			26,366		
Total Assets	\$810,610			\$877,409		
<b>INTEREST-BEARING LIABILITIES:</b>						
Interest bearing deposits	207,888	134	0.26	232,445	97	0.17
Time deposits	328,288	815	0.99	365,344	1,077	1.18
Other borrowings	45,207	386	3.41	76,973	591	3.07
Total interest-bearing liabilities	581,383	1,335	0.92	674,762	1,765	1.05
Demand deposits	84,604			72,897		
Non-interest-bearing liabilities	6,478			4,727		
Stockholders' equity (5)	138,145			125,023		
Total liabilities and stockholders' equity	\$810,610			\$877,409		
Net interest income		\$ 5,105			\$ 5,542	
Interest-rate spread (3)			2.35 %			2.38 %
Net interest margin (4)			2.59 %			2.60 %
Ratio of average interest-earning assets to average interest bearing liabilities	1.36			1.26		

(1)Includes nonaccrual loans.

(2)Includes interest-bearing deposits, federal funds sold, and securities purchased under agreements to resell.

(3)Interest-rate spread represents the difference between the average yield on interest-earning assets and the average cost of interest bearing liabilities.

(4)Net interest margin is net interest income as a percentage of average interest-earning assets.

(5) Average balances are daily average balances except for the parent company which have been calculated on a monthly basis.

For The Six Months Ended June 30,  
2013 2012

	Interest			Interest		
	<u>Average</u>	<u>and</u>	<u>Average</u>	<u>Average</u>	<u>and</u>	<u>Average</u>
	<u>Balance</u>	<u>Dividends</u>	<u>Yield/Rate</u>	<u>Balance</u>	<u>Dividends</u>	<u>Yield/Rate</u>
			(Dollars in Thousands)			
<b>INTEREST-EARNING ASSETS:</b>						
Loans (1)	\$295,370	\$ 8,476	5.74%	\$320,569	\$ 9,787	6.11 %
Investment securities	356,478	4,278	2.40	415,576	4,737	2.28
Other (2)(5)	131,503	203	0.31	103,644	184	0.36
Total interest-earning assets	783,351	12,957	3.31	839,789	14,708	3.50
Non-interest-earning assets	23,724			28,391		
Total Assets	\$807,075			\$868,180		
<b>INTEREST-BEARING LIABILITIES:</b>						
Interest bearing deposits	207,103	256	0.25	224,576	207	0.18
Time deposits	330,782	1,651	1.00	366,002	2,193	1.20
Other borrowings	45,545	774	3.40	77,557	1,232	3.18
Total interest-bearing liabilities	583,430	2,681	0.92	668,135	3,632	1.09
Demand deposits	81,025			72,182		
Non-interest-bearing liabilities	5,971			4,923		
Stockholders' equity (5)	136,649			122,940		
Total liabilities and stockholders' equity	\$807,075			\$868,180		
Net interest income		\$ 10,276			\$ 11,076	
Interest-rate spread (3)			2.39%			2.41 %
Net interest margin (4)			2.62%			2.64 %
Ratio of average interest-earning assets to average interest bearing liabilities	1.34			1.26		

(1)Includes nonaccrual loans.

(2)Includes interest-bearing deposits, federal funds sold, and securities purchased under agreements to resell.

(3)Interest-rate spread represents the difference between the average yield on interest-earning assets and the average cost of interest bearing liabilities.

(4) Net interest margin is net interest income as a percentage of average interest-earning assets.

(5) Average balances are daily average balances except for the parent company which have been calculated on a monthly basis.



## Results of Operations

### Results of Operations for the Three and Six Months Ended June 30, 2013 Compared to the Three and Six Months Ended June 30, 2012.

**Net Income Allocated to Common Stockholders.** Net income allocated to common stockholders for the three and six months ended June 30, 2013 was \$0.9 million and \$1.8 million, respectively, or \$0.06 per common share and \$0.13 per common share, respectively, compared to net income allocated to common stockholders of \$3.3 million and \$5.5 million, respectively, or \$0.23 per common share and \$0.38 per common share, for the three and six months ended June 30, 2012, respectively.

The Company's net income is largely dependent on interest rate levels, the demand for the Company's loan and deposit products, and the strategies employed to manage the interest rate and other risks inherent in the banking business.

**Net Interest Income.** The Company's primary source of revenue is net interest income, or the difference between interest income earned on interest-earning assets, such as loans and investment securities, and interest expense on interest-bearing liabilities such as deposits and borrowings. The amount of interest income is dependent upon many factors including: (i) the amount of interest-earning assets that the Company can maintain based upon its funding sources; (ii) the relative amounts of interest-earning assets versus interest-bearing liabilities; and (iii) the difference between the yields earned on those assets and the rates paid on those liabilities. Non-performing loans adversely affect net interest income because they must still be funded by interest-bearing liabilities, but they do not provide interest income. Furthermore, when we designate an asset as non-performing, all interest which has been accrued but not actually received is deducted from current period income, further reducing net interest income.

For the three and six-month periods ended June 30, 2013, net interest income was \$5.1 million and \$10.3 million, respectively, compared to net income of \$5.5 million and \$11.1 million, respectively, for the three and six-month periods ended June 30, 2012. The decrease in net interest income during the 2013 period compared to the 2012 period was primarily due to the decrease in the average yields earned on the average amount of interest-earning assets, partially offset by the decrease in the average amount of interest-bearing liabilities and the decrease in the average rates paid on interest-bearing liabilities.

The average yields earned on interest-earning assets declined to 3.27% and 3.31% during the three and six-month periods ended June 30, 2013, respectively, from 3.43% and 3.50% during the three and six-month periods ended June 30, 2012, respectively. The average rates paid on interest-bearing liabilities declined to 0.92% and 0.92% during the three and six-month periods ended June 30, 2013, respectively, from 1.05% and 1.09% during the three and six-month

periods ended June 30, 2012, respectively. The Company's interest-rate spread, the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities, declined to 2.35% and 2.39% during the three and six-month periods ended June 30, 2013, respectively, from 2.38% and 2.41% during the three and six-month periods ended June 30, 2012, respectively.

**Net Interest Margin.** Net interest margin, or annualized net interest income as a percentage of average interest-earning assets, was 2.59% and 2.62% for the three and six-month periods ended June 30, 2013, respectively, compared to 2.60% and 2.64% for the three and six-month periods ended June 30, 2012, respectively. We seek to secure and retain customer deposits with competitive products and rates, while making strategic use of the prevailing interest rate environment to borrow funds at what we believe to be attractive rates. We invest such deposits and borrowed funds in a prudent mix of fixed and adjustable rate loans, investment securities, and short-term interest-earning assets. The decrease in net interest margin is primarily due to the decrease in the average amounts of higher yielding loans as a percentage of the total mix of interest-earning assets.

**Interest Income.** Total interest income for the quarter ended June 30, 2013 decreased by \$0.9 million to \$6.4 million from \$7.3 million for the quarter ended June 30, 2012. The decrease in total interest income was primarily due to the decrease in the average yield earned on the average amount of interest-earning assets to 3.27% during the 2013 quarter from 3.43% during the 2012 quarter, and the decrease in the average amount of higher yielding loans to \$297.7 million during the 2013 quarter from \$322.6 million during the 2012 quarter.

Total interest income for the six months ended June 30, 2013 decreased by \$1.7 million to \$13.0 million from \$14.7 million for the six months ended June 30, 2012. The decrease in total interest income was primarily due to the decrease in the average yield earned on the average amount of interest-earning assets to 3.31% during the 2013 six-month period from 3.50% during the 2012 six-month period, and the decrease in the average amount of higher yielding loans to \$295.4 million during the 2013 period from \$320.6 million during the 2012 period.

The following tables present the composition of interest income for the indicated periods:

	Three Months Ended June 30,			
	2013		2012	
	Interest	% of	Interest	% of
	Income	Total	Income	Total
	(In thousands, except percentages)			
Loans	\$4,249	65.98 %	\$4,882	66.81 %
Investment Securities	2,093	32.50	2,300	31.48
Other	98	1.52	125	1.71
Total Interest Income	\$6,440	100.00 %	\$7,307	100.00 %

	Six Months Ended June 30,			
	2013		2012	
	Interest	% of	Interest	% of
	Income	Total	Income	Total
	(In thousands, except percentages)			
Loans	\$8,476	65.42 %	\$9,787	66.54 %

Investment Securities	4,278	33.02	4,737	32.21
Other	203	1.56	184	1.25
Total Interest Income	\$12,957	100.00%	\$14,708	100.00%

Loans, which are inherently risky and therefore command a higher return than our portfolio of investment securities and other interest-earning assets, decreased to 37.8% and 37.7% of our total average interest-earning assets during the three and six-month periods ended June 30, 2013, respectively, from 37.9% and 38.2% of total interest-earning assets during the three and six-month periods ended June 30, 2012, respectively. The average amounts of investment securities was 45.5% and 45.5% of total average interest-earning assets during the three and six-month periods ended June 30, 2013, respectively, compared to 49.3% and 49.5% of total interest-earning assets during the three and six-month periods ended June 30, 2012, respectively. While we actively seek to originate new loans with qualified borrowers who meet the Bank's underwriting standards, our strategy has been to maintain those standards, sacrificing some current income to avoid possible large future losses in the loan portfolio.

At June 30, 2013 and 2012, total non-performing loan assets were \$882,000 and \$520,000, respectively, all of which were non-accrual loans. Depending upon the contractual interest rate of a loan, significant additions to non-performing loans, were such additions to occur, could have a material adverse effect on our results of operations. The effect of the decrease in non-accrual loans in 2013 from 2012 was negligible.

**Federal Home Loan Bank Stock.** The Bank owns stock of the Federal Home Loan Bank New York ("FHLB-NY") which is necessary for it to be a member of the FHLB-NY. Membership requires the purchase of stock equal to 1% of the Bank's residential mortgage loans or 5% of the outstanding borrowings, whichever is greater. The stock is redeemable at par. Therefore, its cost is equivalent to its redemption value. The Bank's ability to redeem FHLB-NY shares is dependent upon the redemption practices of the FHLB-NY. At June 30, 2013, the FHLB-NY neither placed restrictions on redemption of shares in excess of a member's required investment in stock, nor stated that it will cease paying dividends. The Bank did not consider this asset impaired at either June 30, 2013 or December 31, 2012.

**Interest Expense.** Total interest expense for the quarter ended June 30, 2013 decreased by \$0.4 million to \$1.3 million from \$1.8 million for the quarter ended June 30, 2012. The decrease in interest expense was due to the decrease in the average amounts of interest-bearing liabilities to \$581.4 million for the quarter ended June 30, 2013 from \$674.8 million during the quarter ended June 30, 2012, and the decrease in the average rates paid on interest-bearing liabilities to 0.92% during the 2013 quarter from 1.05% during the 2012 quarter.

Total interest expense for the six-month period ended June 30, 2013 decreased by \$0.9 million to \$2.7 million from \$3.6 million for the six-month period ended June 30, 2012. The decrease in interest expense was due to the decrease in the average amounts of interest-bearing liabilities to \$583.4 million during the six-month period ended June 30, 2013 from \$668.1 million during the six-month period ended June 30, 2012, respectively, and the decrease in the average rates paid on interest-bearing liabilities to 0.92% during the 2013 six-month period from 1.09% during the 2012 six-month period.

The following tables present the components of interest expense as of the dates indicated:

	Three Months Ended June 30,					
	2013			2012		
	Interest	% of	Interest	% of		
	Expense	Total	Expense	Total		
	(In thousands, except percentages)					
Interest-Bearing Deposits	\$134	10.04 %	\$97	5.50 %		
Time Deposits	815	61.05	1,077	61.02		
Other Borrowings	386	28.91	591	33.48		
Total Interest Expense	\$1,335	100.00 %	\$1,765	100.00 %		

	Six Months Ended June 30,					
	2013			2012		
	Interest	% of	Interest	% of		
	Expense	Total	Expense	Total		
	(In thousands, except percentages)					
Interest-Bearing Deposits	\$256	9.55 %	\$207	5.70 %		
Time Deposits	1,651	61.62	2,193	60.38		
Other Borrowings	774	28.83	1,232	33.92		
Total Interest Expense	\$2,681	100.00 %	\$3,632	100.00 %		

**Non-Interest Income.** Non-interest income consists primarily of realized gains on sales of marketable securities and service fee income. Total non-interest income for the three and six months ended June 30, 2013 was \$459,000 and \$1.0 million respectively, compared to \$121,000 and \$644,000 for the three and six months ended June 30, 2012, respectively. The increase in non-interest income was primarily due to a tax refund.

**Non-Interest Expense.** Non-interest expense includes salaries and employee benefits, occupancy and equipment expenses, legal and professional fees, and other operating expenses associated with the day-to-day operations of the Company. Total non-interest expense for the three and six months ended June 30, 2013 was \$4.4 million and \$9.0 million, respectively, compared to \$4.2 million and \$8.3 million for the three and six months ended June 30, 2012, respectively.

The following tables present the components of non-interest expense as of the dates indicated:

Three Months Ended June 30,	
2013	2012

	Non-Interest		Non-Interest	
	Expense	% of Total	Expense	% of Total
	(In thousands, except percentages)			
Salaries and Employee Benefits	\$2,893	63.62 %	\$2,380	57.31 %
Net Occupancy Expense	808	17.76	577	13.89
Equipment Expense	89	1.95	88	2.12
FDIC Assessment	(3 )	-0.06	300	7.22
Data Processing Expense	107	2.36	112	2.70
Other	653	14.37	696	16.76
Total Non-Interest Expense	\$4,547	100.00%	\$4,153	100.00%

	Six Months Ended June 30,			
	2013		2012	
	Non-Interest Expense Total	% of Expense Total	Non-Interest Expense Total	% of Expense Total
(In thousands, except percentages)				
Salaries and Employee Benefits	\$5,595	62.10 %	\$4,860	58.25 %
Net Occupancy Expense	1,401	15.55	1,161	13.92
Equipment Expense	178	1.97	166	1.99
FDIC Assessment	297	3.30	600	7.19
Data Processing Expense	234	2.60	224	2.68
Other	1,304	14.48	1,332	15.97
Total Non-Interest Expense	\$9,009	100.00 %	\$8,343	100.00 %

**Provision for Income Tax.** During the three and six months ended June 30, 2013, the Company recorded an income tax provision of \$0.5 million and \$1.1 million, respectively, compared to income tax benefit of \$1.8 million and \$2.1 million for three and six months ended June 30, 2012, respectively.

### Issuer Purchases of Equity Securities

On May 15, 2003, The Company's Board of Directors authorized the purchase of up to an additional 450,000 shares of its Common Stock in the open market, from time to time, depending upon prevailing market conditions, thereby increasing the maximum number of shares which may be purchased by the Company from 1,950,000 shares of Common Stock to 2,400,000 shares of Common Stock. Since 1990 through June 30, 2013, the Company has purchased a total of 1,898,909 shares of its Common Stock. We did not repurchase shares of the Company's Common Stock during the first and second quarters of 2013. At June 30, 2013, there were 501,091 shares of Common Stock which may yet be purchased under our stock repurchase plan.

**Provision for Loan Losses.** The allowance for loan losses is the estimated amount considered necessary to cover credit losses inherent in the loan portfolio at the balance sheet date. The allowance is established through the provision for loan losses that is charged against income. In determining the allowance for loan losses, management makes significant estimates which involve a high degree of judgment, subjectivity of the assumptions utilized, and potential for changes in the economic environment that could result in changes to the amount of the recorded allowance for loan losses.

The allowance for loan losses has been determined in accordance with GAAP, principally FASB ASC 450, "Contingencies" ("ASC 450"), and FASB ASC 310, "Receivables" ("ASC 310"). Under the above accounting principles, we are required to maintain an allowance for probable losses at the balance sheet date. We are responsible for the timely and periodic determination of the amount of the allowance required. Management believes that the allowance for loan losses is adequate to cover specifically identifiable losses, as well as estimated losses inherent in



our portfolio for which certain losses are probable but not specifically identifiable.

Management performs a monthly evaluation of the adequacy of the allowance for loan losses. The analysis of the allowance for loan losses has two components: specific and general reserves. Specific reserves are made for loans determined to be impaired. Impairment is measured by determining the present value of expected future cash flows or, as a practical expedient for collateral-dependent loans, the fair value of the collateral adjusted for market conditions and selling expenses. The Bank considers its investment in one-to-four family real estate loans and consumer loans to be smaller balance homogeneous loans and therefore excluded from separate identification for evaluation of impairment. These homogeneous loan groups are evaluated for impairment on a collective basis under ASC 310.

The general reserve is determined by segregating the remaining loans by type of loan, risk weighting (if applicable), and payment history. Management also analyzes historical loss experience, delinquency trends, general economic conditions, geographic concentrations, and industry and peer comparisons. This analysis establishes factors that are applied to the loan segments to determine the amount of the general reserves. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revisions based upon changes in economic and real estate market conditions. Actual loan losses may be significantly more than the allowance for loan losses management has established which could have a material negative effect on the Company's financial results.

On a monthly basis, the Bank's management committee reviews the current status of various loan assets in order to evaluate the adequacy of the allowance for loan losses. In this evaluation process, specific loans are analyzed to determine their potential risk of loss. This process includes all loans, concentrating on non-accrual and classified loans. Each non-accrual or classified loan is evaluated for potential loss exposure. Any shortfall results in a recommendation of a specific allowance if the likelihood of loss is evaluated as probable. To determine the adequacy of collateral on a particular loan, an estimate of the fair market value of the collateral is based on the most current appraised value available. This appraised value is then reduced to reflect estimated liquidation expenses.

As a substantial amount of our loan portfolio is collateralized by real estate, appraisals of the underlying value of property securing loans are critical in determining the amount of the allowance required for specific loans. Assumptions for appraisal valuations are instrumental in determining the value of properties. Overly optimistic assumptions or negative changes to assumptions could significantly impact the valuation of a property securing a loan and the related allowance determined. The assumptions supporting such appraisals are carefully reviewed by management to determine that the resulting values reasonably reflect amounts realizable on the related loans. Based on the composition of our loan portfolio, management believes the primary risks are increases in interest rates, a decline in the economy, generally, and a decline in real estate market values in the New York City metropolitan area. Any one or combination of these events may adversely affect our loan portfolio resulting in increased delinquencies, loan losses, and future levels of loan loss provisions. Management believes the allowance for loan losses reflects the inherent credit risk in our portfolio, the level of our non-performing loans, and our charge-off experience.

A loan is considered nonperforming when it becomes delinquent ninety days or when other adverse factors become known to us. We generally order updated appraisals from independent third party licensed appraisers at the time the loan is identified as nonperforming. Depending upon the property type, we receive appraisals within thirty to ninety days from the date the appraisals are ordered. Upon receipt of the appraisal, which is discounted by us to take account

of estimated selling and other holding costs, we compare the adjusted appraisal amount to the carrying amount of the real estate dependent loan and record any impairment through the allowance for loan loss at that time.

The majority of our real estate dependent loans are concentrated in the New York City metropolitan area, we do not make adjustments to the appraisals for this concentration. We do not increase the appraised value of any property. Any adjustments we make to the appraisals are to decrease the appraised value due to selling and other holding costs.

Although management believes that we have established and maintained the allowance for loan losses at adequate levels, additions may be necessary if future economic and other conditions differ substantially from the current operating environment. Although management uses what it believes is the best information available, the level of the allowance for loan losses remains an estimate that is subject to significant judgment and short-term change. In addition, the FDIC, the DFS, and other regulatory bodies, as an integral part of their examination process, will periodically review our allowance for loan losses. Such agencies may require us to recognize adjustments to the allowance based on their judgments about information available to them at the time of their examination.

The following table sets forth information with respect to activity in the Company's allowance for loan losses during the periods indicated (in thousands, except percentages):

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2013	2012	2013	2012
Average loans outstanding	\$297,735	\$322,629	\$295,370	\$320,569
Allowance at beginning of period	\$10,705	\$17,720	\$11,008	\$17,720
Charge-offs:				
Commercial and other loans	—	(2 )	—	(2 )
Real estate loans	(20 )	—	(20 )	—
Total loans charged-off	(20 )	(2 )	(20 )	(2 )
Recoveries:				
Commercial and other loans	—	—	—	—
Real estate loans	—	—	—	—
Total loans recovered	—	—	—	—
Net recoveries (charge-offs)	(20 )	(2 )	(20 )	(2 )
Provision for loan losses Charged to operating expenses	(298 )	—	(601 )	—
Allowance at end of period	\$10,387	17,718	\$10,387	17,718
Ratio of net recoveries (charge-offs) to average loans outstanding	-0.01 %	0.00 %	-0.01 %	0.00 %
Allowance as a percent of total loans	3.39 %	5.52 %	3.72 %	5.52 %
Total loans at end of period	\$306,392	\$320,938	\$306,392	\$320,938

Based on better economic conditions during the 3rd quarter, 2012 and the payoff of various commercial loans, management determined that an adjustment was necessary to reduce the ALL by \$4.2 million as of September 30, 2012.

The loan portfolio as of September 30, 2012 decreased to \$309.5 million from \$320.9 as of June 30, 2012. In addition, loans rated Special Mention declined by \$10 million during the quarter from \$21.7 million to \$11.7 million.

The overall ALL allocation risk factor decreased from 5.52% as of June 30, 2012 to 4.37% as of September 30, 2012. The \$4.2 million decline in our September 30, 2012 ALL was composed of (a) \$1.37 million reduction of the ALL relating to 1-4 Family Closed End Mortgage loans as the ALL loss factor for this loan pool fell from 5.95% to 4.61% (b) \$1.16 million reduction in our ALL for Other CRE as our ALL loss factor for this pool declined from 5.24% to 4.16% (c) Elimination, as of September 30 of unallocated reserve of \$1.63 million.

The ALL methodology implemented in December, 2012 continued for the first quarter of 2013. Our ALL as of March 31, 2013 was \$10.7 million, a slight reduction from December 31, 2012 of \$11.0 million. The ALL difference was due to a minor change in our loan portfolio mix with small loan increases in Other CRE and Construction & Development lending offset by reductions in our loan 1-4 Family Mortgage portfolios. In addition, there was a marginal overall improvement in loan quality, as loans rated Special Mention fell by \$5.3 million while Watch loans increased by \$4.3 million.

For the quarter ended June 30, 2013, the ALL was reduced by \$319 thousands due to the reduction of the substandard loan segment.

## **Loan Portfolio.**

**Loan Portfolio Composition.** The Company's loans consist primarily of mortgage loans secured by residential and non-residential properties as well as commercial loans which are either unsecured or secured by personal property collateral. Most of the Company's loans are either made to individuals or personally guaranteed by the principals of the business to which the loan is made. At June 30, 2013 and December 31, 2012, the Company had loans, net of unearned income, of \$305.9 million and \$295.2 million, respectively, and an allowance for loan losses of \$10.4 million and \$11.0 million, respectively. From time to time, the Bank may originate residential mortgage loans, sell them on the secondary market, normally recognizing fee income in connection with the sale.

Interest rates on loans are affected by the demand for loans, the supply of money available for lending, credit risks, the rates offered by competitors, and other conditions. These factors are in turn affected by, among other things, economic conditions, monetary policies of the federal government, and legislative tax policies.

In order to manage interest rate risk, the Bank focuses its efforts on loans with interest rates that adjust based upon changes in the prime rate or changes in United States Treasury or similar indices. Generally, credit risks on adjustable-rate loans are somewhat greater than on fixed-rate loans primarily because, as interest rates rise, so do borrowers' payments, increasing the potential for default. The Bank seeks to impose appropriate loan underwriting standards in order to protect against these and other credit related risks associated with its lending operations.

In addition to analyzing the income and assets of its borrowers when underwriting a loan, the Bank obtains independent appraisals on all material real estate in which the Bank takes a mortgage. The Bank generally obtains title insurance in order to protect against title defects on mortgaged property.

**Commercial Mortgage Loans.** The Bank originates commercial mortgage loans secured by office buildings, retail establishments, multi-family residential real estate, and other types of commercial property. Substantially all of the properties are located in the New York City metropolitan area.

The Bank generally makes commercial mortgage loans with loan-to-value ratios not to exceed 75% and with terms to maturity that do not exceed 15 years. Loans secured by commercial properties generally involve a greater degree of risk than one-to four-family residential mortgage loans. Because payments on such loans are often dependent on successful operation or management of the properties, repayment may be subject, to a greater extent, to adverse conditions in the real estate market or the economy. The Bank seeks to minimize these risks through its underwriting policies. The Bank evaluates the qualifications and financial condition of the borrower, including credit history, profitability and expertise, as well as the value and condition of the underlying property. The factors considered by the Bank include net operating income; the debt coverage ratio (the ratio of cash net income to debt service); and the loan-to-value ratio. When evaluating the borrower, the Bank considers the financial resources and income level of the borrower, the borrower's experience in owning or managing similar property, and the Bank's lending experience with the borrower. The Bank's policy requires borrowers to present evidence of the ability to repay the loan without having to resort to the sale of the mortgaged property. The Bank also seeks to focus its commercial mortgage loans on loans to companies with operating businesses, rather than passive real estate investors.

**Commercial Loans and Finance Leases.** The Bank makes commercial loans to businesses for inventory financing, working capital, machinery and equipment purchases, expansion, and other business purposes. These loans generally have higher yields than mortgage loans, with maturities of one year, after which the borrower's financial condition and the terms of the loan are re-evaluated. At June 30, 2013 and December 31, 2012, \$23.1 million and \$23.2 million, respectively, or 7.5% and 7.8%, respectively, of the Company's total loan portfolio consisted of such loans.

Commercial loans tend to present greater risks than mortgage loans because the collateral, if any, tends to be rapidly depreciable, difficult to sell at full value, and is often easier to conceal. In order to limit these risks, the Bank evaluates these loans based upon the borrower's ability to repay the loan from ongoing operations. The Bank considers the business history of the borrower and perceived stability of the business as important factors when considering applications for such loans. Occasionally, the borrower provides commercial or residential real estate collateral for such loans, in which case the value of the collateral may be a significant factor in the loan approval process.

**Residential Mortgage Loans (1 to 4 family loans).** The Bank makes residential mortgage loans secured by first liens on one-to-four family owner-occupied or rental residential real estate. At June 30, 2013 and December 31, 2012, \$82.0 million and \$84.2 million, respectively, or 26.8% and 28.5%, respectively, of the Company's total loan portfolio

consisted of such loans. The Bank offers both adjustable rate mortgages ("ARMS") and fixed-rate mortgage loans. The relative proportion of fixed-rate loans versus ARMs originated by the Bank depends principally upon current customer preference, which is generally driven by economic and interest rate conditions and the pricing offered by the Bank's competitors. At June 30, 2013, 7.8% of the Bank's residential one-to-four family owner-occupied first mortgage portfolio were ARMs and 92.2% were fixed-rate loans. At December 31, 2012, approximately 9.0% of the Bank's residential one-to-four family owner-occupied first mortgage portfolio were ARMs and 91% were fixed-rate loans. The percentage represented by fixed-rate loans tends to increase during periods of low interest rates. The ARMs generally carry annual caps and life-of-loan ceilings, which limit interest rate adjustments.



The Bank's residential loan underwriting criteria are generally comparable to those required by Fannie Mae and other major secondary market loan purchasers. Generally, ARM credit risks are somewhat greater than fixed-rate loans primarily because, as interest rates rise, the borrowers' payments rise, increasing the potential for default. The Bank's teaser rate ARMs (ARMs with low initial interest rates that are not based upon the index plus the margin for determining future rate adjustments) were underwritten based on the payment due at the fully-indexed rate.

In addition to verifying income and assets of borrowers, the Bank obtains independent appraisals on all residential first mortgage loans and title insurance is required at closing. Private mortgage insurance is required on all loans with a loan-to-value ratio in excess of 80% and the Bank requires real estate tax escrows on such loans. Real estate tax escrows are voluntary on residential mortgage loans with loan-to-value ratios of 80% or less.

Fixed-rate residential mortgage loans are generally originated by the Bank for terms of 15 to 30 years. Although 30 year fixed-rate mortgage loans may adversely affect our net interest income in periods of rising interest rates, the Bank originates such loans to satisfy customer demand. Such loans are generally originated at initial interest rates which exceed the fully indexed rate on ARMs offered at the same time. Fixed-rate residential mortgage loans originated by the Bank generally include due-on-sale clauses, which permit the Bank to demand payment in full if the borrower sells the property without the Bank's consent.

Due-on-sale clauses are an important means of adjusting the rates on the Bank's fixed-rate mortgage loan portfolio, and the Bank will generally exercise its rights under these clauses if necessary to maintain market yields.

ARMs originated in recent years have interest rates that adjust annually based upon the movement of the one year treasury bill constant maturity index, plus a margin of 2.00% to 2.75%. These loans generally have a maximum interest rate adjustment of 2% per year, with a lifetime maximum interest rate adjustment, measured from the initial interest rate, of 5.5% or 6.0%.

The Bank offers a variety of other loan products including residential single family construction loans to persons who intend to occupy the property upon completion of construction, home equity loans secured by junior mortgages on one-to-four family owner-occupied residences, and short-term fixed-rate consumer loans either unsecured or secured by monetary assets such as bank deposits and marketable securities or personal property. At June 30, 2013 and December 31, 2012, \$201.3 million and \$188.4 million, respectively, or 65.7% and 63.7%, respectively, of the Company's total loan portfolio consisted of such other loan products.

**Origination of Loans.** Loan originations can be attributed to depositors, retail customers, phone inquiries, advertising, the efforts of the Bank's loan officers, and referrals from other borrowers, real estate brokers, and builders. The Bank originates loans primarily through its own efforts, occasionally obtaining loan opportunities as a

result of referrals from loan brokers.

The Bank's lending limit generally restricts extensions of credit to one borrower to 15% of the Bank's capital stock, surplus fund, and undivided profits, but allow such extensions of credit to one borrower of up to 25% of the Bank's capital stock, surplus fund, and undivided profits, if the additional 10% is secured by collateral that can be adequately valued. This means that as of June 30, 2013, the Bank could lend \$19.8 million to one borrower, and this amount may be increased up to \$33.0 million, if the loan is secured by collateral that can be adequately valued.

**Delinquency Procedures.** When a borrower fails to make a required payment on a loan, the Bank attempts to cause the deficiency to be cured by contacting the borrower. The Bank reviews past due loans on a case by case basis, taking the action it deems appropriate in order to collect the amount owed. Litigation may be necessary if other procedures are not successful. Judicial resolution of a past due loan can be delayed if the borrower files a bankruptcy petition because collection action cannot be continued unless the Bank first obtains relief from the automatic stay provided by the Bankruptcy Code.

If a non-mortgage loan becomes delinquent and satisfactory arrangements for payment cannot be made, the Bank seeks to realize upon any personal property collateral to the extent feasible and collect any remaining amount owed from the borrower through legal proceedings, if necessary.

It is the Bank's policy to discontinue accruing interest on a loan when it is 90 days past due or if management believes that continued interest accruals are unjustified. The Bank may continue interest accruals if a loan is more than 90 days past due if the Bank determines that the nature of the delinquency and the collateral are such that collection of the principal and interest on the loan in full is reasonably assured. When the accrual of interest is discontinued, all accrued but unpaid interest is charged against current period income. Once the accrual of interest is discontinued, the Bank records interest as and when received until the loan is restored to accruing status. If the Bank determines that collection of the loan in full is in reasonable doubt, then amounts received are recorded as a reduction of principal until the loan is returned to accruing status.

### Capital Adequacy

Quantitative measures established by regulations to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets, and of Tier I capital to average assets. Management believes that, as of June 30, 2013, the Bank meets all capital adequacy requirements to which it is subject.

As of June 30, 2013, the Bank met all regulatory requirements for classification as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the following table. There are no conditions or events since that date that management believes have changed the institution's category.

The following table set forth the actual and required regulatory capital amounts and ratios of the Company and the Bank as of June 30, 2013 (dollars in thousands):

Actual	For capital adequacy purposes		To be well capitalized under prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio

June 30, 2013

Total Capital (to Risk-Weighted Assets)

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Company	141,914	36.96%	30,721	≥8.0%	\$—	N/A
Bank	132,232	35.00%	30,221	≥8.0%	37,776	≥10.0 %
Tier I Capital (to Risk-Weighted Assets)						
Company	137,045	35.69%	15,360	≥4.0%	—	N/A
Bank	127,440	33.74%	15,110	≥4.0%	22,665	≥6.0 %
Tier I Capital (to Average Assets)						
Company	137,045	16.92%	32,402	≥4.0%	—	N/A
Bank	127,440	15.86%	32,137	≥4.0%	40,172	≥5.0 %

## Liquidity

The management of the Company's liquidity focuses on ensuring that sufficient funds are available to meet loan funding commitments, withdrawals from deposit accounts, the repayment of borrowed funds, and ensuring that the Bank and the Company comply with regulatory liquidity requirements. Liquidity needs of the Bank have historically been met by deposits, investments in federal funds sold, principal and interest payments on loans, and maturities of investment securities. Additional liquidity, up to approximately \$368.6 million is available from the Federal Reserve Bank and the FHLB-NY.

The current uncertainties in the credit markets have negatively impacted our ability to liquidate, if necessary, investments in auction rate securities. We are not certain as to when the liquidity issues relating to these investments will improve; however, we have the intent to hold these available for sale securities to maturity, and do not believe we will be required to sell these securities prior to maturity.

Based on our expected operating cash flows and our other sources of cash, we do not expect the potential lack of liquidity in these auction rate securities to affect our capital, liquidity, or our ability to execute our current business plan. We have cash and cash equivalents totaling \$104.2 million, or 13.2% of total assets at June 30, 2013. In addition, we have the capacity to borrow up to approximately \$234.4 million from the Federal Reserve Bank and approximately \$134.2 million from the FHLB-NY if the need should arise.

For the parent company, Berkshire Bancorp Inc., liquidity means having cash available to fund its normal operating expenses and to pay stockholder dividends on its common stock, when and if declared by the Company's Board of Directors. On November 28, 2012, the Company's Board of Directors declared a cash dividend in respect of the common stock of the Company in the amount of \$.08 per share. Such dividend was paid on December 20, 2012 to the holders of record of its common stock as of the close of business on December 10, 2012. This was the first dividend payment since the Company announced in March 2009 that it would temporarily suspend its stated policy of paying a regular cash dividend on its common stock. The declaration, payment, and amount of dividends in the future are within the discretion of the Board of Directors and will depend upon our earnings, capital requirements, financial condition, and other relevant factors including possibly requiring regulatory approval.

The ability of the Company to fund its normal operating expenses is not currently dependent upon the receipt of dividends from the Bank. At June 30, 2013, the Company had cash of approximately \$3.5 million. However, the payment of dividends on its common stock when and if declared by the Board of Directors, will be dependent upon the receipt of dividends from the Bank.

The Bank maintains financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments, \$20.1 million at June 30, 2013, include commitments to extend credit, stand-by letters of credit, and loan commitments.

At June 30, 2013, the Bank had outstanding commitments of \$326.4 million; including \$4.8 million of operating leases, and \$321.6 million of time deposits. These commitments include \$226.0 million that mature or renew within one year, \$97.3 million that mature or renew after one year and within three years, \$3.3 million that mature or renew after three years and within five years and commitments of \$0.9 million that mature or renew after five years.

## **Impact of Inflation and Changing Prices**

The Company's financial statements measure financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increasing cost of the Company's operations. The assets and liabilities of the Company are largely monetary. As a result, interest rates have a greater impact on the Company's performance than do the effects of general levels of inflation. In addition, interest rates do not necessarily move in the direction, or to the same extent, as the price of goods and services. However, in general, high inflation rates are accompanied by higher interest rates, and vice versa.

## **ITEM 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK**

**Interest Rate Risk.** Fluctuations in market interest rates can have a material effect on the Bank's net interest income because the yields earned on loans and investments may not adjust to market rates of interest with the same frequency, or with the same speed, as the rates paid by the Bank on its deposits.

Most of the Bank's deposits are either interest-bearing demand deposits or short term certificates of deposit and other interest-bearing deposits with interest rates that fluctuate as market rates change. Management of the Bank seeks to reduce the risk of interest rate fluctuations by concentrating on loans and securities investments with either short terms to maturity or with adjustable rates or other features that cause yields to adjust based upon interest rate fluctuations. In addition, to cushion itself against the potential adverse effects of a substantial and sustained increase in market interest rates, the Bank has from time to time purchased off balance sheet interest rate cap contracts which generally provide that the Bank will be entitled to receive payments from the other party to the contract if interest rates exceed specified levels. These contracts are entered into with major financial institutions.

The Company seeks to maximize its net interest margin within an acceptable level of interest rate risk. Interest rate risk can be defined as the amount of the forecasted net interest income that may be gained or lost due to favorable or unfavorable movements in interest rates. Interest rate risk, or sensitivity, arises when the maturity or repricing characteristics of assets differ significantly from the maturity or repricing characteristics of liabilities.

## **ITEM 4 - CONTROLS AND PROCEDURES**

Disclosure Controls and Procedures.

As of the end of the period covered by this Quarterly Report on Form 10-Q, the Company evaluated the effectiveness of the design and operation of its "disclosure controls and procedures" as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934, as amended ("Disclosure Controls"). The Disclosure Controls are designed to allow the Company to reach a reasonable level of assurance that information required to be disclosed by the Company is recorded, processed, summarized and reported within the time period specified in the SEC's rules and forms and that any information relating to the Company is accumulated and communicated to management, including its principal executive/financial officer to allow timely decisions regarding required disclosure. The evaluation of the Disclosure Controls ("Controls Evaluation") was done under the supervision and with the participation of the Company's management, including the Chief Executive Officer ("CEO"), who is also the Chief Financial Officer ("CFO").

Based upon the Controls Evaluation, our CEO/CFO concluded that our disclosure controls and procedures were effective to ensure that information required to be disclosed in the reports we file and submit under the Exchange Act is recorded, processed, summarized and reported as and when required and that such information is accumulated and communicated to our management as appropriate to allow timely decisions regarding required disclosure.



## **Remediation of Material Weakness**

As disclosed in more detail in the Company's Form 10-K for the year ended December 31, 2012 (the "Form 10-K"), management previously identified the material weaknesses related to income taxes computations, financial statement closing process and allowance for loan losses.

A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting such that there is a reasonable possibility that a material misstatement of a company's annual or interim financial statements will not be prevented or detected on a timely basis.

During the second quarter of 2013, management has remedied the material weaknesses as discussed below.

### *1. Material weakness related to income taxes computations –*

This weakness was identified by management during the review of the income taxes accrual process as of December 31, 2012.

During the second quarter of 2013, the Bank implemented an additional control with regard to the income tax computations. An additional level of senior management review was implemented to ascertain that the income tax computations and related disclosures are properly stated.

### *2. Material weakness related to financial statement closing process –*

This weakness was identified during the review of the year end general ledger testing process as of December 31, 2012.

During the second quarter of 2013, the Bank also implemented an additional control with regard to the financial statement closing process. An additional level of senior management review was implemented to ascertain that general ledger reconciliations, significant estimates and disclosures are properly stated and unrecorded adjustments and omitted disclosures are immaterial to the financial statements both individually and in the aggregate.

*3. Material weakness related to allowance for loans –*

This weakness was identified by management during the review of the ALL documentation process as of December 31, 2012.

During the second quarter of 2013, management expanded the level of documentation to better support the trend analysis discussion relating to the qualitative factors in its ALL calculation.

In addition, while management has the ultimate responsibility to ensure the allowance for loan losses is properly stated, each quarterly ALL package will be reviewed by an independent vendor consultant to ascertain that the required documentation is in place and to serve as a secondary quality control process.

#### Changes in Internal Control over Financial Reporting.

The above changes made in the Company's internal control over financial reporting, as defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act, during the fiscal quarter ended June 30, 2013, have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

#### Limitations on the Effectiveness of Controls

The Company's management, including the CEO/CFO, does not expect that its Disclosure Controls and/or its internal control over financial reporting will prevent all errors and all fraud. A control system, no matter how well conceived and operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met. Further, the design of a control system must reflect the fact that there are resource constraints, and the benefits of controls must be considered relative to their costs.

Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within the Company have been detected. These inherent limitations include the realities that judgments in decision making can be faulty, and that breakdowns can occur because of simple error or mistake. Additionally, controls can be circumvented by the individual acts of some persons, by collusion of two or more people, or by management override of the control. The design of any system of controls also is based in part upon certain assumptions about the likelihood of future events, and there can be no assurance that any design will succeed in achieving its stated goals under all potential future conditions; over time, control may become inadequate because of changes in conditions, or the degree of compliance with the policies or procedures may deteriorate. Because of the inherent limitations in a cost effective control system, misstatements due to error or fraud may occur and not be detected.

## PART II. OTHER INFORMATION

### Item 6. Exhibits

Exhibit

Number Description

10.1 Amendment No. 7, dated as of April 25, 2013, to Employment Agreement, dated as of January 1, 2001, by and between The Berkshire Bank and David Lukens (incorporated by reference to exhibit 10.3 to the company's Quarterly report on Form 10-Q for the quarter ended March 31, 2013). +

31 Certification of Principal Executive and Financial Officer pursuant to Section 302 Of The Sarbanes-Oxley Act of 2002.

32 Certification of Principal Executive and Financial Officer pursuant to Section 906 Of The Sarbanes-Oxley Act of 2002.

101. The following materials from the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2013, formatted in Extensible Business Reporting Language (XBRL), pursuant to Rule 406T of Regulation S-T: (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Comprehensive Income, (iv) Consolidated Statements of Stockholders' Equity, (v) Consolidated Statements of Cash Flows and (vi) related notes to consolidated financial statements. Users of this data are advised that the information contained in the XBRL documents is unaudited and these are not the official publicly filed financial statements of the Company.

Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

+ Denotes a management compensation plan or arrangement.

**SIGNATURES**

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

**BERKSHIRE BANCORP INC.**  
**(Registrant)**

Date: August 14, 2013 By: /s/ Joseph Fink  
**Joseph Fink**  
**President and Chief**  
**Financial Officer**

EXHIBIT INDEX

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