Lake Shore Bancorp, Inc.
Form 10-K
March 31, 2010

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United States
Securities and Exchange Commission
Washington, D.C. 20549

FORM 10-K

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

For the fiscal year ended December 31, 2009

o 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<br>(State or Other Jurisdiction<br>of Incorporation or Organization) | 20-4729288<br>(I.R.S. Employer Identification No.) |
|---|---|

125 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: Nasdaq Global Market.

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 o 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 o 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 o

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 o No o

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Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K 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. o

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 o | Accelerated filer o |
| Non-accelerated filer o (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 o No x

The aggregate market value of the voting stock held by non-affiliates of the registrant as of June 30, 2009 was $17,905,573 based on the per share closing price as of June 30, 2009 on the Nasdaq Global Market for the registrant's common stock, which was $7.00.

There were 6,089,722 shares of the registrant's common stock, $.01 par value per share, outstanding at March 24, 2010.

DOCUMENTS INCORPORATED BY REFERENCE:

| | Part of 10-K where incorporated |
|---|---|
| Portions of the registrant's Proxy Statement for the 2010 Annual Meeting of Stockholders | III |

LAKE SHORE BANCORP, INC.
ANNUAL REPORT ON FORM 10-K
FOR THE FISCAL YEAR ENDED
DECEMBER 31, 2009

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PART I

Item 1. Business.

## General

Lake Shore Bancorp, Inc. ("Lake Shore Bancorp," "us," or "we") is a federally-chartered corporation organized in 2006 and is registered as a savings and loan holding company with the Office of Thrift Supervision ("OTS"). Lake Shore Bancorp serves as the holding company for Lake Shore Savings Bank ("Lake Shore Savings"). As of March 24, 2010, Lake Shore, MHC, a federal mutual holding company registered as a savings and loan holding company with the OTS, owned 59.7% of the outstanding shares of Lake Shore Bancorp's common stock. Our common stock is quoted 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, MHC does not engage in any business activity other than its investment in a majority of the common stock of Lake Shore Bancorp. Federal law and regulations require that as long as Lake Shore, MHC is in existence, it must own at least a majority of Lake Shore Bancorp's common stock.

At December 31, 2009, Lake Shore Bancorp had total assets of $425.7 million, of which $259.2 million was comprised of loans receivable, net and $118.4 million was comprised of available for sale securities. At December 31, 2009, total deposits were $318.4 million and total equity was $55.4 million.

For over 118 years we have served the local community of Dunkirk, New York. Lake Shore Savings was chartered as a New York savings and loan association in 1891. In 1987, we opened our second office in Fredonia, New York. Since 1993, we have more than tripled our asset-size and expanded to nine 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 in Dunkirk, New York and nine 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, home equity loans and lines of credit and commercial real estate loans 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, payments of loan principal, 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 in Dunkirk, New York and nine 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 Orchard Park, East Amherst, Hamburg and Kenmore. Our first branch office in Erie County opened during April 2003 and the most recent branch office opened in December 2008. We also have six stand-alone ATMs. The opening of the Orchard Park, East Amherst, Hamburg and Kenmore branch offices demonstrates the implementation of our growth strategy which is focused on expansion within Erie County while preserving our market share in Chautauqua County. We plan to open another Erie County branch office in Depew during April 2010. We continue to be among the top residential mortgage lenders in Chautauqua County.

Our geographic market area for loans and deposits is principally Chautauqua and Erie Counties, New York. Northern Chautauqua County is located on Lake Erie in the western portion of New York and is approximately 45 miles from Buffalo, New York. There are multiple prime industries in this county and a skilled and productive labor force. Northern Chautauqua County is served by three accredited hospitals and offers higher education opportunities. We have lending and deposit relationships with such institutions. Southern Chautauqua County is more of a tourist area, featuring 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 covering 1,058 square miles. 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 and Erie County's population base is five times larger than Chautauqua County, which offers us a new source of 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 component parts. The principal employment sectors are service-related (excluding financial), 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 affecting the national and global financial markets are not having a significant effect on the housing prices in our market area. However, unemployment rates in 2009 have increased which may affect our ability to originate residential mortgage loans.

Our future growth will be influenced by opportunities and stability in 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 in our local 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 institutions, mortgage banking firms, credit unions, mortgage brokers, finance companies, insurance companies, and brokerage and investment banking firms. The most direct competition for deposits has historically come from credit unions, commercial banks and savings banks. Specifically, we compete with regional financial institutions such as Northwest Savings Bank and Evans Bank; state-wide financial institutions such as M&T Bank, Key Bank, and First Niagara Bank; and nation-wide financial institutions such as HSBC Bank USA and Bank of America. We are significantly smaller than many of these state-wide and nation-wide financial institution competitors. We face additional competition for deposits from short-term money market funds, corporate and government securities funds, and from brokerage firms, mutual funds and insurance companies.

To remain competitive, we provide superior customer service and are active participants in our local community. The following are examples of our commitment to customer service:

We have expanded our branch network and ATM network to grow our customer base and provide greater convenience to our existing customers.

We offer a Direct Access Secure Hotline (DASH) with 24 hour, 7 days a week access to all customer accounts via telephone.

We provide online bill pay and e-statements to our customers. We also have a secure account management on-line banking website which allows customers instant access to their account activity via the internet. We continue to upgrade our on-line banking services as technology evolves.

We offer retail customers with a Smart Account (NOW account), Free & Easy Checking account or Money Market Checking account, a "Navigator Card," an ATM/Debit card which may be used at ATM machines within our ATM network for deposits and withdrawals and as a debit card anywhere MasterCard is accepted.

We entered into alliances with M&T Bank and Evans National Bank to provide customers surcharge free access to their accounts with us through the ATMs of these institutions as well as our own.

We offer a variety of mortgage loan products, including: 5/1, 7/1 and 7/23 adjustable rate mortgages, an 80/15/5 loan, which is a combined mortgage and home equity product, a construction end loan, a "no closing cost" mortgage and home equity product, and a Rural Development Guaranteed Loan Program (GLP) mortgage loan, which provides 100% financing.

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In our last three Community Reinvestment Act evaluations by the Office of Thrift Supervision, most recently concluding on November 28, 2007, we consistently received an "Outstanding" rating.

We offer a Home Equity Line of Credit product which provides an 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.

We provide Remote Deposit services to our commercial customers, which allows the customer to deposit checks electronically from their place of business and to obtain access to detailed reports of their deposit activity. Customers gain efficiencies from time saved having to go to a branch office to make a deposit.

We issue Business Debit Cards to allow our business customers the convenience of accessing their funds through the use of a debit card instead of writing checks. The Business Debit Card carries the MasterCard logo and enables the business to use their card anywhere MasterCard is accepted.

Lending Activities

General. We have a long-standing commitment to the origination of residential mortgage loans, including home equity loans, and we also originate commercial real estate, commercial and consumer loans. We currently retain substantially all of the loans that we originate; however, we have sold and may in the future sell residential mortgage and student loans into the secondary market, retaining servicing rights for the residential mortgage loans. At December 31, 2009, we had total loans of $258.4 million, of which $185.8 million, or 71.9%, were one-to-four family residential mortgages. Of residential mortgage loans outstanding at that date, 4.4% were adjustable-rate mortgage loans and 95.6% were fixed rate loans. At December 31, 2009, 11.7% of the loan portfolio was comprised of home equity loans, of which 72.3% were adjustable rate loans and 27.7% were fixed rate loans. The remainder of our loans at December 31, 2009, amounting to $42.5 million, or 16.4% of total loans, consisted of 11.0% commercial real estate loans, 0.1% construction loans, 4.4% commercial loans and 0.9% consumer loans, which include personal loans, home improvement loans, overdraft lines of credit, automobile loans and guaranteed student loans.

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 Board of Governors of the Federal Reserve System (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.

| | At December 31, | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2009 | | 2008 | | 2007 | | 2006 | | 2005 | |
| | Amount | Percent of Total | Amount | Percent of Total | Amount | Percent of Total | Amount | Percent of Total | Amount | Percent of Total |
| | (Dollars in thousands) | | | | | | | | | |
| Mortgage loans: | | | | | | | | | | |
| One-to-four family | $185,753 | 71.88 % | $175,808 | 73.35 % | $157,834 | 72.36 % | $149,408 | 72.72 % | $148,172 | 71.85 % |
| Commercial real estate | 28,328 | 10.96 | 19,513 | 8.14 | 20,394 | 9.35 | 17,150 | 8.35 | 16,827 | 8.16 |
| Construction loans | 365 | 0.14 | 6,479 | 2.70 | 2,775 | 1.27 | 1,570 | 0.76 | 1,635 | 0.79 |
| Home equity loans and lines of credit | 30,158 | 11.67 | 28,143 | 11.74 | 26,569 | 12.18 | 25,896 | 12.60 | 28,624 | 13.88 |
| | 244,604 | 94.66 | 229,943 | 95.93 | 207,572 | 95.16 | 194,024 | 94.43 | 195,258 | 94.68 |
| Other loans: | | | | | | | | | | |
| Commercial loans | 11,430 | 4.42 | 7,403 | 3.09 | 8,246 | 3.78 | 8,746 | 4.26 | 8,264 | 4.00 |
| Consumer loans | 2,377 | 0.92 | 2,350 | 0.98 | 2,306 | 1.06 | 2,689 | 1.31 | 2,712 | 1.32 |
| | 13,807 | 5.34 | 9,753 | 4.07 | 10,552 | 4.84 | 11,435 | 5.57 | 10,976 | 5.32 |
| Total loans | 258,411 | 100.00% | 239,696 | 100.00% | 218,124 | 100.00% | 205,459 | 100.00% | 206,234 | 100.00% |
| Deferred loan costs | 2,327 | | 2,243 | | 1,813 | | 1,475 | | 1,166 | |
| Allowance for loan losses | (1,564) | | (1,476) | | (1,226) | | (1,257) | | (1,240) | |
| Loans, net | $259,174 | | $240,463 | | $218,711 | | $205,677 | | $206,160 | |

Loan Maturity. The following table presents the contractual maturity of our loans at December 31, 2009. 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.

| | One-to-Four Family | Commercial Real Estate | Construction Loans | Home Equity Loans | Commercial | Consumer | Total |
|---|---|---|---|---|---|---|---|
| Amounts due in: | | | | | | | |
| One year or less | $ 34 | $ 25 | $ — | $28 | $ 63 | $ 1,088 | $1,238 |
| After one year through five years | 2,802 | 534 | — | 4,326 | 1,531 | 677 | 9,870 |
| Beyond five years | 182,917 | 27,769 | 365 | 25,804 | 9,836 | 612 | 247,303 |
| Total | $ 185,753 | $ 28,328 | $ 365 | $30,158 | $ 11,430 | $ 2,377 | $258,411 |
| | | | | | | | |
| Interest rate terms on amounts due after one year: | | | | | | | |
| Fixed rate | $ 177,643 | $ 12,527 | $ 365 | $8,334 | $ 7,446 | $ 1,229 | $207,544 |
| Adjustable rate | 8,076 | 15,776 | — | 21,796 | 3,921 | 60 | 49,629 |
| Total | $ 185,719 | $ 28,303 | $ 365 | $30,130 | $ 11,367 | $ 1,289 | $257,173 |

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

| | For the Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2009 | 2008 | 2007 | 2006 | 2005 |
| | (Dollars in thousands) | | | | |
| Total loans: | | | | | |
| Balance outstanding at beginning of period | $ 239,696 | $ 218,124 | $ 205,459 | $ 206,234 | $ 199,922 |
| Originations: | | | | | |
| Mortgage loans | 64,725 | 61,229 | 44,046 | 30,806 | 36,504 |
| Commercial and consumer loans | 6,670 | 4,854 | 5,371 | 7,047 | 7,067 |
| Total originations | 71,395 | 66,083 | 49,417 | 37,853 | 43,571 |
| Deduct: | | | | | |
| Principal repayments: | | | | | |
| Mortgage loans | 40,439 | 34,587 | 29,641 | 31,303 | 30,498 |
| Commercial and consumer loans | 4,967 | 8,041 | 6,076 | 5,990 | 6,141 |
| Total principal payments | 45,406 | 42,628 | 35,717 | 37,293 | 36,639 |
| Transfers to foreclosed real estate | 708 | 422 | 81 | 357 | 118 |
| Loan sales – Sonyma(1) and Freddie Mac(2) | 6,300 | 1,311 | 482 | 406 | — |
| Loan sales – guaranteed student loans (3) | — | 2 | 333 | 402 | 419 |
| Loans charged off | 266 | 148 | 139 | 170 | 83 |
| Total deductions | 52,680 | 44,511 | 36,752 | 38,628 | 37,259 |
| Balance outstanding at end of period | $ 258,411 | $ 239,696 | $ 218,124 | $ 205,459 | $ 206,234 |

(1) State of New York Mortgage Agency.

(2) During 2009, we sold $6.2 million of residential mortgage loans with low yields to Freddie Mac in order to offset long term interest rate risk.

(3) During 2008, we were notified that Sallie Mae would no longer purchase student loans. As a result, we now retain student loans in our loan portfolio after a student graduates.

Residential Mortgage Lending. We emphasize the origination of residential mortgage loans secured by one-to-four family properties. At December 31, 2009, loans on one-to-four family residential properties accounted for $185.8

million, or 71.9%, of our total loan portfolio. Of residential mortgage loans outstanding on that date, 4.4% of our loans were adjustable rate mortgage loans and 95.6% were fixed rate loans. At December 31, 2009, approximately 66.5% of our residential mortgage portfolio was secured by property located in Chautauqua County, 29.5% by property located in Erie County and 4.0% by property located elsewhere. Approximately 12% of all residential loan originations during fiscal year 2009 were re-financings of loans already in our portfolio.

Our loan originations are obtained from customers, residents of our local communities or referrals from local real estate agents, attorneys and builders. Management believes that the Erie County branch offices will be a significant source of new loan generation. Management believes that expanding our residential mortgage lending will continue to enhance our reputation as a service-oriented institution, particularly in Erie County, where we are actively developing and expanding our market presence.

Residential mortgage loan originations are generally for terms of 15, 20 or 30 years, amortized on a monthly basis with interest and principal due either bi-weekly or monthly. Residential real estate loans may remain outstanding for significantly shorter periods than their contractual terms as borrowers may refinance or prepay most loans at their option without penalty. Conventional 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 or “negative amortization” mortgage loans.

Our residential lending policies and procedures ensure that our residential mortgage loans generally conform to secondary market guidelines. We underwrite all conforming rate loans using the same criteria required by the Federal Home Loan Mortgage Corporation. We originate residential mortgage loans with a loan to value ratio up to 97%, and up to 102% with our 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. Our adjustable rate mortgage loans include loans that provide for an interest rate based on the interest paid on U.S. Treasury securities of varying maturities plus varying margins. We currently offer adjustable rate mortgage loans with initial rates below those which would prevail under the foregoing computation, based upon a determination of market factors and competitive rates for adjustable-rate loans in our market area. For adjustable rate mortgage loans, borrowers are qualified at the initial fully indexed rate.

Our adjustable rate 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 of 2% or 5% per adjustment period with a ceiling rate of 5% or 6%, depending on the product, over the life of the loan. These loans also carry a floor of 4.5%. The retention of adjustable rate 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 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 are underwritten using the same criteria required by the State of New York Mortgage Agency for its own loan products. After a loan is originated and funded, we may sell the loan to the State of New York Mortgage Agency. We have also sold loans to the Federal Home Loan Mortgage Corporation. During 2009 we elected to sell $6.3 million of residential mortgage loans with low yields to offset long term interest rate risk. We retain all servicing rights for residential mortgage loans that we sell.

Home Equity Loans and Lines of Credit. We provide home equity loans and home equity lines of credit to our customers. We offer a home equity loan or line of credit with a minimum balance 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 prime, generally have a 15 year draw period and a 15 year payback period. 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. Fixed rate home equity loans range from terms of 5 to 15 years. Home equity loans, as a group, totaled $30.2 million and $28.1 million at December 31, 2009 and 2008, respectively. At December 31, 2009, approximately 72.3% of such loans had adjustable rates and 27.7% had fixed rates. At December 31, 2009 and 2008, such loans constituted 11.7% of our total loan portfolio.

Commercial Real Estate Loans. We originate commercial real estate loans to finance the purchase of real property, which generally consists of developed real estate. In underwriting commercial real estate loans, consideration is given to the property's historic cash flow, current and projected occupancy, location, and physical condition. At December 31, 2009 and 2008, our commercial real estate loan portfolio consisted of loans totaling $28.3 million and $19.5 million, respectively, or 11.0% and 8.1%, respectively, of total loans. Of the commercial real estate portfolio at December 31, 2009, approximately 47.3% consisted of loans that are collateralized by properties in Chautauqua County, 46.9% by properties in Erie County and 5.8% by property located elsewhere. We lend up to a maximum loan-to-value ratio of 80% on commercial properties and require a minimum debt coverage ratio of 1.2 to 1. 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 residential mortgage loans. Also, commercial real estate loans typically involve large 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.

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 one-year 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 or commercial mortgage, as applicable. At both December 31, 2009 and 2008, our construction loan portfolio consisted of loans totaling $365,000 and $6.5 million, or 0.1% and 2.7%, respectively, of total loans.

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. The average commercial loan is for a principal amount of approximately $89,000. At December 31, 2009 and 2008, our commercial loan portfolio consisted of loans totaling $11.4 million and $7.4 million, respectively, or 4.4% and 3.1%, respectively, of total loans. Many commercial loans have variable interest rates tied to the prime rate, and are for terms generally not in excess of 7 years. Whenever possible, we collateralize these loans with a lien on business assets and equipment and the personal guarantees from principals of the borrower. Interest rates on commercial loans generally have higher yields than 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 intangible assets 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 conduct on-site reviews of the commercial loan portfolio to ensure adherence to our underwriting standards and policy requirements.

Consumer Loans. We offer a variety of consumer loans. At December 31, 2009 and 2008, our consumer loan portfolio totaled $2.4 million, or 0.9% and 1.0%, respectively, of total loans. 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

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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, student loans guaranteed by New York State Higher Education Services Corporation (“HESC”), 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 the borrowers and primarily on used vehicles. We also maintain a portfolio of guaranteed student loans, guaranteed by New York State HESC. During 2008, we discontinued the origination of student loans, as we were notified by Sallie Mae that they would no longer purchase these loans. We hold the student loans remaining in our portfolio and service the loans once the student graduates and begins repayment. 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. 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.

Loan Approval Procedures and Authority. Our lending policies are established by our Board of Directors. In January 2010, we modified certain lending limits to allow greater flexibility for internal manager approval.

In 2009, home equity loans in excess of $25,000 and all mortgage loans up to $417,000 were required to be approved by the Internal Residential Loan Committee, which meets on a weekly basis. Loans between $417,000 and $750,000 were required to be approved by the Executive Committee of our Board of Directors and loans in excess of $750,000 required full Board of Director approval. Effective January 2010, home equity loans and mortgage loans between $417,000 and $1.0 million are required to be approved by the Internal Residential Loan Committee, and must also be approved by any two of the following officers: Chief Executive Officer, Chief Operating Officer, or Chief Lending Officer. Loans in excess of $1.0 million will require full Board of Director approval.

For commercial loans, certain Vice Presidents and Commercial Lending Officers have authority to approve loans for principal amounts up to $100,000. In 2009, commercial loans with principal balances between $100,000 and $350,000 were required to be approved by the Internal Commercial Loan Committee and by any one of the following: Chief Executive Officer or Chief Commercial Lending Officer. Loans between $350,000 and $1.0 million were presented to the Executive Committee for approval and loans in excess of $1.0 million required full Board of Director approval. In 2010, commercial loans in excess of $100,000 to $500,000 must be approved by the Internal Commercial Loan Committee. Commercial loans between $500,000 and $1.0 million must be approved by the Internal Commercial Loan Committee, and must also be approved by the Chief Executive Officer, Chief Operating Officer or Chief Commercial Lending Officer. All loans with principal amounts in excess of $1,000,000 require full Board of Director 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 mortgage 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 conforming mortgage loans that are eligible for sale on the secondary market.  We require title insurance on all secondary market mortgage loans and certain other loans.  We also require borrowers to obtain hazard insurance, and if applicable, we may 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 mortgage loans, the maintenance of sound credit standards for new loan originations and loan administration procedures have resulted in historically low delinquency ratios, especially in light of current economic conditions.  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.  When a borrower fails to make required payments on a residential, 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.

Once a 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. A final letter is sent to the borrower demanding payment in full by a certain date.  Failure to pay after 90 days of the original due date generally results in legal action, notwithstanding ongoing collection.  In the case of a secured loan, the collateral is reviewed 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, repossessions and attempt to collect the deficiency from the borrower.

Loans Past Due 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.  Non-performing assets,

including non-performing loans and foreclosed real estate, totaled $2.0 million at December 31, 2009 and $1.7 million at December 31, 2008.

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

| | At December 31, | | | | |
|---|---|---|---|---|---|
| | 2009 | 2008 | 2007 | 2006 | 2005 |
| | (Dollars in thousands) | | | | |
| Loans past due 90 days or more but still accruing: | | | | | |
| Mortgage loans on real estate: | | | | | |
| One-to-four family | $456 | $562 | $209 | $503 | $548 |
| Construction | — | — | — | — | — |
| Commercial real estate | 65 | 46 | 208 | 133 | 239 |
| Home equity loans and lines of credit | 142 | 25 | 65 | 83 | 54 |
| Other loans: | | | | | |
| Commercial loans | — | — | 85 | — | 76 |
| Consumer loans | 1 | 15 | — | — | 12 |
| Total | $664 | $648 | $567 | $719 | $929 |
| Loans accounted for on a non-accrual basis: | | | | | |
| Mortgage loans on real estate: | | | | | |
| One-to-four family | $753 | $790 | $918 | $579 | $368 |
| Construction | — | — | — | — | — |
| Commercial real estate | 192 | 152 | 107 | — | — |
| Home equity loans and lines of credit | 32 | 49 | 42 | 4 | 5 |
| Other loans: | | | | | |
| Commercial loans | 19 | — | — | — | 43 |
| Consumer loans | 17 | 12 | 10 | 7 | 17 |
| Total non-accrual loans | 1,013 | 1,003 | 1,077 | 590 | 433 |
| Total nonperforming loans | 1,677 | 1,651 | 1,644 | 1,309 | 1,362 |
| Foreclosed real estate | 322 | 48 | 61 | 183 | 86 |
| Restructured loans | — | — | — | — | — |
| Total nonperforming assets | $1,999 | $1,699 | $1,705 | $1,492 | $1,448 |
| Ratios: | | | | | |
| Nonperforming loans as a percent of gross loans: | 0.65 % | 0.69 % | 0.75 % | 0.64 % | 0.66 % |
| Nonperforming assets as a percent of total assets: | 0.47 % | 0.42 % | 0.48 % | 0.42 % | 0.43 % |

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 well-secured or in the process of collection. Our Asset Classification Committee designates loans on which we stop accruing interest income as non-accrual loans and 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 $1.0 million at December 31, 2009 and 2008. If all non-accrual loans had been current in accordance with their terms during the years ended December 31, 2009, 2008 and 2007, interest income on such loans would have amounted to $44,000, $77,000 and $67,000 respectively. At December 31, 2009, we had three loans which are not included above which are classified as "troubled debt restructurings" as defined in FASB ASC Subtopic 310 "Receivables". The loans are commercial loans held by one borrower for start-up costs related to a franchise restaurant business, totaling $2.7 million. The loans were classified as impaired due to delinquency status and concerns about repayment ability. The Company has worked with the borrower

and the terms on the loan were modified. As of December 31, 2009, the loan payments were current with the terms of the modified loan and as such, these loans are not considered to be "non-performing" at this time.

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, we either sell the real property securing the loan at a foreclosure sale or sell the property as soon thereafter as practical.

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" must 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. "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 continuance as a loan of the institution is not warranted. Regulations also provide for a "special mention" category, 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.

When we classify loans as either substandard or doubtful, we allocate a portion of the related general loss allowances to such loans as we deem prudent. The allowance for loan losses represents amounts that have been established to recognize losses inherent in the loan portfolio that are both probable and reasonably estimable at the date of the consolidated financial statements. When we classify problem loans as loss, we charge-off such amount. Our determination as to the classification of our loans and the amount of our loss allowances are subject to review by our regulatory agencies, 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, 2009, classified loans consisted of special mention loans of $1.2 million, substandard loans of $3.0 million and doubtful loans of $2.2 million. The classified loans total includes $2.0 million of nonperforming loans and foreclosed real estate.

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

| | At December 31, | | |
|---|---|---|---|
| | 2009 | 2008 | 2007 |
| | (Dollars in thousands) | | |
| Special mention | $ 1,214 | $ 1,431 | $ 2,900 |
| Substandard | 3,006 | 3,332 | 2,942 |
| Doubtful | 2,209 | 2,329 | 510 |
| Loss | — | 3 | 3 |
| | | | |
| Total classified loans | $ 6,429 | $ 7,095 | $ 6,355 |

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

| | At December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2009 | | 2008 | | 2007 | |
| | 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) | | | | | |
| Residential real estate(1) | $ 947 | $ 1,215 | $ 777 | $ 1,426 | $ 1,091 | $ 1,061 |
| Commercial real estate | 93 | 257 | 146 | 198 | — | 314 |
| Commercial business(2) | — | 19 | 2,728 | — | 41 | 85 |
| Consumer loans | 39 | 18 | 7 | 24 | 4 | 10 |
| Total | $ 1,079 | $ 1,509 | $ 3,658 | $ 1,648 | $ 1,136 | $ 1,470 |

(1) Includes home equity loans and lines of credit and construction loans.

(2) The increase in delinquent commercial business loans in 2008 was primarily due to four loans made to one borrower to fund the start-up of a franchise restaurant business, totaling $2.6 million. We worked with the borrower to cure the delinquency and as of December 2009, the loans were restructured and payments were current.

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 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 Thrift Supervision, 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, thereby adversely affecting our results of operations.

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. The qualitative and environmental factors include 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. An unallocated component is 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 payment when due. Impairment is measured on a loan-by-loan basis for 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 and residential loans for impairment disclosures. At December 31, 2009, there were four loans classified as impaired loans. At December 31, 2008, there were five loans classified as impaired loans. Refer to Note 5 in the Notes to the Consolidated Financial Statements for more information on our impaired loans.

Provision for loan losses decreased by $126,000 to $265,000 for the year ended December 31, 2009 from $391,000 for the year ended December 31, 2008. Despite an increase in non-performing assets from $1.7 million at December 31, 2008 to $2.0 million at December 31, 2009, management determined that additional provisions were not necessary due to the overall quality of the loan portfolio. The majority of our loans are residential mortgage loans or commercial mortgage loans backed by first lien collateral on real estate held in the Western New York region. Western New York has not been impacted as 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. In light of current economic conditions, we are continuing to monitor our loan portfolio and if necessary we will adjust the provision for loan losses.

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

| | At or for the Year Ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2009 | 2008 | 2007 | 2006 | 2005 |
| | (Dollars in thousands) | | | | |
| Balance at beginning of period: | $ 1,476 | $ 1,226 | $ 1,257 | $ 1,240 | $ 1,288 |
| Provision for loan losses | 265 | 391 | 105 | 158 | 20 |
| Charge-offs: | | | | | |
| Mortgage loans on real estate: | | | | | |
| One-to-four family | 146 | 102 | 25 | 49 | 16 |
| Construction | — | — | — | — | — |
| Commercial real estate | 24 | — | — | — | — |
| Home equity loans and lines of credit | 54 | — | 80 | — | 29 |
| Other loans: | | | | | |
| Commercial loans | 9 | 16 | 19 | 86 | 12 |
| Consumer loans | 33 | 30 | 15 | 35 | 26 |
| Total charge-offs: | 266 | 148 | 139 | 170 | 83 |
| Recoveries: | | | | | |
| Mortgage loans on real estate: | | | | | |
| One-to-four family | 74 | — | — | — | — |
| Construction | — | — | — | — | — |
| Commercial real estate | — | — | — | — | — |
| Home equity loans and lines of credit | 7 | — | — | — | — |
| Other loans: | | | | | |
| Commercial loans | — | 3 | — | 28 | 14 |
| Consumer loans | 8 | 4 | 3 | 1 | 1 |
| Total Recoveries | 89 | 7 | 3 | 29 | 15 |
| | | | | | |
| Net charge-offs | 177 | 141 | 136 | 141 | 68 |
| | | | | | |
| Balance at end of period | $ 1,564 | $ 1,476 | $ 1,226 | $ 1,257 | $ 1,240 |
| | | | | | |
| Average loans outstanding | $ 250,846 | $ 228,392 | $ 210,610 | $ 205,419 | $ 200,652 |
| | | | | | |
| Allowance for loan losses as a percent of total net loans | 0.60 % | 0.61 % | 0.56 % | 0.61 % | 0.60 % |
| Allowance for loan losses as a percent of non-performing loans | 93.26 % | 89.40 % | 74.57 % | 96.03 % | 91.04 % |
| | | | | | |
| Ratio of net charge-offs to average loans outstanding | 0.07 % | 0.06 % | 0.06 % | 0.07 % | 0.03 % |

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 periods 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, | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2009 | | | 2008 | | | 2007 | | | 2006 | | | 2 | |
| | 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 Allowance to Total Allowance | % of Loans in Category to Total Loans | Amount | % Allo T To Allo |
| | (Dollars in thousands) | | | | | | | | | | | | | |
| | $265 | 16.9 % | 71.9 % | $449 | 30.4 % | 73.5 % | $631 | 51.5 % | 72.4 % | $733 | 58.3 % | 72.7 % | $648 | 52 |
| | 313 | 20.0 % | 11.0 % | 165 | 11.2 % | 8.2 % | 339 | 27.6 % | 9.3 % | 236 | 18.8 % | 8.3 % | 238 | 19 |
| ans | — | 0.0 % | 0.1 % | 26 | 1.8 % | 2.7 % | — | — | 1.3 % | — | — | 0.8 % | — | — |
| | 107 | 6.9 % | 11.7 % | 145 | 9.8 % | 11.8 % | 71 | 5.8 % | 12.2 % | 93 | 7.4 % | 12.6 % | 94 | 7. |
| | 685 | 43.8 % | 94.7 % | 785 | 53.2 % | 96.2 % | 1,041 | 84.9 % | 95.2 % | 1,062 | 84.5 % | 94.4 % | 980 | 79 |
| | 834 | 53.3 % | 4.4 % | 643 | 43.6 % | 3.1 % | 130 | 10.6 % | 3.8 % | 136 | 10.8 % | 4.3 % | 141 | 11 |
| | 37 | 2.4 % | 0.9 % | 45 | 3.0 % | 0.7 % | 34 | 2.8 % | 1.0 % | 32 | 2.5 % | 1.3 % | 33 | 2. |
| | 871 | 55.7 % | 5.3 % | 688 | 46.6 % | 3.8 % | 164 | 13.4 % | 4.8 % | 168 | 13.4 % | 5.6 % | 174 | 14 |
| | $1,556 | 99.5 % | 100.0 % | $1,473 | 99.8 % | 100.00 % | $1,205 | 98.3 % | 100.00 % | $1,230 | 97.9 % | 100.0 % | $1,154 | 93 |
| d | $8 | 0.5 % | | $3 | 0.2 % | | $21 | 1.7 % | | $27 | 2.1 % | | $86 | 6. |
| of | $1,564 | 100.0 % | | $1,476 | 100.0 % | | $1,226 | 100.0 % | | $1,257 | 100.0 % | | $1,240 | 10 |

(1) Increases as of December 31, 2009 and 2008 are primarily due to a reserve calculated on four loans to one borrower that were classified as impaired. The reserve was calculated based on the present value of the discounted cash flows in accordance with ASC 310-10-35. A reserve of $570,000 was set aside in 2008 for these loans, with an additional reserve of $127,000 recorded during 2009.

## 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 and 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.

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. We have also 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.

As of December 31, 2009, our entire portfolio was classified as "available for sale" and reported at fair value. Our portfolio consists of collateralized mortgage obligations, mortgage backed securities, asset-backed securities, U.S. Government obligations and municipal bonds. Nearly all our mortgage backed securities are directly or indirectly insured or guaranteed by the Federal Home Loan Mortgage Corporation, the Government National Mortgage Association or the Federal National Mortgage Association. The municipal securities we invest in have maturities of 20 years or less and often have private insurance guaranteeing repayment.

We have investments in Federal Home Loan Bank of New York stock, which must be held as a condition of membership in the Federal Home Loan Bank system.

Fair values of available for sale securities were based on a market approach, with the exception of seven non-agency 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.

Management evaluated our investment portfolio and determined that a pre-tax $1.9 million other than temporary impairment existed on four non-agency, asset-backed securities during 2008. The impairment of these securities was considered to be other than temporary due to developments in the financial condition and near-term prospects of the issuers or insurers backing the securities, a downturn of economic conditions in the financial services industry and deteriorating book values of these securities.

The impairment charge of $1.9 million represents a write down of these securities to their fair market value and was recognized in earnings during 2008. We did not take any additional impairment charges on our investment portfolio during 2009.

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Management continues to evaluate the value of these investments and will make any necessary adjustments as conditions dictate.

Classification of Investments. Federal regulations require us to regularly review and classify our investments based on credit risk, not interest rate risk. A decline in the market value of a security simply due to interest rate fluctuation is not a basis for adverse classification. Instead, the classification is based on the likelihood of timely collection of principal and interest and also market price depreciation due to credit quality concerns.

In assessing the credit quality of securities in our investment portfolio, we review the qualitative ratings provided by nationally recognized statistical rating organizations ("NRSROs"), such as Standard and Poor ("S&P"), Moody's or Fitch. Securities that are rated in the first four rating categories by NRSROs are generally considered investment quality and are not adversely classified. If a security has a rating below the first four categories, 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.

The Company's policies require that only investment grade securities are to be purchased. However, the Company may legally hold a "fallen angel", defined as a security that it purchased at investment grade which has subsequently fallen to a below investment grade level.

Our determination as to the classification of our investments are subject to review by our regulatory agencies. We regularly review our investment portfolio to determine whether any investments require classification in accordance with applicable regulations. Our review of our investments portfolio at December 31, 2009 and 2008 indicated seven private label securities that were below investment grade, with an amortized cost of $6.8 million and fair value of $5.3 million. The rating on one collateralized mortgage security was Ba3 by Moody's. The ratings on the Asset-backed securities ranged from Caa3 to D. All seven securities were classified as "Substandard." These securities were also evaluated for other-than-temporary impairment as noted in the Other than Temporary Impairment section of Part I, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.

The following table presents the composition of our securities portfolio (excluding Federal Home Loan Mortgage Corporation common stock) in dollar amount of each investment type at the dates indicated.

| | At December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2009 | | 2008 | | 2007 | |
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| | (Dollars in thousands) | | | | | |
| Securities available for sale: | | | | | | |
| U.S. Treasury Bonds | $5,129 | $ 5,469 | $5,135 | $ 6,521 | $5,143 | $ 5,546 |
| Municipal Bonds | 27,303 | 27,967 | 17,192 | 17,322 | 11,572 | 11,621 |
| Mortgage-backed securities: | | | | | | |
| Collateralized mortgage obligations | 55,549 | 56,922 | 54,626 | 55,303 | 53,106 | 53,113 |
| Government National Mortgage Association | 7 | 7 | 23 | 25 | 28 | 30 |
| Federal National Mortgage Association | 9,564 | 9,989 | 8,250 | 8,657 | 5,957 | 5,959 |
| Federal Home Loan Mortgage Corporation | 9,615 | 10,028 | 14,385 | 14,807 | 15,290 | 15,203 |
| Asset-backed securities (private label) | 9,578 | 7,966 | 11,391 | 10,212 | 14,514 | 13,688 |
| Total available for sale | $116,745 | $ 118,348 | $111,002 | $ 112,847 | $105,610 | $ 105,160 |

At December 31, 2009, non-U.S. Government and Government agency securities that exceeded 10.0% of equity were as follows:

| Issuer | Book Value | Fair Value |
|---|---|---|
| | (In thousands) | |
| Asset backed securities | | |
| Countrywide Asset Backed Certificates | $ 5,798 | $ 4,811 |
| Total | $ 5,798 | $ 4,811 |

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, 2009. 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.

| | One year or less | | 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 | Weighted Average Yield | Amortized Cost | Fair Value | Weighted Average Yield |
| | (Dollars in thousands) | | | | | | | | | | |
| Available for Sale Securities: | | | | | | | | | | | |
| U.S. Treasury Bonds | $998 | 4.19% | $— | — | $— | — | $4,131 | 5.10% | $5,129 | $5,469 | 4.92% |
| Municipal Bonds | — | — | 897 | 3.62% | 7,337 | 3.79% | 19,069 | 4.00% | 27,303 | 27,967 | 3.93% |
| Mortgage-backed securities | 5,365 | 3.77% | 2,161 | 4.12% | 4,683 | 4.26% | 62,526 | 4.57% | 74,735 | 76,946 | 4.48% |
| Asset-backed securities | — | — | — | — | — | — | 9,578 | 5.49% | 9,578 | 7,966 | 5.49% |
| Total debt securities: | $6,363 | 3.84% | $3,058 | 3.97% | $12,020 | 3.97% | $95,304 | 4.57% | $116,745 | $118,348 | 4.45% |

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 “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, interest bearing and non-interest bearing checking accounts, retirement accounts, time deposits and Interest on Lawyer Accounts.

Deposit balances in our NOW accounts constituted 66% and 58% of the total checking account balances at December 31, 2009 and 2008, respectively. These accounts are interest-earning checking accounts, with a weighted average rate at December 31, 2009 of 0.20%.

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, and the rates charged on other sources of funds. Core deposits (defined as savings deposits, money market accounts, demand accounts and other interest bearing accounts) represented 40.6% and 38.7% of total deposits on December 31, 2009 and 2008, respectively. At December 31, 2009 and 2008, time deposits with remaining terms to maturity of less than one year amounted to $135.1 million and $117.0 million, respectively.

The following table presents our time deposit accounts categorized by interest rates which mature during each of the periods set forth below and the amounts of such time deposits by interest rate at each of December 31, 2009, 2008 and 2007.

| | Period to maturity from December 31, 2009 | | | | 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 | 2009 | 2008 | 2007 |
| | (Dollars in thousands) | | | | | | |
| Interest Rate Range | | | | | | | |
| 1.99% and below | $78,151 | $ 9,398 | $ 2,355 | $ 1 | $89,905 | $3,271 | $2,292 |
| 2.00% to 2.99% | 12,079 | 15,916 | 1,195 | 7,732 | 36,922 | 33,541 | 596 |
| 3.00% to 3.99% | 42,587 | 3,156 | 4,334 | 669 | 50,746 | 128,183 | 39,216 |
| 4.00% to 4.99% | 1,538 | 2,898 | 5,966 | 132 | 10,534 | 13,650 | 71,329 |
| 5.00% to 5.99% | 702 | — | 50 | 163 | 915 | 1,042 | 21,656 |
| Total | $135,057 | $ 31,368 | $ 13,900 | $ 8,697 | $189,022 | $179,687 | $135,089 |

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

| | At December 31, | | | | | |
|---|---|---|---|---|---|---|
| | 2009 | | 2008 | | 2007 | |
| | Amount | Percent of total deposits | Amount | Percent of total deposits | Amount | Percent of total deposits |
| | (Dollars in thousands) | | | | | |
| Deposit type: | | | | | | |
| Savings | $29,027 | 9.12 % | $27,290 | 9.31 % | $25,282 | 10.50 % |
| Money market | 37,336 | 11.73 % | 25,157 | 8.58 % | 23,202 | 9.63 % |
| Interest bearing demand | 41,857 | 13.15 % | 35,303 | 12.04 % | 37,934 | 15.75 % |
| Non-interest bearing demand | 21,172 | 6.64 % | 25,811 | 8.80 % | 19,321 | 8.02 % |
| Total core deposits | 129,392 | 40.64 % | 113,561 | 38.73 % | 105,739 | 43.90 % |
| Time deposits with original maturities of: | | | | | | |
| Three months or less | 6,577 | 2.07 % | 3,539 | 1.21 % | 1,727 | 0.72 % |
| Over three months to twelve months | 66,927 | 21.02 % | 43,728 | 14.90 % | 95,100 | 39.5 % |
| Over twelve months to twenty-four months | 83,819 | 26.32 % | 110,424 | 37.65 % | 23,636 | 9.81 % |
| Over twenty-four months to thirty-six months | 12,220 | 3.84 % | 9,648 | 3.29 % | 9,745 | 4.05 % |
| Over thirty-six months to forty-eight months | 10,968 | 3.44 % | 10,370 | 3.54 % | 3,202 | 1.33 % |
| Over forty-eight months to sixty months | 8,040 | 2.52 % | 1,511 | 0.52 % | 1,212 | 0.50 % |
| Over sixty months | 471 | 0.15 % | 467 | 0.16 % | 467 | 0.19 % |
| Total time deposits | 189,022 | 59.36 % | 179,687 | 61.27 % | 135,089 | 56.10 % |
| Total deposits | $318,414 | 100.00 % | $293,248 | 100.00 % | $240,828 | 100.00 % |

At December 31, 2009, we had $54.5 million in time deposits with balances of $100,000 or more maturing as follows:

| Maturity Period | Amount (In thousands) |
|---|---|
| Three months or less | $ 20,726 |
| Over three months through six months | 8,996 |
| Over six months through twelve months | 8,295 |
| Over twelve months | 16,481 |
| Total | $ 54,498 |

Short-term Borrowings. Our borrowings consist of short-term Federal Home Loan Bank advances. At December 31, 2009 and 2008, our short-term borrowings from the Federal Home Loan Bank of New York were $6.9 million and $5.5 million, respectively. The short-term borrowings at December 31, 2009 had fixed rates of interest ranging from 0.36% to 0.38% and mature within one year. The following table sets forth information concerning balances and interest rates on our borrowings at the dates and for the periods indicated. We have an available line of credit of $37.9 million at December 31, 2009 and a one month overnight re-pricing line of credit of $37.9 million from the Federal Home Loan Bank of New York. We had no outstanding borrowings on either of these lines of credit as of December 31, 2009.

| | At December 31, | | |
|---|---|---|---|
| | 2009 | 2008 | 2007 |
| | (Dollars in thousands) | | |
| At December 31 | | | |
| Amount outstanding | $ 6,850 | $ 5,500 | $ 18,505 |
| Weighted average interest rate | 0.37 % | 2.60 % | 4.61 % |
| For the year ended December 31 | | | |
| Highest amount at month-end | $ 6,950 | $ 11,172 | $ 27,502 |
| Daily average amount outstanding | 5,073 | 6,899 | 14,750 |
| Weighted average interest rate | 0.92 % | 3.37 % | 5.20 % |

Subsidiary Activities

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

## Personnel

As of December 31, 2009, we had 91 full-time employees and 22 part-time employees. The employees are not represented by a collective bargaining unit and we consider our relationship with our employees to be good.

## Regulation

Regulation of Lake Shore Bancorp and Lake Shore, MHC.

Lake Shore Bancorp and Lake Shore, MHC are savings and loan holding companies regulated by the Office of Thrift Supervision (the “OTS”). As such, Lake Shore Bancorp and Lake Shore, MHC are registered with and subject to OTS examination and supervision, as well as certain reporting requirements. In addition, the OTS has enforcement authority over Lake Shore Bancorp and Lake Shore, MHC and any of their non-savings association subsidiaries. Among other things, this authority permits the OTS to restrict or prohibit activities that are determined to be a serious risk to the financial safety, soundness or stability of a subsidiary savings association. Unlike bank holding companies, federal savings and loan holding companies are not subject to any regulatory capital requirements or to supervision by the Federal Reserve System.

Restrictions Applicable to Lake Shore Bancorp. Activities of unitary savings and loan holding companies formed after May 4, 1999, such as Lake Shore Bancorp, must be financially related activities permissible for bank holding companies, as defined under the Bank Holding Company Act of 1956, as amended (the “BHCA”). Accordingly, Lake Shore Bancorp’s activities are restricted to:

- furnishing or performing management services for a savings association subsidiary of such holding company;
- conducting an insurance agency or escrow business;
- holding, managing, or liquidating assets owned or acquired from a savings association subsidiary of such company;
- holding or managing properties used or occupied by a savings association subsidiary of such company;
- acting as trustee under a deed of trust;
- any other activity (i) that the Board of Governors of the Federal Reserve System (the "Federal Reserve Board"), by regulation, has determined to be permissible for bank holding companies under Section 4(c) of the BHCA, unless the Director of the OTS, by regulation, prohibits or limits any such activity for savings and loan holding companies, or (ii) in which multiple savings and loan holding companies were authorized by regulation to directly engage in on March 5, 1987;
- purchasing, holding, or disposing of stock acquired in connection with a qualified stock issuance if the purchase of such stock by such holding company is approved by the Director of the OTS; and
- any activity permissible for financial holding companies under section 4(k) of the BHCA. Permissible activities which are deemed to be financial in nature or incidental thereto under section 4(k) of the BHCA include:
  - lending, exchanging, transferring, investing for others, or safeguarding money or securities;
  - insurance activities or providing and issuing annuities, and acting as principal, agent, or broker;
  - financial, investment, or economic advisory services;
  - issuing or selling instruments representing interests in pools of assets that a bank is permitted to hold directly;
  - underwriting, dealing in, or making a market in securities;
  - activities previously determined by the Federal Reserve Board to be closely related to banking;
  - activities that bank holding companies are permitted to engage in outside of the U.S.; and
  - portfolio investments made by an insurance company.

In addition, Lake Shore Bancorp is not permitted to be acquired unless the acquirer is engaged solely in financial activities, and is not permitted to acquire a company unless the Company is engaged solely in financial activities.

Savings and loan holding companies and their subsidiaries that are neither savings associations nor service corporations of a savings association can engage in all services and activities permissible for bank holding companies pursuant to regulations promulgated by the Federal Reserve Board under Section 4(c) of the BHCA. Prior OTS approval to engage in such activities will not be required as long as the holding company received an examination rating of satisfactory or above prior to January 1, 2008 or a composite rating of "1" or "2" thereafter, in its most recent examination, and is not in troubled condition, and the holding company does not propose to commence the activity by an acquisition (in whole or in part) of a going concern.

OTS also prohibits service at a savings and loan holding company by any person convicted of certain criminal offenses or who agreed to enter into a pre-trial diversion or similar program in connection with a prosecution for such criminal offenses. The regulation implements a provision of the Federal Deposit Insurance Act, the purpose of which was to prevent persons who are currently prohibited from serving at an insured institution from serving at a holding company controlling such institution. In general, a person convicted of criminal offenses involving dishonesty, breach of trust or money laundering is prohibited from serving at a bank or its holding company. OTS has the authority to review proposed appointments on a case-by-case basis, and by regulation has exempted categories of employees of certain savings and loan holding companies engaged in activities that the holding company is not permitted to not engage in.

Restrictions Applicable to Activities of Mutual Holding Companies. Under federal law, a mutual holding company, such as Lake Shore, MHC, may engage only in the following activities:

investing in the stock of a savings association;

acquiring a mutual association through the merger of such association into a savings association subsidiary of such holding company or an interim savings association subsidiary of such holding company;

merging with or acquiring another holding company, one of whose subsidiaries is a savings association;

investing in a corporation the capital stock of which is available for purchase by a savings association under federal law or under the law of any state where the subsidiary savings association or association is located; and

the permissible activities described above for non-grandfathered savings and loan holding companies.

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 the activities listed above, and it has a period of two years to cease any non-conforming activities and divest any non-conforming investments.

Restrictions Applicable to All Savings and Loan Holding Companies. Federal law prohibits savings and loan holding companies, including Lake Shore Bancorp and Lake Shore, MHC, directly or indirectly, from acquiring:

control (as defined under the Home Owner's Loan Act ("HOLA"), Change in Bank Control Act ("CIBCA") and OTS regulations thereunder) of another savings association (or a holding company parent) without prior OTS approval;

through merger, consolidation, or purchase of assets, another savings association or a holding company thereof, or acquiring all or substantially all of the assets of such institution (or a holding company) without prior OTS approval; or

control of any depository institution not insured by the FDIC (except through a merger with and into the holding company's savings association subsidiary that is approved by the OTS).

A savings and loan holding company may not acquire as a separate subsidiary an insured institution that has a principal office outside of the state where the principal office of its subsidiary institution is located, except:

in the case of certain emergency acquisitions approved by the FDIC;

if such holding company controls a savings association subsidiary that operated a home or branch office in such additional state as of March 5, 1987; or

if the laws of the state in which the savings association to be acquired is located specifically authorize a state-chartered savings association to be acquired by a savings association chartered by the state where the acquiring savings association or savings and loan holding company is located or by a holding company that controls such a state-chartered association.

If the savings association subsidiary of a federal mutual holding company fails to meet the qualified thrift lender test set forth in Section 10(m) of the HOLA and regulations of the OTS, the holding company must register with the Federal Reserve Board as a bank holding company under the BHCA within one year of the savings association's failure to so qualify.

Change in Control. Federal law requires, with few exceptions, OTS approval (or, in some cases, notice and effective clearance) prior to any acquisition of control of Lake Shore Bancorp. Among other criteria, under the HOLA, CIBCA and OTS regulations thereunder, "control" is conclusively presumed to exist if a person or company acquires, directly or indirectly, more than 25% of any class of voting stock of the savings association or holding company. Under OTS regulations, control is also presumed to exist, subject to rebuttal, if an acquirer acquires more than 10% of any class of voting stock (or more than 25% of any class of stock) and is subject to any of several "control factors," including, among other matters, the relative ownership position of a person, the existence of control agreements and board composition.

Waivers of Dividends by Lake Shore, MHC. OTS regulations require Lake Shore, MHC to notify the OTS of any proposed waiver of its receipt of dividends from Lake Shore Bancorp. The OTS reviews dividend waiver notices on a case-by-case basis, and, in general, does not object to any such waiver if:

the waiver would not be detrimental to the safe and sound operation of the subsidiary savings association; and

the mutual holding company's board of directors determines that such waiver is consistent with such directors' fiduciary duties to the mutual holding company's members.

Under OTS regulations in the event Lake Shore, MHC converts to stock form, our public stockholders would not be diluted because of any dividends waived by Lake Shore, MHC (and waived dividends would not be considered in determining an appropriate exchange ratio).

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Conversion of Lake Shore, MHC to Stock Form.  OTS 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 stock 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 and borrowers of Lake Shore Savings would receive the right to subscribe for additional 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.  Under OTS regulations, Minority Stockholders would not be diluted because of any dividends waived by Lake Shore, MHC (and waived dividends would not be considered in determining an appropriate exchange ratio), in the event Lake Shore, MHC converts to stock form.  The total number of shares held by Minority Stockholders after a Conversion Transaction also would be increased by any purchases by Minority Stockholders in the offering conducted as part of the Conversion Transaction.

Any Conversion Transaction would require the approval of a majority of the outstanding shares of common stock of Lake Shore Bancorp held by Minority Stockholders and by two-thirds of the total outstanding shares of common stock of Lake Shore Bancorp.  Any second-step Conversion Transaction also would require the approval of a majority of the eligible votes of members of Lake Shore, MHC.

Regulation of Lake Shore Savings

Lake Shore Savings is a federal stock savings bank and is subject to the regulation, examination and supervision of the OTS and the FDIC, as its deposit insurer.

Lake Shore Savings is a member of the Deposit Insurance Fund ("DIF"), and its deposit accounts are insured up to applicable limits by the FDIC, currently $250,000 per account category.  Lake Shore Savings files reports with the OTS concerning its activities and financial condition, and it must obtain regulatory approvals prior to entering into certain transactions, such as mergers with, or acquisitions of, other depository institutions.  The OTS and the FDIC conduct periodic examinations to assess Lake Shore Savings' compliance with various regulatory requirements.  This regulation and supervision establishes a comprehensive framework of activities in which a savings association can engage and is intended primarily for the protection of the insurance fund and depositors.  As a savings and loan holding company, Lake Shore Bancorp is required to file certain reports with, and otherwise comply with, the rules and regulations of the OTS and of the Securities and Exchange Commission under the federal securities laws.

The OTS and the FDIC have significant discretion in connection with their supervisory and enforcement activities and examination policies, including policies with respect to the classification of assets and the establishment of adequate loan loss reserves for regulatory purposes.  Any change in such policies, whether by the OTS, the FDIC, the Securities and Exchange Commission or the United States Congress, could have a material adverse impact on us, Lake Shore Savings, and our operations and stockholders.

The following discussion is intended to be a summary of the material statutes and regulations applicable to savings associations and their savings and loan holding companies, and it does not purport to be a comprehensive description of all such statutes and regulations.

Regulation of Federal Savings Associations

Business Activities. Lake Shore Savings derives its lending and investment powers from the HOLA, and the regulations promulgated thereunder by the OTS. Under these laws and regulations, Lake Shore Savings may invest in mortgage loans secured by residential and commercial real estate, commercial and consumer loans, certain types of debt securities, and certain other assets. Lake Shore Savings may also establish an operating subsidiary to engage in activities permissible for federal savings associations and service corporations that may engage in activities not otherwise permissible for Lake Shore Savings, including certain real estate equity investments and securities and insurance brokerage. Lake Shore Savings' authority to invest in certain types of loans or other investments is limited by federal law.

Capital Requirements. The OTS regulations require savings associations to meet three minimum capital standards: (i) a tangible capital ratio requirement of 1.5% of total assets as adjusted under the OTS regulations; (ii) a leverage ratio requirement of 3.0% of core capital to such adjusted total assets, if a savings association has been assigned the highest composite rating of 1 under the Uniform Financial Institutions Rating System; and (iii) a risk-based capital ratio requirement of 8.0% of core and supplementary capital to total risk-based assets. The minimum leverage capital ratio for any other depository institution that does not have a composite rating of 1 will be 4%, unless a higher leverage capital ratio is warranted by the particular circumstances or risk profile of the depository institution. In determining the amount of risk-weighted assets for purposes of the risk-based capital requirement, a savings association must compute its risk-based assets by multiplying its assets and certain off-balance sheet items by risk-weights, which range from 0% for cash and obligations issued by the United States Government or its agencies to 100% for consumer and commercial loans, as assigned by the OTS capital regulation based on the risks found by the OTS to be inherent in the type of asset.

Tangible capital is defined, generally, as common stockholders' equity (including retained earnings), certain non-cumulative perpetual preferred stock and related earnings, minority interests in equity accounts of fully consolidated subsidiaries, less intangibles (other than certain mortgage servicing rights), and investments in and loans to subsidiaries engaged in activities not permissible for a national bank. Core capital is defined similarly to tangible capital, but core capital also includes certain qualifying supervisory goodwill and certain purchased credit card relationships. Supplementary capital currently includes cumulative and other preferred stock, mandatory convertible debt securities, subordinated debt and intermediate preferred stock and the allowance for loan and lease losses. In addition, up to 45% of unrealized gains on available-for-sale equity securities with a readily determinable fair value may be included in tier 2 capital. The allowance for loan and lease losses includable in supplementary capital is limited to a maximum of 1.25% of risk-weighted assets, and the amount of supplementary capital that may be included as total capital cannot exceed the amount of core capital.

At December 31, 2009, Lake Shore Savings met each of its capital requirements, in each case on a fully phased-in basis.

Prompt Corrective Regulatory Action. Under the OTS prompt corrective action regulations, the OTS is required to take certain, and is authorized to take other, supervisory actions against undercapitalized savings associations. For this purpose, a savings association would be placed in one of the following four categories based on the association's capital:

well-capitalized;

adequately capitalized;

undercapitalized; or

critically undercapitalized.

At December 31, 2009, Lake Shore Savings met the criteria for being considered “well-capitalized.” If appropriate, the OTS can require corrective action by a savings association holding company under the “prompt corrective action” provision of federal law.

Capital Distributions. The OTS imposes various restrictions or requirements on Lake Shore Savings’ ability to make capital distributions, including cash dividends. A savings association that is the subsidiary of a savings and loan holding company must file a notice with the OTS at least 30 days before making a capital distribution. Lake Shore Savings must file an application for prior approval if the total amount of its capital distributions, including the proposed distribution, for the applicable calendar year would exceed an amount equal to Lake Shore Savings’ net income for that year plus Lake Shore Savings’ retained net income for the previous two years.

The OTS may disapprove of a notice of application if:

Lake Shore Savings would be undercapitalized following the distribution;

the proposed capital distribution raises safety and soundness concerns;

the capital distribution would violate a prohibition contained in any statute, regulation, or agreement; or

Lake Shore Bancorp’s ability to pay dividends, service its debt obligations, and repurchase its common stock is dependent upon receipt of dividend payments from Lake Shore Savings.

Liquidity. A federal savings association is required to maintain a sufficient amount of liquid assets to ensure its safe and sound operation.

Deposit Insurance. The FDIC merged the Bank Insurance Fund and the Savings Association Insurance Fund to form the DIF on March 31, 2006. Lake Shore Savings is a member of the DIF, which insures customer deposit accounts as described below, and the institution pays deposit insurance assessments to the FDIC to support the FDIC’s maintenance of the DIF. Historically, the FDIC insured customer deposit accounts up to $100,000; however, pursuant to the Emergency Economic Stabilization Act enacted in October 2008, the DIF currently insures customer deposit accounts up to $250,000. This expanded coverage was extended in May, 2009 to continue until at least December 31, 2013, and may or may not be extended beyond that date. In November 2008, in order to provide additional stability to the financial system, the FDIC also expanded its deposit coverage to provide a full guarantee to insured depository institutions that participate in the Transaction Account Guarantee Program (“TAGP”) of its Temporary Liquidity Guarantee Program (“TLGP”) for customers’ non-interest bearing transaction accounts for all amounts in such accounts. Lake Shore Savings participates in the TAGP component which allows us to provide full FDIC insurance coverage for non-interest bearing transaction accounts, but we opted out of the component relating to the complete guarantee of newly issued senior unsecured debt. Our participation in the TLGP will require the payment of additional insurance premiums to the FDIC.

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Effective January 1, 2007, the FDIC established a risk-based assessment system for determining the deposit insurance assessments to be paid by insured depository institutions to maintain the reserve ratio of the DIF in a range between 1.15 to 1.50% of estimated insured deposits held by insured depository institutions. The FDIC deposit insurance assessment system sets deposit insurance premiums based upon the risks a particular bank or savings association poses to the DIF. Under the assessment system, the FDIC assigns an institution to one of four risk categories, with the first category having two sub-categories based on the institution's most recent supervisory and capital evaluations, designed to measure risk. Formerly, assessment rates ranged from 5 basis points of assessable deposits for an institution in the least risky sub-category of the lowest risk category to 43 basis points of assessable deposits for an institution in the highest risk category.

The FDIC is authorized to raise the assessment rates as necessary to maintain the DIF. In October 2008, the FDIC proposed raising assessment rates to implement a Restoration Plan for the DIF, which had fallen significantly below the minimum target level of 1.15% as a result of recent bank failures. On February 27, 2009, the FDIC voted to implement an amended Restoration Plan. Under the amended Restoration Plan, the FDIC implemented an assessment rate schedule to raise the DIF reserve ratio to 1.15% within seven years. Pursuant to the Plan, the FDIC implemented a final rule that sets assessment rates and makes adjustments based on risk. Under the final rule, banks in the lowest risk category will pay initial base rates ranging from 12 basis points to 16 basis points of assessable deposits on an annual basis, beginning on April 1, 2009 (applicable to assessments for the second quarter of 2009 and thereafter); but this may be further adjusted to between 7 and 24 basis points of assessable deposits for banks' holding unsecured debt, certain secured liabilities and brokered deposits beyond a certain amount. Banks in the highest risk category will pay an initial base rate of 45 basis points of assessable deposits, which may also be adjusted to between 40 basis points and 77.5 basis points of assessable deposits for excess amounts of unsecured debt, certain secured liabilities and brokered deposits. The FDIC also has the ability to adjust the assessment rate schedule from quarter to quarter.

In 2009, the FDIC revised the method for calculating the assessment rate for depository institutions by introducing several adjustments to an institution's initial base assessment rate. A depository institution is assessed premiums by the FDIC based on its risk category as adjusted and the amount of deposits held. Higher levels of bank failures over the past two years combined with the increased level of insurance coverage for consumer deposit accounts have dramatically increased resolution costs of the FDIC and depleted the DIF. In light of the increased stress on the DIF caused by these developments, and in order to maintain a strong funding position and restore the reserve ratios of the deposit insurance fund, the FDIC 1) imposed a special assessment in June, 2009, 2) has increased assessment rates of insured institutions generally, and 3) has required insured institutions to prepay on December 30, 2009 the premiums that are expected to become due over the next three years. Moreover, on January 12, 2010, the FDIC issued a proposed rule that seeks to modify the FDIC's risk-based deposit insurance assessment system (risk-based assessment system) to account for the risks posed by certain employee compensation programs offered by certain depository institutions. The FDIC does not propose to limit the amount which employees are compensated, but rather is considering adjusting risk-based deposit insurance assessment rates to adequately compensate the DIF for the risks inherent in the design of certain compensation programs. At this time we do not believe our compensation programs will result in increased risk-based assessments. As a participant in the TLGP, which was scheduled to end on December 31, 2009 but which has been extended until June 30, 2010, Lake Shore Savings is also assessed an annual rate surcharge on its noninterest-bearing transaction deposit amounts over $250,000. The former rate of 10 basis points has been raised for duration of the extension period to 15 basis points for depository institutions in risk category I, 20 basis points for depository institutions in risk category II, and 25 basis points for depository institutions in risk categories III and IV. However, it is not assessed on amounts that are otherwise insured, for example, in a custodial account that has pass-through coverage for each actual owner where each owner has an account balance of less than $250,000. This surcharge is collected through the normal assessment cycle.

In addition, all FDIC-insured institutions are required to pay assessments to the FDIC to fund interest payments on bonds issued by the Financing Corporation ("FICO"), an agency of the federal government established to recapitalize the predecessor to the Savings Association Insurance Fund. These assessments, set by the FDIC quarterly, are currently set at .0114% of DIF-assessable deposits, and will continue until the FICO bonds mature in 2017 through 2019.

Under the Federal Deposit Insurance Act, the FDIC may terminate the insurance of an institution's deposits upon a finding that the 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. Management does not know of any practice, condition or violation that might lead to termination of deposit insurance.

Standards for Safety and Soundness. Under federal law, the OTS has adopted a set of guidelines prescribing safety and soundness standards. These guidelines establish general standards relating to internal controls and information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, asset quality, earnings standards, compensation, fees and benefits. In general, the guidelines require appropriate systems and practices to identify and manage the risks and exposures specified in the guidelines. In addition, the OTS adopted regulations that authorize, but do not require, the OTS to order an institution that has been given notice that it is not satisfying these safety and soundness standards to submit a compliance plan. If, after being notified, an institution fails to submit an acceptable plan of compliance or fails in any material respect to implement an accepted plan, the OTS must issue an order directing action to correct the deficiency and may issue an order directing other actions of the types to which an undercapitalized association is subject under the "prompt corrective action" provisions of federal law. If an institution fails to comply with such an order, the OTS may seek to enforce such order in judicial proceedings and to impose civil money penalties. We believe we are in compliance with the OTS guidelines.

Loans to One Borrower. Lake Shore Savings is generally subject to the same limits on loans to one borrower as is a national bank. With specified exceptions, Lake Shore Savings' total loans or extensions of credit to a single borrower cannot exceed 15% of Lake Shore Savings' unimpaired capital and surplus, which does not include accumulated other comprehensive income. Lake Shore Savings may lend additional amounts up to 10% of its unimpaired capital and surplus which does not include accumulated other comprehensive income, if the loans or extensions of credit are fully secured by readily-marketable collateral. Lake Shore Savings currently complies with applicable loans-to-one borrower limitations.

Consumer Protection and Compliance Provisions. Lake Shore Savings is subject to various laws and regulations dealing generally with consumer protection matters. Lake Shore Savings may be subject to potential liability under these laws and regulations for material violations. Lake Shore Savings' loan operations are also subject to federal laws applicable to credit transactions, such as the:

Federal "Truth-In-Lending Act," governing disclosures of credit terms to consumer borrowers;

"Home Mortgage Disclosure Act of 1975," 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 of 1978," as amended by the Fair and Accurate Credit Transactions Act ("FACT Act"), governing the use and provision of information to credit reporting agencies, certain identity theft protections and certain credit and other disclosures;

"Fair Debt Collection Act," governing the manner in which consumer debts may be collected by collection agencies;

"Servicemembers Civil Relief Act";

"Credit Card Accountability Responsibility and Disclosure Act of 2009"; and

Rules and regulations of the various federal agencies charged with the responsibility of implementing these federal laws.

Lake Shore Savings' deposit operations are also subject to federal laws applicable to deposit transactions, such as the:

"Truth in Savings Act," which imposes disclosure obligations to enable consumers to make informed decisions about accounts at depository institutions;

"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 issued by the Federal Reserve Board to implement that Act, 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; and

Rules and regulations of the various federal agencies charged with the responsibility of implementing these federal laws.

Subprime Mortgage Lending. The Federal Reserve Board approved a final rule for home mortgage loans to better protect consumers and facilitate responsible lending.  The rule prohibits unfair, abusive or deceptive home mortgage lending practices and restricts certain other mortgage practices and also establishes advertising standards and requires certain mortgage disclosures to be given to consumers earlier in the transaction.  The final rule amends the Federal Reserve Board's regulations that implement the Truth in Lending Act, and was adopted under the Home Ownership and Equity Protection Act.  Four key protections were added for a category defined as "higher-priced mortgage loans" secured by a consumer's principal dwelling.  For loans in this category, the protections are aimed to (a) prohibit a lender from making a loan without regard to borrowers' ability to repay the loan from income and assets other than the home's value; (b) require creditors to verify the income and assets they rely upon to determine repayment ability; (c) ban any prepayment penalty if the payment can change in the initial four years (for other higher-priced loans, a prepayment penalty period cannot last for more than two years); and (d) require creditors to establish escrow accounts for property taxes and homeowner's insurance for all first-lien mortgage loans.  In addition to the rules governing higher-priced loans, the rules also afford protections for loans secured by a consumer's principal dwelling, regardless of whether the loan is higher-priced.  Lake Shore Savings does not participate in any subprime lending as part of our internal lending program.

Real Estate Lending Standards.  The OTS and the other federal banking agencies adopted regulations to prescribe standards for extensions of credit that: (i) are secured by real estate; or (ii) are

made for the purpose of financing the construction of improvements on real estate. The OTS regulations require each savings association to establish and maintain written internal real estate lending standards that are consistent with safe and sound banking practices and appropriate to the size of the association and the nature and scope of its real estate lending activities. The standards also must be consistent with accompanying OTS guidelines, which include loan-to-value ratios for the different types of real estate loans. Associations are also permitted to make a limited amount of loans that do not conform to the proposed loan-to-value limitations so long as such exceptions are reviewed and justified appropriately. The guidelines also list a number of lending situations in which exceptions to the loan-to-value standards are justified.

Qualified Thrift Lender Test. The HOLA requires that Lake Shore Savings, as a savings association, comply with the qualified thrift lender test. Under the qualified thrift lender test, Lake Shore Savings is required to maintain at least 65% of its portfolio assets in certain "qualified thrift investments" for at least nine months of the most recent twelve-month period. "Qualified thrift investments" include, but are not limited to loans made to purchase, refinance, construct, improve, or repair domestic residential housing or manufactured housing, home equity loans, mortgage backed securities, Federal Home Loan Bank stock, loans for educational purposes, loans to small businesses, and loans made through credit cards or credit card accounts. "Portfolio assets" means, in general, Lake Shore Savings' total assets less the sum of:

specified liquid assets up to 20% of total assets;

goodwill and other intangible assets; and

the value of property used to conduct Lake Shore Savings' business.

Lake Shore Savings may also satisfy the qualified thrift lender test by qualifying as a domestic building and loan association as defined in the Internal Revenue Code of 1986, as amended. Lake Shore Savings met the qualified thrift lender test at December 31, 2009 and in each of the prior 12 months, and, therefore, qualified as a thrift lender. If Lake Shore Savings fails the qualified thrift lender test, it must either operate under certain restrictions on its activities or convert to a national bank charter.

Community Reinvestment Act. Under the Community Reinvestment Act ("CRA"), as implemented by OTS regulations, a savings association has a continuing and affirmative obligation consistent with its safe and sound operation to help meet the credit needs of its community, including low- and moderate-income neighborhoods. The CRA does not establish specific lending requirements or programs for financial institutions nor does it limit an institution's discretion to develop the types of products and services that it believes are best suited to its particular community. The CRA requires the OTS, in connection with its examination of a savings association, to assess the association's record of meeting the credit needs of its community and to take such record into account in its evaluation of certain applications by such association. The CRA also requires all institutions to publicly disclose their CRA ratings.

The CRA regulations establish an assessment system that bases an association's rating on its actual performance in meeting community needs. In particular, the assessment system that Lake Shore Savings is subject to focuses on the following performance standards:

a lending test, which evaluates a savings association's record of helping to meet the credit needs of its assessment area through its lending activities by considering a savings association's home mortgage, small business, small farm, and community development lending; and

a community development test, to evaluate the institution's community development loans, investments, and services in its assessment areas.

Lake Shore Savings has an on-going commitment to work with the Chautauqua Home Rehabilitation and Improvement Corporation ("CHRIC") in obtaining Federal Home Loan Bank grants to assist with community improvement efforts. Chautauqua County has some of the oldest housing stock in the nation. There are many homes in Chautauqua County that are in need of repairs to enable such homes to be in compliance with applicable housing codes. Through the sponsorship of Lake Shore Savings, CHRIC has obtained grant funds through the Federal Home Loan Bank Affordable Housing Program which have enabled many homeowners to have needed repairs completed on their homes to bring them up to code. Lake Shore Savings has also participated in various lending programs with CHRIC from time to time that have been geared to the low- to moderate-income population of Chautauqua County. These partnerships are ways by which Lake Shore Savings strives to improve its community and which has contributed to its receiving an "Outstanding" CRA rating on its last three evaluations by the OTS, the most recent being as of November 28, 2007.

Branching. Subject to certain limitations, HOLA and OTS regulations permit federally-chartered savings associations to establish branches in any State of the United States. The authority to establish such a branch is available as long as Lake Shore Savings continues to meet the Qualified Thrift Lender test under the HOLA. See "—Qualified Thrift Lender Test." The authority for a federal savings association to establish an interstate branch network would facilitate a geographic diversification of the association's activities. This authority under the HOLA and OTS regulations preempts any State law purporting to regulate branching by federal savings associations.

Privacy. The OTS has adopted final regulations applicable to savings associations implementing the privacy protection provisions required by the Gramm-Leach-Bliley Act. The regulations generally require that Lake Shore Savings disclose its privacy policy, including identifying with whom it shares a customer's "non-public personal information," to customers at the time of establishing the customer relationship and annually thereafter. In addition, Lake Shore Savings is required to provide its customers with the ability to "opt-out" of having their personal information shared with unaffiliated third parties and not to disclose account numbers or access codes to non-affiliated third parties for marketing purposes. Lake Shore Savings currently has a privacy protection policy in place and believes that such policy is in compliance with the regulations.

On November 17, 2009, OTS and each of the federal banking regulatory agencies released a final model privacy notice form designed to make it easier for consumers to understand how financial institutions collect and share information about them. The model form can be used by financial institutions to comply with these requirements. The final rule issued by the regulators provides that a financial institution that chooses to use the model form obtains a "safe harbor" and will satisfy the disclosure requirements for notices. The rule also removes, after a transition period, the sample clauses now included in the appendices of the agencies' privacy rules.

Affiliate Marketing. The federal banking agencies, including the OTS, implemented interagency rules pertaining to the FACT Act. Section 214 of the FACT Act provides consumers with the ability to restrict companies from using certain information obtained from affiliates to make marketing solicitations. In general, a person is prohibited from using information received from an affiliate to make a solicitation for marketing purposes to a consumer, unless the consumer is given notice and had a reasonable opportunity to opt out of such solicitations. The rule permits opt-out notices to be given by any affiliate that has a preexisting business relationship with the consumer and permits a joint notice from

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two or more affiliates. Moreover, such notice would not be required where Lake Shore Bancorp seeks to use information pertaining to a consumer with whom it has a pre-existing business relationship. The notice that is required under the FACT Act may be combined with other required disclosures to be provided under other provisions of law, including notices required under the privacy provisions of the Gramm-Leach-Bliley Act.

Identity Theft Prevention. The federal banking agencies, including the OTS, implement Section 315 of the FACT Act, requiring each financial institution or creditor to develop a written identity theft prevention program to detect, prevent, and mitigate identity theft in connection with the opening of certain accounts or certain existing accounts. Among the requirements under the new rule, Lake Shore Savings is required to adopt "reasonable policies and procedures" to:

Identify relevant red flags for covered accounts and incorporate those red flags into the program;

Detect red flags that have been incorporated into the identity theft prevention program;

Respond appropriately to any red flags that are detected to prevent and mitigate identity theft; and

Ensure the identity theft prevention program is updated periodically, to reflect changes in risks to customers or to the safety and soundness of the financial institution or creditor from identity theft.

Prohibitions Against Tying Arrangements. Federal savings associations are subject to the prohibitions of 12 U.S.C. § 1464(q) and 1467a(x) on certain tying arrangements. A depository institution is 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.

Transactions with Related Parties. Lake Shore Savings' authority to engage in transactions with its affiliates is limited by the HOLA, OTS regulations and Sections 23A and 23B of the Federal Reserve Act. In general, these transactions must be on terms which are as favorable to Lake Shore Savings as comparable transactions with non-affiliates. In addition, certain types of these transactions are restricted to an aggregate percentage of Lake Shore Savings' capital. Collateral in specified amounts must usually be provided by affiliates in order to receive loans from Lake Shore Savings. In addition, the OTS regulations prohibit a savings association from lending to any of its affiliates that engage in activities that are not permissible for bank holding companies and from purchasing the securities of any affiliate, other than a subsidiary.

Regulation W of the Federal Reserve Board implements Sections 23A and 23B, including expanding the definition of what constitutes an affiliate subject to Sections 23A and 23B and exempting certain subsidiaries of state-chartered banks from the restrictions of Sections 23A and 23B. The Federal Reserve Board expects each depository institution that is subject to Sections 23A and 23B to implement policies and procedures to ensure compliance with Regulation W.

Lake Shore Savings' authority to extend credit to its directors, executive officers and 10% stockholders, 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

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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. The regulations allow small discounts on fees on residential mortgages for directors, officers and employees. In addition, extensions for credit in excess of certain limits must be approved by Lake Shore Savings' board of directors.

Section 402 of the Sarbanes-Oxley Act of 2002 prohibits the extension of personal loans to directors and executive officers of issuers. The prohibition, however, does not apply to mortgages advanced by an insured depository institution, such as Lake Shore Savings, that are subject to the insider lending restrictions of Section 22(h) of the Federal Reserve Act.

Anti-Money Laundering/Terrorist Financing Provisions. Lake Shore Savings is subject to the Bank Secrecy Act, as amended by the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act ("USA PATRIOT Act"), which gives the federal government powers to address money laundering and terrorist threats through enhanced domestic security measures, expanded surveillance powers, and increased information sharing. Title III of the USA PATRIOT Act takes measures intended to encourage information sharing among financial institutions, bank regulatory agencies and law enforcement bodies. Further, certain provisions of Title III impose affirmative obligations on a broad range of financial institutions, including banks, thrifts, brokers, dealers, credit unions, money transfer agents, and parties registered under the Commodity Exchange Act.

Under applicable law, all financial institutions must:

Establish anti-money laundering programs that include, at minimum: (1) internal policies, procedures, and controls; (2) specific designation of an anti-money laundering compliance officer; (3) ongoing employee training programs; and (4) an independent audit function to test the anti-money laundering program.

Implement minimum standards for customer due diligence, identification and verification.

Establish, maintain, administer, or manage private banking accounts or correspondent accounts for non-United States persons or their representatives (including foreign individuals visiting the United States) in a manner that takes into account enhanced due diligence procedures and controls, where necessary, to detect and report instances of money laundering through such accounts.

Financial institutions may not establish, maintain, administer, or manage correspondent accounts for foreign shell banks (foreign banks that do not have a physical presence in any country). Financial institutions must take action through reasonable steps to ensure that correspondent accounts provided to foreign banks are not being used to indirectly provide banking services to foreign shell banks.

The Office of Foreign Assets Control ("OFAC"), which is a division of the U.S. Department of the Treasury, is responsible for helping to insure that United States entities do not engage in transactions with "enemies" of the United States, as defined by various Executive Orders and Acts of Congress. OFAC has sent, and will send, bank regulatory agencies lists of names of persons and organizations suspected of aiding, harboring or engaging in terrorist acts. If a bank finds a name on any transaction, account or wire transfer that is on an OFAC list, the bank is required to investigate, and if the match is confirmed, the bank must take additional actions including freezing the account, file a suspicious activity report and notify the FBI. Lake Shore Savings checks high-risk OFAC areas including new accounts, wire transfers and customer files.

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Bank regulators are directed to consider a holding company's effectiveness in combating money laundering when ruling on various applications.

Enforcement. The OTS has primary enforcement responsibility over savings associations, including Lake Shore Savings. This enforcement authority includes, among other things, the ability to assess civil money penalties, to issue cease and desist orders and to remove directors and officers. In general, these enforcement actions may be initiated in response to violations of laws and regulations and to unsafe or unsound practices.

Federal Home Loan Bank System. Lake Shore Savings is a member of the Federal Home Loan Bank of New York ("FHLBNY"), which is one of the regional Federal Home Loan Banks that make up the Federal Home Loan Bank System. Each Federal Home Loan Bank serves as a central credit facility for its member institutions by extending advances up to a maximum aggregate amount of twenty times the amount paid in by such member for capital stock in the Bank. Any advances from a Federal Home Loan Bank must be secured by specified types of collateral, and all long term advances may be obtained only for the purpose of providing funds for residential housing finance. Lake Shore Savings, as a member of the FHLBNY, is required to acquire and hold shares of capital stock in the FHLBNY in an amount at least equal to 0.20% of the mortgage-related assets of Lake Shore Savings. Lake Shore Savings is also required to own activity-based stock, the amount of which is calculated to reflect at least 4.50% of Lake Shore Savings' outstanding advances. These percentages are subject to change by the Federal Home Loan Bank. Lake Shore Savings was in compliance with this requirement at December 31, 2009, with an investment in FHLBNY stock of $2.5 million.

Management evaluates the stock for impairment in accordance with FASB ASC Topic 320, "Investments – Debt and Equity Securities" ("ASC 320"). Management's determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the FHLB as compared to the capital stock amount for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLB. The FHLB stock was not deemed to be impaired, and therefore no impairment charges were recorded during the year ended December 31, 2009.

Each Federal Home Loan Bank is required to provide funds for the resolution of insolvent thrifts and to contribute funds for affordable housing programs. These requirements could reduce the amount of earnings that the Federal Home Loan Banks can pay as dividends to their members and could also result in the Federal Home Loan Banks imposing a higher rate of interest on advances to their members. If dividends were reduced, or interest on future Federal Home Loan Bank advances increased, Lake Shore Savings' net interest income would be affected.

Membership in the Federal Home Loan Bank is voluntary for all federally-chartered savings associations, such as Lake Shore Savings. Each Federal Home Loan Bank System has adopted a capital structure meeting a leverage limit and a risk-based permanent capital requirement. Two classes of stock are authorized: Class A (requires a six month notice prior to redemption) and Class B (requires a five year notice prior to redemption).

Federal Reserve System. Lake Shore Savings is subject to provisions of the Federal Reserve Act and the Federal Reserve Board's regulations pursuant to which depository institutions may be required to maintain non-interest-earning reserves against their deposit accounts and certain other liabilities. Currently, reserves must be maintained against transaction accounts (primarily NOW and regular checking accounts). The Federal Reserve Board regulations generally require that reserves be maintained

in the amount of 3.0% of the aggregate of transaction accounts up to $42.1 million. The amount of aggregate transaction accounts in excess of $42.1 million is currently subject to a reserve ratio of 10.0%. The Federal Reserve Board regulations currently exempt $6.0 million of otherwise reservable balances from the reserve requirements, which exemption is adjusted by the Federal Reserve Board at the end of each year. Lake Shore Savings is in compliance with the foregoing reserve requirements. Because required reserves must be maintained in the form of vault cash, a non-interest bearing account at a Federal Reserve Bank, or a pass-thru account as defined by the Federal Reserve Board, must be maintained by the depository institution. The effect of this reserve requirement is to reduce Lake Shore Savings' interest-earning assets. The balances maintained to meet the reserve requirements imposed by the Federal Reserve Board may be used to satisfy liquidity requirements imposed by the OTS. The Federal Reserve Board is consolidating its check processing operation so that all checks presented to depository institutions in the United States, payable on depository institutions in the United States, are deemed to be local checks.

Developments in Regulation of the Financial Sector

Actions taken by Congress and bank regulatory agencies in response to recent market instability. In response to the widely-publicized challenging conditions during 2008, 2009 and into 2010 within the U.S. banking and financial system, the Treasury and federal banking agencies have taken various actions as part of a comprehensive strategy to stabilize the financial system and housing markets, and to strengthen U.S. financial institutions.

Emergency Economic Stabilization Act of 2008. The Emergency Economic Stabilization Act of 2008 ("EESA"), enacted on October 3, 2008, provided the Secretary of Treasury with authority to, among other things, establish the Troubled Asset Relief Program ("TARP") to purchase from financial institutions up to $700 billion of troubled assets, which include residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14, 2008. The term "troubled assets" also included any other financial instrument that the Secretary, after consultation with the Chairman of the Federal Reserve Board determines the purchase of which is necessary to promote financial market stability, upon transmittal of such determination in writing, to the appropriate committees of the U.S. Congress. EESA also provided for the temporary increase of federal deposit insurance coverage levels under the DIF from $100,000 to $250,000 per deposit category, per depositor, per institution, through December 31, 2013.

On October 14, 2008, the Treasury announced the Capital Purchase Program ("CPP") under EESA, pursuant to which Treasury would purchase up to $250 billion of senior preferred shares from qualifying financial institutions on standardized terms. The program was voluntary and required an institution to comply with a number of restrictions and provisions, including limits on executive compensation, stock redemptions and declaration of dividends. After careful consideration, we withdrew our application to participate in the CPP in February 2009.

On February 25, 2009, the Treasury announced the Capital Assistance Program ("CAP"), which is a new capital program under the Treasury Department's Financial Stability Plan. The purpose of the CAP is to restore confidence throughout the financial system by ensuring that the nation's largest banking institutions have a sufficient capital cushion against larger than expected future losses, should they occur due to a more severe economic environment, and to support lending to creditworthy borrowers. The CAP does not replace the CPP and is open to qualifying institutions regardless of whether they participated in the CPP. The deadline to apply for the CAP was May 25, 2009. Recipients of CAP funding are subject to requirements governing executive compensation and corporate governance for the entire period during which Treasury holds equity issued under the CAP.

American Recovery and Reinvestment Act of 2009. On February 17, 2009, the President signed the American Recovery and Reinvestment Act of 2009 into law as a $787 billion dollar economic

stimulus. The stimulus includes discretionary spending for among other things, infrastructure projects; increased unemployment benefits and food stamps; as well as tax relief for individuals and businesses.

The Credit Card Accountability Responsibility and Disclosure Act of 2009. In 2009, Congress enacted the Credit Card Accountability, Responsibility, and Disclosure Act of 2009 ("CARD Act"), which brings significant changes to rules dealing with consumer credit card accounts. The Federal Reserve Board has promulgated certain rules implementing the CARD Act. The CARD Act makes numerous changes to the Truth in Lending Act, affecting the marketing, underwriting, pricing, billing and other aspects of the consumer credit card business. Several provisions of the CARD Act became effective in August 2009; others became effective in February 2010; and others will become effective in August 2010. Legislation has been proposed to accelerate the effective date of all of the CARD Act provisions effective as soon as the legislation is enacted, but prospects for enactment are uncertain. In sum, the CARD Act, and its implementing regulations, demands greater transparency within the industry. It requires that credit card agreements be made publicly accessible, imposes notice requirements, and imposes, among other things, restrictions on interest rate changes, billing, fees, and the extension of credit to college students. The new law could reduce credit availability, or increase the cost of credit to cardholders, possibly affecting our transaction volume and revenues.

The CARD Act also includes provisions that impose limits and restrictions on certain prepaid (or "pay before") card products, including on fees. The Federal Reserve Board has proposed implementing regulations with respect to these provisions. The statutory provisions and implementing regulations may diminish the attractiveness of these products to our customers and may consequently adversely affect transaction volumes and revenues.

Temporary Liquidity Guarantee Program. The FDIC established the TLGP on October 14, 2008 (i) guaranteeing certain debt issued by FDIC-insured institutions and certain holding companies on or after October 14, 2008 through June 30, 2009; and (ii) providing unlimited insurance coverage for non-interest bearing transaction accounts.

The Debt Guarantee Program ("DGP") component of the TLGP provides liquidity to the inter-bank lending market and promotes stability in the unsecured funding market. Under the DGP, the FDIC temporarily guarantees all newly-issued senior unsecured debt up to prescribed limits. In general, the maximum amount of outstanding debt that is guaranteed under the DGP for each participating entity at any time is limited to 125 percent of the par value of the participating entity's senior unsecured debt. The DGP ensures that such debt would be fully protected in the event the issuing institution subsequently fails or its holding company files for bankruptcy. Entities that did not wish to participate in the DGP had to opt out by December 5, 2008. We opted out of the DGP.

Under the TAGP component of the TLGP, non-interest bearing transaction accounts are fully insured through June 30, 2010. Non-interest bearing transaction accounts are any deposit accounts with respect to which interest is neither accrued nor paid and on which the insured depository institution does not reserve the right to require advance notice of an intended withdrawal, including traditional demand deposit checking accounts that allow for an unlimited number of deposits and withdrawals at any time. Transactions accounts do not include interest-bearing money market deposit accounts or sweep arrangements that result in funds being placed in an interest-bearing account as the result of the sweep. The unlimited guarantee under the TAGP is in addition to, and separate from, the general deposit insurance coverage provided for under the DIF, currently at $250,000 per depositor, per institution until December 31, 2013. We have opted to participate in the TAGP and as such are bound by the requirements of the program, including the quarterly payment of an annualized assessment of 15, 20, or 25 basis points, depending on our risk category, on any deposit amounts exceeding the existing deposit insurance limit of $250,000. This assessment is in addition to our usual risk-based assessment, as discussed above in the paragraph regarding "Deposit Insurance."

Unfair and Deceptive Practices.  On January 29, 2009, the OTS, along with other federal banking agencies ("the Agencies") issued a joint, final rule under Section 5 of the Federal Trade Commission Act ("FTC Act") that provides clarification to the body of law surrounding unfair or deceptive acts or practices. In adopting the rule, the Agencies drew on the statutory definition of what constitutes an "unfair" act or practice under the FTC Act, and also drew on the definition of what constitutes a "deceptive" act or practice under applicable FTC guidance.  The Agencies identified five credit card practices that they conclusively determined to be unfair, and therefore unlawful under the FTC Act.  Furthermore, the Agencies reserved the right to regulate all other unfair or deceptive acts or practices of banks on a case-by-case basis.  The effective date of the final rule is July 1, 2010.

Truth in Savings Act regulatory amendments. In conjunction with issuing the joint, final rule regarding unfair or deceptive acts or practices, the Federal Reserve Board also adopted a final rule amending its regulations that implement the Truth in Savings Act.  The final rule, published in the Federal Register on January 29, 2009, addresses depository institutions' disclosure practices related to overdrafts.  The final rule extends to all institutions and includes the requirement to disclose on periodic statements the total amounts charged for overdraft fees and returned items fees, for both the statement period and the year-to-date period.  The final rule also requires institutions that provide account balance information through an automated system to provide a balance that excludes additional funds that may be made available to cover overdrafts

Consumer Overdraft Consent regulatory amendment.  The Federal Reserve Board has promulgated a final rule under Regulation E that requires financial institution to obtain an accountholder's consent prior to assessing any fees or charges in connection with the payment of any consumer overdraft for any ATM or one-time debit transaction.  The rule requires financial institutions to 1) provide the consumer with a notice explaining the overdraft service, 2) provide a reasonable opportunity for the consumer to affirmatively consent to the service, 3) obtain the consumer's affirmative consent to the institution's payment of ATM withdrawals or one-time debit card transactions pursuant to the institution's overdraft service, and 4) provide the consumer with written confirmation of the consumer's consent.  Financial institutions must implement the rule no later than July 1, 2010.

Proposed Legislation and Regulatory Action. In 2009, the U.S. House of Representatives passed the Wall Street Reform and Consumer Protection Act of 2009, which, among other things, calls for the absorption of our primary federal regulator, OTS, into the Office of the Comptroller of the Currency. In addition, the reform legislation provides for the establishment of a Consumer Financial Protection Agency having broad authority to regulate providers of credit, savings, payment and other consumer financial products and services; creates a new structure for resolving troubled or failed financial institutions; requires certain over-the-counter derivative transactions to be cleared in a central clearinghouse and/or effected on the exchange; revises the assessment base for the calculation of the FDIC assessments; and creates a structure to regulate systemically important financial companies, including providing regulators with the power to require such companies to sell or transfer assets and terminate activities if they determine that the size or scope of activities of the company pose a threat to the safety and soundness of the company or the financial stability of the United States. Other proposals have been made both domestically and internationally, including additional capital and liquidity requirements and limitations on size or types of activity in which banks may engage. The U.S. Senate is expected to consider its own version of the legislation, addressing similar, but not identical issues.

New statutes, regulations and guidance are regularly proposed that contain wide-ranging potential changes to the statutes, regulations and competitive relationships of financial institutions operating and doing business in the United States. We cannot predict whether or in what form any proposed regulation or statute will be adopted or the extent to which our business may be affected by any new regulation or statute.

Federal Securities Laws

Our common stock is registered with the Securities and Exchange Commission under Section 12(b) of the Securities Exchange Act of 1934, as amended. We are subject to information, proxy solicitation, insider trading restrictions, and other requirements under the Securities Exchange Act of 1934.

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 commercial 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 1A. Risk Factors.

Risks Related To Our Business

Our loan portfolio includes loans with a higher risk of loss. We originate commercial mortgage loans, commercial loans, consumer loans, and residential mortgage loans primarily within our market area. Commercial mortgage, commercial, and consumer loans 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 Mortgage Loans. Repayment is dependent upon income being generated in amounts sufficient to cover operating expenses and debt service.

Commercial 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 of the loan due to depreciation, damage, or loss.

The financial crisis and economic recession have resulted in uncertainty in the financial markets in general. While all financial institutions have been impacted by the economic conditions, the sub-prime lending issues have not affected Western New York in the same manner as other areas of the country and are not expected to affect our loan portfolio. Higher prices for businesses and consumers and increasing unemployment could affect our loan portfolio, if business owners or consumers are not able to make loan payments. As a result of the economic downturn, 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. Any further 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. We make various assumptions and judgments about the collectibility 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 high percentage of traditional real estate loans in our loan portfolio 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 loans in our portfolio other than traditional real estate loans, 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. We believe that the current amount of allowance for loan losses is sufficient to absorb inherent losses in our loan portfolio.

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. In 2007, interest rates began to fall towards the end of the year, as a result of the sub-prime lending crisis. During

2007 the weighted average interest rate on our loan portfolio was not enough to offset the higher interest expenses incurred on our deposit portfolio, which resulted in lower profitability. In 2008 and 2009, interest rates on deposit products began to steadily decline, while rates on loan products remained steady. In 2008 and 2009, loan growth was experienced in the Erie County market, and resulted in increased net interest income, however, there can be no assurance that such growth will continue.

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 most recently opened a new branch in Kenmore, New York in December 2008 and plan to open another Erie County branch office in Depew, New York during April 2010. 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 18 to 24 months for the Kenmore and Depew branches to become profitable after they have opened. All of our other full-service branches are individually profitable. 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. Depending upon locating acceptable sites, we anticipate opening one or two branches every 12 to 24 months.

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 ability to grow may be limited if we cannot make acquisitions. We intend to seek to expand our banking franchise, internally and by acquiring other financial institutions or branches and other financial service providers. 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 internal 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. In addition, commencing for the year ended December 31, 2009, we have also obtained a report by our independent auditors on the effectiveness of our internal controls. If we fail to identify and correct any significant deficiencies in the design or operating effectiveness of our internal control over

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financial reporting or fail to prevent fraud, current and potential stockholders 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.

Risks Related To Recent Developments And The Banking Industry Generally

Our business may be adversely affected by conditions in the financial services industry and U.S. and global credit markets. Beginning in the latter half of 2007 and continuing into 2010, negative developments in the capital markets and the economic recession have resulted in uncertainty in the financial markets in general. Although there are some indicators of improving economic conditions, there can be no assurance that such conditions will continue to improve and it is also possible that conditions will again deteriorate. Factors such as consumer spending, business investment, government spending and inflation all affect the business and economic environment and, ultimately, the amount and profitability of our business. Loan portfolio performances have deteriorated at many institutions resulting from, among other factors, a weak economy and a decline in the value of the collateral supporting their loans. The competition for deposits has increased significantly due to liquidity concerns at many of these same institutions. In an economic environment characterized by higher unemployment, lower family income, lower corporate earnings, lower business investment and lower consumer spending, stock prices of bank holding companies, like ours, have been negatively affected by the current condition of the financial markets, as has our ability, if needed, to raise capital or borrow in the debt markets.

Dramatic declines in the housing market over the past three years, with falling home prices and increasing foreclosures, unemployment and under-employment, have negatively impacted the credit performance of real estate related loans and resulted in significant write-downs of asset values by financial institutions. These write-downs have caused many financial institutions to seek additional capital, to reduce or eliminate dividends, to merge with larger and stronger institutions and, in some cases, to fail. This market turmoil and tightening of credit have led to an increased level of commercial and consumer delinquencies, lack of consumer confidence, increased market volatility and widespread reduction of business activity generally. The resulting economic pressure on consumers and lack of confidence in the financial markets may cause adverse changes in payment patterns, causing increases in delinquencies and default rates, which may impact our charge-offs and provision for loan losses.

As a result, there is a potential for new federal or state laws and regulations regarding lending and funding practices and liquidity standards, and financial institution regulatory agencies are expected to be very aggressive in responding to concerns and trends identified in examinations. Negative developments in the financial services industry and the impact of new legislation in response to those developments could adversely impact our operations, including our ability to originate or sell loans, and adversely impact our financial performance.

There can be no assurance that recently enacted legislation will help stabilize the U.S. financial system. As discussed further above in Part I, Item 1 “Business—Regulation—Developments in Regulation of the Financial Sector,” since October 2008, numerous legislative actions have been taken in response to the financial crisis affecting the banking system and financial markets.

Each of these programs was implemented to help stabilize and provide liquidity to the financial system. There can be no assurance, however, as to the actual impact that the EESA and its implementing regulations, the CPP, the Financial Stability Plan, the ARRA, the FDIC programs, or any other governmental program will have on the financial markets. The failure of the EESA, the FDIC or the U.S. government to stabilize the financial markets and the continuation or worsening of current financial market conditions could materially and adversely affect our business, financial condition, results of operations, access to credit or the trading price of our common stock.

The soundness of other financial institutions could adversely affect us. Our ability to engage in routine funding transactions could be adversely affected by the actions and commercial soundness of other financial institutions. Financial services institutions are interrelated as a result of trading, clearing, counterparty or other relationships. As a result, defaults by, or even rumors or questions about, one or more financial services institutions, or the financial services industry generally, have led to market-wide liquidity problems and could lead to losses or defaults by us or by other institutions. Many of these transactions expose us to credit risk in the event of default of our counterparty or client. In addition, our credit risk may be exacerbated when the collateral held by us cannot be realized upon or is liquidated at prices not sufficient to recover the full amount of the financial instrument exposure. There is no assurance that any such losses would not materially and adversely affect our results of operations.

Recent 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.

Higher FDIC deposit insurance premiums and assessments could adversely affect our financial condition. Beginning in late 2008, the economic environment caused higher levels of bank failures, which dramatically increased FDIC resolution costs and led to a significant reduction in the Deposit Insurance Fund (“DIF”). FDIC insurance premiums have increased substantially in 2009 and we expect to pay significantly higher FDIC premiums in the future. Effective April 1, 2009, the FDIC adopted a final rule revising its risk-based assessment system. The changes to the assessment system involve adjustments to the risk-based calculation of an institution’s unsecured debt, secured liabilities and brokered deposits. The revisions effectively result in a range of possible assessments under the risk-based system of 7 to 77.5 basis points, which may increase premiums paid by FDIC insured institutions.

On May 22, 2009, the FDIC imposed a 5 basis point special assessment on each insured depository institution’s assets minus Tier 1 capital as of June 30, 2009. The amount of the special assessment for any institution could not exceed 10 basis points times the institution’s assessment base. This emergency assessment was calculated based on the institution’s assets as of June 30, 2009, and totaled $185,000 for the Company, and was collected on September 30, 2009. Additional special assessments may be imposed by the FDIC for future periods. On November 12, 2009, the FDIC Board of Directors approved a final rule that required insured depository institutions to prepay their quarterly risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011, and 2012, on December 30, 2009, unless an exemption is obtained from the FDIC. Under this new rule, we accounted for the prepayment by recording the entire amount as a prepaid expense (an asset) as of December 30, 2009, the date the payment was made. Subsequently, we will record an expense (charge to earnings) for the regular quarterly assessment and an offsetting credit to the prepaid assessment until the asset is exhausted. Once the asset is exhausted, we will resume paying the quarterly deposit insurance assessments and recording the expense when it is paid.

We also participate in the FDIC's Temporary Liquidity Guarantee Program, or TLGP, for noninterest-bearing transaction deposit accounts. Banks that participate in the TLGP's noninterest-bearing transaction account guarantee will pay the FDIC an annual assessment of 10 basis points on the amounts in such accounts above the amounts covered by FDIC deposit insurance. The general termination date for the transaction account guarantee portion of the TLGP was December 31, 2009. To promote an orderly phase-out of the program, on August 26, 2009, the FDIC adopted a final rule extending the program for six months, through June 30, 2010. For institutions that chose to remain in the program, the fee was raised and adjusted to reflect the institution's risk profile. Any institution currently participating in the program that wished to opt out of the transaction account guarantee program extension had to submit its opt-out election to the FDIC on or before November 2, 2009. We have decided to remain in the program, and therefore will be subject to additional fees for the extended portion of the program.

There can be no assurance that there will not be additional significant deposit insurance premium increases, special assessments or prepayments in order to restore the DIF's reserve ratio. Increases in FDIC insurance premiums will add to our cost of operations and could have a significant impact on the profitability of our business.

There can be no assurance regarding the impact of pending legislation or regulatory changes on the U.S. financial services industry and the U.S. financial system or that the phase-out of existing recovery programs will not adversely impact the system. Current legislation and regulatory changes are being proposed for many aspects of the existing structure of the U.S. financial system. Any of these proposed changes could have a material adverse impact on our business, financial condition, results of operations, access to credit and the value of our securities. Similarly, the premature termination, manner or timing of the phase-out of existing programs implemented to assist the U.S. financial system in recovering from the recent financial crisis could have a material adverse impact on our business, financial condition, results of operations, access to credit or the value of our securities.

The results of our operations may be adversely affected if asset valuations cause other-than-temporary impairment charges. We may be required to record future impairment charges on our investment securities 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 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.

Our local economy may affect our future growth possibilities. We are in uncertain economic times, including uncertainty with respect to financial markets that have been volatile as a result of sub-prime mortgage related issues and other matters. 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. 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 and Erie Counties, New York. The financial crisis has negatively impacted our local economy and any further downturn in our local economy may further limit funds available for deposit and may negatively affect our borrowers' ability to repay their loans on a timely basis. 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 prolonged economic downturn would likely 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. If the current economic downturn in the economy as a whole, or in our geographic market areas, continues for a prolonged period, borrowers may be less likely to repay their loans as scheduled or at all. 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 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. Our results of operations depend substantially on our net interest income, which is the difference between the interest income earned on our interest-earning assets and the interest expense paid on our interest-bearing liabilities. Increases in interest rates may decrease loan demand and make it more difficult for borrowers to repay adjustable rate loans.

We also are subject to reinvestment risk associated with changes in interest rates. Changes in interest rates may affect the average life of loans and mortgage-related securities. Decreases in interest rates can result in increased prepayments of loans and mortgage-related securities, as borrowers refinance to reduce borrowing costs. Under these circumstances, we are subject to reinvestment risk to the extent that we are unable to reinvest the cash received from such prepayments at rates that are comparable to the rates on existing loans and securities.

Our earnings may be adversely impacted by a decrease in interest rates on residential mortgage loans. Low rates on these loan products may result in an increase in prepayments, as borrowers refinance their loans. If we cannot re-invest the funds received from prepayments at a comparable spread, net interest income could be reduced. Also, in a falling interest rate environment, certain categories of deposits may reach a point where market forces prevent further reduction in interest paid on those product. The net effect of these circumstances is reduced net interest income and possibly net interest spread. At December 31, 2009, 73.7% of our loans with contractual maturities of greater than one year had an average fixed rate of 6.04% which is higher than current yields on these products. In addition, 71.4% of our certificates of deposit, with an average interest rate of 2.24%, will mature within one year, and 42.2% of our borrowed funds, with an average interest rate of 2.80%, will contractually mature within one year. Therefore, in a decreasing rate environment, our interest income may decrease more rapidly than the yields paid on our deposits and borrowings causing a narrowing of our net interest rate spread and a decrease in our earnings. Our earnings may also be impacted by an increase in interest rates on loans, creating decreased demand for loans. Likewise, if interest rates rise, rates on deposit products will increase faster than loan rates, increasing short term deposit interest expense faster than income earned on loan products.

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 2. Properties.

We conduct our business through our corporate headquarters, administrative offices, and nine branch offices. At December 31, 2009, the net book value of the computer equipment and other furniture, fixtures, and equipment at our offices totaled $676,000. For more information, see Note 6 and Note 10 in the Notes to our Consolidated Financial Statements.

| Location | Leased or Owned | Original Date Acquired | Net Book Value December 31, 2009 (In thousands) |
|---|---|---|---|
| Corporate Headquarters | | | |
| 125 East Fourth Street<br>Dunkirk, NY 14048 | Owned | 1995 | $ 134 |
| Branch Offices: | | | |
| Chautauqua County | | | |
| 128 East Fourth Street<br>Dunkirk, NY 14048 | Owned/Leased (1) | 1930 | 913 |
| 30 East Main Street<br>Fredonia, NY 14063 | Owned | 1996 | 736 |
| 1 Green Avenue<br>Jamestown, NY 14701 | Owned/Leased(2) | 1996 | 682 |
| 115 East Fourth Street<br>Jamestown, NY 14701 | Owned | 1997 | 318 |
| 106 East Main Street<br>Westfield, NY 14787 | Owned | 1998 | 242 |
| Erie County | | | |
| 5751 Transit Road<br>East Amherst, NY 14051 | Owned | 2003 | 1,134 |
| 3111 Union Road<br>Orchard Park, NY 14127 | Leased(3) | 2003 | 395 |
| 59 Main Street<br>Hamburg, NY 14075 | Leased(4) | 2005 | 1,008 |
| 3438 Delaware Ave<br>Kenmore, NY 14217 | Owned | 2008 | 1,260 |
| Administrative Offices: | | | |
| 31 East Fourth Street<br>Dunkirk, NY 14048 | Owned | 2003 | 359 |
| 123 East Fourth Street<br>Dunkirk, NY 14048 | Owned | 1995 | 93 |

(1) The building is owned. Additional parking lot is leased. The lease expires in November 2014.

(2) The building is owned. The land is leased. The lease expires in September 2015.

(3) The lease expires in January 2017.

(4) The lease expires in 2028.

Item 3. Legal Proceedings.

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. [Reserved]

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 |
| 2008 | | | | |
| First Quarter | $ 10.63 | $ 7.81 | $ 0.04 | February 15, 2008 |
| Second Quarter | 10.20 | 8.13 | 0.05 | May 15, 2008 |
| Third Quarter | 10.09 | 6.34 | 0.05 | August 15, 2008 |
| Fourth Quarter | 9.67 | 6.65 | 0.05 | November 14, 2008 |
| 2009 | | | | |
| First Quarter | $ 8.01 | $ 4.31 | $ 0.05 | February 13, 2009 |
| Second Quarter | 7.55 | 6.41 | 0.05 | May 15, 2009 |
| Third Quarter | 8.25 | 7.00 | 0.05 | August 14, 2009 |
| Fourth Quarter | 8.25 | 7.46 | 0.05 | November 13, 2009 |

On February 2, 2010, the Board of Directors of Lake Shore Bancorp declared a quarterly cash dividend of $0.06 per common share outstanding that was payable on February 23, 2010 to stockholders of record as of the close of business on February 8, 2010. Refer to Note 21 in the Notes to our Consolidated Financial Statements.

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.

As of March 24, 2010 there were approximately 1,378 record holders of Lake Shore Bancorp 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, 2009:

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, 2009 through October 31, 2009 | 5,000 | $ 8.05 | 5,000 | 76,264 |
| November 1, 2009 through November 30, 2009 | 1,024 | $ 7.51 | 1,024 | 75,240 |
| December 1, 2009 through December 31, 2009 | 6,628 | $ 7.67 | 6,628 | 68,612 |
| Total | 12,652 | $ 7.81 | 12,652 | 68,612 |

(1) On February 24, 2010, our Board of Directors approved a new stock repurchase plan pursuant to which we can repurchase up to 122,642 shares of our outstanding common stock. This amount represented 5% of our outstanding stock not owned by the MHC as of February 24, 2010. The repurchase plan does not have an expiration date and superseded all of the prior stock repurchase programs.

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, beginning on page F-1 of this Form 10-K.

| | As of December 31, | | | | |
|---|---|---|---|---|---|
| | 2009 | 2008 | 2007 | 2006 | 2005 |
| | (Dollars in thousands) | | | | |
| Selected financial condition data: | | | | | |
| Total assets | $425,656 | $407,833 | $357,801 | $354,237 | $333,724 |
| Loans, net | 259,174 | 240,463 | 218,711 | 205,677 | 206,160 |
| Securities available for sale | 118,381 | 112,863 | 105,922 | 108,016 | 94,082 |
| Securities held to maturity | — | — | — | — | 2,275 |
| Federal Home Loan Bank stock | 2,535 | 2,890 | 3,081 | 2,481 | 2,716 |
| Total cash and cash equivalents | 22,064 | 29,038 | 10,091 | 18,682 | 12,053 |
| Total deposits | 318,414 | 293,248 | 240,828 | 249,637 | 250,890 |
| Short-term borrowings | 6,850 | 5,500 | 18,505 | 10,605 | 11,205 |
| Long-term debt | 36,150 | 46,460 | 37,940 | 32,750 | 37,480 |
| Total equity | 55,446 | 54,228 | 53,465 | 53,747 | 27,995 |
| Allowance for loan losses | 1,564 | 1,476 | 1,226 | 1,257 | 1,240 |
| Non-performing loans | 1,677 | 1,651 | 1,644 | 1,309 | 1,362 |
| Non-performing assets | 1,999 | 1,699 | 1,705 | 1,492 | 1,448 |

| | For the year ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2009 | 2008 | 2007 | 2006 | 2005 |
| | (Dollars in thousands, except per share data) | | | | |
| Selected operating data: | | | | | |
| Interest income | $19,693 | $19,983 | $18,622 | $17,774 | $15,956 |
| Interest expense | 7,929 | 8,778 | 9,133 | 8,045 | 6,426 |
| Net interest income | 11,764 | 11,205 | 9,489 | 9,729 | 9,530 |
| Provision for loan losses | 265 | 391 | 105 | 158 | 20 |
| Net interest income after provision for loan losses | 11,499 | 10,814 | 9,384 | 9,571 | 9,510 |
| Total non-interest income | 2,415 | 600 | 2,002 | 1,805 | 1,847 |
| Total non-interest expense | 11,035 | 9,602 | 9,118 | 8,646 | 8,350 |
| Income before income taxes | 2,879 | 1,812 | 2,268 | 2,730 | 3,007 |
| Income taxes | 718 | 342 | 451 | 911 | 953 |
| Net income | $2,161 | $1,470 | $1,817 | $1,819 | $2,054 |
| Basic earnings per common share (1) | $0.37 | $0.24 | $0.29 | $0.24 | $— |
| Diluted earnings per common share (1) | $0.37 | $0.24 | $0.29 | $0.24 | $— |
| Dividends declared per share | $0.20 | $0.19 | $0.13 | $0.03 | $— |

(1) The Company completed an initial public offering of its common stock on April 3, 2006.

| | At or for the year ended December 31, | | | | |
|---|---|---|---|---|---|
| | 2009 | 2008 | 2007 | 2006 | 2005 |
| Selected financial ratios and other data | | | | | |
| Performance ratios: | | | | | |
| Return on average assets | 0.52 % | 0.39 % | 0.52 % | 0.52 % | 0.62 % |
| Return on average equity | 3.93 % | 2.76 % | 3.39 % | 4.05 % | 7.47 % |
| Dividend payout ratio(1) | 54.05 % | 79.17 % | 44.83 % | 12.50 % | — |
| Interest rate spread(2) | 2.70 % | 2.75 % | 2.42 % | 2.60 % | 2.93 % |
| Net interest margin(3) | 3.03 % | 3.19 % | 2.92 % | 3.00 % | 3.09 % |
| Efficiency ratio(4) | 77.83 % | 81.34 % | 79.35 % | 74.96 % | 73.39 % |
| Non interest expense to average total assets | 2.65 % | 2.53 % | 2.60 % | 2.49 % | 2.53 % |
| Average interest-earning assets to average interest-bearing liabilities | 116.16 % | 117.53 % | 117.94 % | 116.16 % | 107.51 % |
| | | | | | |
| Capital ratios: | | | | | |
| Total risk-based capital to risk weighted assets(5) | 20.33 % | 21.78 % | 23.72 % | 23.88 % | 17.06 % |
| Tier 1 risk-based capital to risk weighted assets(5) | 19.95 % | 21.35 % | 22.90 % | 22.81 % | 16.00 % |
| Tangible capital to tangible assets(5) | 10.85 % | 11.20 % | 12.28 % | 11.68 % | 8.47 % |
| Tier 1 leverage (core) capital to adjustable tangible assets(5) | 10.85 % | 11.20 % | 12.28 % | 11.68 % | 8.47 % |
| Equity to total assets | 13.03 % | 13.30 % | 14.94 % | 15.17 % | 8.39 % |
| | | | | | |
| Asset quality ratios: | | | | | |
| Non-performing loans as a percent of total net loans | 0.65 % | 0.69 % | 0.75 % | 0.64 % | 0.66 % |
| Non-performing assets as a percent of total assets | 0.47 % | 0.42 % | 0.48 % | 0.42 % | 0.43 % |
| Allowance for loan losses as a percent of total net loans | 0.60 % | 0.61 % | 0.56 % | 0.61 % | 0.60 % |
| Allowance for loan losses as a percent of non-performing loans | 93.26 % | 89.40 % | 74.57 % | 96.03 % | 91.04 % |
| | | | | | |
| Other data: | | | | | |
| Number of full service offices | 9 | 9 | 8 | 8 | 8 |

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

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

(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 subject to formula-based 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 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 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 costs, 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. Since 1993, following the appointment of our current Chief Executive Officer, and despite the fact that the Western New York market area has been economically stagnant, we have significantly increased in asset size and have grown from being two branches to nine branches. Since 2000 our asset size has more than doubled and we opened four new branches. We plan to open our tenth branch office in April 2010. We are among the largest lenders in market share of residential mortgages in Chautauqua County.

Beginning in the latter half of 2007 and continuing into 2010, negative developments in the capital markets and the economic recession have resulted in uncertainty in the financial markets in general and have negatively impacted liquidity and credit quality across the financial markets. The far-reaching effects of the recession include deterioration in the labor market, rising unemployment, volatile equity markets, and declining home values, all of which are weighing negatively on consumer sentiment as evidenced by weak spending throughout this time period. During 2008 and 2009, financial markets experienced unprecedented events, and the market exhibited extreme volatility and evaporating liquidity as credit quality concerns, sharp fluctuations in commodity prices, volatility in rate indices such as Prime and LIBOR, and illiquidity persisted. Concerns regarding increased credit losses from the weakening economy negatively affected the capital and earnings levels of most financial institutions. Liquidity in the debt markets was extremely low despite the efforts of the Treasury and the Federal Reserve Board to inject capital and liquidity into financial institutions, and as a result, asset values continue to be under pressure. Although there are some indicators of improving economic conditions, there can be no assurance that such conditions will continue to improve and it is also possible that conditions will again deteriorate.

As discussed further above in Part I, Item 1 "Business—Regulation—Developments in Regulation of the Financial Sector," since October 2008, numerous legislative actions have been taken in response to the financial crisis affecting the banking system and financial markets. These legislative actions were implemented to help stabilize and provide liquidity to the financial system. There can be no assurance, however, 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 shareholders.

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 118 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. In December 2008, we opened our newest branch office in Kenmore, New York. This office had generated deposits of $25.4 million as of December 31, 2009. Our offices are located in Dunkirk, Fredonia, Jamestown, Lakewood and Westfield, in Chautauqua County, New York and in East Amherst, Hamburg, Orchard Park and Kenmore 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. We will be opening another branch office in Depew, New York during April 2010. This will be our fifth branch location in Erie County, New York and our tenth branch overall.

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.

Residential Mortgage and Other Lending. Historically, our lending portfolio has been composed predominantly of residential mortgage loans. At December 31, 2009 and 2008, we held $185.8 million and $175.8 million of residential mortgage loans, respectively, which constituted 71.9% and 73.3% of our total loan portfolio, at such respective dates. We originate commercial real estate loans to finance the purchase of real property, which generally consists of developed real estate. At December 31, 2009 and 2008, our commercial real estate loan portfolio consisted of loans totaling $28.3 million and $19.5 million, respectively, or 11.0% and 8.1%, respectively, of total 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. Other loan products offered to our customers include home equity loans, construction loans and consumer loans, including auto loans, overdraft lines of credit and share loans. At December 31, 2009 and 2008, our commercial loan portfolio consisted of loans totaling $11.4 million and $7.4 million, respectively, or 4.4% and 3.1%, respectively, of total loans. We will sell loans when appropriate and will retain servicing rights to those loans. Residential mortgage loans will continue to be the dominant type of loan in our lending portfolio.

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. At December 31, 2009 and 2008, our investment securities totaled $120.9 million and $115.8 million, respectively.

Treasury Yield Curve. As with all community banks, we face a challenge in monitoring our interest rate risk. Banks generate revenue on the difference between the interest earned on loans, which are generally for longer terms, and the interest paid on deposits, which are generally for shorter terms. This mismatch between shorter term deposits and longer term loans usually produces a positive contribution to earnings because the yield curve is normally positively sloped. During 2007 and 2008, the Federal Reserve cut the federal funds rate 10 times and as of December 31, 2009 the targeted federal funds rate was between 0% and 0.25%. During 2008, and continuing in 2009, there was unprecedented volatility in the markets including the failure of large investment banks, the conservatorship of Fannie Mae and Freddie Mac, a global liquidity crisis, continuing housing market declines and an ongoing credit crisis with financial institutions. There have been coordinated global initiatives and significant injections of capital and liquidity into the capital markets and financial institutions in response to these events. Between December 2008 and December 2009, yields in long-term Treasury maturities have shifted upward. For example, the yield on the 10 year Treasury note increased from 2.21% as of December 31, 2008 to 3.84% as of December 31, 2009, an increase of 63 basis points. Over that same one year time period the yield on a mortgage backed security increased by only 36 basis points. Given the changes to the treasury yield curve and spread relationship with mortgages, our net interest margin could decline if interest rates on loans remain low or decline further.

Interest Rate Risk. The current interest rate environment is challenging for community banks. Residential mortgage rates have declined in part due to the Federal Reserve Board purchasing mortgage backed securities. The lower rates on residential mortgage products often causes higher rate loans in the portfolio to prepay (or re-finance) and new loan originations to be recorded at lower rates. Adjustable rate mortgages continue to have their interest rates adjust downward which reduces interest income. At the same time, interest rates on long term funding have not declined commensurately with mortgage rates, resulting in a narrower interest rate spread. To address these challenges, we have implemented a number of strategies including refinance mitigation and loan sales. We sold $6.3 million of low rate residential mortgage loans during the year ended December 31, 2009. In addition, we continue to monitor market rates for funding options. Prior to 2008, we had purchased an interest rate floor product to help offset lower interest income received on floating rate loans if rates declined. During 2008 and through January 2009, our interest income was enhanced by payments on the floor. In January 2009, management decided to sell the floor based on its current value and prospects for further rate declines. Net of the cost of the investment, $1.0 million of interest income was recorded due to an increase in market value over the life of the interest rate floor product. We also received $348,000 of interest income over the life of the interest rate floor product.

We employ a third party financial advisor to assist us in managing our investment portfolio and developing balance sheet strategies. At December 31, 2009 and 2008, we had $118.4 million and $112.9 million,

respectively, invested in securities available for sale, the majority of which are mortgage-backed, collaterized mortgage obligations (“CMOs”) and municipal securities. We do not own any collateralized debt obligations (“CDOs”) or structured investment vehicles (“SIVs”).

Other than Temporary Impairment

During 2008, we wrote down four non-agency asset-backed securities in our investment portfolio due to the continued disruption of the securities and housing markets. The write-down resulted in a pre-tax loss of $1.9 million ($1.2 million, net of tax), which was recorded in “Other Non-interest Income” in the consolidated statements of operations. The securities were rated “AAA” by the major rating agencies when purchased. Three of the securities are collateralized by second lien home equity loans to prime borrowers. These securities were “wrapped” by an insurance guarantee issued by Financial Guaranty Insurance Co. (“FGIC”). As a result of FGIC’s exposure to troubled assets and the inability to raise additional capital, the major rating agencies downgraded FGIC. As a result of FGIC’s downgrade, the major rating agencies downgraded the ratings on these securities. The fourth security is backed by first lien residential mortgages to sub-prime borrowers. The majority of the mortgages underlying this security are adjustable rate loans. As of December 31, 2009 the security was rated CCC/Caa3 by S&P and Moody’s, respectively. The fair market values for all of these securities have experienced significant declines. The price declines, accounting rules and associated SEC guidance contributed to management’s determination that the impairment on these securities was “other-than-temporary” during 2008. It should be noted that all of these securities continue to make payments as of December 31, 2009. No additional impairments in these securities or impairments on other securities were taken during the year ended December 31, 2009. Management monitors the securities portfolio for the possibility of additional OTTI on a quarterly basis. Refer to Note 3 of the Notes to Consolidated Financial Statements for more information on OTTI.

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 quarterly 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.

In management’s opinion, the accounting policy relating to valuation of investments is a critical accounting policy. The fair values of our investments are determined using public quotations, third party dealer quotes, pricing models, or discounted cash flows. Thus, the determination 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 results of operations. Refer to Note 14 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 operations. The credit portion of a decline in the fair market value of investments below cost deemed to be other-than-temporary 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 other than temporary impairment. Refer to Note 3 of the Notes to Consolidated Financial Statements for more information on other than temporary impairment.

These critical policies and their application are reviewed periodically by the Audit Committee and the 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.

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-earnings assets and average cost of interest-bearing liabilities, interest earned and interest paid for the periods 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 periods presented. Average balances are derived from daily balances over the periods 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 municipals.

| | At December 31, 2009 | | For the Year ended December 31, 2009 | | | For the Year ended December 31, 2008 | | | For the Year ended December 31, 2007 | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | Actual Balance | Yield/ Rate | 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-bearing deposits & Federal funds sold | $15,007 | 0.68% | $18,413 | $102 | 0.55% | $13,554 | $284 | 2.10% | $3,959 | $130 | 3.28% |
| Securities | 120,916 | 4.58% | 118,938 | 5,533 | 4.65% | 109,846 | 5,146 | 4.68% | 110,535 | 5,010 | 4.53% |
| Loans | 259,174 | 5.42% | 250,846 | 14,058 | 5.60% | 228,392 | 14,553 | 6.37% | 210,610 | 13,482 | 6.40% |
| Total interest-earning assets | 395,097 | 4.98% | 388,197 | $19,693 | 5.07% | 351,792 | $19,983 | 5.68% | 325,104 | $18,622 | 5.73% |
| Other assets | 30,559 | | 28,068 | | | 27,005 | | | 25,351 | | |
| Total assets | $425,656 | | $416,265 | | | $378,797 | | | $350,455 | | |
| Interest-bearing liabilities: | | | | | | | | | | | |
| Demand and NOW accounts | $41,857 | 0.17% | $37,581 | $71 | 0.19% | $36,025 | $145 | 0.40% | $37,011 | $242 | 0.65% |
| Money market accounts | 37,336 | 0.59% | 28,765 | 221 | 0.77% | 23,631 | 229 | 0.97% | 24,324 | 323 | 1.33% |
| Savings accounts | 29,027 | 0.30% | 29,577 | 86 | 0.29% | 28,057 | 154 | 0.55% | 26,722 | 135 | 0.51% |
| Time deposits | 189,022 | 3.00% | 189,066 | 5,667 | 3.00% | 154,857 | 5,929 | 3.83% | 139,271 | 6,214 | 4.46% |
| Borrowed funds | 43,000 | 4.11% | 47,860 | 1,768 | 3.69% | 55,372 | 2,202 | 3.98% | 46,948 | 2,099 | 4.47% |
| Other interest-bearing liabilities | 1,322 | 8.85% | 1,339 | 116 | 8.66% | 1,370 | 119 | 8.69% | 1,394 | 120 | 8.61% |
| Total interest bearing liabilities | 341,564 | 2.32% | 334,188 | 7,929 | 2.37% | 299,312 | 8,778 | 2.93% | 275,670 | 9,133 | 3.31% |
| Other non-interest bearing liabilities | 28,646 | | 27,141 | | | 26,244 | | | 21,239 | | |
| Stockholders' Equity | 55,446 | | 54,936 | | | 53,241 | | | 53,546 | | |
| Total liabilities and equity | $425,656 | | $416,265 | | | $378,797 | | | $350,455 | | |
| Net interest income | | | | $11,764 | | | $11,205 | | | $9,489 | |
| Interest rate spread | | | | | 2.70% | | | 2.75% | | | 2.42% |
| Net interest margin | | | | | 3.03% | | | 3.19% | | | 2.92% |

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 period to the volume change between the two periods. The effect of changes in rate is measured by applying the change in rate between the two periods to the average volume during the first period. 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, 2009 Compared to Year Ended December 31, 2008 | | | Year Ended December 31, 2008 Compared to Year Ended December 31, 2007 | |
| --- | --- | --- | --- | --- |
| Rate | Volume | Net Change | Rate | Volume |