LAKE SHORE BANCORP, INC.
Form 10-K
March 27, 2015

United States

Securities and Exchange Commission

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2014

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

Commission File No.: 000-51821

Lake Shore Bancorp, Inc.

(Exact Name of Registrant as Specified in Its Charter)

United States	
(State or Other Jurisdiction of Incorporation or Organization)	20-4729288 (I.R.S. Employer Identification No.)

31 East Fourth Street, Dunkirk, NY 14048

(Address of Principal Executive Offices, including zip code)

(716) 366-4070

(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act: Common Stock, $0.01 par value per share

Name of each exchange on which registered: The NASDAQ Stock Market, LLC

Securities registered pursuant to Section 12(g) of the Act: None.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes [ ] No [X]

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes [ ] No [X]

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 [X] No []

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. []

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 definition 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 [ ] (Do not check if smaller reporting company)Smaller reporting company [X]

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

The aggregate market value of the voting stock held by non-affiliates of the registrant as of June 30, 2014 was $22,083,847 based on the per share closing price as of June 30, 2014 on the Nasdaq Global Market for the registrant's common stock, which was $12.45.

There were 5,995,439 shares of the registrant's common stock, $.01 par value per share, outstanding at March 23, 2015.

DOCUMENTS INCORPORATED BY REFERENCE:

	Part of 10-K where incorporated
Portions of the registrant's Proxy Statement for the 2015 Annual Meeting of Stockholders	III

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ANNUAL REPORT ON FORM 10-K
FOR THE FISCAL YEAR ENDED
DECEMBER 31, 2014

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PART I

Item 1. Business.

General

Lake Shore Bancorp, Inc. (“Lake Shore Bancorp,” the “Company,” “us,” or “we”) operates as a mid-tier, federally chartered savings and loan holding company of Lake Shore Savings Bank (“Lake Shore Savings” or the “Bank”). A majority of Lake Shore Bancorp’s issued and outstanding common stock (60.7% as of December 31, 2014) is held by Lake Shore, MHC (the “MHC”), a federally chartered mutual holding company, which serves as the parent company to Lake Shore Bancorp. The MHC does not engage in any business activity other than its investment in a majority of the common stock of Lake Shore Bancorp. The Board of Governors of the Federal Reserve System (the “Federal Reserve Board”) is the regulator for the MHC. Federal law and regulations require that as long as the MHC is in existence, it must own at least a majority of Lake Shore Bancorp’s common stock. The remaining common shares of Lake Shore Bancorp are owned by public stockholders and the Lake Shore Savings Bank Employee Stock Ownership Plan (“ESOP”). Our common stock is traded on the Nasdaq Global Market under the symbol “LSBK”. Unless the context otherwise requires, all references herein to Lake Shore Bancorp or Lake Shore Savings include Lake Shore Bancorp and Lake Shore Savings on a consolidated basis.

Lake Shore Bancorp, Inc. was organized in 2006 for the purpose of acting as the savings and loan holding company of Lake Shore Savings Bank in connection with the Company’s initial public stock offering. The Company, a federal corporation, is regulated by the Federal Reserve Board. At December 31, 2014, Lake Shore Bancorp had total consolidated assets of $487.5 million, of which $284.9 million was comprised of loans receivable, net and $138.2 million was comprised of available for sale securities. At December 31, 2014, total consolidated deposits were $386.9 million and total consolidated stockholders’ equity was $71.6 million.

Lake Shore Savings Bank was chartered as a New York savings and loan association in 1891. In 2006, the Bank converted from a New York-chartered mutual savings and loan association to a federal savings bank charter. The Bank is subject to the supervision and regulation of the Office of the Comptroller of the Currency (“OCC”).

For over 123 years, the Bank has served the local community of Dunkirk, New York. In 1987, we opened our second office in Fredonia, New York. Since 1993, we have expanded to eleven branch offices. In addition, we have added three administrative office buildings which comprise our corporate headquarters in Dunkirk, New York. Our principal business consists of (1) attracting retail deposits from the general public in the areas surrounding our corporate headquarters and main branch office in Dunkirk, New York and ten other branch offices in Chautauqua and Erie Counties, New York and (2) investing those deposits, together with funds generated from operations, primarily in one- to four-family residential mortgage loans, commercial real estate loans, home equity lines of credit and, to a lesser extent, commercial business loans, consumer loans, and investment securities. Our revenues are principally derived from interest generated from our loans and interest earned and dividends received on our investment securities. Our primary sources of funds for lending and investments are deposits, borrowings, payments of loan principal and interest, payments on mortgage-backed and asset-backed securities, maturities and calls of investment securities and income resulting from operations in prior periods.

Available Information

Lake Shore Bancorp's annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and any amendments to such reports filed or furnished pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended, are made available free of charge on our website, www.lakeshoresavings.com, as soon as reasonably practicable after such reports are electronically filed with, or furnished to, the Securities and Exchange Commission. Such reports are also available on the Securities and Exchange Commission's website at www.sec.gov. Information on our website shall not be considered a part of this Form 10-K.

Market Area

Our operations are conducted out of our corporate headquarters and main branch office in Dunkirk, New York and ten other branch offices. Our branches in Chautauqua County, New York are located in Dunkirk, Fredonia, Jamestown, Lakewood and Westfield. In Erie County, New York our branch offices are located in Depew, East Amherst, Hamburg, Kenmore, Orchard Park, and Snyder. Our first branch office in Erie County opened during April 2003 and the most recent branch office opened in April 2014. We also have seven stand-alone ATMs. The opening of six branch offices in Erie County, New York since 2003 demonstrates the implementation of our growth strategy which is focused on expansion within Erie County while preserving our market share in Chautauqua County.

Our geographic market area for loans and deposits is principally located within Chautauqua and Erie Counties, New York. Chautauqua County is located on Lake Erie in the western portion of New York and is approximately 45 miles from Buffalo, New York. Chautauqua County is served by four accredited hospitals and offers higher education opportunities at the State University of New York (SUNY) at Fredonia, a four year liberal arts school, and at SUNY Jamestown, a community college. Chautauqua County features tourist areas near Chautauqua Lake, but it also hosts a broad diversity of industry, commercial establishments and financial institutions as well as a skilled and productive workforce. Jamestown, New York, where we opened the first of two branch offices in 1996, is the most populous city in Chautauqua County.

Erie County is a metropolitan center located on the western border of New York. Located within Erie County is the city of Buffalo, the second largest city in the State of New York. As the city of Buffalo has redeveloped, so too have its suburbs throughout Erie County, which also host the Buffalo Niagara International Airport in Cheektowaga, New York and professional sports franchises. One of the main commercial thorough-fares in Erie County is Transit Road, which has experienced robust development in recent years and is the location of one of our branch offices.

The demographic characteristics of our market area are less attractive than national and state measures. Both Chautauqua and Erie Counties exhibit slower rates of population growth when compared to the United States and New York State averages. In addition, both Chautauqua and Erie Counties have lower per capita income and slower growth in per capita income when compared to the United States and the New York State averages. Since Chautauqua County has historically exhibited less attractive demographic characteristics, we may have limited growth opportunities in Chautauqua County. However, Erie County displays a stronger housing market than Chautauqua County and Erie County’s population base is five times larger than Chautauqua County, which offers us an expanded source of new customers in the form of deposit and lending opportunities. Notwithstanding these demographic characteristics, our primary market area has historically been stable, with a diversified base of employers and employment sectors. The local economies that we serve are not dependent on one key employer. Transportation equipment is the largest manufacturing industry in the Buffalo area, as well as production of automobile component parts. The principal employment sectors are service-related, wholesale and retail trade, and durable-goods manufacturing. Most of the job opportunities in Chautauqua and Erie Counties have been in service-related industries, and service jobs now account for the largest portion of the workforce.

The challenging economic conditions that affected the national and global financial markets in 2007 and 2008 did not have a significant effect on the housing prices in our market area. Furthermore, unemployment rates in our market area have decreased since December 2012 from 8.4% to 5.5% in Erie County and from 8.9% to 6.4% in Chautauqua County as of December 31, 2014. New York State’s unemployment rate as of December 31, 2014 was 5.8%, the lowest level since September 2008.

Our future growth will be influenced by the strength of our regional economy, other demographic trends and the competitive environment. We believe that we have developed lending products and marketing strategies to address the credit-related needs of the residents and small businesses in our local market area.

New York State currently has several incentive programs for businesses to invest in the Western New York region. One example is the “Start-Up NY” program, which offers tax incentives to start, expand or relocate a qualified business to a tax-free areas within the state, primarily near a university or community college campus, in order to access top talent and research facilities. Qualified businesses for this program include advance materials & manufacturing, biotech & life sciences, tech & electronics, and optics & imaging. This program has generated significant interest in Western New York for new business development, due to its proximity to Canada, history of being a strong industrial and manufacturing center, and number of quality colleges and universities in the area.

Furthermore, the Erie County region and the City of Buffalo have recently experienced economic expansion led by major growth in the heath care and education sectors, and a resurgence in the central business district, which has led to an influx of private investment in development of hotels and housing in the downtown sector. Major construction projects are currently underway on the waterfront and at the Buffalo Niagara Medical Campus. The Buffalo Niagara Medical Campus has grown significantly with the construction of a new children’s hospital, expansion of an existing cancer/research hospital and construction of a new medical school by the State University of New York at Buffalo. Development on the waterfront has centered around redevelopment of property for mixed use, including public access and private development that includes office space, ice rinks, a hotel and restaurants. The economic development within the region also impacts the small business and middle-market customers that we focus on and we believe we will be able to capitalize on opportunities created by economic growth in this section of our market area.

Competition

We face intense competition both in making loans and attracting deposits. New York State has a high concentration of financial institutions, many of which are branches of large money centers and regional banks which have resulted from the consolidation of the banking industry in New York and surrounding states. Some of these competitors have greater resources than we do and may offer services that we do not provide. For example, we do not offer trust or investment services. Customers who seek “one stop shopping” may be drawn to our competitors who offer such services.

Our competition for loans comes principally from commercial banks, savings banks, mortgage banking companies, credit unions, and other financial service companies. The most direct competition for deposits has historically come from credit unions, commercial banks and savings banks. Specifically, we compete with local financial institutions such as Cattaraugus County Bank and Evans Bank; regional financial institutions such as M&T Bank, Community Bank, NA, and First Niagara Bank; and national financial institutions such as Key Bank and Bank of America. We are significantly smaller than many of these financial institution competitors. We face additional competition for deposits from non-depository competitors such as mutual funds, securities and brokerage firms and insurance companies. We remain very competitive in Chautauqua County, New York and as of June 30, 2014 we had 14.9% of total deposits and ranked 4th out of 11 banks in this market area, according to the Federal Deposit Insurance Corporation (“FDIC”) annual deposit market share report. Our deposit market share in Erie County, New York has steadily increased since we entered this market area in 2003. To remain competitive, we provide superior customer service and are active participants in our local community.

Lending Activities

General. Historically, as a thrift institution, we have primarily originated residential mortgage loans, including home equity loans. In recent years, we have become more focused on originating commercial real estate and commercial business loans to add adjustable rate loans to our portfolio and diversify the risk on our balance sheet, limit interest rate risk and to position ourselves for a rising interest rate environment. At December 31, 2014 we had total gross loans of $283.8 million. Typically, we retain the loans that we originate. However, we have occasionally sold residential mortgage loans into the secondary market, with retention of servicing rights. In the fourth quarter of 2014, we began to sell fixed rate, long-term residential mortgage loans with low yields (primarily sold loans with interest rates below 5% and maturities of 30 years) at the time of origination, with servicing retained, in an effort to manage interest rate risk and we plan to continue this

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practice in the near future. We also purchase a limited number of equipment loans from a third party broker, which are secured by first liens on the new equipment purchases by small businesses located throughout the Northeastern United States.

The interest rates we offer for loans are affected principally by the demand for loans, the supply of money available for lending purposes and the interest rates offered by our competitors. These factors, in turn, are affected by general and local economic conditions and monetary policies of the federal government, including the Federal Reserve Board.

Loan Portfolio. The following table sets forth the composition of our loan portfolio, by type of loan, in dollar amounts and in percentages at the dates indicated. We did not have any loans held for sale as of these dates.

	At December 31, 2014		2013		2012		2011		2010	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Pe of
	(Dollars in thousands)									
Real Estate loans:										
Residential one- to four-family	$ 167,840	59.14%	$ 170,793	61.81%	$ 167,794	61.68%	$ 182,922	66.82%	$ 183,929	70
Home equity	32,337	11.39%	31,675	11.46%	30,724	11.29%	30,671	11.20%	30,613	11
Commercial	68,238	24.04%	58,746	21.26%	57,653	21.19%	44,776	16.36%	33,782	12
Construction	449	0.16%	936	0.34%	416	0.15%	519	0.19%	616	0.2
	268,864	94.73%	262,150	94.87%	256,587	94.31%	258,888	94.57%	248,940	95
Other loans:										
Commercial	13,467	4.74%	12,645	4.58%	13,680	5.03%	12,911	4.72%	10,360	3.9
Consumer	1,495	0.53%	1,517	0.55%	1,791	0.66%	1,948	0.71%	2,224	0.8
	14,962	5.27%	14,162	5.13%	15,471	5.69%	14,859	5.43%	12,584	4.8
Total loans	283,826	100.00%	276,312	100.00%	272,058	100.00%	273,747	100.00%	261,524	10
Net deferred loan costs	2,948		2,846		2,681		2,687		2,460	
Allowance for loan losses	(1,921)		(1,813)		(1,806)		(1,366)		(953)	
Loans receivable, net	$ 284,853		$ 277,345		$ 272,933		$ 275,068		$ 263,031	

Loan Maturity. The following table presents the contractual maturity of our loans at December 31, 2014. The table does not include the effect of prepayments or scheduled principal amortization. Loans having no stated repayment schedule or maturity and overdraft loans are reported as being due in one year or less.

	Real Estate				Other Loans		
	Residential, One- to Four-Family	Home Equity	Commercial	Construction	Commercial	Consumer	Total
	(Dollars in thousands)						
Amounts due in:							
One year or less	$ 50	$ 303	$ 1,826	$ -	$ 4,361	$ 800	$ 7,340
After one year through five years	6,186	5,733	4,915	-	7,530	392	24,756
Beyond five years	161,604	26,301	61,497	449	1,576	303	251,730
Total	$ 167,840	$ 32,337	$ 68,238	$ 449	$ 13,467	$ 1,495	$ 283,826
Interest rate terms on amounts due after one year:							
Fixed rate	$ 160,844	$ 2,687	$ 30,347	$ 449	$ 9,000	$ 591	$ 203,918
Adjustable rate	6,946	29,347	36,065	-	106	104	72,568
Total	$ 167,790	$ 32,034	$ 66,412	$ 449	$ 9,106	$ 695	$ 276,486

The following table presents our loan originations, purchases, sales, and principal repayments for the years indicated.

	For the Year Ended December 31,				
	2014	2013	2012	2011	2010
	(Dollars in thousands)				
Total Loans:					
Balance outstanding at beginning of year	$ 276,312	$ 272,058	$ 273,747	$ 261,524	$ 258,411
Originations:					
Real estate loans	46,413	53,066	48,091	49,030	46,321
Commercial and consumer loans	4,560	3,536	5,383	7,553	7,580
Total originations	50,973	56,602	53,474	56,583	53,901
Loan Purchases - Commercial Loans	2,857	1,228	1,033	1,679	1,135
Total Originations and Purchases	53,830	57,830	54,507	58,262	55,036
Deduct:					
Principal repayments:					
Real estate loans	36,118	45,341	48,382	38,694	38,055
Commercial and consumer loans	7,879	5,944	5,807	6,392	10,568
Total principal repayments	43,997	51,285	54,189	45,086	48,623
Transfers to foreclosed real estate	448	704	1,001	252	307
Loan sales - SONYMA(1) & FHLMC(2)	1,737	1,436	767	639	243

Loans charged off	134	151	239	62	2,750
Total deductions	46,316	53,576	56,196	46,039	51,923
Balance outstanding at end of year	$ 283,826	$ 276,312	$ 272,058	$ 273,747	$ 261,524

(1) State of New York Mortgage Agency.

(2) During 2014, we sold $1.5 million of long-term fixed rate residential mortgage loans with low yields to the Federal Home Loan Mortgage Corporation (“FHLMC”) in order to offset long-term interest rate risk.

One- to Four-Family Residential Mortgage Lending. At December 31, 2014, we had one- to four-family residential loans of $167.8 million, or 59.1% of the total loan portfolio. Of one- to four-family residential mortgage loans outstanding on that date, 95.9% were fixed rate loans and 4.1% were adjustable rate loans. At December 31, 2014, approximately 61.3% of our one- to four-family residential mortgage portfolio was secured by property located in Chautauqua County, 33.6% by property located in Erie County and 5.1% by property located elsewhere, primarily in New York State. Approximately 6.5% of all residential loan originations during fiscal year 2014 were re-financings of loans already in our portfolio.

Our residential mortgage loan originations are obtained from customers, residents of our local communities or referrals from local real estate agents, attorneys and builders.   The retention of fixed rate one- to four-family residential mortgage loans in our loan portfolio increases our interest rate risk in a rising interest rate environment, since the yields earned on such fixed-rate assets would remain fixed, while the rates paid by the Bank for deposits and borrowings may increase, which could lower net interest income. In an effort to manage interest rate risk, the Bank began to sell low yield, long-term fixed rate (residential mortgages (primarily yields less than 5% and terms of 30 years) at origination on the secondary market, with servicing retained, during the fourth quarter of 2014 and we plan to continue this practice in the near future.

One- to four-family residential mortgage loan originations are generally for terms of 10, 15, 20 or 30 years, amortized on a monthly basis with interest and principal due either bi-weekly or monthly. One- to four-family residential real estate loans may remain outstanding for significantly shorter periods than their contractual terms as borrowers may refinance or prepay loans at their option without penalty. Conventional one- to four-family residential mortgage loans originated by us customarily contain “due-on-sale” clauses that permit us to accelerate the indebtedness of the loan upon transfer of ownership of the mortgaged property. We do not offer “interest only” mortgage loans, subprime or “negative amortization” mortgage loans.

Our residential lending policies and procedures ensure that our one- to four-family residential mortgage loans generally conform to secondary market guidelines. We underwrite all conforming rate loans (i.e. loans with less than a $417,000 loan balance) using the same criteria required by the Federal Home Loan Mortgage Corporation (“FHLMC”). We originate one- to four-family residential mortgage loans with a loan-to-value ratio up to 97%, and up to 103.5% with our United States Department of Agriculture (“USDA”) Rural Development Guaranteed Loan Program (“GLP”) mortgage loan product. Mortgages originated with a loan-to-value ratio exceeding 80% normally require private mortgage insurance. Private mortgage insurance is not required on loans with an 80% or less loan-to-value ratio. We do not originate any sub-prime mortgage loans and we do not have any sub-prime mortgage loans in our residential mortgage loan portfolio.

We offer adjustable rate mortgage loans with a maximum term of 30 years. When an adjustable rate mortgage is originated, the initial interest rate is established based on market conditions and competitor rates. These adjustable rate mortgage loans have terms generally up to 30 years, with rates that adjust annually after one, three, five, or seven years, depending on the loan product. After the initial fixed rate time period, the interest rate on these loans will re-price based upon a specific U.S. Treasury index plus an additional margin, taking into consideration the cap and floor rates established at the time of loan origination.

Our adjustable rate one- to four-family residential mortgage loans include limits on increases or decreases in the interest rate of the loan. The interest rate may increase or decrease by a maximum percentage amount per adjustment period with a ceiling rate and a floor rate being defined at the time of origination. The retention of adjustable rate one- to four-family residential mortgage loans in our loan portfolio helps reduce exposure to changes in interest rates. However, there are unquantifiable credit risks resulting from potential increased costs to the borrower as a result of the pricing of adjustable rate mortgage loans. During periods of rising interest rates, the risk of default on one- to four-family adjustable rate mortgage loans may increase due to the increase of interest cost to the borrower.

We regularly provide a loan product to our customers that is underwritten using the criteria required by FHLMC. After a loan is originated and funded, we may sell the loan to FHLMC. During 2014, we sold $1.5

million of one –to four- family residential mortgage loans originated to FHLMC and we plan to continue to do so in the future to manage interest rate risk. We also sold loans to the State of New York Mortgage Agency ("SONYMA") during 2014 and will continue to do so as long as the product is offered. We retain all servicing rights for one- to four-family residential mortgage loans that we sell.

Historically, Lake Shore Savings retained the majority of residential mortgage loans that it originated in its portfolio. As a result, Lake Shore Savings is exposed to increases in market interest rates, since the yield earned on fixed-rate assets would remain fixed, while the rates paid by Lake Shore Savings for deposits and borrowings may increase, which could result in lower net interest income.

Home Equity Loans and Lines of Credit. We currently provide all-in-one home equity lines of credit and have provided home equity loans in the past to our customers. Home equity lines of credit are generally made for owner-occupied homes, and are secured by first or second mortgages on residences. At December 31, 2014, home equity loans and lines of credit totaled $32.3 million, or 11.4% of the total loan portfolio, of which 91.6% were adjustable rate loans and 8.4% were fixed rate loans. The all-in-one home equity line of credit must have a minimum line amount of $5,000 up to a maximum of 85% of the total loan-to-value ratio. Home equity lines of credit products, which have interest rates tied to the prime rate, generally have a 15 year draw period and a 15 year payback period. Since 2010, our adjustable rate home equity loans include limits on decreases in the interest rate of the loan. The decrease in the interest rate may not be below the "floor" rate established at time of origination. A customer has the option to convert either a portion, or the entire line of credit balance, to a term loan at a fixed rate of interest. As the customer pays down the balance on the term loan, the funds available on the line of credit increase by a like amount. All-in-one home equity lines of credit have 15 year maximum terms.

Commercial Real Estate Loans. We originate commercial real estate loans to finance or refinance the purchase of real property, which generally consists of developed real estate, such as office buildings, warehouses, retail properties and apartment buildings, which is typically held as collateral for the loan. At December 31, 2014, commercial real estate loans totaled $68.2 million, or 24.0% of the total loan portfolio. In underwriting commercial real estate loans, consideration is given to the property's historic cash flow, paying capacity of the obligor, current and projected occupancy, location, and physical condition. Within the commercial real estate portfolio at December 31, 2014, approximately 21.7% consisted of loans that are collateralized by properties located in Chautauqua County, 66.8% by properties located in Erie County, and 11.5% by properties located elsewhere in New York State. The average principal amount of a commercial real estate loan is approximately $417,000 at December 31, 2014. The largest commercial real estate loan in our portfolio as of December 31, 2014 was $3.8 million secured by a commercial building used as a shopping plaza with multiple commercial tenants. This loan was performing in accordance with its terms on that date. We originate a variety of fixed and adjustable rate commercial real estate loans generally for terms up to 5 to 10 years and payments based on an amortization schedule of up to 20 years. Adjustable rate loans are typically based on the current Federal Home Loan Bank of NY ("FHLBNY") rates for a similar termed borrowing with an added spread based on the type and size of the loan. We typically lend up to a maximum loan-to-value ratio of 75% on commercial real estate properties and require a minimum debt coverage ratio of 1.2 to 1, a first lien on collateral and the personal guarantees of the owners.

Commercial real estate lending involves additional risks compared with one- to four-family residential lending, because payments on loans secured by commercial real estate properties are often dependent on the successful operation or management of the properties, and/or the collateral value of the commercial real estate securing the loan, and repayment of such loans may be subject to adverse conditions in the real estate market or economic conditions to a greater extent than one- to four-family residential mortgage loans. In addition tenancy of the properties needs to be monitored as to lease rates, term of lease and tenant worthiness. Also, commercial real estate loans typically involve larger loan balances to single borrowers or groups of related borrowers. Our loan policies limit the amount of loans to a single borrower or group of borrowers to reduce this risk and are designed to set such limits within those prescribed by applicable federal and state statutes and regulations. We engage a third party to conduct a credit review of the commercial real estate portfolio, including compliance with the Bank's underwriting standards and policy requirements.

Construction Loans. We originate loans to finance the construction of both one- to four-family homes and commercial real estate. These loans typically have a 12 month or less construction period, whereby draws are taken and interest only payments are made. As part of the draw process, inspection and lien checks are required prior to the disbursement of the proceeds. At the end of the construction period, the loan automatically converts to either a conventional residential or commercial real estate mortgage, as applicable. At December 31, 2014, construction loans totaled $449,000, or less than 1% of our total loan portfolio.

Commercial Loans. In addition to commercial real estate loans, we also engage in small business commercial lending, including business installment loans, lines of credit, and other commercial loans. At December 31, 2014, commercial loans totaled $13.5 million, or 4.7% of the total loan portfolio. This amount includes $3.8 million of equipment loans that we have purchased from a third party broker. The average principal amount of a commercial loan is approximately $67,000 at December 31, 2014. The largest outstanding commercial loan in our portfolio as of December 31, 2014 was $1.4 million secured by general business assets. This loan was performing in accordance with its terms on that date. Most of our commercial loans have fixed interest rates, and are for terms generally not in excess of 10 years. Whenever possible, we collateralize these loans with a lien on business assets and equipment and require the personal guarantees from principals of the borrower. Interest rates on commercial loans generally have higher yields than rates on one- to four-family residential mortgages. We offer commercial loan services designed to give business owners borrowing opportunities for modernization, inventory, equipment, construction, consolidation, real estate, working capital, vehicle purchases, and the refinancing of existing corporate debt.

Commercial loans are generally considered to involve a higher degree of risk than residential mortgage loans because the collateral underlying the loans may be in the form of furniture, fixtures, and equipment and/or inventory subject to market obsolescence. Commercial loans may also involve relatively large loan balances to single borrowers or groups of related borrowers, with the repayment of such loans typically dependent on the successful operation and income stream of the borrower. Such risks can be significantly affected by economic conditions. In addition, commercial business lending generally requires substantially greater oversight efforts compared to residential real estate lending. We engage a third party to conduct credit reviews of the commercial loan portfolio, including compliance with the Bank's underwriting standards and policy requirements.

Consumer Loans. We offer a variety of consumer loans. At December 31, 2014, consumer loans totaled $1.5 million, or less than 1% of the total loan portfolio. The largest component of our consumer loan portfolio are personal consumer loans and overdraft lines of credit, which are available for amounts up to $5,000 for unsecured loans and greater amounts for secured loans depending on the type of loan and value of the collateral. Consumer loans, excluding overdraft lines of protection, generally are offered for terms of up to 10 years, depending on the collateral, at fixed interest rates. Our consumer loan portfolio also consists of vehicle loans, motorcycle loans, other unsecured consumer loans up to $5,000, secured and unsecured property improvement loans, and other secured loans.

Generally, the volume of consumer lending has declined as borrowers have opted for home equity lines, where a mortgage-interest federal tax deduction is available, as compared to unsecured loans or loans secured by property other than residential real estate. We continue to make automobile loans directly to borrowers and primarily on used vehicles. We make other consumer loans, which may or may not be secured. The terms of such loans vary depending on the collateral.

Consumer loans are generally originated at higher interest rates than residential mortgage loans but also tend to have a higher credit risk due to the loans being either unsecured or secured by rapidly depreciable assets. Furthermore, consumer loan payments are dependent on the borrower's continuing financial stability, and therefore are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Despite these risks, our level of consumer loan delinquencies generally has been low. No assurance can be given, however, that our delinquency rate or losses will continue to remain low in the future.

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Loan Approval Procedures and Authority. Our lending policies are approved by our Board of Directors. Home equity loans in excess of $25,000 and all one- to four-family residential mortgage loans up to $417,000 require approval by the Internal Residential Loan Committee. If these types of loans are between $417,000 and $1.0 million, then the approval of two of the following officers: President and Chief Executive Officer, Chief Financial Officer, Executive Vice President – Commercial Division, Vice President - Commercial and Small Business Lending - Chautauqua County, along with another member of the Internal Residential Loan Committee is required. If these types of loans are in excess of $1.0 million, then full Board approval is required.

For all commercial loans, including commercial real estate loans, certain Vice Presidents and Commercial Lending Officers have authority to approve loans for total obligor credit up to $100,000. Commercial loans with total obligor credit in excess of $100,000 and up to $500,000 require the approval of two members of the Internal Commercial Loan Committee, one of which must be either the: President and Chief Executive Officer, Executive Vice President – Commercial Division or Vice President – Senior Commercial Lending Officer. Commercial loans with total obligor credit in excess of $500,000 and up to $1.0 million require majority approval by four designated members of the Board of Directors, including the President and CEO, the Chairman of the Board and the Chairman of the Asset/Liability Management Committee. Commercial loans with total obligor credit in excess of $1.0 million require full Board approval.

Additionally, branch managers are granted authority to approve certain loans, mainly consumer loans, in smaller amounts deemed appropriate by our Board of Directors. Levels of lending authority for consumer loans are established and granted to specific branch managers and loan officers based on position and experience.

Current Lending Procedures. Upon receipt of a completed loan application from a prospective borrower, we order a credit report and verify certain other information. If necessary, we obtain additional financial or credit related information. We require an appraisal for all residential and commercial real estate loans and home equity loans, including loans made to refinance existing mortgage loans. Appraisals are performed by licensed third-party appraisal firms that have been approved by our Board of Directors. An appraisal management firm has been hired to handle all requests for appraisals on residential real estate loans. We require title insurance on all residential and commercial real estate loans and certain other loans. We also require hazard insurance on all real estate loans, and if applicable, we require borrowers to obtain flood insurance prior to closing. Based on loan-to-value ratios and lending guidelines, escrow accounts may be required for such items as real estate taxes, hazard insurance, flood insurance, and private mortgage insurance premiums.

Asset Quality

One of our key operating objectives has been, and continues to be, maintaining a high level of asset quality. Our high proportion of one- to four-family residential mortgage loans, the maintenance of sound credit standards for new loan originations and loan administration procedures have resulted in low delinquency ratios. These factors have contributed to our strong financial condition.

Collection Procedures. We have adopted a loan collection policy to maintain adequate control on the status of delinquent loans and to ensure compliance with the Fair Debt Collection Practices Act, the Dodd-Frank Act and the Consumer Protection Act. When a borrower fails to make required payments on a residential, home equity, commercial, or consumer loan, we take a number of steps to induce the borrower to cure the delinquency and restore the loan to a current status. Our collections department documents every time a borrower is contacted either by phone or in writing and maintains records of all collection efforts. Once an account becomes delinquent for 15 days, a late notice is mailed to the borrower and any guarantors on a loan. A second notice is mailed following the 30th day of delinquency. At this time, we also directly contact the borrower. Such contact may be repeated if a loan is delinquent between 60-89 days.

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Once a one- to four-family residential loan has been delinquent for more than 90 days, the loan is deemed a "classified asset" and is reported to our Board of Directors. In 2010, amendments to the New York State ("NYS") Real Property Actions and Proceedings Law ("RPAPL") became effective whereby specific pre-foreclosure procedures for any one- to four-family residence located in NYS must be followed. When the Company wants to pursue foreclosure action against a borrower, the law requires us to mail a 90 day pre-foreclosure notice of the impending foreclosure action to the borrower prior to commencement of the action. Within 3 days of sending this notice, the collection department sends the notice information to the NYS Superintendent of Banks through the NYS Banking Department's online system. The Company must also send a 30-day demand letter to the borrower sixty days after the initial pre-foreclosure notice was sent. The demand letter includes updated loan balances regarding the potential foreclosure action. In order to receive approval for foreclosure action from the courts, the law requires a mandatory conference hearing between the court, borrower and bank. Prior to proceeding with any foreclosure action in the case of a secured loan, we will review the collateral to determine whether its possession would be cost-effective for us. In cases where the collateral fails to fully secure the loan, in addition to repossessing the collateral, we may also sue on the note underlying the loan.

If a commercial loan has been delinquent for more than 30 days, the loan file is reviewed for classification, and the borrower is contacted. If a commercial loan is 90 days or more past due, the loan is considered non-performing. If the delinquency continues, the borrower is advised of the date that the delinquency must be cured, or the loan is considered to be in default. At that time, foreclosure procedures are initiated on loans secured by real estate, and all other legal remedies are pursued.

The collection procedures for consumer loans include the sending of periodic late notices and letters to a borrower once a loan is past due. On a monthly basis, a review is made of all consumer loans which are 30 days or more past due. Consumer loans that are 180 days delinquent, where the borrowers have failed to demonstrate repayment ability, are classified as loss and charged-off. Once a charge-off decision has been made, the collections manager or management pursues legal action such as small claims court, judgments, salary garnishment and repossessions in an attempt to collect the deficiency from the borrower.

Non-performing Loans and Non-performing Assets. We define non-performing loans as loans that are either non-accruing or accruing whose payments are 90 days or more past due and non-accruing troubled debt restructurings. Non-performing assets, including non-performing loans and foreclosed real estate totaled $5.1 million, or 1.05% of total assets at December 31, 2014, and $5.2 million or 1.08% of total assets at December 31, 2013.

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The following table presents information regarding our non accrual loans, accruing loans delinquent 90 days or more, non-performing loans, foreclosed real estate, and non-performing and performing loans classified as troubled debt restructurings, as of the dates indicated.

	At December 31,				
	2014	2013	2012	2011	2010
	(Dollars in thousands)				
Loans past due 90 days or more but still accruing:					
Real estate loans:					
Residential, one- to four-family	$ -	$ 79	$ 10	$ 328	$ 391
Home equity	1	2	-	21	39
Commercial	-	-	-	-	43
Construction	-	-	-	-	-
Other loans:					
Commercial	-	-	-	87	-
Consumer	9	-	18	23	59
Total	$ 10	$ 81	$ 28	$ 459	$ 532
Loans accounted for on a non-accrual basis:					
Real estate loans:					
Residential, one- to four-family	$ 2,413	$ 2,145	$ 1,628	$ 1,821	$ 1,279
Home equity	335	325	299	209	122
Commercial	1,891	1,911	255	228	370
Construction	-	-	-	-	-
Other loans:					
Commercial	76	137	201	76	27
Consumer	4	7	9	5	11
Total non-accrual loans	4,719	4,525	2,392	2,339	1,809
Total non-performing loans	4,729	4,606	2,420	2,798	2,341
Foreclosed real estate	401	581	580	315	304
Total non-performing assets	$ 5,130	$ 5,187	$ 3,000	$ 3,113	$ 2,645
Ratios:					
Non-performing loans as a percent of net loans:	1.66 %	1.66 %	0.89 %	1.02 %	0.89
Non-performing assets as a percent of total assets:	1.05 %	1.08 %	0.62 %	0.64 %	0.55
Troubled debt restructuring:					
Loans accounted for on a non-accrual basis					
Residential, one- to four-family	$ -	$ 48	-	-	-
Home equity	-	-	31	31	-
Performing loans					
Residential, one- to four-family	$ 224	$ 144	-	-	-
Home equity	10	4	-	-	-

Loans are placed on non-accrual status either when reasonable doubt exists as to the full timely collection of interest and principal, or when a loan becomes 90 days past due, unless an evaluation by the internal Asset Classification Committee indicates that the loan is in the process of collection and is either guaranteed or well secured. When our Asset Classification Committee designates loans on which we stop

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accruing interest income as non-accrual loans, we reverse outstanding interest income that was previously credited. We may again recognize income in the period that we collect such income, when the ultimate collectability of principal is no longer in doubt. We return a non-accrual loan to accrual status when factors indicating doubtful collection no longer exist.

Our recorded investment in non-accrual loans totaled $4.7 million at December 31, 2014 and $4.5 million at December 31, 2013. The increase in non-accrued interest income during the year ended December 31, 2014 was primarily due to one commercial real estate loan with a principal balance of $1.2 million at December 31, 2014 which became non-performing during the fourth quarter of 2013. If all non-accrual loans had been current in accordance with their terms during the years ended December 31, 2014, 2013 and 2012, interest income on such loans would have amounted to $381,000, $162,000 and $143,000 respectively.

Real estate acquired as a result of foreclosure is classified as foreclosed real estate until such time as it is sold. We carry foreclosed real estate at its fair value less estimated selling costs at the date of acquisition. If a foreclosure action is commenced and the loan is not brought current, paid in full, or refinanced before the foreclosure sale, the property could be sold at the foreclosure sale (to an outside bidder). If not, and we retain the property, then we will sell the real property securing the loan as soon thereafter as practical. Our foreclosed real estate totaled $401,000 at December 31, 2014 and $581,000 at December 31, 2013.

Troubled debt restructurings ("TDRs") occur when we grant borrowers' concessions that we would not otherwise grant but for economic or legal reasons pertaining to the borrower's financial difficulties. A concession is made when the terms of the loan modification are more favorable than the terms the borrower would have received in the current market under similar financial difficulties. These concessions may include, but are not limited to, modifications of the terms of the debt, the transfer of assets or the issuance of an equity interest by the borrower to satisfy all or part of the debt, or the substitution or addition of borrower(s). The Company identifies loans for potential TDRs primarily through direct communication with the borrower and evaluation of the borrower's financial statements, revenue projections, tax returns and credit reports. Even if the borrower is not presently in default, management will consider the likelihood that cash flow shortages, adverse economic conditions, and negative trends may result in a payment default in the near future. Generally, we will not return a TDR to accrual status until the borrower has demonstrated the ability to make principal and interest payments under the restructured terms for at least six consecutive months. Our TDRs are impaired loans, which may result in specific allocations and subsequent charge-offs if appropriate.

At December 31, 2014, seven loans were classified as TDRs, including five one- to four-family residential loans for $224,000 and two home equity loans for $10,000. All of these loans were performing in accordance with their revised terms at December 31, 2014. At December 31, 2013, five loans were classified as TDRs including four one- to four-family residential loans for $192,000 and one home equity loan for $4,000. One of the TDR loans, a one- to four-family residential loan, for $48,000 was placed on non-accrual status and was included with non-accrual loans in the above table. This loan was classified as substandard and was 30 days past due and was not performing in accordance with its revised terms at December 31, 2013.

Classification of Loans. Federal regulations require us to regularly review and classify our loans. In addition, our regulators have the authority to identify problem loans and, if appropriate, require them to be classified. There are three classifications for problem loans: substandard, doubtful and loss. "Substandard loans" have one or more defined weaknesses and are characterized by the distinct possibility that we will sustain some loss if the deficiencies are not corrected. A substandard loan would be one inadequately protected by the current net worth and paying capacity of the obligor or pledged collateral, if applicable. “Doubtful loans” have all the weaknesses inherent in substandard loans with the additional characteristic that the weaknesses present make collection or liquidation in full on the basis of currently existing facts, conditions and values questionable, and there is a high possibility of loss. A loan classified as a “loss” is considered uncollectible and of such little value that its continuance on the books is not warranted. This does not mean that an asset does not have recovery or salvage value, but simply that it is not practical or desirable to defer writing off all or a portion of a worthless asset even though partial recovery may occur in the future. Regulations also provide for a “special mention” category, (i.e. criticized loans) described as loans which do not currently expose us to a sufficient degree of risk to warrant classification but do possess credit deficiencies or potential weaknesses deserving our close attention.

The allowance for loan losses is established through a provision for loan losses based on management evaluation of the losses inherent in the loan portfolio. When we classify loans as either substandard or doubtful, we set aside a loss reserve for such loans as we deem prudent. When we classify problem loans as loss, we typically charge-off the outstanding loan balance against the allowance for loan losses reserve. Our determination as to the classification of our loans and the amount of our loss allowances are subject to review by our regulators, which can require that we establish additional loss allowances. We regularly review our loan portfolio to determine whether any loans require classification in accordance with applicable regulations. On the basis of our review of our loans at December 31, 2014, classified and criticized loans consisted of special mention loans of $3.9 million, substandard loans of $5.9 million, doubtful loans of $718,000 and loss loans of $3,000. The classified and criticized loans total included $4.7 million of nonperforming loans.

The following table shows the aggregate amounts of our classified and criticized loans at the dates indicated.

	At December 31,		
	2014	2013	2012
	(Dollars in thousands)		
Special mention loans	$ 3,854	$ 3,090	$ 3,863
Substandard loans	5,882	5,701	5,773
Doubtful loans	718	582	230
Loss loans	3	4	-
Total classified and criticized loans	$ 10,457	$ 9,377	$ 9,866

Delinquencies. The following table provides information about delinquencies in our loan portfolio at the dates indicated.

	At December 31,					
	2014		2013		2012	
	60-89 Days Past Due	90 + Days Past Due	60-89 Days Past Due	90 + Days Past Due	60-89 Days Past Due	90 + Days Past Due
	(Dollars in thousands)					
Real estate loans:						
Residential, one- to four-family	$ 467	$ 1,059	$ 825	$ 880	$ 379	$ 1,300
Home equity	136	206	32	156	28	215
Commercial	-	1,891	-	1,911	-	255
Construction	-	-	-	-	-	-

Other loans:						
Commercial	9	37	-	41	20	71
Consumer	5	13	1	4	5	26
Total	$ 617	$ 3,206	$ 858	$ 2,992	$ 432	$ 1,867

Allowance for Loan Losses. The allowance for loan losses is a valuation account that reflects our evaluation of the losses inherent in our loan portfolio. We maintain the allowance through provisions for loan

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losses that we charge to income. We charge losses on loans against the allowance for loan losses when we believe the collection of the loan is unlikely.

Our evaluation of risk in maintaining the allowance for loan losses includes the review of all loans on which the collectability of principal may not be reasonably assured. We consider the following factors as part of this evaluation: historical loan loss experience; payment status; the estimated value of the underlying collateral; changes in lending policies, procedures and loan review system; changes in the experience, ability, and depth of lending management and other relevant staff; trends in loan volume and the nature of the loan portfolio; and national and local economic conditions. There may be other factors that may warrant consideration in maintaining an allowance at a level sufficient to provide for probable loan losses. Although our management believes that it has established and maintained the allowance for loan losses to reflect losses inherent in our loan portfolio, based on its evaluation of the factors noted above, future additions may be necessary if economic and other conditions differ substantially from the current operating environment.

In addition, various regulatory agencies periodically review our allowance for loan losses as an integral part of their examination process. These agencies, including the Office of the Comptroller of the Currency, may require us to increase the allowance for loan losses or the valuation allowance for foreclosed real estate based on their evaluation of the information available to them at the time of their examination.

The allowance consists of allocated, general and unallocated components. The allocated component relates to loans that are classified as doubtful, substandard, loss or special mention. See "Asset Quality – Classification of Loans." For such loans that are also classified as impaired, an allowance is established when the discounted cash flows, collateral value or observable market price of the impaired loan is lower than the carrying value of the loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative and environmental factors, as mentioned above. An unallocated component may be maintained to cover uncertainties that could affect management's estimate of probable losses, such as downturns in the local economy. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating allocated and general losses in the portfolio.

A loan is considered impaired when, based on current information and events, it is probable that we will not be able to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Impairment is measured on a loan-by-loan basis for commercial real estate loans and commercial loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, we do not separately identify individual consumer, home equity or one- to four-family real estate loans for impairment disclosures, unless they are subject to a troubled debt restructuring or as part of a larger loan relationship assessment. At December 31, 2014, there were five one- to four-family real estate loans, four commercial real estate loans, two commercial business loans, and two home equity loans classified as impaired loans for a total of $2.5 million. At December 31, 2013, there were four one- to four-family real estate loans, three commercial real estate loans, three commercial business loans and one home equity loan classified as impaired loans for a total of $2.6 million. Refer to Note 5 in the Notes to the Consolidated Financial Statements for more information on our impaired loans.

Provision for loan losses increased by $117,000 to $222,000 for the year ended December 31, 2014 from $105,000 for the year ended December 31, 2013. The increase in provision for loan losses was primarily due to an increase in our commercial real estate portfolio, along with an increase in substandard one- to four-family real estate loans during 2014. Our credit quality continues to remain strong. The ratio of nonperforming loans to total net loans was 1.66% as of December 31, 2014 and 2013. The majority of our non-performing loans are one- to four-family residential mortgage loans or commercial real estate loans backed by first lien collateral on real estate held in the Western New York region. Western New York has not been impacted as

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severely as other parts of the country by fluctuating real estate market values. We do not hold any sub-prime loans in our loan portfolio.

The following table sets forth activity in our allowance for loan losses and other ratios at or for the years indicated.

	At or for the Year Ended December 31,				
	2014	2013	2012	2011	2010
	(Dollars in thousands)				
Balance at beginning of year:	$ 1,813	$ 1,806	$ 1,366	$ 953	$ 1,564
Provision for loan losses	222	105	656	415	2,115
Charge-offs:					
Real estate loans:					
Residential, one- to four-family	(26)	(51)	(134)	-	(35)
Home equity	(39)	-	(14)	(29)	(6)
Commercial	-	(21)	-	(15)	(2,440)
Construction	-	-	-	-	-
Other loans:					
Commercial	(25)	(47)	(80)	(1)	(247)
Consumer	(44)	(32)	(11)	(17)	(22)
Total charge-offs	(134)	(151)	(239)	(62)	(2,750)
Recoveries:					
Real estate loans:					
Residential, one- to four-family	6	35	1	4	19
Home equity	1	5	-	-	-
Commercial	-	9	20	52	-
Construction	-	-	-	-	-
Other loans:					
Commercial	-	3	1	-	-
Consumer	13	1	1	4	5
Total recoveries	20	53	23	60	24
Net charge-offs	(114)	(98)	(216)	(2)	(2,726)
Balance at end of year	$ 1,921	$ 1,813	$ 1,806	$ 1,366	$ 953
Average loans outstanding	$ 276,360	$ 271,705	$ 268,265	$ 270,697	$ 258,150
Allowance for loan losses as a percent of total net loans	0.67%	0.65%	0.66%	0.50%	0.36%
Allowance for loan losses as a percent of non-performing loans	40.62%	39.36%	74.63%	48.82%	40.71%
Ratio of net charge-offs to average loans outstanding	0.04%	0.04%	0.08%	0.01%	1.06%

The following table presents our allocation of the allowance for loan losses by loan category and the percentage of loans in each category to total loans at the years indicated. The allowance for loan losses allocated to each category is not necessarily indicative of inherent losses in any particular category and does not restrict the use of the allowance to absorb losses in other categories.

	At December 31, 2014			2013			2012			2011	
	Amount	% of Allowance to Total Allowance	% of Loans in Category to Total Loans	Amount	% of Allowance to Total Allowance	% of Loans in Category to Total Loans	Amount	% of Allowance to Total Allowance	% of Loans in Category to Total Loans	Amount	% of Allowan to Total Allowan
	(Dollars in thousands)										
Real Estate Loans:											
Residential, one- to four-family	$ 446	23.2%	59.1%	$ 355	19.6%	61.8%	$ 393	21.7%	61.7%	$ 441	32.3%
Home equity	106	5.5%	11.4%	80	4.4%	11.5%	79	4.4%	11.3%	125	9.2%
Commercial (1)(2)	1,163	60.5%	24.0%	1,104	60.9%	21.3%	1,118	61.9%	21.2%	522	38.2%
Construction	-	-	0.2%	-	-	0.3%	-	-	0.1%	-	-
	1,715	89.2%	94.7%	1,539	84.9%	94.9%	1,590	88.0%	94.3%	1,088	79.7%
Other loans:											
Commercial(2)	184	9.6%	4.7%	218	12.0%	4.6%	202	11.2%	5.0%	265	19.4%
Consumer	22	1.2%	0.6%	9	0.5%	0.5%	14	0.8%	0.7%	13	0.9%
	206	10.8%	5.3%	227	12.5%	5.1%	216	12.0%	5.7%	278	20.3%
Total allocated	$ 1,921	100.0%	100.0%	$ 1,766	97.4%	100.0%	$ 1,806	100.0%	100.0%	$ 1,366	100.0%
Total unallocated	-	-		47	2.6%		-	-		-	-
Balance at end of year	$ 1,921	100.0%		$ 1,813	100.0%		$ 1,806	100.0%		$ 1,366	100.0%

(1) The increase as of December 31, 2012 was primarily due to an increase in our commercial real estate portfolio and classified commercial real estate loans.

(2) The increase as of December 31, 2011 was primarily due to the review of certain environmental factors for commercial real estate loans and commercial loans. Management concluded that an increased reserve was needed for its commercial loan portfolio due to the increase in portfolio size and the standard risks presented by these types of loans.

Investment Activities

General. Our Board of Directors reviews and approves our investment policy on an annual basis. This policy dictates that investment decisions be made based on the safety of the investment, liquidity requirements, potential returns, cash flow targets, and consistency with our interest rate risk management strategy. The Board of Directors has delegated primary responsibility for ensuring that the guidelines in the investment policy are followed to the Chief Executive Officer and the Chief Financial Officer. Our Chief Executive Officer or our Chief Financial Officer are responsible for making securities portfolio decisions in accordance with established policies and have the authority to purchase and sell securities within the specific guidelines established by the investment policy. In addition, all transactions are reviewed by the Asset/Liability Committee of the Board of Directors which meets at least quarterly. Given that Lake Shore Savings has a substantial portfolio of fixed-rate residential mortgage loans, Lake Shore Savings maintains high balances of liquid investments to help mitigate interest rate risk.

All of our securities carry market risk, as increases in market rates of interest may cause a decrease in the fair value of the securities. Our investment policy is designed primarily to manage the interest rate sensitivity of our assets and liabilities, to generate a favorable return without incurring undue interest rate or credit risk, to complement our lending activities and to provide and maintain liquidity within established guidelines. In establishing our investment strategies, we consider our interest rate sensitivity, the types of securities to be held, liquidity and other factors. The Company’s current investment strategy utilizes a risk management approach of diversified investing among three categories: short-, intermediate-, and long-term. The emphasis of this approach is to increase overall investment securities yields while managing interest rate risk. The Company has engaged an independent financial advisor to recommend investment securities according to a plan which has been approved by the Asset/Liability Committee and the Board of Directors. Federal savings banks have authority to invest in various types of assets, including U.S. Government obligations, securities of various federal agencies, obligations of states and municipalities, mortgage-backed and asset-backed securities, collateralized-mortgage obligations, certain time deposits of insured banks and savings institutions, certain bankers' acceptances, repurchase agreements, loans of federal funds, and, subject to certain limits, corporate debt and commercial paper.

All of the securities in our portfolio are classified as "available for sale". The securities are reported at fair value, and unrealized gains and losses on the securities are excluded from earnings and reported, net of deferred taxes, as a separate component of equity. Our current securities portfolio consists of collateralized mortgage obligations, mortgage backed securities, asset-backed securities, U.S. Government obligations and municipal bonds. Nearly all of our mortgage backed securities are directly or indirectly insured or guaranteed by FHLMC, the Government National Mortgage Association ("GNMA") or the Federal National Mortgage Association ("FNMA", or "Fannie Mae"). The municipal securities we invest in have maturities of 20 years or less and many have private insurance guaranteeing repayment. The majority of municipal securities in our portfolio are unlimited general obligation bonds.

We have investments in FHLBNY stock, which must be held as a condition of membership in the Federal Home Loan Bank system. The investment in FHLBNY stock is considered restricted and is reported at cost on the Consolidated Statements of Financial Condition.

Fair values of available for sale securities were based on a market approach, with the exception of four private-label asset-backed securities that are not currently trading in an active market. Fair values of these securities were calculated based on a cash flow approach. Securities which are fixed income instruments that are not quoted on an exchange, but are traded in active markets, are valued using prices obtained from our custodian, which used third party data service providers.

Classification of Investments. Federal regulations require us to regularly review and classify our investments based on credit risk in determining credit quality of investment portfolios as well as for calculating risk based capital. A decline in the market value of a security due to interest rate fluctuations is not a basis for adverse classification. Instead, the classification is based on the likelihood of the timely and full collection of principal and interest.

In assessing the credit quality of securities in our investment portfolio, we conduct an internal risk analysis, which includes a review of third party research and analytics. If our research indicates that an issuer of a security does not have adequate capacity to meet its financial obligations for the life of the asset, the Company will review the security and consider it for classification.

A security may be classified as Substandard, Doubtful or Loss. A "Substandard" classification indicates that the investment is inadequately protected by the sound worth and paying capacity of the obligor or of the collateral pledged. Investments classified as "Substandard" must have a well defined weakness or weaknesses that jeopardize the liquidation of the debt, and the Company may sustain some loss if deficiencies are not corrected. A "Doubtful" classification has all the weaknesses of a "Substandard" classification with the added characteristic that the weaknesses make collection or liquidation in full highly questionable and improbable. Investments classified "Loss" are considered uncollectible and their continuance as an asset of the Company is no longer warranted.

Our determination as to the classification of our investments are subject to review by our regulators. We regularly review our investment portfolio to determine whether any investments require classification in accordance with applicable regulations. Our review of our investment portfolio at December 31, 2014 indicated four private-label asset-backed securities that we considered for classification, as the issuer did not

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have an adequate capacity to meet its financial commitments over the projected life of the investment or the risk of default by the obligor was possible, resulting in an expectation that the Bank would not receive the full and timely repayment of principal and interest as expected. These four securities had an amortized cost of $1.5 million and fair value of $2.0 million. All four securities were classified as "Substandard." These securities were also evaluated for other-than-temporary impairment and as noted in the Other than Temporary Impairment section of Part II, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and we concluded that no other than temporary impairment charges needed to be recorded during the year ended December 31, 2014. An additional $180,000 of other-than-temporary impairment needed to be recorded for one private-label asset-backed security during the year ended December 31, 2013. During the years ended December 31, 2014 and 2013, we recaptured $175,000 and $3,000, respectively of prior year other-than-temporary impairment charges. The recaptured amounts are reflected in the "recovery on previously impaired investment securities" line item in the Consolidated Statements of Income shown in "Part IV Exhibits and Financial Schedules."

The following table presents the composition of our securities portfolio in dollar amount of each investment type at the dates indicated.

	At December 31,					
	2014		2013		2012	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(Dollars in thousands)					
Securities available for sale:						
U.S. Treasury bonds	$ 12,817	$ 14,361	$ 12,857	$ 13,848	$ 12,896	$ 15,195
Municipal bonds	57,158	60,786	57,199	58,044	51,666	56,264
Mortgage-backed securities:						
Collateralized mortgage obligations -private label	61	61	77	81	92	94
Collateralized mortgage obligations -government sponsored entities	50,465	49,992	63,840	62,625	57,574	58,167
Government National Mortgage Association	524	571	2,153	2,219	2,607	2,896
Federal National Mortgage Association	7,107	7,473	11,452	11,634	15,232	16,272
Federal Home Loan Mortgage Corporation	2,650	2,767	5,774	5,816	5,708	6,194
Asset-backed securities-private label	1,546	2,023	3,637	3,498	4,514	4,117
Asset-backed securities-government sponsored entities	111	122	130	134	150	163
Equity securities	22	46	22	65	22	6
Total available for sale	$ 132,461	$ 138,202	$ 157,141	$ 157,964	$ 150,461	$ 159,368

At December 31, 2014, we did not have any non-U.S. Government and Government agency securities that exceeded 10.0% of our equity.

Investment Securities Portfolio, Maturities and Yields. The following table sets forth the scheduled maturities, amortized cost and weighted average yields for our investment portfolio, with the exception of equity securities, at December 31, 2014. Due to repayments of the underlying loans, the average life maturities of mortgage-backed and asset-backed securities generally are substantially less than the final maturities. The weighted average yield does not include the impact of a tax-equivalent adjustment for bank qualified municipals.

	More than One Year through Five Years		More than Five Years through Ten Years		More than Ten Years		Total Securities		
	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Fair Value	Weighted Average Yield
	(Dollars in thousands)								
Securities available for sale:									
U.S. Treasury bonds	$ -	-	$ 10,603	3.43%	$ 2,214	4.44%	$ 12,817	$ 14,361	3.60%
Municipal bonds	851	3.92%	23,003	3.77%	33,304	3.61%	57,158	60,786	3.68%
Mortgage-backed securities	972	3.76%	2,844	3.74%	56,991	2.55%	60,807	60,864	2.62%
Asset-backed securities	-	-	-	-	1,657	5.12%	1,657	2,145	5.12%
Total securities available for sale	$ 1,823	3.83%	$ 36,450	3.67%	$ 94,166	3.01%	$ 132,439	$ 138,156	3.21%

Sources of Funds

General. Deposits, borrowings, repayments and prepayments of loans and securities principal, proceeds from the sale of securities, proceeds from maturing securities, and cash flows provided by operations are our primary sources of funds for use in lending, investing and for other general purposes. See "Part II, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources."

Deposits. We offer a variety of deposit accounts having a range of interest rates and terms. We currently offer regular savings deposits (consisting of Christmas Club, passbook and statement savings accounts), money market accounts savings and checking, interest bearing and non-interest bearing checking accounts (i.e., demand deposits), health savings accounts, retirement accounts, time deposits and Interest on Lawyer Accounts ("IOLA"). In addition to accounts for individuals, we also offer commercial checking accounts designed for the businesses operating in our market area.

Deposit flows are influenced significantly by general and local economic conditions, changes in prevailing interest rates, pricing of deposits, and competition. Our deposits are primarily obtained from communities surrounding our offices and we rely primarily on paying competitive rates, service, and long-standing relationships with customers to attract and retain these deposits. We normally do not use brokers to obtain deposits, although we have in the past and may do so in the future.

When we determine our deposit rates, we consider local competition, U.S. Treasury securities offerings, our liquidity needs, and the rates charged on other sources of funds. We generally review our deposit mix and pricing on a weekly basis. Our deposit pricing strategy has generally been to offer competitive rates and to be towards the top of the local market for rates on most types of deposit products. Core deposits (defined as savings deposits, money market accounts, demand deposit accounts and other interest bearing accounts) represented 52.9% and 50.4% of total deposits on December 31, 2014 and 2013, respectively. At December 31, 2014 and 2013, time deposits with remaining terms to maturity of less than one year amounted to $104.8 million and $74.2 million, respectively.

The following table presents our time deposit accounts categorized by interest rates which mature during each of the years set forth below and the amounts of such time deposits by interest rate at December 31, 2014, 2013 and 2012.

	Period to maturity at December 31, 2014				At December 31,		
	Less than One Year	More than One Year to Two Years	More than Two Years to Three Years	More than Three Years	2014	2013	2012
	(Dollars in thousands)						
Interest Rate Range							
0.49% and below	$ 40,930	$ 4,803	$ 274	$ -	$ 46,007	$ 53,515	$ 23,259
0.50% and 0.99%	15,828	10,643	2,677	362	29,510	29,540	59,203
1.00% and 1.99%	1,138	23,160	16,958	15,450	56,706	52,316	54,049
2.00% to 2.99%	46,713	2,852	-	165	49,730	56,474	60,816
3.00% to 5.99%	175	-	-	-	175	730	1,170
Total	$ 104,784	$ 41,458	$ 19,909	$ 15,977	$ 182,128	$ 192,575	$ 198,497

The following table presents the distribution of our deposit accounts at the dates indicated by dollar amount and percent of portfolio:

	At December 31,					
	2014		2013		2012	
	Amount	Percent of total deposits	Amount	Percent of total deposits	Amount	Percent of total deposits
	(Dollars in thousands)					
Deposit type:						
Savings	$ 42,507	10.99%	$ 38,833	10.00%	$ 36,990	9.77%
Money market	78,457	20.28%	77,990	20.09%	68,228	18.02%
Interest bearing demand	46,685	12.07%	44,517	11.47%	42,350	11.19%
Non-interest bearing demand	37,162	9.60%	34,320	8.84%	32,478	8.58%
Total core deposits	204,811	52.94%	195,660	50.40%	180,046	47.56%
Time deposits with original maturities of:						
Three months or less	1,466	0.38%	1,925	0.50%	4,205	1.11%
Over three months to twelve months	32,515	8.40%	40,569	10.45%	43,751	11.57%
Over twelve months to twenty-four months	30,671	7.93%	31,417	8.09%	33,126	8.75%
Over twenty-four months to thirty-six months	10,303	2.66%	10,668	2.75%	12,341	3.26%
Over thirty-six months to forty-eight months	2,695	0.70%	3,673	0.95%	5,025	1.33%
Over forty-eight months to sixty months	104,073	26.89%	103,390	26.62%	99,084	26.18%

Over sixty months	405	0.10%	933	0.24%	965	0.26%
Total time deposits	182,128	47.06%	192,575	49.60%	198,497	52.44%
Total deposits	$ 386,939	100.00%	$ 388,235	100.00%	$ 378,543	100.00%

At December 31, 2014, we had $68.6 million in time deposits with balances of $100,000 or more maturing as follows:

Maturity Period	Amount (In thousands)
Three months or less	$ 9,597
Over three months through six months	12,116
Over six months to twelve months	14,947
Over twelve months	31,945
Total	$ 68,605

Short-term Borrowings. Historically, our borrowings have consisted of a mix of short-term and long-term Federal Home Loan Bank advances. At December 31, 2014, we did not hold any short-term borrowings on our balance sheet. At December 31, 2013 our short-term borrowings from the Federal Home Loan Bank of New York were $11.7 million. We have a written agreement with the Federal Home Loan Bank of New York which allows us to borrow up to $121.1 million as of December 31, 2014 and was collateralized by a pledge of certain fixed-rate one- to four-family real estate loans. At December 31, 2014, we had outstanding long-term advances under this agreement of $19.0 million. The Bank also pledges securities as collateral at the Federal Reserve Bank discount window for overnight borrowings. At December 31, 2014, securities with a book value of $10.7 million and fair value of $11.4 million were pledged for potential borrowings at the Federal Reserve Bank discount window. There were no balances outstanding with the Federal Reserve Bank at December 31, 2014. The Bank has also established lines of credit with correspondent banks, currently totaling $22.0 million, of which $20.0 million is unsecured and the remaining $2.0 million is secured by a pledge of the Bank’s securities when a draw is made. The lines of credit provide for overnight borrowings through the purchase of Fed Funds, at an interest rate equal to the Fed Funds rate plus a spread. At December 31, 2014, there were no balances outstanding on these lines of credit.

The following table sets forth information concerning balances and interest rates on our short-term borrowings at the dates and for the years indicated.

	2014	2013	2012
	(Dollars in thousands)		
At December 31			
Amount outstanding	$ -	$ 11,650	$ 11,200
Weighted average interest rate	- %	0.39 %	0.38 %
For the year ended December 31			
Highest amount at a month-end	$ 12,350	$ 14,450	$ 14,320
Daily average amount outstanding	5,383	12,794	12,763

Weighted average interest rate	0.38 %	0.38 %	0.39 %

Subsidiary Activities

Lake Shore Savings is the only subsidiary of Lake Shore Bancorp. Lake Shore Savings has no subsidiaries.

Personnel

As of December 31, 2014, we had 110 full-time employees and 12 part-time employees. The employees are not represented by a collective bargaining unit and we consider our relationship with our employees to be good.

Supervision and Regulation

General

Lake Shore Savings Bank is examined and supervised by the OCC, while Lake Shore Bancorp, Inc. and Lake Shore, MHC are examined and supervised by the Federal Reserve Board. This regulation and supervision establishes a comprehensive framework of activities in which an institution may engage and is intended primarily for the protection of the FDIC's deposit insurance fund and depositors. Under this system of federal regulation, financial institutions are periodically examined to ensure that they satisfy applicable standards with respect to their capital adequacy, assets, management, earnings, liquidity and sensitivity to market interest rates. Lake Shore Savings also is a member of and owns stock in the Federal Home Loan Bank of New York, which is one of the twelve regional banks in the Federal Home Loan Bank System. Lake Shore Savings also is regulated, to a lesser extent, by the FDIC with respect to insurance of deposit accounts and the Federal Reserve Board, with respect to reserves to be maintained against deposits and other matters. Lake Shore Savings' relationship with its depositors and borrowers also is regulated to a great extent by both federal and state laws, especially in matters concerning the ownership of deposit accounts and the form and content of Lake Shore Savings' mortgage documents.

Any change in these laws or regulations, whether by the FDIC, the OCC, the Federal Reserve Board or Congress, could have a material adverse impact on Lake Shore, MHC, Lake Shore Bancorp and Lake Shore Savings and their operations.

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") made extensive changes in the regulation of federal savings banks such as the Bank. Under the Dodd-Frank Act, the Company's former regulator, the Office of Thrift Supervision ("OTS") was eliminated. Responsibility for the supervision and regulation of federal savings banks was transferred to the OCC, which is an agency that is responsible for the regulation and supervision of national banks. The OCC assumed responsibility for implementing and enforcing many of the laws and regulations applicable to federal savings banks. The transfer of regulatory functions became effective on July 21, 2011. At the same time, responsibility for the regulation and supervision of savings and loan holding companies, such as the Company was transferred to the Federal Reserve Board, which supervises bank holding companies.

Additionally, the Dodd-Frank Act created a new Consumer Financial Protection Bureau ("CFPB") as an independent bureau of the Federal Reserve Board. The CFPB assumes responsibility for the implementation of the federal financial consumer protection and fair lending laws and regulations, a function previously assigned to prudential regulators, and has authority to impose new requirements. However, institutions of less than $10 billion in assets, such as the Bank, will continue to be examined for compliance with consumer protection and fair lending laws and regulations by, and be subject to the enforcement authority of, their primarily regulator rather than the CFPB.

In addition to eliminating the OTS and creating the CFPB, the Dodd-Frank Act, among other things, directs changes in the way that institutions are assessed for deposit insurance, mandates the imposition of consolidated capital requirements on savings and loan holding companies, requires originators of securitized loans to retain a percentage of the risk for the transferred loans, regulates rate-setting for certain debit card interchange fees, repeals restrictions on the payment of interest on commercial demand deposits and contains a number of reforms related to mortgage originations. The Dodd-Frank Act increased shareholder influence over boards of directors by requesting companies to give shareholders a non-binding vote on executive compensation and so called "Golden Parachute" payments. The Dodd-Frank Act contained the so-called "Volcker Rule," which generally prohibits banking organizations from engaging in proprietary trading and from investing in, sponsoring or having certain relationships with hedge or private equity funds ("covered funds"). On December 13, 2013, federal agencies issued a final rule implementing the Volcker Rule which, among other things, requires banking organizations to restructure and limit certain of their investments in and relationships with covered funds. At this time, management expects that this rule will have a minimal impact on Lake Shore Savings, Lake Shore Bancorp and Lake Shore, MHC. In addition, the CFPB has finalized a rule implementing the "Ability to Pay" requirements of the Dodd-Frank Act. The regulations generally require creditors to make a reasonable, good faith determination as to a borrower's ability to repay most residential mortgage loans. The final rule establishes a safe harbor for certain "Qualified Mortgages," which contain certain features deemed less risky and omit certain other characteristics considered to enhance risk. The Ability to Repay final rules were effective January 1, 2014.

Some of the provisions of the Dodd-Frank Act are subject to delayed effective dates and/or require the issuance of implementing regulations. Their full impact on operations cannot yet be fully assessed. However, the Dodd-Frank Act has resulted in increased regulatory burden, compliance costs and interest expense for the Company.

Certain of the regulatory requirements that are or will be applicable to Lake Shore Savings, Lake Shore Bancorp and Lake Shore, MHC are described below. This description of statutes and regulations is not intended to be a complete explanation of such statutes and regulations and their effect on Lake Shore Savings, Lake Shore Bancorp and Lake Shore, MHC and is qualified in its entirety by reference to the actual statutes and regulations.

Federal Banking Regulation

Business Activities. A federal savings bank derives its lending and investment powers from the Home Owners' Loan Act, as amended, and the regulations of the OCC. Under these laws and regulations, Lake Shore Savings may originate mortgage loans secured by residential and commercial real estate, commercial business loans and consumer loans, and it may invest in certain types of debt securities and certain other assets. Certain types of lending, such as commercial real estate, commercial business and consumer loans, are subject to an aggregate limit calculated as a specified percentage of Lake Shore Savings' capital or assets. Specifically, Lake Shore Savings may invest in non-residential real estate loans which may not in the aggregate exceed 400% of capital, commercial business loans up to 20% of assets in the aggregate and consumer loans up to 35% of assets in the aggregate. Lake Shore Savings also may establish subsidiaries that may engage in activities not otherwise permissible for Lake Shore Savings, including real estate investment and securities and insurance brokerage.

Capital Requirements. For 2014, OCC regulations required savings banks to meet three minimum capital standards: a 1.5% tangible capital ratio, a 4% leverage ratio (3% for savings banks receiving the highest regulatory rating) and an 8% risk-based capital ratio. The prompt corrective action standards discussed below, in effect, established a minimum 2% tangible capital standard.

The risk-based capital standard for savings banks required the maintenance of Tier 1 (core) and total capital (which is defined as core capital and supplementary capital) to risk-weighted assets of at least 4% and 8%, respectively. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet assets, are multiplied by a risk-weight factor of 0% to 100% assigned by federal regulations based on the risks believed inherent in the type of asset. Core capital is defined as common stockholders' equity (including retained earnings but excluding accumulated other comprehensive income), certain noncumulative perpetual preferred stock and related surplus and minority interests in equity accounts of consolidated subsidiaries, less intangibles other than certain mortgage servicing rights and credit card relationships. The components of supplementary capital currently include cumulative preferred stock, long-term perpetual preferred stock, mandatory convertible securities, subordinated debt and intermediate preferred stock, the allowance for loan and lease losses limited to a maximum of 1.25% of risk-weighted assets and up to 45% of net unrealized gains on available-for-sale equity securities with readily determinable fair market values. Overall, the amount of supplementary capital included as part of total capital cannot exceed 100% of core capital. Additionally, a savings bank that retains credit risk in connection with an asset sale may be required to maintain additional regulatory capital because of the recourse back to the savings bank. In assessing an institution's capital adequacy, the federal regulators take into consideration not only these numeric factors but also qualitative factors as well, and has the authority to establish higher capital requirements for individual associations where necessary.

At December 31, 2014, Lake Shore Savings Bank's capital exceeded all applicable minimal capital requirements.

In July 2013, the federal banking agencies issued a final rule that revised the leverage and risk-based capital requirements and the method for calculating risk-weighted assets to make them consistent with the agreements that were reached by the Basel Committee on Banking Supervision in "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" ("Basel III") and the Dodd-Frank Act. Among other things, the rule establishes a new common equity Tier 1 minimum capital requirement (4.5% of risk-weighted assets), establishes a uniform minimum leverage ratio of 4%, increases the minimum Tier 1 capital to risk-weighted assets requirement (from 4% to 6% of risk-weighted assets), and assigns a higher risk weighting (150%) to exposures that are more than 90 days past due or are on non-accrual status and to certain commercial real estate facilities that finance the acquisition, development or construction of real property. The final rule also requires unrealized gains and losses on certain "available for sale" securities holdings to be included for purposes of calculating regulatory capital unless a one-time opt-out is exercised. Additional restraints will also be imposed on the inclusion in regulatory capital of mortgage-servicing assets, deferred tax assets and minority interests. The rule limits a banking organization's capital distributions and certain discretionary bonus payments if the banking organization does not hold a "capital conservation buffer" consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets in addition to the amount necessary to meet its minimum risk-based capital requirements. The final rule became effective for Lake Shore Savings Bank on January 1, 2015. The capital conservation buffer requirements will be phased in beginning January 1, 2016 and ending January 1, 2019, when the full capital conservation buffer requirement will be effective. At this time, management does not believe that the updated capital limits under this final rule will have a material impact on the capital of Lake Shore Savings Bank.

Loans to One Borrower. Generally, a federal savings bank may not make a loan or extend credit to a single or related group of borrowers in excess of 15% of unimpaired capital and surplus. An additional amount may be loaned, equal to 10% of unimpaired capital and surplus, if the loan is secured by readily marketable collateral, which generally does not include real estate. As of December 31, 2014, Lake Shore Savings' largest lending relationship with a single or related group of borrowers totaled $8.6 million, which represented 13.3% of unimpaired capital and surplus; therefore, Lake Shore Savings was in compliance with the loans-to-one borrower limitations.

Qualified Thrift Lender Test. As a federal savings bank, Lake Shore Savings is subject to a qualified thrift lender, or "QTL," test. Under the QTL test, Lake Shore Savings must maintain at least 65% of its "portfolio assets" in "qualified thrift investments" in at least nine months of the most recent 12-month period. "Portfolio assets" generally means total assets of a savings institution, less the sum of specified liquid assets up to 20% of total assets, goodwill and other intangible assets, and the value of property used in the conduct of the savings bank's business.

"Qualified thrift investments" includes various types of loans made for residential and housing purposes, investments related to such purposes, including certain mortgage-backed and related securities, and loans for personal, family, household and certain other purposes up to a limit of 20% of portfolio assets. "Qualified thrift investments" also include 100% of an institution's credit card loans, education loans and small business loans. Lake Shore Savings also may satisfy the QTL test by qualifying as a "domestic building and loan association" as defined in the Internal Revenue Code.

A savings bank that fails the QTL test must either convert to a commercial bank charter or operate under specified restrictions. The Dodd-Frank Act makes noncompliance with the QTL Test potentially subject to agency enforcement action for violation of law. At December 31, 2014, Lake Shore Savings maintained 77.00% of its portfolio assets in qualified thrift investments and, therefore, satisfied the QTL test.

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Capital Distributions. OCC regulations govern capital distributions by a federal savings bank, which include cash dividends, stock repurchases and other transactions charged to the capital account. A savings bank must file an application for approval of a capital distribution if:

- the total capital distributions for the applicable calendar year exceed the sum of the savings bank's net income for that year to date plus the savings bank's retained net income for the preceding two years;
- the savings bank would not be at least adequately capitalized following the distribution;
- the distribution would violate any applicable statute, regulation, agreement or OCC-imposed condition; or
- the savings bank is not eligible for expedited treatment of its filings.

Even if an application is not otherwise required, every savings bank that is a subsidiary of a holding company must still file a notice with the Federal Reserve Board at least 30 days before the board of directors declares a dividend or approves a capital distribution.

The Federal Reserve Board may disapprove a notice or application if:

- the savings bank would be undercapitalized following the distribution;
- the proposed capital distribution raises safety and soundness concerns; or
- the capital distribution would violate a prohibition contained in any statute, regulation or agreement.

In addition, the Federal Deposit Insurance Act provides that an insured depository institution shall not make any capital distribution if, after making such distribution, the institution would be undercapitalized.

Liquidity. A federal savings institution is required to maintain a sufficient amount of liquid assets to ensure its safe and sound operation. We seek to maintain a ratio of liquid assets not subject to pledge as a percentage of deposits and borrowings of 10% or greater. At December 31, 2014, this ratio was 39.7%.

Community Reinvestment Act and Fair Lending Laws. All savings banks have a responsibility under the Community Reinvestment Act and related regulations of the OCC to help meet the credit needs of their communities, including low-and moderate-income neighborhoods. In connection with its examination of a federal savings bank, the OCC is required to assess the savings bank's record of compliance with the Community Reinvestment Act. In addition, the Equal Credit Opportunity Act and the Fair Housing Act prohibit lenders from discriminating in their lending practices on the basis of characteristics specified in those statutes. A savings bank's failure to comply with the provisions of the Community Reinvestment Act could result in denial of certain corporate applications, such as branches or mergers, or in restrictions on its activities. The failure to comply with the Equal Credit Opportunity Act and the Fair Housing Act could result in enforcement actions by the OCC, as well as other federal regulatory agencies and the Department of Justice. Lake Shore Savings received a "satisfactory" Community Reinvestment Act rating in its most recent federal examination.

Transactions with Related Parties. A federal savings bank's authority to engage in transactions with its "affiliates" is limited by OCC regulations and by Sections 23A and 23B of the Federal Reserve Act. The term "affiliate" for these purposes generally means any company that controls, is controlled by, or is under common control with an insured depository institution such as Lake Shore Savings. Lake Shore Bancorp, Inc. and Lake Shore MHC are affiliates of Lake Shore Savings. In general, transactions with affiliates must be on terms that are as favorable to the savings bank as comparable transactions with non-affiliates. In addition, certain types of these transactions are restricted to an aggregate percentage of the savings bank's capital. Collateral in specified amounts must usually be provided by affiliates in order to receive loans from the

savings bank. In addition, OCC regulations prohibit a savings bank from lending to any of its affiliates that are engaged in activities that are not permissible for bank holding companies and from purchasing the securities of any affiliate, other than a subsidiary. Finally, transactions with affiliates must be consistent with safe and sound banking practices and may not involve low-quality assets. The OCC requires savings banks to maintain detailed records of all transactions with affiliates.

Lake Shore Savings' authority to extend credit to its directors, executive officers and 10% shareholders, as well as to entities controlled by such persons, is currently governed by the requirements of Sections 22(g) and 22(h) of the Federal Reserve Act and Regulation O of the Federal Reserve Board. Among other things, these provisions require that extensions of credit to insiders (i) be made on terms that are substantially the same as, and follow credit underwriting procedures that are not less stringent than, those prevailing for comparable transactions with unaffiliated persons and that do not involve more than the normal risk of repayment or present other unfavorable features, and (ii) not exceed certain limitations on the amount of credit extended to such persons, individually and in the aggregate, which limits are based, in part, on the amount of Lake Shore Savings' capital. In addition, Lake Shore Savings' board of directors must approve extensions of credit in excess of certain limits. Extensions of credit to executive officers are subject to additional restrictions based on the category of loan.

At December 31, 2014, Lake Shore Savings is in compliance with Regulation O.

Enforcement. The OCC has primary enforcement responsibility over federal savings institutions and has the authority to bring enforcement action against all "institution-affiliated parties," including stockholders, and attorneys, appraisers and accountants who knowingly or recklessly participate in wrongful action likely to have an adverse effect on an insured institution. Formal enforcement action may range from the issuance of a capital directive or cease and desist order, to removal of officers and/or directors of the institution and the appointment of a receiver or conservator. Civil penalties cover a wide range of violations and actions, and range up to $25,000 per day, unless a finding of reckless disregard is made, in which case penalties may be as high as $1.0 million per day. The FDIC also has the authority to recommend to the OCC that enforcement action be taken with respect to a particular savings institution. If the OCC does not take action, the FDIC has authority to take action under specified circumstances.

Standards for Safety and Soundness. Federal law requires each federal banking agency to prescribe certain standards for all insured depository institutions. These standards relate to, among other things, internal controls, information systems and audit systems, loan documentation, credit underwriting, interest rate risk exposure, asset growth, compensation, and other operational and managerial standards as the agency deems appropriate. The federal banking agencies adopted Interagency Guidelines Prescribing Standards for Safety and Soundness to implement the safety and soundness standards required under federal law. The guidelines set forth the safety and soundness standards that the federal banking agencies use to identify and address problems at insured depository institutions before capital becomes impaired. The guidelines address internal controls and information systems, internal audit systems, credit underwriting, loan documentation, interest rate risk exposure, asset growth, compensation, fees and benefits. If the appropriate federal banking agency determines that an institution fails to meet any standard prescribed by the guidelines, the agency may require the institution to submit to the agency an acceptable plan to achieve compliance with the standard. If an institution fails to meet these standards, the appropriate federal banking agency may require the institution to submit a compliance plan.

Prompt Corrective Action Regulations. Under the prompt corrective action regulations, the OCC is authorized to take supervisory actions against undercapitalized savings banks. For this purpose in 2014, a savings bank was placed in one of the following five categories based on the savings bank's capital:

- well-capitalized (at least 5% leverage capital, 6% Tier 1 risk-based capital and 10% total risk-based capital);

- adequately capitalized (at least 4% leverage capital, 4% Tier 1 risk-based capital and 8% total risk-based capital);

- undercapitalized (less than 4% leverage capital, 4% Tier 1 risk-based capital or 8% total risk-based capital);
- significantly undercapitalized (less than 3% leverage capital, 3% Tier 1 risk-based capital or 6% total risk-based capital); and
- critically undercapitalized (less than 2% tangible capital).

Generally, the OCC is required to appoint a receiver or conservator for a savings bank that is "critically undercapitalized" within specific time frames. "Undercapitalized" institutions are subject to certain restrictions, such as on capital distributions and growth. The regulations also provide that a capital restoration plan must be filed with the OCC within 45 days of the date a savings bank receives notice that it is "undercapitalized," "significantly undercapitalized" or "critically undercapitalized." Any holding company for the savings bank required to submit a capital restoration plan must guarantee the lesser of: an amount equal to 5% of the savings bank's assets at the time it was notified or deemed to be undercapitalized by the OCC, or the amount necessary to restore the savings bank to adequately capitalized status. This guarantee remains in place until the OCC notifies the savings bank that it has maintained adequately capitalized status for each of four consecutive calendar quarters. The OCC has the authority to require payment and collect payment under the guarantee. The failure of a holding company to provide the required guarantee will result in certain operating restrictions on the savings bank, such as restrictions on the ability to declare and pay dividends, pay executive compensation and management fees, and increase assets or expand operations. The OCC may also take any one of a number of discretionary supervisory actions against undercapitalized savings banks, including the issuance of a capital directive and the replacement of senior executive officers and directors.

At December 31, 2014, Lake Shore Savings met the criteria for being considered "well-capitalized." In connection with the final capital rule described earlier, the federal banking agencies have adopted amendments, effective January 1, 2015, to the prompt corrective action framework. The various categories have been revised to incorporate the new common equity Tier 1 capital requirement as well as the increases in the Tier 1 to risk-based assets requirement and other revisions.

Insurance of Deposit Accounts. Lake Shore Savings is a member of the Deposit Insurance Fund, which is administered by the FDIC. Deposit accounts in the Bank are insured by the FDIC. The Dodd-Frank Act permanently increased the maximum amount of deposit insurance for banks and savings institutions to $250,000 per depositor. The FDIC imposes an assessment for deposit insurance on all depository institutions. Under the FDIC's risk-based assessment system, insured institutions are assigned to risk categories based on supervisory evaluations, regulatory capital levels and certain other factors. An institution's assessment rate depends upon the category to which it is assigned and certain adjustments specified by FDIC regulations, with institutions deemed less risky paying lower rates. Assessment rates (inclusive of possible adjustments) currently range from 2 ½ to 45 basis points of each institution's total assets less tangible capital. The FDIC may increase or decrease the scale uniformly, except that no adjustment can deviate more than two basis points from the base scale without notice and comment rulemaking. The FDIC's current system represents a change, as required by the Dodd-Frank Act, from its prior practice of basing the assessment on an institution's volume of deposits.

The Dodd-Frank Act increased the minimum target Deposit Insurance Fund ratio from 1.15% of estimated insured deposits to 1.35% of estimated insured deposits. The FDIC must seek to achieve the 1.35% ratio by September 30, 2020. Insured institutions with assets of $10 billion or more are supposed to fund the increase. The Dodd-Frank Act eliminated the 1.5% maximum fund ratio, instead leaving it to the discretion of the FDIC and the FDIC has exercised that discretion by establishing a long term fund ratio of 2%.

The FDIC has authority to increase insurance assessments. Any significant increases would have an adverse effect on the operating expenses and results of operations of Lake Shore Savings. Management cannot predict what assessment rates will be in the future.

Insurance of deposits may be terminated by the FDIC upon a finding that an institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC. We do not currently know of any practice, condition or violation that may lead to termination of our deposit insurance.

In addition to the FDIC assessments, the Financing Corporation ("FICO") is authorized to impose and collect, with the approval of the FDIC, assessments for anticipated payments, issuance costs and custodial fees on bonds issued by the FICO in the 1980s to recapitalize the former Federal Savings and Loan Insurance Corporation. The bonds issued by the FICO are due to mature in 2017 through 2019. For the quarter ended December 31, 2014, the annualized FICO assessment was equal to 0.62 basis points of total assets less tangible capital.

Prohibitions Against Tying Arrangements. Federal savings banks are prohibited, subject to some exceptions, from extending credit to or offering any other service, or fixing or varying the consideration for such extension of credit or service, on the condition that the customer obtain some additional service from the institution or its affiliates or not obtain services of a competitor of the institution.

Federal Home Loan Bank System. Lake Shore Savings is a member of the Federal Home Loan Bank System, which consists of twelve regional Federal Home Loan Banks. The Federal Home Loan Bank System provides a central credit facility primarily for member institutions. As a member of the Federal Home Loan Bank of New York, Lake Shore Savings is required to acquire and hold shares of capital stock in the Federal Home Loan Bank. As of December 31, 2014, Lake Shore Savings was in compliance with this requirement.

Other Regulations

Interest and other charges collected or contracted for by Lake Shore Savings are subject to state usury laws and federal laws concerning interest rates. Lake Shore Savings' operations are also subject to federal laws applicable to credit transactions, such as the:

- Truth-In-Lending Act, governing disclosures of credit terms to consumer borrowers;
- Real Estate Settlement Procedures Act, requiring that borrowers for one- to four-family residential real estate loans receive various disclosures, including good faith estimates of settlement costs, lender servicing and escrow account practices;
- Home Mortgage Disclosure Act, requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves;
- Equal Credit Opportunity Act, prohibiting discrimination on the basis of race, creed or other prohibited factors in extending credit;
- Fair Credit Reporting Act, governing the use and provision of information to credit reporting agencies;
- Fair Debt Collection Act, governing the manner in which consumer debts may be collected by collection agencies;
- Truth in Savings Act; and
- rules and regulations of the various federal agencies charged with the responsibility of implementing such federal laws.

The operations of Lake Shore Savings also are subject to the:

- Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;
- Electronic Funds Transfer Act and Regulation E promulgated thereunder, which govern automatic deposits to and withdrawals from deposit accounts and customers' rights and liabilities arising from the use of automated teller machines and other electronic banking services;
- Check Clearing for the 21st Century Act (also known as "Check 21"), which gives "substitute checks," such as digital check images and copies made from that image, the same legal standing as the original paper check;
- Title III of The Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (referred to as the "USA PATRIOT Act"), which requires savings banks to, among other things, establish broadened anti-money laundering compliance programs, due diligence policies and controls to ensure the detection and reporting of money laundering. Such required compliance programs are intended to supplement existing compliance requirements, also applicable to financial institutions, under the Bank Secrecy Act and the Office of Foreign Assets Control Regulations; and
- The Gramm-Leach-Bliley Act, which places limitations on the sharing of consumer financial information by financial institutions with unaffiliated third parties. Specifically, the Gramm-Leach-Bliley Act requires all financial institutions offering financial products or services to retail customers to provide such customers with the financial institution's privacy policy and provide such customers the opportunity to "opt out" of the sharing of certain personal financial information with unaffiliated third parties.

Holding Company Regulation

General. Lake Shore, MHC and Lake Shore Bancorp are savings and loan holding companies within the meaning of the Home Owners' Loan Act. As such, Lake Shore, MHC and Lake Shore Bancorp are registered with the Federal Reserve Board and are subject to Federal Reserve Board regulations, examinations, supervision and reporting requirements. In addition, the Federal Reserve Board has enforcement authority over Lake Shore, MHC and Lake Shore Bancorp, and their subsidiaries. Among other things, this authority permits the Federal Reserve Board to restrict or prohibit activities that are determined to be a serious risk to the subsidiary savings institution. As federal corporations, Lake Shore, MHC and Lake Shore Bancorp are generally not subject to state business organization laws.

Permitted Activities. Pursuant to Section 10(o) of the Home Owners' Loan Act and Federal Reserve Board regulations and policy, a mutual holding company and a federally chartered mid-tier holding company such as Lake Shore Bancorp may engage in the following activities:

(i)investing in the stock of a savings institution;

(ii)acquiring a mutual savings bank through the merger of such savings institution into a savings institution subsidiary of such holding company or an interim savings bank subsidiary of such holding company;

(iii)merging with or acquiring another holding company, one of whose subsidiaries is a savings institution;

(iv)investing in a corporation, the capital stock of which is available for purchase by a savings institution under federal law or under the law of any state where the subsidiary savings institution or savings institutions share their home offices;

(v)furnishing or performing management services for a savings institution subsidiary of such company;

(vi)holding, managing or liquidating assets owned or acquired from a savings subsidiary of such company;

(vii)holding or managing properties used or occupied by a savings institution subsidiary of such company;

(viii)acting as trustee under deeds of trust;

(ix)any other activity (A) that the Federal Reserve Board, by regulation, has determined to be permissible for bank holding companies under Section 4(c) of the Bank Holding Company Act of 1956, unless the Federal Reserve Board, by regulation, prohibits or limits any such activity for savings and loan holding companies; or (B) in which multiple savings and loan holding companies were authorized (by regulation) to directly engage on March 5, 1987;

(x)any activity permissible for financial holding companies (if such status is elected by the Company) under Section 4(k) of the Bank Holding Company Act, including securities and insurance underwriting; and

(xi)purchasing, holding, or disposing of stock acquired in connection with a qualified stock issuance if the purchase of such stock by such savings and loan holding company is approved by the Federal Reserve Board. If a mutual holding company acquires or merges with another holding company, the holding company acquired or the holding company resulting from such merger or acquisition may only invest in assets and engage in activities listed in (i) through (xi) above, and has a period of two years to cease any nonconforming activities and divest of any nonconforming investments.

The Home Owners' Loan Act prohibits a savings and loan holding company, including Lake Shore Bancorp and Lake Shore, MHC, directly or indirectly, or through one or more subsidiaries, from acquiring more than 5% of another savings institution or holding company thereof, without prior written approval of the Federal Reserve Board. It also prohibits the acquisition or retention of, with certain exceptions, more than 5% of a non-subsidiary company engaged in activities other than those permitted by the Home Owners' Loan Act; or acquiring or retaining control of an institution that is not federally insured. In evaluating applications by holding companies to acquire savings institutions, the Federal Reserve Board must consider the financial and managerial resources, future prospects of the company and institution involved, the effect of the acquisition on the risk to the insurance fund, the convenience and needs of the community and competitive factors.

The Federal Reserve Board is prohibited from approving any acquisition that would result in a multiple savings and loan holding company controlling savings institutions in more than one state, subject to two exceptions: (i) the approval of interstate supervisory acquisitions by savings and loan holding companies, and (ii) the acquisition of a savings institution in another state if the laws of the state of the target savings institution specifically permit such acquisitions.

The states vary in the extent to which they permit interstate savings and loan holding company acquisitions.

Capital. Historically, savings and loan holding companies have not been subject to regulatory capital requirements. The Dodd-Frank Act, however, requires the Federal Reserve Board to promulgate consolidated capital requirements for depository institution holding companies that are no less stringent, both quantitatively and in terms of components of capital, than those applicable to institutions themselves. Instruments such as cumulative preferred stock and trust-preferred securities, which are currently includable within Tier 1 capital by bank holding companies within certain limits, would no longer be includable as Tier 1 capital, subject to certain grandfathering. The previously discussed final rule regarding regulatory capital requirements implements the Dodd-Frank Act as to savings and loan holding companies. Consolidated regulatory capital

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requirements identical to those applicable to the subsidiary savings bank will apply to savings and loan holding companies with $1 billion or more in total consolidated assets as of January 1, 2015. As is the case with the savings bank subsidiary, the capital conservation buffer requirement will be phased in between 2016 and 2019. Legislation was enacted in December 2014 which requires the Federal Reserve Board to amend its "Small Bank Holding Company" Policy Statement to extend the applicability to bank and savings and loan holding companies of up to $1 billion in assets. That will exempt such holding companies from the consolidated holding company capital requirements. Although the Company is currently within the asset size threshold, it is uncertain when the Federal Reserve Board will act and whether the Company would qualify for the exemption under other conditions that may apply.

Source of Strength. The Dodd-Frank Act extends the "source of strength" doctrine to savings and loan holding companies. The Federal Reserve Board has promulgated regulations implementing the "source of strength" policy that requires holding companies act as a source of strength to their subsidiary depository institutions by providing capital, liquidity and other support in times of financial stress. Federal Reserve Board policies also provide that holding companies should pay dividends only out of current earnings and only if the prospective rate of earnings retention by the holding company appears consistent with the organization's capital needs, asset quality and overall financial condition. These policies may affect the ability of a savings and loan holding company to pay dividends or otherwise make capital distribution.

Waivers of Dividends by Lake Shore, MHC. The Dodd-Frank Act requires federally-chartered mutual holding companies to give the Federal Reserve Board notice before waiving the receipt of dividends, and provides that in the case of "grandfathered" mutual holding companies, like Lake Shore, MHC, the Federal Reserve Board "may not object" to a dividend waiver if the board of directors of the mutual holding company waiving dividends determines that the waiver: (i) would not be detrimental to the safe and sound operation of the subsidiary savings bank; and (ii) is consistent with the board's fiduciary duties to members of the mutual holding company. To qualify as a grandfathered mutual holding company, a mutual holding company must have been formed, issued stock and waived dividends prior to December 1, 2009. Lake Shore, MHC qualifies as a grandfathered mutual holding company. The Dodd-Frank Act further provides that the Federal Reserve Board may not consider waived dividends in determining an appropriate exchange ratio upon the conversion of a grandfathered mutual holding company to stock form. In September 2011, however, the Federal Reserve Board issued an interim final rule that also requires, as a condition to waiving dividends, that each mutual holding company obtain the approval of a majority of the eligible votes of its members within 12 months prior to the declaration of the dividend being waived. Lake Shore, MHC solicited its members to vote on the proposal to waive dividends and on February 4, 2015, the members approved the waiver of dividends. The Board of Directors of Lake Shore, MHC subsequently approved a dividend waiver in accordance with the regulations and submitted it to the Federal Reserve Board for their non-objection. As of March 3, 2015, Lake Shore, MHC received the non-objection of the Federal Reserve Board to waive its right to receive dividends paid by the Company during the twelve months ending February 3, 2016. It is expected that Lake Shore, MHC will continue to waive future dividends, except to the extent dividends are needed to fund Lake Shore, MHC's continuing operations, subject to the ability of Lake Shore, MHC to obtain regulatory approval of its requests to waive dividends and its ability to obtain future member approval of dividend waivers. For more information, see Item 1A, "Risk Factors – Our ability to pay dividends is subject to the ability of Lake Shore Savings to make capital distributions to Lake Shore Bancorp and the waiver of dividends by Lake Shore, MHC."

Conversion of Lake Shore, MHC to Stock Form. Federal Reserve Board regulations permit Lake Shore, MHC to convert from the mutual form of organization to the capital stock form of organization (a "Conversion Transaction"). There can be no assurance when, if ever, a Conversion Transaction will occur, and the board of directors has no current intention or plan to undertake a Conversion Transaction. In a Conversion Transaction, a new holding company would be formed as the successor to Lake Shore Bancorp (the "New Holding Company"), Lake Shore, MHC's corporate existence would end, and certain depositors of Lake Shore Savings Bank would receive the right to subscribe for shares of the New Holding Company. In a Conversion Transaction, each share of common stock held by stockholders other than Lake Shore, MHC (“Minority Stockholders”) would be automatically converted into a number of shares of common stock of the New Holding Company determined pursuant to an exchange ratio that ensures that Minority Stockholders own the same percentage of common stock in the New Holding Company as they owned in Lake Shore Bancorp immediately prior to the Conversion Transaction. The total number of shares of common stock held by Minority Stockholders after a Conversion Transaction also would be increased by any purchases by Minority Stockholders in the stock offering conducted as part of the Conversion Transaction.

Any Conversion Transaction would be subject to approvals by Minority Stockholders and members of Lake Shore, MHC.

Liquidation Rights. Each depositor of Lake Shore Savings has both a deposit account in Lake Shore Savings and a pro rata ownership interest in the net worth of Lake Shore, MHC based upon the deposit balance in his or her account. This ownership interest is tied to the depositor's account and has no tangible market value separate from the deposit account. This interest may only be realized in the unlikely event of a complete liquidation of Lake Shore Savings. Any depositor who opens a deposit account obtains a pro rata ownership interest in Lake Shore, MHC without any additional payment beyond the amount of the deposit. A depositor who reduces or closes his or her account (including reductions to pay for shares of common stock in the stock offering) receives a portion or all, respectively, of the balance in the deposit account but nothing for his or her ownership interest in the net worth of Lake Shore, MHC, which is lost to the extent that the balance in the account is reduced or closed.

In the unlikely event of a complete liquidation of Lake Shore Savings, all claims of creditors of Lake Shore Savings, including those of depositors of Lake Shore Savings (to the extent of their deposit balances), would be paid first. Thereafter, if there were any assets of Lake Shore Savings remaining, these assets would be distributed to Lake Shore Bancorp as Lake Shore Savings' sole stockholder. Then, if there were any assets of Lake Shore Bancorp remaining, depositors of Lake Shore Savings would receive those remaining assets, pro rata, based upon the deposit balances in their deposit account in Lake Shore Savings immediately prior to liquidation.

Federal Securities Laws

Lake Shore Bancorp common stock is registered with the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended. Lake Shore Bancorp is subject to the information, proxy solicitation, insider trading restrictions and other requirements under the Securities Exchange Act of 1934.

The registration under the Securities Act of 1933 of shares of the common stock in the stock offering does not cover the resale of the shares. Shares of the common stock purchased by persons who are not affiliates of Lake Shore Bancorp may be resold without registration. Shares purchased by an affiliate of Lake Shore Bancorp will be subject to the resale restrictions of Rule 144 under the Securities Act of 1933. If Lake Shore Bancorp meets the current public information requirements of Rule 144 under the Securities Act of 1933, each affiliate of Lake Shore Bancorp who complies with the other conditions of Rule 144, including those that require the affiliate's sale to be aggregated with those of other persons, would be able to sell in the public market, without registration, a number of shares not to exceed, in any three month period, the greater of 1% of the outstanding shares of Lake Shore Bancorp, or the average weekly volume of trading in the shares during the preceding four calendar weeks. Provision may be made in the future by Lake Shore Bancorp to permit affiliates to have their shares registered for sale under the Securities Act of 1933.

Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 addresses, among other issues, corporate governance, auditing and accounting, executive compensation, and enhanced and timely disclosure of corporate information. As directed by the

Sarbanes-Oxley Act, the Chief Executive Officer and Chief Financial Officer are required to certify that its quarterly and annual reports do not contain any untrue statement of a material fact. The rules adopted by the Securities and Exchange Commission under the Sarbanes-Oxley Act have several requirements, including having these officers certify that: they are responsible for establishing, maintaining and regularly evaluating the effectiveness of internal control over financial reporting; they have made certain disclosures to its auditors and the audit/risk committee of the Board of Directors about internal control over financial reporting; and they have included information in the quarterly and annual reports about their evaluation and whether there have been changes in internal control over financial reporting or in other factors that could materially affect internal control over financial reporting.

Item 1A. Risk Factors.

Risks Related To Our Business

Our loan portfolio includes loans with a higher risk of loss. We originate commercial real estate loans, commercial business loans, consumer loans, and residential real estate loans (including home equity loans) primarily within our market area. Commercial real estate, commercial business, and consumer loans, which comprised in the aggregate 29.3% of our total loan portfolio at December 31, 2014, may expose a lender to greater credit risk than loans secured by residential real estate because the collateral securing these loans may not be sold as easily as residential real estate. In addition, commercial real estate and commercial business loans may also involve relatively large loan balances to individual borrowers or groups of borrowers. These loans also have greater credit risk than residential real estate for the following reasons:

- Commercial Real Estate Loans. Repayment is dependent upon income being generated in amounts sufficient to cover operating expenses and debt service.
- Commercial Business Loans. Repayment is generally dependent upon the successful operation of the borrower’s business.
- Consumer Loans. Consumer loans (such as personal lines of credit) may or may not be collateralized with assets that provide an adequate source of payment for the loan due to depreciation, damage, or loss.

Deterioration or minimal improvement in economic conditions in our market area could affect the performance of our loan portfolio. Higher prices for businesses and consumers and high unemployment could negatively affect our loan portfolio, if business owners or consumers are not able to make loan payments. As a result of the economic downturn in recent years, we have noticed an increase in our delinquent loans. Any further downturn in the real estate market or our national or local economy could adversely affect the value of the properties securing the loans or revenues from the borrower’s business thereby increasing the risk of non-performing loans.

If our allowance for loan losses is not sufficient to cover actual loan losses, our earnings could decrease. Our loan customers may not repay their loans according to their terms and the collateral securing the payment of these loans may be insufficient to pay any remaining loan balance. We therefore may experience significant loan losses, which could have a material adverse effect on our operating results. A downturn in the real estate market or the local economy could exacerbate this risk. We review our allowance for loan losses on a monthly basis to ensure that it is funded adequately to cover any anticipated losses.

Material additions to our allowance for loan losses also would materially decrease our net income, and the charge-off of loans may cause us to increase the allowance for loan losses. Our provision for loan losses in 2014 was $222,000, a $117,000, or 111.4%, increase over 2013, partially due to an increase in the size of our commercial loan portfolio by $10.3 million from December 31, 2013 and increases in classified real estate and commercial loans. We make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. We rely on our loan quality reviews, our experience and our evaluation of economic conditions, among other factors, in determining the amount of the allowance for loan losses. If our assumptions prove to be incorrect, our allowance for loan losses may not be sufficient to cover losses inherent in our loan portfolio, resulting in additions to our allowance. The increased focus on commercial loan originations has been one of the more significant factors we have taken into account in evaluating our allowance for loan losses and provision for loan losses. If we were to further increase the amount of commercial loans in our portfolio, we may decide to make increased provisions for loan losses. In addition, bank regulators periodically review our allowance for loan losses and may require us to increase our provision for loan losses or recognize further loan charge-offs, which may have a material adverse effect on our financial condition and results of operations.

Low demand for real estate loans may lower our profitability. Making loans secured by real estate, including one- to four-family and commercial real estate, is our primary business and primary source of revenue. If customer demand for real estate loans decreases, our profits may decrease because our alternative investments, primarily securities, generally earn less income than real estate loans. Customer demand for loans secured by real estate could be reduced due to weaker economic conditions, an increase in unemployment, a decrease in real estate values or an increase in interest rates. Interest rates on deposit products steadily declined between 2008 and 2012 at a greater pace than the rate decline on loan products, resulting in a positive net interest margin during that time period. Furthermore, we experienced commercial loan growth during 2010 through 2014, especially in the Erie County market area, which had a positive impact on net interest income. However, loan demand for retail customers slowed down during 2010 through 2014, which resulted in decreasing loan interest income. If rates begin to rise, loan demand may continue to be low, and deposit expenses may increase, which could lower our profitability.

We have opened new branches and expect to open additional new branches in the near future. Opening new branches reduces our short-term profitability due to one-time fixed expenses coupled with low levels of income earned by the branches until their customer bases are built. We opened a new branch in Snyder, New York during the second quarter of 2013. In addition, we may continue to expand through de novo branching. The expense associated with building and staffing new branches will significantly increase our non-interest expense, with compensation and occupancy costs constituting the largest amount of increased costs. Losses are expected from new branches for some time as the expenses associated with it are largely fixed and typically greater than the income earned as a branch builds up its customer base. Our management has projected that it will take approximately 24 to 36 months for new branches to become profitable after they have opened. There can be no assurance that our branch expansion strategy will result in increased earnings, or that it will result in increased earnings within a reasonable period of time. We expect that the success of our branching strategy will depend largely on the ability of our staff to market the deposit and loan products offered by us. The probability of opening a new branch will depend on available site locations, as well on the economic environment and projected demand in targeted market areas.

The results of our operations may be adversely affected if asset valuations cause other-than-temporary impairment charges. In 2013 and 2012, the Company determined that one private-label asset backed security was other than temporary impaired and had a non-cash, pre-tax, impairment charge of $180,000 and $102,000, respectively. We may be required to record future impairment charges on our investment securities or other assets if they suffer declines in value that are considered other-than-temporary. Numerous factors, including lack of liquidity for re-sales of certain investment securities, absence of reliable pricing information for investment securities, adverse changes in business climate, adverse actions by regulators, or unanticipated changes in the competitive environment could have a negative effect on our investment portfolio or other assets in future periods. If an impairment charge is significant enough it could have a material adverse effect on the Company’s liquidity, its ability to pay dividends to shareholders, and its regulatory capital ratios.

Changes in interest rates could adversely affect our results of operations and financial condition. Our results of operations and financial condition are significantly affected by changes in interest rates. We derive our income mainly from the difference or “spread” between the interest earned on loans, securities and other interest-earning assets and interest paid on deposits, borrowings and other interest-bearing liabilities. In general, the larger the spread, the more we earn. When market rates of interest change, the interest we receive on our assets and the interest we pay on our liabilities will fluctuate. This can cause decreases in our spread and can adversely affect our income.

From an interest rate risk perspective, we have generally been liability sensitive, which indicates that our liabilities generally re-price faster than assets. In response to negative economic developments, the Federal Reserve Board’s

Open Market Committee steadily reduced its federal funds rate target and has continued to maintain the Fed Funds rate at 0.00%-0.25% for more than six years, which has had the effect of reducing our cost of funds. Given our historic liability sensitivity, the decline in our cost of funds initially outpaced the decline in yield on our interest earning assets thereby having a positive impact on our net interest rate spread and net interest margin. However, in 2014, the rate of reduction in our cost of interest-bearing liabilities slowed in relation to the continuing decline in the yield on our interest-earning assets. Consequently, our net interest rate spread decreased by 13 basis points to 3.06% for the year ended December 31, 2014 from 3.19% for the year ended December 31, 2013. Our net interest margin declined 13 basis points to 3.21% for the year ended December 31, 2014 from 3.34% for the year ended December 31, 2013.

We continue to be at risk of additional reductions in our net interest rate spread and net interest margin resulting from further declines in our yield on interest earning assets that may outpace any subsequent reductions in our cost of funds. In particular, our ability to further reduce the cost of our interest-bearing deposits is increasingly limited given that most deposit offering rates are already well below 1.00% at December 31, 2014. Moreover, our liability sensitivity may adversely affect net income in the future when market interest rates ultimately increase from historical lows and our cost of interest-bearing liabilities rises faster than our yield on interest-earning assets.

Interest rates also affect how much money we lend. For example, when interest rates rise, the cost of borrowing increases resulting in a decrease in loan demand. As rates rise, we expect loan applications to decrease, prepayment speeds on loans and mortgage-backed securities to slowdown and the interest rate on our loan portfolio to remain static. Therefore, in an increasing rate environment, our cost of funds is expected to increase more rapidly than the yields earned on our loan portfolio and securities portfolio. An increasing rate environment is expected to cause a decrease in our net interest rate spread and a decrease in our earnings.

Changes in market interest rates could also reduce the value of our interest-earning assets including, but not limited to, our securities portfolio. In particular, the unrealized gains and losses on securities available for sale are reported, net of tax, in accumulated other comprehensive income which is a component of stockholders' equity. As such, declines in the fair value of such securities resulting from increases in market interest rates may adversely affect stockholders' equity.

In order to mitigate the effect of a rising interest rate environment, the Bank's Asset-Liability Committee is continuing to review its options in relation to shortening the term of interest earning assets, increasing short term investments in liquid assets to take advantage of rising rates, increasing core deposit growth, implementation of new products, promotion of adjustable rate commercial loan products and use of derivative products.

We depend on our executive officers and key personnel to implement our business strategy and could be harmed by the loss of their services. We believe that our growth and future success will depend in large part upon the skills of our management team. The competition for qualified personnel in the financial services industry is intense, and the loss of our key personnel or an inability to continue to attract, retain and motivate key personnel could adversely affect our business. We cannot assure you that we will be able to retain our existing key personnel or attract additional qualified personnel. Although we have an employment agreement with our President and Chief Executive Officer, that contains a non-compete provision, the loss of the services of one or more of our executive officers and key personnel could impair our ability to continue to develop our business strategy.

Our information systems may experience an interruption or breach in security. We rely heavily on communications and information systems to conduct our business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in our customer accounts, general ledger, deposit, loan and other systems. There have been increasing efforts to breach data security at financial institutions through cyber attacks. Recently, there have been several instances involving financial services and consumer-based companies reporting the unauthorized disclosure of customer information or the destruction or theft of corporate data. We may be unable to proactively address these types of security breaches or to implement adequate preventative measures because the techniques used to cause these breaches change frequently, often are not recognized until launched against a target and may originate from less regulated and remote areas throughout the world. While we have policies and procedures designed to prevent or limit the effect of the possible failure, interruption or security breach of our information systems, there can be no assurance that any such failure, interruption or security breach will not occur or, if any does occur, that it will be adequately addressed. Additionally, we outsource our data processing to third parties. If the third party provider encounters difficulties or if we have difficulty in communicating with such third party, it will significantly affect our ability to adequately process and account for customer transactions, which would significantly affect our business operations. Furthermore, breaches of such third party's technology may also cause reimbursable loss to our consumer and business customers, through no fault of our own. Fraud attacks targeting customer-controlled devices, plastic payment card terminals, and merchant data collection points provide another source of potential loss, again through no fault of our own. The occurrence of any failures, interruptions or security breaches of information systems used to process customer transactions could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our financial condition, results of operations and cash flows. The Company maintains a system of internal controls to mitigate such occurrences and maintains insurance coverage for exposures that are insurable. The Company regularly tests internal controls to ensure that they are appropriate and functioning as designed.

We continually encounter technological change. The financial services industry is continually undergoing rapid technological change with frequent introductions of new technology-driven products and services. The effective use of technology increases efficiency and enables financial institutions to better serve customers and to reduce costs. Our future success depends, in part, upon our ability to address the needs of our customers by using technology to provide products and services that will satisfy customer demands, as well as to create additional efficiencies in our operations. Our largest competitors have substantially greater resources to invest in technological improvements. We may not be able to effectively implement new technology-driven products and services or be successful in marketing these products and services to our customers. Failure to successfully keep pace with technological change affecting the financial services industry could have a material adverse effect on us.

Our ability to grow may be limited. We intend to seek to expand our banking franchise, organically and by acquiring other financial institutions or branches and other financial service providers if the right opportunity occurs. However, we have no specific plans for expansion or acquisitions at this time. Our ability to grow through selective acquisitions of other financial institutions or branches will depend on successfully identifying, acquiring and integrating those institutions or branches. We cannot assure you that we will be able to generate organic growth or identify attractive acquisition candidates, make acquisitions on favorable terms or successfully integrate any acquired institutions or branches.

If we fail to maintain an effective system of internal control over financial reporting, we may not be able to accurately report our financial results or prevent fraud, and, as a result, investors and depositors could lose confidence in our financial reporting, which could adversely affect our business, the trading price of our stock and our ability to attract additional deposits. Section 404 of the Sarbanes-Oxley Act of 2002 (the "Sarbanes-Oxley Act") and the rules and regulations of the Securities and Exchange Commission (the "SEC"), requires us to evaluate our internal control over financial reporting and provide an annual management report on our internal control over financial reporting, including, among other matters, management's assessment of the effectiveness of internal control over financial reporting. If we fail to identify and correct any significant deficiencies in the design or operating effectiveness of our internal control over financial reporting or fail to prevent fraud, current and potential shareholders and depositors could lose confidence in our financial reporting, which could adversely affect our business, financial condition and results of operations, the trading price of our stock and our ability to attract additional deposits.

Our risk management framework may not be effective in mitigating risk and reducing the potential for significant losses. Our risk management framework is designed to minimize risk and loss to us. We seek to identify, measure, monitor, report and control our exposure to risk, including strategic, market, liquidity, compliance and operational risks. While we use a diverse set of risk monitoring and mitigation techniques, these techniques are inherently limited because they cannot anticipate the existence or future development of currently unanticipated or unknown risks. Recent economic conditions and heightened legislative and regulatory scrutiny of the financial services industry, among other developments, have increased our level of risk. Accordingly, we could suffer losses as a result of our failure to properly anticipate and manage these risks.

Public Shareholders Do Not Exercise Voting Control Over Us.A majority of our voting stock is owned by Lake Shore, MHC. Lake Shore, MHC is controlled by its board of directors, who consist of those persons who are members of the board of directors of Lake Shore Bancorp and Lake Shore Savings. Lake Shore, MHC will determine the outcome of the election of the board of directors of Lake Shore Bancorp, and, as a general matter, controls the outcome of all matters presented to the shareholders of Lake Shore Bancorp for resolution by vote, except for matters that require a vote greater than Lake Shore, MHC's ownership interest. Consequently, Lake Shore, MHC, acting through its board of directors, is able to control the business and operations of Lake Shore Bancorp and may be able to prevent any challenge to the ownership or control of Lake Shore Bancorp by shareholders other than Lake Shore, MHC. There is no assurance that Lake Shore, MHC will not take actions that the public shareholders believe are against their interests.

Risks Related To Recent Developments And The Banking Industry Generally

Financial reform legislation has, among other things, eliminated the Office of Thrift Supervision, tightened capital standards and created a new Consumer Financial Protection Bureau, and will result in new laws and regulations that are expected to increase our costs of operations. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting the implementing rules and regulations, and consequently many of the details and much of the impact of the Dodd-Frank Act may not be known for many months or years.

Among other things, as a result of the Dodd-Frank Act:

- the OCC became the primary federal regulator for federal savings banks such as Lake Shore Savings (replacing the Office of Thrift Supervision), and the Federal Reserve Board now supervises and regulates all savings and loan holding companies that were formerly regulated by the Office of Thrift Supervision, including the Company and the MHC;
- the federal prohibition on paying interest on commercial demand deposits has been eliminated, thus allowing businesses to have interest-bearing checking accounts. This change has increased our interest expense;
- the Federal Reserve Board is required to set minimum capital levels for depository institution holding companies that are as stringent as those required for their insured depository subsidiaries, and the components of Tier 1 capital are required to be restricted to capital instruments that are currently considered to be Tier 1 capital for insured depository institutions. The new capital rule for savings and loan holding companies will take effect on January 1, 2015. The Federal Reserve has proposed a new rule that would exempt certain savings and loan holding companies with less than $1.0 billion in assets. See "Supervision and Regulation – Holding Company Regulation – Capital;"
- the federal banking regulators are required to implement new leverage and capital requirements that take into account off-balance sheet activities and other risks, including risks relating to securitized products and derivatives;
- a new CFPB has been established, which has broad powers to supervise and enforce consumer protection laws. The CFPB has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions, including the authority to prohibit "unfair, deceptive or abusive" acts and practices. The CFPB has examination and enforcement authority over all banks and savings institutions with more than $10 billion in assets. Banks and

savings institutions with $10 billion or less in assets, like Lake Shore Savings, will be examined by their applicable bank regulators; and

- federal preemption rules that have been applicable for national banks and federal savings banks have been weakened, and state attorneys general have the ability to enforce federal consumer protection laws.

In addition to the risks noted above, we expect that our operating and compliance costs, and possibly our interest expense, will increase as a result of the Dodd-Frank Act and the implementing rules and regulations. The need to comply with additional rules and regulations, as well as state laws and regulations to which we were not previously subject, will also divert management’s time from managing our operations. Higher capital levels could reduce our ability to grow and decrease our interest-earning assets which would adversely affect our return on stockholders’ equity.

Our ability to pay dividends is subject to the ability of Lake Shore Savings to make capital distributions to Lake Shore Bancorp and the waiver of dividends by Lake Shore, MHC. The value of Lake Shore Bancorp’s common stock is significantly affected by our ability to pay dividends to our public shareholders. Our long-term ability to pay dividends to our shareholders is based primarily upon the ability of the Bank to make capital distributions to Lake Shore Bancorp, and also to the availability of cash at the holding company level in the event earnings are not sufficient to pay dividends. Under OCC safe harbor regulations, the Bank may distribute to Lake Shore Bancorp capital in an amount not exceeding net income for the current calendar year and the prior two calendar years. Our ability to pay dividends and the amount of such dividends is also affected by the ability of Lake Shore, MHC, our mutual holding company and majority shareholder of Lake Shore Bancorp, to waive the receipt of dividends declared by Lake Shore Bancorp. Lake Shore, MHC waived its right to receive most of its dividends on its shares of Lake Shore Bancorp since its inception in 2006, with the exception of two dividends declared in 2012 and part of a dividend declared in 2011. The ability to waive dividends meant that Lake Shore Bancorp had more cash resources to pay dividends to its public shareholders than if Lake Shore, MHC accepted such dividends. Lake Shore, MHC is now required to obtain a waiver from the Federal Reserve Board allowing it to waive its right to dividends.

The Federal Reserve Board in 2011 issued regulations that govern the activities of Lake Shore Bancorp and Lake Shore, MHC and the regulations were implemented in the fourth quarter of 2011. Under Section 239.8(d) of the Federal Reserve Board’s Regulation MM governing dividend waivers, a mutual holding company may waive its right to dividends on shares of its subsidiary if the mutual holding company gives written notice of the waiver to the Federal Reserve Board and the Federal Reserve Board does not object. For a company such as Lake Shore, MHC, that was formed, issued stock and waived dividends prior to December 1, 2009, the Federal Reserve Board may not object to a dividend waiver if such waiver would not be detrimental to the safety and soundness of the savings bank subsidiary and the board of directors of the mutual holding company expressly determines that such dividend waiver is consistent with the board’s fiduciary duties to the members of the mutual holding company. Regulation MM also requires as a condition to waiving dividends, that a mutual holding company obtain the approval of a majority of the eligible votes of its members within 12 months prior to the declaration of the dividend being waived.

Lake Shore, MHC solicited its members to vote on the proposal to waive dividends and on February 4, 2015, the members approved the waiver of dividends. The Board of Directors of Lake Shore, MHC subsequently approved a dividend waiver in accordance with the regulations and submitted it to the Federal Reserve Board for their non-objection. As of March 3, 2015, Lake Shore, MHC received the non-objection of the Federal Reserve Board to waive its right to receive dividends paid by the Company during the twelve months ending February 3, 2016. It is expected that Lake Shore, MHC will continue to waive future dividends, except to the extent dividends are needed to fund Lake Shore, MHC’s continuing operations, subject to the ability of Lake Shore, MHC to obtain regulatory approval of its requests to waive dividends and its ability to obtain future member approval of dividend waivers.

While Lake Shore, MHC is grandfathered for purposes of the dividend waiver provisions of Regulation MM and has complied with all additional requirements imposed, we cannot predict whether the

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Federal Reserve Board will grant a dividend waiver request and, if granted, there can be no assurance as to the conditions, if any, the Federal Reserve Board will place on future dividend waiver requests by grandfathered mutual holding companies such as Lake Shore, MHC. If Lake Shore, MHC is unable to waive the receipt of dividends, our ability to pay dividends to our shareholders may be substantially impaired and the amounts of any such dividends may be significantly reduced.

We will become subject to more stringent capital requirements, which may adversely impact our return on equity, require us to raise additional capital or constrain us from paying dividends or repurchasing shares. In July 2013, the federal banking agencies approved a new rule that substantially amends the regulatory risk-based capital rules applicable to us. The final rule implements the "Basel III" regulatory capital reforms and changes required by the Dodd-Frank Act.

The final rule includes new minimum risk-based capital and leverage ratios, which will be effective for Lake Shore Savings on January 1, 2015 and refines the definition of what constitutes "capital" for purposes of calculating these ratios. The new minimum capital requirements will be: (i) a new common equity Tier 1 capital ratio of 4.5%; (ii) a Tier 1 capital ratio of 6% (increased from 4%); (iii) a total capital ratio of 8% (unchanged from current rules); and (iv) a Tier 1 leverage ratio of 4%. The final rule also established a "capital conservation buffer" of 2.5%, and will result in the following minimum ratios: (i) a common equity Tier 1 capital ratio of 7.0%, (ii) a Tier 1 to risk-based assets capital ratio of 8.5%, and (iii) a total capital ratio of 10.5%. The new capital conservation buffer requirement would be phased in beginning in January 2016 at 0.625% of risk-weighted assets and would increase each year until fully implemented in January 2019. An institution will be subject to limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses if its capital level falls below the buffer amount. These limitations will establish a maximum percentage of eligible retained income that can be utilized for such actions.

The application of more stringent capital requirements for Lake Shore Savings could, among other things, result in lower returns on equity, require the raising of additional capital, and result in regulatory actions such as the inability to pay dividends or repurchase shares if we were to be unable to comply with such requirements.

New regulations could restrict our ability to originate and sell mortgage loans. The CFPB has issued a rule designed to clarify for lenders how they can avoid monetary damages under the Dodd-Frank Act, which would hold lenders accountable for ensuring a borrower's ability to repay a mortgage. Loans that meet this "qualified mortgage" definition will be presumed to have complied with the new ability-to-repay standard.

Under the CFPB's rule, a "qualified mortgage" loan must not contain certain specified features, including:

- excessive upfront points and fees (those exceeding 3% of the total loan amount, less "bona fide discount points" for prime loans);
- interest-only payments;
- negative-amortization; and
- terms longer than 30 years.

Also, to qualify as a "qualified mortgage," a borrower's total monthly debt-to-income ratio may not exceed 43%. Lenders must also verify and document the income and financial resources relied upon to qualify the borrower for the loan and underwrite the loan based on a fully amortizing payment schedule and maximum interest rate during the first five years, taking into account all applicable taxes, insurance and assessments. The CFPB's rule on qualified mortgages could limit our ability or desire to make certain types of loans or loans to certain borrowers, or could make it more expensive/and or time consuming to make these loans, which could limit our growth or profitability.

Negative developments in the financial industry and the credit markets may subject us to additional regulation. As a result of the recent global financial crisis, the potential exists for new federal or state laws and regulations regarding lending and funding practices and liquidity standards to be promulgated, and bank regulatory agencies are expected to be active in responding to concerns and trends identified in examinations, including the expected issuance of many formal enforcement orders. Negative developments in the financial industry and credit markets, and the impact of new legislation in response to those developments, may negatively impact our operations by restricting our business operations, including our ability to originate or sell loans, and may adversely impact our financial performance.

Our local economy may affect our future growth possibilities. Our success significantly depends upon the growth in population, income levels, deposits and housing starts in our current market area, which is primarily located in Chautauqua County, New York and Erie County, New York. Unlike many larger institutions, we are not able to spread the risks of unfavorable local economic conditions across a large number of diversified economies and geographic locations. If the communities in which we operate do not grow, or if prevailing economic conditions locally or nationally are unfavorable, our business may be negatively affected. A weak economy could lead to a deterioration of the credit quality of our loan portfolio and reduce our level of customer deposits, which in turn would hurt our business. Moreover, the value of real estate or other collateral that may secure our loans could be adversely affected.

Competition in our primary market area may reduce our ability to attract and retain deposits and originate loans. We operate in a competitive market for both attracting deposits, which is our primary source of funds, and originating loans. Historically, our most direct competition for savings deposits has come from credit unions, community banks, large commercial banks and thrift institutions in our primary market area. Particularly in times of extremely low or extremely high interest rates, we have faced additional significant competition for depositors from brokerage firms and other firms' short-term money market securities and corporate and government securities. Our competition for loans comes principally from mortgage brokers, commercial banks, other thrift institutions, and insurance companies. Competition for loan originations and deposits may limit our future growth and earnings prospects.

Changes in the Federal Reserve Board's monetary or fiscal policies could adversely affect our results of operations and financial condition. Our earnings will be affected by domestic economic conditions and the monetary and fiscal policies of the United States government and its agencies. The Federal Reserve Board has, and is likely to continue to have, an important impact on the operating results of banks through its power to implement national monetary policy, among other things, in order to curb inflation or combat a recession. The Federal Reserve Board affects the levels of bank loans, investments and deposits through its control over the issuance of United States government securities, its regulation of the discount rate applicable to member banks and its influence over reserve requirements to which member banks are subject. We cannot predict the nature or impact of future changes in monetary and fiscal policies.

Item 1B. Unresolved Staff Comments.

None.

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Item 2. Properties.

We conduct our business through our corporate headquarters, administrative offices, and eleven branch offices. At December 31, 2014, the net book value of the computer equipment and other furniture, fixtures, and equipment at our offices totaled $1.2 million. For more information, see Note 6 and Note 9 in the Notes to our Consolidated Financial Statements.

Location	Leased or Owned	Original Date Acquired		Net Book Value December 31, 2014
	(Dollars in thousands)			
Corporate Headquarters				
31 East Fourth Street Dunkirk, NY 14048	Owned	2003	$	824
Branch Offices:				
Chautauqua County branches				
128 East Fourth Street Dunkirk, NY 14048	Owned/Leased(1)	1930		747
30 East Main Street Fredonia, NY 14063	Owned	1996		637
1 Green Avenue Lakewood, NY 14701	Owned/Leased(2)	1996		557
115 East Fourth Street Jamestown, NY 14701	Owned	1997		382
106 East Main Street Westfield, NY 14787	Owned/Leased(3)	1998		137
Erie County branches				
5751 Transit Road East Amherst, NY 14051	Owned	2003		999
3111 Union Road Orchard Park, NY 14127	Leased(4)	2003		463
59 Main Street Hamburg, NY 14075	Leased(5)	2005		781
3438 Delaware Avenue Kenmore, NY 14217	Owned	2008		1,116
570 Dick Road Depew, NY 14043	Leased(6)	2009		72
4950 Main Street Snyder, NY 14226	Owned	2012		1,271
Administrative Offices:				
125 East Fourth Street Dunkirk, NY 14048	Owned	1995		163
123 East Fourth Street Dunkirk, NY 14048	Owned	1995		80
415 Washington Avenue				

Dunkirk, NY 14048	Owned	2010	55

(1) The building is owned. Additional parking lot is leased. The lease expires in 2019.
(2) The building is owned. The land is leased. The lease expires in 2015, but has a renewal option for an additional 10 years.
(3) The building is owned. Additional parking lot is leased. The lease expires in 2015, but has an automatic one-year renewal option.
(4) The lease expires in 2017.

(5) The lease expires in 2028.

(6) The lease expires in 2019.

Item 3. Legal Proceedings.

At December 31, 2014, we are not involved in any pending legal proceedings other than routine legal proceedings occurring in the ordinary course of business. We believe that these routine legal proceedings, in the aggregate, are immaterial to our financial condition and results of operations.

Item 4. Mine Safety Disclosures.

Not applicable.

PART II

Item 5. Market for Registrant's Common Equity and Related Stockholder Matters.

Market Information

Lake Shore Bancorp, Inc. common stock trades on the Nasdaq Global Market under the symbol "LSBK". The table below shows the reported high and low sales prices of the common stock during the periods indicated.

	Sales Price		Dividend Information	
Period	High	Low	Amount Per Share	Date of Payment
2013				
First quarter	$ 14.69	$ 9.01	$ 0.07	March 29, 2013
Second quarter	12.00	11.00	0.07	May 21, 2013
Third quarter	11.86	10.93	0.07	August 20, 2013
Fourth quarter	12.50	11.40	0.07	November 19, 2013
2014				
First quarter	$ 12.52	$ 12.20	$ 0.07	March 18, 2014
Second quarter	12.50	12.25	0.07	May 21, 2014
Third quarter	13.02	11.95	0.07	August 19, 2014
Fourth quarter	14.00	12.50	0.07	November 18, 2014

The Board of Directors intends to review the payment of dividends quarterly and plans to continue to maintain a regular quarterly dividend, dependent upon our earnings, financial condition and other relevant factors. Refer to Part I, Item 1. “Business – Supervision and Regulation – Holding Company Regulation” and Part I, Item 1a. “Risk Factors – Risks Related to Recent Developments and The Banking Industry Generally” above for information on the possible restriction of dividend payments and MHC dividend waivers.

As of March 23, 2015 there were approximately 1,314 record holders of Lake Shore Bancorp, Inc. common stock.

The following table reports information regarding repurchases by Lake Shore Bancorp of its common stock in each month of the quarter ended December 31, 2014:

COMPANY PURCHASES OF EQUITY SECURITIES

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet be Purchased Under the Plans or Programs (1)
October 1 through October 31, 2014	-	$ -	-	56,410
November 1 through November 30, 2014	-	-	-	56,410
December 1 through December 31, 2014	-	-	-	56,410
Total	-	$ -	-	56,410

(1) On November 17, 2010, our Board of Directors approved a new stock repurchase plan pursuant to which we can repurchase up to 116,510 shares of our outstanding common stock. This amount represented 5% of our outstanding stock not owned by the MHC as of November 23, 2010. The repurchase plan does not have an expiration date and superseded all of the prior stock repurchase programs.

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Item 6. Selected Financial Data.

Our selected consolidated financial and other data is set forth below, which is derived in part from, and should be read in conjunction with, our audited consolidated financial statements and notes thereto as of December 31, 2014 and 2013 and for the years ended December 31, 2014, 2013 and 2012, beginning on page F-1 of this Form 10-K. Our selected consolidated financial and other data as of December 31, 2012, 2011 and 2010 and for the years ended December 31, 2011 and 2010 are from audited consolidated financial statements and notes not included in this Form 10-K.

	As of December 31,				
	2014	2013	2012	2011	2010
	(Dollars in thousands)				
Selected financial condition data:					
Total assets	$ 487,471	$ 482,167	$ 482,387	$ 488,597	$ 479,047
Loans, net	284,853	277,345	272,933	275,068	263,031
Securities available for sale	138,202	157,964	159,368	164,165	153,924
Federal Home Loan Bank stock	1,375	1,560	1,852	2,219	2,401
Total cash and cash equivalents	35,811	17,202	19,765	23,704	33,514
Total deposits	386,939	388,235	378,543	379,798	375,785
Short-term borrowings	-	11,650	11,200	6,910	5,000
Long-term debt	18,950	7,850	14,400	27,230	34,160
Total stockholders' equity	71,630	65,271	66,985	63,947	55,210
Allowance for loan losses	1,921	1,813	1,806	1,366	953
Non-performing loans	4,729	4,606	2,420	2,798	2,341
Non-performing assets	5,130	5,187	3,000	3,113	2,645

	For the year ended December 31,				
	2014	2013	2012	2011	2010
	(Dollars in thousands, except per share data)				
Selected operating data:					
Interest income	$ 17,879	$ 18,614	$ 19,650	$ 20,765	$ 19,926
Interest expense	3,348	3,556	4,603	5,636	6,316
Net interest income	14,531	15,058	15,047	15,129	13,610
Provision for loan losses	222	105	656	415	2,115
Net interest income after provision for loan losses	14,309	14,953	14,391	14,714	11,495
Total non-interest income	2,235	2,092	2,030	1,666	3,454
Total non-interest expense	12,819	12,334	11,811	11,307	11,533
Income before income taxes	3,725	4,711	4,610	5,073	3,416
Income taxes	567	968	984	1,393	373
Net income	$ 3,158	$ 3,743	$ 3,626	$ 3,680	$ 3,043

Basic earnings per common share	$ 0.55	$ 0.66	$ 0.64	$ 0.65	$ 0.53
Diluted earnings per common share	$ 0.55	$ 0.65	$ 0.64	$ 0.65	$ 0.53
Dividends declared per share	$ 0.28	$ 0.28	$ 0.25	$ 0.28	$ 0.24

	At or for the year ended December 31,				
	2014	2013	2012	2011	2010
Selected financial ratios and other data					
Performance ratios:					
Return on average assets	0.65%	0.77%	0.74%	0.76%	0.67%
Return on average equity	4.58%	5.64%	5.47%	6.15%	5.32%
Dividend payout ratio(1)	50.91%	43.08%	39.06%	43.08%	45.28%
Interest rate spread(2)	3.06%	3.19%	3.07%	3.14%	2.98%
Net interest margin(3)	3.21%	3.34%	3.26%	3.34%	3.21%
Efficiency ratio(4)	76.46%	71.92%	69.16%	67.32%	67.59%
Non-interest expense to average total assets	2.63%	2.55%	2.40%	2.34%	2.54%
Average interest-earning assets to average interest-bearing liabilities	120.93%	119.39%	119.69%	116.58%	115.39%
Capital ratios:					
Total risk-based capital to risk weighted assets(5)	25.71%	25.08%	23.77%	21.81%	20.44%
Tier 1 risk-based capital to risk weighted assets(5)	24.95%	24.36%	23.04%	21.27%	20.05%
Tangible capital to tangible assets(5)	13.16%	12.75%	12.14%	11.18%	10.28%
Tier 1 leverage (core) capital to adjustable tangible assets(5)	13.16%	12.75%	12.14%	11.18%	10.28%
Equity to total assets	14.69%	13.54%	13.89%	13.09%	11.52%
Asset quality ratios:					
Non-performing loans as a percent of total net loans	1.66%	1.66%	0.89%	1.02%	0.89%
Non-performing assets as a percent of total assets	1.05%	1.08%	0.62%	0.64%	0.55%
Allowance for loan losses as a percent of total net loans	0.67%	0.65%	0.66%	0.50%	0.36%
Allowance for loan losses as a percent of non-performing loans	40.62%	39.36%	74.63%	48.82%	40.71%
Other data:					
Number of full service offices	11	11	10	10	10

(1)Represents dividends declared per share as a percent of diluted earnings per share.

(2)Represents the difference between the weighted-average yield on interest-earning assets and the weighted-average cost of interest-bearing liabilities for the year.

(3)Represents the net interest income as a percent of average interest-earning assets for the year.

(4)Represents non-interest expense divided by the sum of net interest income and non-interest income.

(5)Represents the capital ratios of Lake Shore Savings Bank since Lake Shore Bancorp, Inc., as a savings and loan holding company is not currently subject to formula-based capital requirements at the holding company level.

Item 7. Management’s Discussion and Analysis of Financial Condition and Results of Operations.

This discussion and analysis reflects our consolidated financial statements and other relevant statistical data and is intended to enhance your understanding of our consolidated financial condition and results of operations. You should read the information in this section in conjunction with our consolidated financial statements and accompanying notes to the consolidated financial statements beginning on page F-1 of this Form 10-K, and the other statistical data provided in this Form 10-K.

Important Note Regarding Forward-Looking Statements

Certain statements in this annual report are “forward-looking” within the meaning of the Private Securities Litigation Reform Act of 1995, which statements generally can be identified by the use of forward-looking terminology, such as “may,” “will,” “expect,” “estimate,” “anticipate,” “believe,” “target,” “plan,” “project” or “continue” or the negatives thereof o variations thereon or similar terminology, and are made on the basis of management’s current plans and analyses of our business and the industry in which we operate as a whole. These forward-looking statements are subject to risks and uncertainties, including, but not limited to, economic conditions, competition, interest rate sensitivity and exposure to regulatory and legislative changes, and the other risks and uncertainties identified in Part I, Item 1A “Risk Factors.” These factors in some cases have affected, and in the future could affect, our financial performance and could cause actual results to differ materially from those expressed in or implied by such forward-looking statements. We do not undertake to publicly update or revise our forward-looking statements even if experience or future changes make it clear that any projected results expressed or implied therein will not be realized.

General

Our results of operations depend primarily on our net interest income, which is the difference between the interest income we earn on loans and investments and the interest expense we pay on deposits and other interest-bearing liabilities. Net interest income is affected by the relative amounts of interest-earning assets and interest-bearing liabilities and the interest rates we earn or pay on these balances.

Our operations are also affected by non-interest income, such as service fees and gains and losses on the sales of securities and loans, our provision for loan losses and non-interest expenses which include salaries and employee benefits, occupancy and equipment costs, professional fees and other general and administrative expenses.

Financial institutions like us, in general, are significantly affected by economic conditions, competition, and the monetary and fiscal policies of the federal government. Lending activities are influenced by the demand for and supply of housing, competition among lenders, interest rate conditions, and funds availability. Our operations and lending are principally concentrated in the Western New York area, and our operations and earnings are influenced by local economic conditions. Deposit balances and cost of funds are influenced by prevailing market rates on competing investments, customer preferences, and levels of personal income and savings in our primary market area. Certain areas of the Western New York market area have recently experienced economic growth, especially in Erie County.

While the recession is officially over and improvements have been noted in the housing market and unemployment rate, the Federal Reserve has continued to maintain the Fed Funds rate at 0.00%-0.25% for more than six years. The Federal Reserve has indicated that the Fed Funds rate will remain low until its dual mandates of maximum employment and a 2% inflation rate are achieved on a consistent basis, and as such, this rate is not expected to increase until mid-2015 or beyond. At the December 2013 meeting of the Federal Open Market Committee (“FOMC”), the Federal Reserve began to taper its quantitative easing (“QE”) program by reducing its purchases of mortgage-backed securities and treasury bonds by $10 billion per month. This program was further reduced by the FOMC at each subsequent meeting until the end of the program in October 2014. The Fed continues to reinvest cash flow received on its portfolio back into agency mortgage backed securities and treasury bonds. This action will continue to exert downward pressure on long-term rates.

Current interest rates on residential mortgage loans remain very low compared to historical yields, and the rates have declined since January 2014. Despite this recent decline in interest rates on residential mortgage loans, the current interest rates have increased by approximately 40 basis points since January 2013, which has resulted in decreased loan origination and refinance activity. We will continue to closely monitor the impact of the national and regional economy on our net interest margin, results of operations and critical risk areas, including interest rate risk and credit risk.

As discussed further above in Part I, Item 1 “Business - Supervision and Regulation,” since October 2008, numerous legislative actions, including the Dodd-Frank Act, have been taken in response to the financial crisis affecting the banking system and financial markets. While we do not know all the possible outcomes from these initiatives, we can anticipate that the Company will need to dedicate more resources to ensure compliance with new legislation and regulations, which may impact profitability. There can be no assurance as to the actual impact any governmental program will have on the financial markets or our financial condition and results of operations. We remain active in monitoring these developments and supporting the interests of our stockholders.

Management Strategy

Our Reputation. Our primary management strategy has been to retain our perceived image as one of the most respected and recognized community banks in Western New York with over 123 years of service to our community. Our management strives to accomplish this goal by continuing to emphasize our high quality customer service and financial strength.

Branching. We opened our sixth branch office in Erie County, New York during the second quarter of 2013. This branch is located in Snyder, New York and is our eleventh branch overall. Our offices are located in Dunkirk, Fredonia, Jamestown, Lakewood and Westfield in Chautauqua County, New York and in Depew, East Amherst, Hamburg, Kenmore, Orchard Park, and Snyder in Erie County, New York. Saturation of the market in Chautauqua County led to our expansion plan in Erie County, which is a critical component of our future profitability and growth.

An important strategic objective is to continue to evaluate and enhance the technology supporting our customer service. We are committed to making investments in technology and we believe that it represents an efficient way to deploy a portion of our capital. To this end, the Company has developed a five year plan for the implementation of cost effective and efficient digital services to meet our customer’s technology needs, to focus on attracting new customers, and to improve our operational efficiencies. Although we remain committed to expanding our retail branch footprint whenever it makes strategic sense, we will be concentrating our near term efforts on expanding our digital footprint.

Our People. A large part of our success is related to customer service and customer satisfaction. Having employees who understand and value our clientele and their business is a key component to our success. We believe that our present staff is one of our competitive strengths, and thus the retention of such persons and our ability to continue to attract quality personnel is a high priority.

Lending. Historically, our lending portfolio has consisted predominantly of residential one- to four-family mortgage loans. At December 31, 2014 and 2013, we held $167.8 million and $170.8 million of residential one- to four-family mortgage loans, respectively, which constituted 59.1% and 61.8% of our total loan portfolio, at such respective dates. Due to the interest rate risk inherent in holding long-term, fixed rate one- to four-family real estate loans in our portfolio in a potential rising interest rate environment, we have been strategically focused on the origination of commercial real estate loans to finance the purchase of real property, which generally consists of developed real estate. We have also focused on small business commercial lending, including business installment loans, lines of credit and other commercial loans. These types of commercial loans are generally at higher interest rates and for shorter terms than one- to four- family real estate loans, which lowers the Bank's interest rate risk. At December 31, 2014 and 2013, our commercial real estate loan portfolio consisted of loans totaling $68.2 million and $58.7 million respectively, or 24.0% and

21.3%, respectively, of total loans. At December 31, 2014 and 2013, our commercial loan portfolio consisted of loans totaling $13.5 million and $12.6 million, respectively, or 4.7% and 4.6%, respectively, of total loans. Other loan products offered to our customers include home equity lines of credit, construction loans and consumer loans, including automobile loans, overdraft lines of credit and share loans. In the fourth quarter of 2014, we began to sell fixed rate, long-term one- to four-family residential loans (with low yields and 30 year terms) that we originate, as part of our interest rate risk strategy and asset/liability management, and plan to continue to do so in the future, as it is deemed appropriate. We typically retain servicing rights when we sell one- to four-family residential mortgage loans.

Investment Strategy. Our investment policy is designed primarily to manage the interest rate sensitivity of our 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 within established guidelines. We employ a third party financial advisor to assist us in managing our investment portfolio and developing balance sheet strategies.

At December 31, 2014 and 2013, we had $138.2 million and $158.0 million, respectively, invested in securities available for sale, the majority of which are Treasury securities, agency collateralized mortgage obligation securities ("CMOs"), agency mortgage-backed securities, and municipal securities. As of December 31, 2014, we had a net unrealized gain in the investment portfolio of $5.7 million.

Asset-Liability Strategy. As stated above, our business consists primarily of originating one- to four-family residential real estate loans and commercial real estate loans secured by property in our market area and investing in residential mortgage-backed securities, CMOs and municipal securities. One- to four-family residential real estate loans generally involve a lower degree of credit risk and carry a lower yield than commercial real estate and commercial business loans. The average maturity of residential real estate loans is longer than that for commercial loans. Our loans are primarily funded by time deposits, which typically mature within two years on average and core deposits (i.e. checking, savings and money market accounts). As a result, we are exposed to interest rate risk, as our interest-bearing liabilities will mature or re-price more quickly than our interest-earning assets in a rising rate environment. Although we plan to continue to originate one- to four-family residential mortgage loans going forward, we have been and intend to continue to increase our focus on the origination of commercial real estate loans and commercial business loans, which generally have higher returns and shorter durations than one- to four-family residential real estate loans. As part of our asset liability strategy, we review the duration of assets on our balance sheet, and if necessary, we may sell loans or securities to help manage our interest rate risk. Our strategy also involves managing interest expense. In 2014 we have decreased the volume of higher-rate time deposits and have focused on building lower-cost core deposits, with a focus on building commercial relationships in order to help reduce and control our cost of funds. As part of our strategy to expand our commercial loan portfolio, we expect to attract lower cost core deposits as part of these borrower relationships. We offer competitive rates on a variety of deposit products to meet the needs of our customers and we promote long term deposits, where necessary, to meet asset-liability goals. We also consider borrowed funds or derivatives as an opportunity to extend the duration of liabilities at attractive levels.

We are actively involved in managing our balance sheet through the direction of our Asset-Liability Committee and the assistance of a third party advisor. Recent economic conditions have underscored the importance of a strong balance sheet. We strive to achieve this through managing our interest rate risk and maintaining strong capital levels, putting aside adequate loan loss reserves and keeping liquid assets on hand. Diversifying our asset mix not only improves net interest margin but also reduces the exposure of our net interest income and earnings to interest rate risk. We will continue to manage our interest rate risk by diversifying the type and maturity of our assets in our loan and investment portfolios and monitoring the maturities in our deposit portfolio and borrowing facilities.

Critical Accounting Policies

It is management's opinion that accounting estimates covering certain aspects of our business have more significance than others due to the relative importance of those areas to overall performance, or the level of subjectivity required in making such estimates. Management considers the accounting policy relating to the allowance for loan losses to be a critical accounting policy given the uncertainty in evaluating the level of the allowance for loan losses required for probable credit losses and the material effect that such judgments can have on the results of operations. Management's monthly evaluation of the adequacy of the allowance considers our historical loan loss experience, review of specific loans, current economic conditions, and such other factors considered appropriate to estimate loan losses. Management uses presently available information to estimate probable losses on loans; however, future additions to the allowance may be necessary based on changes in estimates, assumptions, or economic conditions. Significant factors that could give rise to changes in these estimates include, but are not limited to, changes in economic conditions in our local area, concentrations of risk and decline in local property values. The Company's determination as to the amount of its allowance for loan losses is subject to review by its bank regulators, which can require that we establish additional loss allowances. Refer to Note 5 of the Notes to Consolidated Financial Statements for more information on the allowance for loan losses.

In management's opinion, the accounting policy relating to the valuation of investments is a critical accounting policy. We use a third party vendor to provide independent pricing of the securities in our investment portfolio, with the exception of four securities which are not actively traded. The third party vendor utilizes public quotations, third party dealer quotes and pricing models. For the four securities that are not actively trading, the Company utilizes discounted cash flow models to determine fair value pricing. Thus, the determination of fair value pricing on investments may require significant judgment or estimation, particularly when liquid markets do not exist for the item being valued. The use of different assumptions for these valuations could produce significantly different results which may have material positive or negative effects on the results of our operations. Refer to Note 13 of the Notes to Consolidated Financial Statements for more information on fair value.

Management also considers the accounting policy relating to the impairment of investments to be a critical accounting policy due to the subjectivity and judgment involved and the material effect an impairment loss could have on the consolidated results of income. The credit portion of a decline in the fair market value of investments below cost deemed to be other-than-temporary ("OTTI") may be charged to earnings resulting in the establishment of a new cost basis for an asset. Management continually reviews the current value of its investments for evidence of OTTI. Refer to Note 3 of the Notes to Consolidated Financial Statements for more information on OTTI.

These critical policies and their application are reviewed periodically by our Audit/Risk Committee and our Board of Directors. All accounting policies are important, and as such, we encourage the reader to review each of the policies included in the notes to the Consolidated Financial Statements to better understand how our financial performance is reported.

Other than Temporary Impairment on Investment

During 2013 and 2012, a $180,000 and $102,000 OTTI write-down, respectively was recorded on one private-label asset-backed security, as management concluded that there was substantial doubt about the ability of the issuer to meet the financial commitments under the security for the projected life of the investment, due to an increased risk of default or risk that full and timely repayment of principal and interest would not be achieved. This conclusion was reached through calculating expected returns using a discounted cash flow model with assumptions that were either equal to or more conservative than actual prepayment speeds, annual default rates and loss severity ratios. In 2014, management sold this particular private-label, asset-backed security due to the ongoing uncertainty surrounding its value. The bond was sold in March 2014 with an overall loss on the sale of approximately $101,000. The loss on sale was recorded in the non-interest income section of the Consolidated Statements of Income, within the "Net gain on sale of securities available for sale" line item. There were no OTTI write-downs during 2014.

Analysis of Net Interest Income

Net interest income represents the difference between the interest we earn on our interest-earning assets, such as mortgage loans and investment securities, and the expense we pay on interest-bearing liabilities, such as time deposits and borrowings. Net interest income depends on both the volume of our interest-earning assets and interest-bearing liabilities and the interest rates we earn or pay on them.

Average Balances, Interest and Average Yields. The following table sets forth certain information relating to our average balance sheets and reflects the average yield on interest-earning assets and average cost of interest-bearing liabilities, interest earned and interest paid for the years indicated. Such yields and costs are derived by dividing income or expense by the average balance of interest-earning assets or interest-bearing liabilities, respectively, for the years presented. Average balances are derived from daily balances over the years indicated. The average balances for loans are net of allowance for loan losses, but include non-accrual loans. Interest income on securities does not include a tax equivalent adjustment for bank qualified municipal bonds.

	For the Year Ended December 31, 2014			For the Year Ended December 31, 2013			For the Year Ended December 31, 2012		
	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
	(Dollars in thousands)								
Interest-earning assets:									
Interest-earning deposits & federal funds sold	$ 26,832	$ 17	0.06%	$ 18,922	$ 14	0.07%	$ 23,663	$ 29	0.12%
Securities	149,389	4,522	3.03%	159,854	4,793	3.00%	169,228	5,542	3.27%
Loans	276,360	13,340	4.83%	271,705	13,807	5.08%	268,265	14,079	5.25%
Total interest-earning assets	452,581	17,879	3.95%	450,481	18,614	4.13%	461,156	19,650	4.26%
Other assets	34,143			34,100			30,810		
Total assets	$ 486,724			$ 484,581			$ 491,966		
Interest-bearing liabilities									
Demand & NOW accounts	$ 45,582	$ 54	0.12%	$ 42,285	$ 48	0.11%	$ 41,233	$ 50	0.12%
	78,690	260	0.33%	73,923	269	0.36%	63,864	306	0.48%

Money market accounts									
Savings accounts	41,496	43	0.10%	38,797	40	0.10%	35,841	46	0.13%
Time deposits	188,180	2,585	1.37%	198,529	2,833	1.43%	212,371	3,577	1.68%
Borrowed funds	19,194	304	1.58%	22,608	262	1.16%	30,765	515	1.67%
Other interest-bearing liabilities	1,110	102	9.19%	1,174	104	8.86%	1,222	109	8.92%
Total interest-bearing liabilities	374,252	3,348	0.89%	377,316	3,556	0.94%	385,296	4,603	1.19%
Other non-interest bearing liabilities	43,489			40,867			40,389		
Stockholders' equity	68,983			66,398			66,281		
Total liabilities & stockholders' equity	$ 486,724			$ 484,581			$ 491,966		
Net interest income		$ 14,531			$ 15,058			$ 15,047	
Interest rate spread			3.06%			3.19%			3.07%
Net interest margin			3.21%			3.34%			3.26%

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Rate Volume Analysis. The following table analyzes the dollar amount of changes in interest income and interest expense for major components of interest-earning assets and interest-bearing liabilities. The table shows the amount of the change in interest income or expense caused by either changes in outstanding balances (volume) or changes in interest rates. The effect of a change in volume is measured by applying the average rate during the first year to the volume change between the two years. The effect of changes in rate is measured by applying the change in rate between the two years to the average volume during the first year. Changes attributable to both rate and volume, which cannot be segregated, have been allocated proportionately to the absolute value of the change due to volume and the change due to rate.

	Year Ended December 31, 2014 Compared to Year Ended December 31, 2013			Year Ended December 31, 2013 Compared to Year Ended December 31, 2012		
	Rate	Volume	Net Change	Rate	Volume	Net Change
	(Dollars in thousands)					
Interest-earning assets:						
Interest-earning deposits & federal funds sold	$ (2)	$ 5	$ 3	$ (10)	$ (5)	$ (15)
Securities	45	(316)	(271)	(452)	(297)	(749)
Loans, including fees	(701)	234	(467)	(451)	179	(272)
Total interest-earning assets	(658)	(77)	(735)	(913)	(123)	(1,036)
Interest-bearing liabilities:						
Demand & NOW accounts	2	4	6	(3)	1	(2)
Money market accounts	(26)	17	(9)	(81)	44	(37)
Savings accounts	-	3	3	(10)	4	(6)
Time deposits	(104)	(144)	(248)	(522)	(222)	(744)
Total deposits	(128)	(120)	(248)	(616)	(173)	(789)
Other interest-bearing liabilities:						
Borrowed funds & other	90	(50)	40	(137)	(121)	(258)
Total interest-bearing liabilities	(38)	(170)	(208)	(753)	(294)	(1,047)
Total change in net interest income	$ (620)	$ 93	$ (527)	$ (160)	$ 171	$ 11

Comparison of Financial Condition at December 31, 2014 and December 31, 2013

Total assets at December 31, 2014 were $487.5 million, an increase of $5.3 million, or 1.1%, from $482.2 million at December 31, 2013. The increase in total assets was primarily due to an $18.6 million increase in cash and cash equivalents and a $7.5 million increase in loans receivable, net. These increases were partially offset by a $19.8 million decrease in securities available for sale and a $931,000 decrease in other assets.

Cash and cash equivalents increased by $18.6 million, or 108.2%, from $17.2 million at December 31, 2013 to $35.8 million at December 31, 2014. The increase was primarily attributed to $14.3 million of net pay-downs received on the investment and loan portfolios and from cash received on the sale of $10.3 million of available for sale securities, partially offset by funds used to originate loans, pay-down borrowings and fund $1.3 million of net deposit outflow. In the past two years, the Company has maintained a higher level of liquid assets, such as short-term interest-earning deposits, in order to manage its interest rate risk. By investing in liquid assets, which can be used to take advantage of interest rate shifts, the Company believes it is better positioned to react to changes in market interest rates. However, investments in short-term liquid assets generally bear lower yields than longer-term investments, resulting in lower levels of interest income.

Securities available for sale decreased by $19.8 million, or 12.5%, to $138.2 million at December 31, 2014 compared to $158.0 million at December 31, 2013. The decrease was primarily due to $14.3 million of paydowns received on the investment portfolio, that were not subsequently re-invested into available for sale securities. As previously noted, the Company is currently maintaining higher levels of liquid assets to be in a better position to take advantage of shifts in market interest rates and to manage interest rate risk. During 2014, the Company also sold six agency mortgage-backed securities for $8.8 million and one asset-backed private-label security for $1.5 million. The agency mortgage-backed securities were sold as part of a strategy to position the balance sheet for a potential rising interest rate environment by shortening the duration of assets. As noted above, the asset-backed, private-label security was sold due to the ongoing other-than-temporary impairment concerns underlying the security. These decreases were partially offset by a $4.9 million increase in the market value (before taxes) of the securities available for sale portfolio during the year ended December 31, 2014 due to a decrease in market interest rates.

Net loans receivable increased during the year ended December 31, 2014 as shown in the table below:

	At December 31, 2014	At December 31, 2013	Change $	%
	(Dollars in thousands)			
Real Estate Loans:				
Residential, one- to four-family	$ 167,840	$ 170,793	$ (2,953)	(1.7) %
Home equity	32,337	31,675	662	2.1 %
Commercial	68,238	58,746	9,492	16.2 %
Construction	449	936	(487)	(52.0)%
Total real estate loans	268,864	262,150	6,714	2.6 %
Other Loans:				
Commercial	13,467	12,645	822	6.5 %
Consumer	1,495	1,517	(22)	(1.5) %
Total gross loans	283,826	276,312	7,514	2.7 %
Allowance for loan losses	(1,921)	(1,813)	(108)	6.0 %
Net deferred loan costs	2,948	2,846	102	3.6 %
Loans receivable, net	$ 284,853	$ 277,345	$ 7,508	2.7 %

The increase in net loans receivable was primarily due to an increase in commercial real estate loans, commercial business loans, and home equity loans, partially offset by a decrease in residential, one- to four-family real estate loans, construction loans and consumer loans. As one- to four-family residential real estate loans present additional interest rate risk to our loan portfolio as a result of the longer duration of these types of assets, we remained strategically focused in 2014 on originating adjustable rate commercial real estate and commercial business loans to diversify our asset mix, to take advantage of the opportunities available to serve small businesses in our market area, and to maintain the net interest margin.

Other assets decreased by $931,000, or 41.2%, to $1.3 million as of December 31, 2014 as compared to $2.3 million at December 31, 2013. The decrease was attributable to a change in the volume of deferred tax assets resulting from increases in unrealized mark to market gains in our securities portfolio during 2014.

The table below shows changes in deposit balances by type of deposit account between December 31, 2014 and December 31, 2013:

	At December 31, 2014	At December 31, 2013	Change $	%
	(Dollars in thousands)			
Demand deposits and NOW accounts:				
Non-interest bearing	$ 37,162	$ 34,320	$ 2,842	8.3 %
Interest bearing	46,685	44,517	2,168	4.9 %
Money market	78,457	77,990	467	0.6 %
Savings	42,507	38,833	3,674	9.5 %
Time deposits	182,128	192,575	(10,447)	(5.4)%
Total Deposits	$ 386,939	$ 388,235	$ (1,296)	(0.3)%

The decrease in total deposits was primarily due to a decrease in time deposits, partially offset by an increase in all other deposit categories. The growth in checking, savings, and money market accounts was the result of the Company’s continued strategic focus on growing low-cost core deposits among its retail and commercial customers.

Our borrowings, consisting of advances from the FHLBNY, decreased by $550,000, or 2.8%, from $19.5 million at December 31, 2013 to $19.0 million at December 31, 2014. Short-term borrowings decreased by $11.7 million, or 100.0%, due to a refinancing of the borrowings into long-term debt to lock in fixed rates with lower interest rate risk. Long-term debt increased by $11.1 million primarily due to the refinancing of short-term borrowings described previously. The refinancing of the short-term borrowings into long-term debt caused our average weighted rate on borrowings to increase by 42 basis points to 1.58% for the year ended December 31, 2014 from 1.16% for the year ended December 31, 2013. During the year ended December 31, 2014, the Company paid off $550,000 of long term debt.

Other liabilities increased by $830,000, or 14.5%, to $6.5 million as of December 31, 2014 as compared to $5.7 million at December 31, 2013. The increase was attributable to a change in the volume of deferred tax liabilities resulting from increases in unrealized mark to market gains in our securities portfolio during 2014.

Total stockholders’ equity increased by $6.4 million, or 9.7%, from $65.3 million at December 31, 2013 to $71.6 million at December 31, 2014. The increase was primarily due to net income of $3.2 million, a $3.0 million increase in unrealized mark to market gains on available for sale securities (after taxes) and an $806,000 increase in additional paid in capital resulting from stock option exercises during the year ended December 31, 2014, partially offset by $590,000 in cash dividends paid during the year ended December 31, 2014.

Comparison of Results of Operations for the Years Ended December 31, 2014 and 2013

General. Net income was $3.2 million for the year ended December 31, 2014, or $0.55 per diluted share, a decrease of $585,000, or 15.6%, compared to net income of $3.7 million, or $0.65 per diluted share, for the year ended December 31, 2013. The decrease in net income was due to a $527,000 decrease in net interest income, a $485,000 increase in non-interest expense and a $117,000 increase in provision for loan losses, partially offset by a $401,000 decrease in income tax expense and a $143,000 increase in non-interest income.

Net Interest Income. Net interest income decreased by $527,000 to $14.5 million for the year ended December 31, 2014 compared to $15.1 million for the year ended December 31, 2013. Total interest income decreased by $735,000 and total interest expense decreased by $208,000. Interest rate spread and net interest margin were 3.06% and 3.21%, respectively, for the year ended December 31, 2014 compared to 3.19% and 3.34%, respectively, for the year ended December 31, 2013. The decrease in the interest rate spread and net interest margin for the year ended December 31, 2014 as compared to the year ended December 31, 2013 was due to an 18 basis point decrease in the average interest rate earned on interest earning assets, offset by a 5 basis point decrease in the average rate paid on interest-bearing liabilities.

Interest Income. Interest income decreased by $735,000, or 3.9%, to $17.9 million for the year ended December 31, 2014 compared to the year ended December 31, 2013. This decrease was primarily a result of reduced interest income on loans and investment securities due to the continued low interest rate environment. Loan interest income decreased by $467,000, or 3.4%, to $13.3 million for the year ended December 31, 2014 compared to the year ended December 31, 2013, primarily due to a decrease in the average yield of the loan portfolio from 5.08% for the year ended December 31, 2013 to 4.83% for the year ended December 31, 2014. The average yield on the loan portfolio decreased as new loans were originated or existing loans were refinanced at lower yields than the rates earned on loans which had paid off, as a result of the current low interest rate environment. The average balance of the loan portfolio increased $4.7 million, or 1.7%, from $271.7 million for the year ended December 31, 2013 to $276.4 million for the year ended December 31, 2014. The increase in the average balance of loans receivable was primarily due to an increase in the average balance of one- to four-family real estate loans, commercial real estate loans and home equity loans, partially offset by a decrease in the average balance of commercial business loans. Investment interest income decreased by $271,000, or 5.7%, from $4.8 million for the year ended December 31, 2013 to $4.5 million for the year ended December 31, 2014 primarily due to a decrease in the average balance of investment securities. The average balance in the investment portfolio decreased from $159.9 million for the year ended December 31, 2013 to $149.4 million for the year ended December 31, 2014. The average balance in the investment portfolio decreased primarily due to the sale of $10.3 million in available for sale securities in the first half of 2014 in order to reduce interest rate risk. The sale of securities and the increase in cash and cash equivalents on the Bank's balance sheet has allowed the Bank to position itself to take advantage of an anticipated rising interest rate environment by shortening the duration of assets, which reduces the risk of holding long term securities at low yields. The average yield on the investment portfolio increased by three basis points from 3.00% for the year ended December 31, 2013 to 3.03% for the year ended December 31, 2014. The average yield on the investment portfolio increased due to the purchase of higher yielding investments during the second half of 2013.

Interest Expense. Interest expense decreased $208,000, or 5.8%, to $3.3 million for the year ended December 31, 2014 compared to $3.6 million for the year ended December 31, 2013. Interest expense on deposits decreased by $248,000, or 7.8%, to $2.9 million for the year ended December 31, 2014 when compared to the year ended December 31, 2013 primarily due to the decrease in the average rate paid on deposits and a shift in the deposit mix away from high cost time deposits towards low cost core deposits, resulting in a larger percentage of the deposit portfolio consisting of low cost core deposits. The average balance of deposits for the year ended December 31, 2014 was $353.9 million with an average rate of 0.83% compared to the average balance of deposits of $353.5 million and an average rate of 0.90% for the year ended December 31, 2013. The decrease in the average rate paid on deposits was due to the continued low interest rate environment during 2014 and due to the shift in the deposit mix. The interest expense related to advances from the FHLBNY increased $42,000, or 16.0%, to $304,000 for the year ended December 31, 2014 as compared to $262,000 for the year ended December 31, 2013. The average balance of advances from the FHLBNY for the year ended December 31, 2014 was $19.2 million with an average rate of 1.58% compared to an average balance of $22.6 million and an average rate of 1.16% for the year ended December 31, 2013. The increase in the average rate paid on advances from the FHLBNY was primarily due to the refinancing of short-term borrowings into long-term debt during the year ended December 31, 2014 to lock in low long-term fixed rates and manage interest rate risk.

Provision for Loan Losses. A provision of $222,000 was recorded to the allowance for loan losses during the year ended December 31, 2014, an increase of $117,000, as compared to a provision of $105,000 during the year ended December 31, 2013. Net charge-offs were $114,000 for the year ended December 31, 2014 compared to $98,000 for the year ended December 31, 2013. Non-performing loans increased to $4.7 million, or 1.66% of total loans, at December 31, 2014 as compared to $4.6 million, or 1.66% of total loans, at December 31, 2013.

During the year ended December 31, 2014, the Company recorded a $175,000 provision for loan losses on one- to four-family and home equity loans primarily due to changes in the related environmental factors used to qualitatively assess inherent losses in the loan portfolio and an increase in classified loan balances. During the year ended December 31, 2014, the Company recorded a $59,000 provision for loan losses on commercial real estate loans due to an increase in loan balances during 2014 and a $44,000 provision for loan losses on consumer loans related to net charge-offs. The provisions for loan losses were partially offset by a $9,000 credit for loan losses on commercial loans during the year ended December 31, 2014, primarily due to changes in the environmental factors used to qualitatively assess inherent losses. The environmental change was specifically related to a decrease in the historical average of net charge-offs on these commercial loans. The provision for loan losses were also partially offset by a $47,000 unallocated credit for loan losses. The unallocated credit reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies to estimate an allowance for loan losses.

During the year ended December 31, 2013, the Company recorded a $60,000 provision for loan losses on commercial business loans primarily due to changes in the related environmental factors used to qualitatively assess inherent losses in the loan portfolio. The changes in the environmental factors occurred due to an increase in historical average net charge-offs over the last three years, which increased the amount of allowance that was set aside for inherent losses in this loan category. A $26,000 provision for loan losses was recorded on consumer loans primarily due to increased loan charge-offs in this category during the year ended December 31, 2013. The provision for loan losses was reduced by a $26,000 credit for loan losses on one- to four-family loans and home equity loans during the year ended December 31, 2013, due to a decrease in classified loans in these categories. During the year ended December 31, 2013, the Company recorded an unallocated provision for loan losses of $47,000. This unallocated provision reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating allocated and general losses in the portfolio.

Refer to Note 5 of the Notes to the Consolidated Financial Statements for details on the provision for loan losses.

Non-interest Income. Non-interest income increased $143,000, or 6.8%, from $2.1 million for the year ended December 31, 2013 to $2.2 million for the year ended December 31, 2014. The increase was primarily due to a non-cash, pre-tax impairment charge of $180,000 recorded on one asset-backed security during the year ended December 31, 2013. Non-interest income was also partially impacted by a $175,000 recovery of previously impaired investment securities during the year ended December 31, 2014, as well as by a $31,000 gain on the sale of loans. These increases were partially offset by a $147,000 decrease in the net gain recorded on the sale of available for sale securities during the year ended December 31, 2014 as compared to the prior year. Furthermore, there was a $57,000 decrease in service charges and fees during the year ended December 31, 2014 as compared to the year ended December 31, 2013. Earnings on bank owned life insurance income decreased $24,000 for the year ended December 31, 2014 when compared to the year ended December 31, 2013, as a result of declining yields earned on the underlying policies.

Non-interest Expenses. Non-interest expenses increased $485,000, or 3.9%, from $12.3 million for the year ended December 31, 2013 to $12.8 million for the year ended December 31, 2014. Salaries and employee benefits expense increased $409,000, or 6.6%, for the year ended December 31, 2014 compared to the year ended December 31, 2013. This was primarily due to annual salary increases, the hiring of an executive vice president for commercial lending, increased staffing expenses for our newest branch office in Snyder, NY which opened in April 2013 and additional expense for stock grants awarded during the year ended December 31, 2014. Occupancy and equipment expense increased $148,000, or 7.3%, for the year ended December 31, 2014 compared to the year ended December 31, 2013, primarily due to increases in software maintenance costs, property taxes, maintenance and repairs of buildings and equipment and the opening of the

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Snyder branch office in the second quarter of 2013. Data processing expenses increased $147,000, or 22.5%, during the year ended December 31, 2014 primarily due to the costs associated with the implementation of new mobile banking, online banking and loan origination technology and related software as well as consulting fees related to the negotiation of our core processing contract. FDIC insurance expense increased $20,000, or 7.6%, for the year ended December 31, 2014 compared to the year ended December 31, 2013, due to an increase in assessed fees. Professional services decreased $104,000, or 8.2%, for the year ended December 31, 2014 when compared to the year ended December 31, 2013, primarily due to lower legal and consulting expenses. Advertising expenses decreased $11,000, or 2.5%, for the year ended Decem