LAKE SHORE BANCORP, INC.
Form 10-K
March 25, 2016

United States

Securities and Exchange Commission

Washington, D.C. 20549

FORM 10-K

(Mark One)

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

For the fiscal year ended December 31, 2015

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

Commission File No.: 000-51821

Lake Shore Bancorp, Inc.

(Exact Name of Registrant as Specified in Its Charter)

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

31 East Fourth Street, Dunkirk, NY 14048

(Address of Principal Executive Offices, including zip code)

(716) 366-4070

(Registrant's telephone number, including area code)

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

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

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

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

Yes [ ] No [X]

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

Yes [ ] No [X]

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

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

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

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

Large accelerated filer [ ]Accelerated filer [ ]

Non-accelerated filer [ ] (Do not check if smaller reporting company)Smaller reporting company [X]

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

The aggregate market value of the voting stock held by non-affiliates of the registrant as of June 30, 2015 was $24,537,537 based on the per share closing price as of June 30, 2015 on the Nasdaq Global Market for the registrant's common stock, which was $13.43.

There were 6,045,434 shares of the registrant's common stock, $.01 par value per share, outstanding at March 24, 2016.

DOCUMENTS INCORPORATED BY REFERENCE:

	Part of 10-K where incorporated
Portions of the registrant's Proxy Statement for the 2016 Annual Meeting of Stockholders	III

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ANNUAL REPORT ON FORM 10-K
FOR THE FISCAL YEAR ENDED
DECEMBER 31, 2015

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PART I

Item 1. Business.

General

Lake Shore Bancorp, Inc. ("Lake Shore Bancorp," the "Company," "us," or "we") operates as a mid-tier, federally chartered savings and loan holding company of Lake Shore Savings Bank ("Lake Shore Savings" or the "Bank"). A majority of Lake Shore Bancorp's issued and outstanding common stock (60.6% as of December 31, 2015) is held by Lake Shore, MHC (the "MHC"), a federally chartered mutual holding company, which serves as the parent company to Lake Shore Bancorp. The MHC does not engage in any substantial business activity other than its investment in a majority of the common stock of Lake Shore Bancorp. The Board of Governors of the Federal Reserve System (the "Federal Reserve Board") is the regulator for the MHC. Federal law and regulations require that as long as the MHC is in existence, it must own at least a majority of Lake Shore Bancorp's common stock. The remaining common shares of Lake Shore Bancorp are owned by public stockholders and the Lake Shore Savings Bank Employee Stock Ownership Plan ("ESOP"). Our common stock is traded on the Nasdaq Global Market under the symbol "LSBK". Unless the context otherwise requires, all references herein to Lake Shore Bancorp or Lake Shore Savings include Lake Shore Bancorp and Lake Shore Savings on a consolidated basis.

Lake Shore Bancorp, Inc. was organized in 2006 for the purpose of acting as the savings and loan holding company of Lake Shore Savings Bank in connection with the Company's initial public stock offering. The Company, a federal corporation, is regulated by the Federal Reserve Board. At December 31, 2015, Lake Shore Bancorp had total consolidated assets of $473.4 million, of which $297.1 million was comprised of loans receivable, net and $113.2 million was comprised of available for sale securities. At December 31, 2015, total consolidated deposits were $369.2 million and total consolidated stockholders' equity was $73.9 million.

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

For over 124 years, the Bank has served the local community of Dunkirk, New York. In 1987, we opened our second office in Fredonia, New York. Since 1993, we have expanded to eleven branch offices. In addition, we have added three administrative office buildings which comprise our corporate headquarters in Dunkirk, New York. Our principal business consists of (1) attracting retail deposits from the general public in the areas surrounding our corporate headquarters and main branch office in Dunkirk, New York and ten other branch offices in Chautauqua and Erie Counties, New York and (2) investing those deposits, together with funds generated from operations, primarily in one- to four-family residential mortgage loans, commercial real estate loans, home equity lines of credit and, to a lesser extent, commercial business loans, consumer loans, and investment securities. Our revenues are principally derived from interest generated from our loans and interest earned and dividends received on our investment securities. Our primary sources of funds for lending and investments are deposits, borrowings, receipts of loan principal and interest payments, mortgage-backed and asset-backed securities payments, proceeds from sales, maturities and calls of investment securities and income resulting from operations in prior periods.

Available Information

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

Market Area

Our operations are conducted out of our corporate headquarters and main branch office in Dunkirk, New York and ten other branch offices. Our branches in Chautauqua County, New York are located in Dunkirk, Fredonia, Jamestown, Lakewood and Westfield. In Erie County, New York our branch offices are located in Depew, East Amherst, Hamburg, Kenmore, Orchard Park, and Snyder. Our first branch office in Erie County opened during April 2003 and the most recent branch office opened in April 2013. We also have seven stand-alone ATMs. The opening of six branch offices in Erie County, New York since 2003 demonstrates the implementation of our growth strategy which is focused on expansion within Erie County while preserving our market share in Chautauqua County.

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

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

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

The challenging economic conditions that affected the national and global financial markets in 2007 and 2008 did not have a significant effect on the housing prices in our market area. Furthermore, unemployment rates in our market area have decreased since December 2013 from 6.4% to 4.7% in Erie County and from 7.4% to 5.7% in Chautauqua County as of December 31, 2015. New York State's unemployment rate as of December 31, 2015 was 4.7%, the lowest level since May 2008.

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

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

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

Competition

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

Our competition for loans comes principally from commercial banks, savings banks, mortgage banking companies, credit unions, and other financial service companies. The most direct competition for deposits comes from credit unions, commercial banks and savings banks. We face additional competition for deposits from non-depository competitors such as mutual funds, securities and brokerage firms and insurance companies. We are significantly smaller than many of the financial institution competitors in our market area. Some of our competitors are not subject to the same degree of regulation as that imposed on federal savings banks or federally insured institutions, and these other institutions may be able to price loans and deposits more aggressively. We remain very competitive in Chautauqua County, New York and as of June 30, 2015 we had 14.7% of total deposits and ranked 4th out of 11 banks in this market area, according to the Federal Deposit Insurance Corporation ("FDIC") annual deposit market share report. Our deposit market share in Erie County, New York has increased since we entered this market area in 2003.

We believe the primary factors in competing for deposits and loans is through personalized service, knowledge of local market area and economy, local decision making, technological convenience via mobile banking and active participation and support of the communities we serve.

Lending Activities

General. Historically, as a thrift institution, we have primarily originated residential mortgage loans, including home equity loans. In recent years, we have become more focused on originating commercial real estate and commercial business loans, also known as C&I Lending, to add adjustable rate loans to our portfolio and diversify the risk on our balance sheet, limit interest rate risk and to position ourselves for a rising interest rate environment. At December 31, 2015, we had total gross loans of $296.1 million. We retain the majority of loans that we originate. However, we do sell residential mortgage loans into the secondary market, with retention of servicing rights. Beginning in the fourth quarter of 2014 and during 2015, we sold fixed rate, conforming long-term residential mortgage loans with low yields (interest rates below 5% and maturities of 30 years) at the time of origination, with servicing retained, in an effort to manage interest rate risk. We plan to continue this practice in the near future. We have also purchased a limited number of equipment loans from a third party broker, which are secured by first liens on the new equipment purchases by small businesses located throughout the Northeastern United States.

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

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

	At December 31,									
	2015		2014		2013		2012		2011	
	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Percent of Total	Amount	Pe of
	(Dollars in thousands)									
Real Estate loans:										
Residential one- to four-family	$ 157,307	53.12%	$ 167,840	59.14%	$ 170,793	61.81%	$ 167,794	61.68%	$ 182,922	66
Home equity	32,770	11.07%	32,337	11.39%	31,675	11.46%	30,724	11.29%	30,671	11
Commercial	83,967	28.35%	68,238	24.04%	58,746	21.26%	57,653	21.19%	44,776	16
Construction	4,849	1.64%	449	0.16%	936	0.34%	416	0.15%	519	0.1
	278,893	94.18%	268,864	94.73%	262,150	94.87%	256,587	94.31%	258,888	94
Other loans:										
Commercial	15,741	5.31%	13,467	4.74%	12,645	4.58%	13,680	5.03%	12,911	4.7
Consumer	1,507	0.51%	1,495	0.53%	1,517	0.55%	1,791	0.66%	1,948	0.7
	17,248	5.82%	14,962	5.27%	14,162	5.13%	15,471	5.69%	14,859	5.4
Total loans	296,141	100.00%	283,826	100.00%	276,312	100.00%	272,058	100.00%	273,747	10
Net deferred loan costs	2,945		2,948		2,846		2,681		2,687	
Allowance for loan losses	(1,985)		(1,921)		(1,813)		(1,806)		(1,366)	

Loans receivable, net	$ 297,101	$ 284,853	$ 277,345	$ 272,933	$ 275,068

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Loan Maturity. The following table presents the contractual maturity of our loans at December 31, 2015. The table does not include the effect of prepayments or scheduled principal amortization. Loans having no stated repayment schedule or maturity and overdraft loans are reported as being due in one year or less.

	Real Estate				Other Loans		
	Residential, One- to Four-Family	Home Equity	Commercial	Construction	Commercial	Consumer	Total
	(Dollars in thousands)						
Amounts due in:							
One year or less	$ 95	$ 648	$ 1,233	$ -	$ 4,783	$ 840	$ 7,599
After one year through five years	4,683	5,851	7,721	-	9,553	438	28,246
Beyond five years	152,529	26,271	75,013	4,849	1,405	229	260,296
Total	$ 157,307	$ 32,770	$ 83,967	$ 4,849	$ 15,741	$ 1,507	$ 296,141
Interest rate terms on amounts due after one year:							
Fixed rate	$ 150,036	$ 2,155	$ 21,639	$ 268	$ 10,820	$ 564	$ 185,482
Adjustable rate	7,176	29,967	61,095	4,581	138	103	103,060
Total	$ 157,212	$ 32,122	$ 82,734	$ 4,849	$ 10,958	$ 667	$ 288,542

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

	For the Year Ended December 31,				
	2015	2014	2013	2012	2011
	(Dollars in thousands)				
Total Loans:					
Balance outstanding at beginning of year	$ 283,826	$ 276,312	$ 272,058	$ 273,747	$ 261,524
Originations:					
Real estate loans	59,992	46,413	53,066	48,091	49,030
Commercial and consumer loans	9,347	4,560	3,536	5,383	7,553
Total originations	69,339	50,973	56,602	53,474	56,583
Loan Purchases - Commercial Loans	242	2,857	1,228	1,033	1,679
Total Originations and Purchases	69,581	53,830	57,830	54,507	58,262
Deduct:					
Principal repayments:					
Real estate loans	39,970	36,118	45,341	48,382	38,694
Commercial and consumer loans	6,253	7,879	5,944	5,807	6,392
Total principal repayments	46,223	43,997	51,285	54,189	45,086
Transfers to foreclosed real estate	1,178	448	704	1,001	252
Loan sales - SONYMA(1) & FHLMC(2)	9,450	1,737	1,436	767	639

Loans charged off	415	134	151	239	62
Total deductions	57,266	46,316	53,576	56,196	46,039
Balance outstanding at end of year	$ 296,141	$ 283,826	$ 276,312	$ 272,058	$ 273,747

(1) State of New York Mortgage Agency.

(2) During 2015 and 2014, we sold $8.3 million and $1.5 million, respectively, of long-term fixed rate residential mortgage loans with low yields to the Federal Home Loan Mortgage Corporation ("FHLMC") in order to offset long-term interest rate risk.

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One- to Four-Family Residential Mortgage Lending. At December 31, 2015, we had one- to four-family residential loans of $157.3 million, or 53.1% of the total loan portfolio. Of one- to four-family residential mortgage loans outstanding on that date, 95.6% were fixed rate loans and 4.4% were adjustable rate loans. At December 31, 2015, approximately 59.5% of our one- to four-family residential mortgage portfolio was secured by property located in Chautauqua County, 33.8% by property located in Erie County and 6.7% by property located elsewhere, primarily in New York State. Approximately 9.6% of all residential loan originations during fiscal year 2015 were re-financings of loans already in our portfolio.

Our residential mortgage loan originations are obtained from customers, residents of our local communities or referrals from local real estate agents, attorneys and builders. The retention of fixed rate one- to four-family residential mortgage loans in our loan portfolio increases our interest rate risk in a rising interest rate environment, since the yields earned on such fixed-rate assets would remain fixed, while the rates paid by the Bank for deposits and borrowings may increase, which could lower net interest income. In an effort to manage interest rate risk, the Bank sold low yield, long-term fixed rate residential mortgages (primarily yields less than 5% and terms of 30 years) at origination on the secondary market, with servicing retained, beginning in the fourth quarter of 2014 and during 2015. We plan to continue this practice in the near future.

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

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

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

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

We regularly provide a loan product to our customers that is underwritten using the criteria required by FHLMC. After a loan is originated and funded, we may sell the loan to FHLMC. During 2015, we originated and sold $8.3 million of long-term low rate one- to four-family residential mortgage loans to FHLMC and we plan to continue to do so in the future to manage interest rate risk. We also sold loans to the State of New York

Mortgage Agency ("SONYMA") during 2015 and will continue to do so as long as the product is offered. During 2015, we originated and sold $1.1 million of one- to four-family residential mortgage loans to SONYMA. We retain all servicing rights for one- to four-family residential mortgage loans that we sell.

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

One- to four-family real estate loans can be affected by economic conditions and the value of the underlying collateral. The majority of our one- to four-family residential loans are backed by property located in Western New York and are affected by economic conditions in this market area. Western New York's housing market has consistently demonstrated stability in home prices despite economic conditions, resulting in stable collateral value and lower risk of loss.

Home Equity Loans and Lines of Credit. We currently provide all-in-one home equity lines of credit and have provided home equity loans in the past to our customers. Home equity lines of credit are generally made for owner-occupied homes, and are secured by first or second mortgages on residences. At December 31, 2015, home equity loans and lines of credit totaled $32.8 million, or 11.1% of the total loan portfolio, of which 93.4% were adjustable rate loans and 6.6% were fixed rate loans. The all-in-one home equity line of credit must have a minimum line amount of $5,000 up to a maximum of 90% of the total loan-to-value ratio. Home equity lines of credit products, which have interest rates tied to the prime rate, generally have a 15 year draw period and a 15 year payback period. Since 2010, our adjustable rate home equity loans include limits on decreases in the interest rate of the loan. The decrease in the interest rate may not be below the "floor" rate established at time of origination. A customer has the option to convert either a portion, or the entire line of credit balance, to a term loan at a fixed rate of interest. As the customer pays down the balance on the term loan, the funds available on the line of credit increase by a like amount. All-in-one home equity lines of credit have 30 year maximum terms.

Home equity loans can be affected by economic conditions and the value of underlying property. Home equity loans may have increased risk of loss if the Company does not hold the first mortgage resulting in the Company being in a secondary position in the event of collateral liquidation. During periods of rising interest rates, the risk of default on home equity loans may increase due to the increase of interest cost to the borrower.

Commercial Real Estate Loans. We originate commercial real estate loans to finance or refinance the purchase of real property, which generally consists of developed real estate, such as office buildings, warehouses, retail properties and multi-family apartment complexes, which are typically held as collateral for the loan. At December 31, 2015, commercial real estate loans totaled $84.0 million, or 28.4% of the total loan portfolio. In underwriting commercial real estate loans, consideration is given to the property's historic cash flow, paying capacity of the obligor, current and projected occupancy, location, and physical condition. Within the commercial real estate portfolio at December 31, 2015, approximately 17.8% consisted of loans that are collateralized by properties located in Chautauqua County, 67.0% by properties located in Erie County, and 15.2% by properties located elsewhere in New York State. The average principal amount of a commercial real estate loan is approximately $473,000 at December 31, 2015. The largest commercial real estate loan in our portfolio as of December 31, 2015 was $3.7 million secured by a commercial building used as a shopping plaza with multiple commercial tenants. This loan was performing in accordance with its terms on that date. We originate a variety of fixed and adjustable rate commercial real estate loans generally for terms of 5 to 10 years and payments based on an amortization schedule of up to 20 years to 25 years. Adjustable rate loans are typically based on the current Federal Home Loan Bank of NY ("FHLBNY") rates for a similar termed borrowing with an added spread based on the type and size of the loan. We typically lend up to a maximum loan-to-value ratio of 75% to 80% on commercial real estate properties and require a minimum debt service coverage ratio of 1.2 to 1, a first lien on collateral and the personal guarantees of the owners.

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

Construction Loans. We originate loans to finance the construction of both one- to four-family homes and commercial real estate. These loans typically have a 12 month or less construction period, whereby draws are taken and interest only payments are made. As part of the draw process, inspection and lien checks are required prior to the disbursement of the proceeds. Funds disbursed may not exceed 80.0% of the loan-to-value of land and up to 80% of loan-to-value of improvements any time during construction. Interest rates on disbursed funds are based on the rates and terms set at time of closing. The majority of our commercial real estate construction loans are variable rate loans with rates tied to prime rate, plus a premium, while the majority of our one- to four-family real estate construction loans are fixed rate loans. A floor rate is also established on any variable rate loans. A minimum of interest only payments on disbursement funds must be made on a monthly basis. At the end of the construction period, the loan automatically converts to either a conventional residential or commercial real estate mortgage, as applicable. At December 31, 2015, construction loans totaled $4.8 million, or 1.6% of the total loan portfolio. At December 31, 2015, there were $4.6 million of loans to finance construction of commercial real estate and $268,000 to finance the construction of one- to four-family homes.

Construction loans can be affected by economic conditions and the value of underlying property. Construction loans may have additional risks related to advancing loan funds during construction due to the uncertain value of the property prior to the completion of construction.

Commercial Loans. In addition to commercial real estate loans, we also engage in commercial business lending to primarily small businesses, including business installment loans, lines of credit, and other commercial loans. At December 31, 2015, commercial loans totaled $15.7 million, or 5.3% of the total loan portfolio. This amount includes $2.5 million of equipment loans that we have purchased from a third party broker. The average principal amount of a commercial loan is approximately $101,000 at December 31, 2015. The largest outstanding commercial loan in our portfolio as of December 31, 2015 was $2.6 million secured by general business assets. This loan was performing in accordance with its terms on that date. Most of our commercial loans have fixed interest rates, and are for terms generally not in excess of 5 years. Whenever possible, we collateralize these loans with a lien on business assets and equipment and require personal guarantees from principals of the borrower. Interest rates on commercial loans generally have higher yields than rates on one- to four-family residential mortgages. We offer commercial loan services designed to give business owners borrowing opportunities for modernization, inventory, equipment, construction, consolidation, real estate, working capital, vehicle purchases, and the refinancing of existing corporate debt.

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

Consumer Loans. We offer a variety of consumer loans. At December 31, 2015, consumer loans totaled $1.5 million, or less than 1% of the total loan portfolio. The largest component of our consumer loan portfolio are personal consumer loans and overdraft lines of credit, which are available for amounts up to $5,000 for unsecured loans and greater amounts for secured loans depending on the type of loan and value of the collateral. Consumer loans, excluding overdraft lines of protection, generally are offered for terms of up to 10 years, depending on the collateral, at fixed interest rates. Our consumer loan portfolio also consists of vehicle loans, 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 of credit, where a mortgage-interest federal tax deduction is available, as compared to unsecured loans or loans secured by property other than residential real estate. We continue to make automobile loans directly to borrowers and primarily on used vehicles. We make other consumer loans, which may or may not be secured. The terms of such loans vary depending on the collateral.

Consumer loans are generally originated at higher interest rates than residential mortgage loans but also tend to have a higher credit risk due to the loans being either unsecured or secured by rapidly depreciable assets. Furthermore, consumer loan payments are dependent on the borrower's continuing financial stability, and therefore are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. The application of various federal and state laws, including federal and state bankruptcy and insolvency laws, may limit the amount which can be recovered on consumer loans in the event of a default. 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 approved by our Board of Directors. Home equity loans and consumer loans secured by real estate in excess of $25,000 and all one- to four-family residential mortgage loans up to $417,000 require approval by the Internal Residential Loan Committee. If these types of loans are between $417,000 and $1.0 million, then the approval of two of the following officers: President and Chief Executive Officer, Chief Financial Officer, Executive Vice President – Commercial Division, Vice President of Banking Operations and Enterprise Risk Management, Vice President - Commercial and Small Business Lending - Chautauqua County, along with another member of the Internal Residential Loan Committee is required. If these types of loans are in excess of $1.0 million, then full Board approval is required.

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

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

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

Asset Quality

One of our key operating objectives has been, and continues to be, maintaining a high level of asset quality. Our high proportion of one- to four-family residential mortgage loans, the maintenance of sound credit standards for new loan originations and loan administration procedures, including third party loan reviews, and strong executive management focus on credit quality have been factors in monitoring and managing our levels of credit risk. These factors have contributed to our strong financial condition.

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

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

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

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

Non-performing Loans and Non-performing Assets. We define non-performing loans as loans that are either non-accruing or accruing whose payments are 90 days or more past due, and non-accruing troubled debt restructurings. Loans are placed on non-accrual status either when reasonable doubt exists as to the full timely collection of interest and principal, or when a loan becomes 90 days past due, unless an evaluation by the internal Asset Classification Committee indicates that the loan is in the process of collection and is either guaranteed or well secured. When our Asset Classification Committee designates loans on which we stop accruing interest income as non-accrual loans, we reverse outstanding interest income that was previously credited. We may again recognize income in the period that we collect such income, when the ultimate collectability of principal is no longer in doubt. We return a non-accrual loan to accrual status when factors indicating doubtful collection no longer exist.

Real estate acquired as a result of foreclosure is classified as foreclosed real estate until such time as it is sold. We carry foreclosed real estate at its fair value less estimated selling costs at the date of acquisition. If a foreclosure action is commenced and the loan is not brought current, paid in full, or refinanced before the foreclosure sale, the property could be sold at the foreclosure sale (to an outside bidder). If not, and we retain the property, then we will sell the real property securing the loan as soon thereafter as practical. Our foreclosed real estate totaled $712,000 at December 31, 2015 and $401,000 at December 31, 2014.

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

At December 31, 2015, seven loans were classified as TDRs, including five one- to four-family residential loans which totaled $216,000 and two home equity loans which totaled $8,000. All of these loans were performing in accordance with their revised terms at December 31, 2015. At December 31, 2014, seven loans were classified as TDRs including five one- to four-family residential loans which totaled $224,000 and two home equity loans which totaled $10,000. All of these loans were performing in accordance with their revised terms at December 31, 2014.

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

	At December 31,				
	2015	2014	2013	2012	2011
	(Dollars in thousands)				
Loans past due 90 days or more but still accruing:					
Real estate loans:					
Residential, one- to four-family	$ 47	$ -	$ 79	$ 10	$ 328
Home equity	88	1	2	-	21
Commercial	-	-	-	-	-
Construction	-	-	-	-	-
Other loans:					
Commercial	-	-	-	-	87
Consumer	27	9	-	18	23
Total	$ 162	$ 10	$ 81	$ 28	$ 459
Loans accounted for on a non-accrual basis:					
Real estate loans:					
Residential, one- to four-family	$ 2,462	$ 2,413	$ 2,145	$ 1,628	$ 1,821
Home equity	361	335	325	299	209
Commercial	1,545	1,891	1,911	255	228
Construction	-	-	-	-	-
Other loans:					
Commercial	132	76	137	201	76
Consumer	6	4	7	9	5
Total non-accrual loans	4,506	4,719	4,525	2,392	2,339
Total non-performing loans	4,668	4,729	4,606	2,420	2,798
Foreclosed real estate	712	401	581	580	315
Total non-performing assets	$ 5,380	$ 5,130	$ 5,187	$ 3,000	$ 3,113
Ratios:					
Non-performing loans as a percent of total loans:	1.57 %	1.66 %	1.66 %	0.89 %	1.02 %
Non-performing assets as a percent of total assets:	1.14 %	1.05 %	1.08 %	0.62 %	0.64 %
Troubled debt restructuring:					
Loans accounted for on a non-accrual basis					
Residential, one- to four-family	$ -	$ -	$ 48	-	-
Home equity	-	-	-	31	31
Performing loans					
Residential, one- to four-family	$ 216	$ 224	$ 144	-	-
Home equity	8	10	4	-	-

Our recorded investment in non-accrual loans totaled $4.5 million at December 31, 2015 and $4.7 million at December 31, 2014. If all non-accrual loans had been current in accordance with their terms during the years ended

December 31, 2015, 2014 and 2013, interest income on such loans would have amounted to $391,000, $381,000 and $162,000 respectively.

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

The allowance for loan losses is established through a provision for loan losses based on management evaluation of the losses inherent in the loan portfolio. When we classify loans as either substandard or doubtful, we set aside a loss reserve for such loans as we deem prudent. When we classify problem loans as loss, we typically charge-off the outstanding loan balance against the allowance for loan losses reserve. Our determination as to the classification of our loans and the amount of our loss allowances are subject to review by our regulators, which can require that we establish additional loss allowances. We regularly review our loan portfolio to determine whether any loans require classification in accordance with applicable regulations.

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

	At December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Special mention loans	$ 5,003	$ 3,854	$ 3,090
Substandard loans	5,693	5,882	5,701
Doubtful loans	217	718	582
Loss loans	2	3	4
Total classified and criticized loans	$ 10,915	$ 10,457	$ 9,377

The total classified and criticized loans as of December 31, 2015 includes $4.7 million of nonperforming loans.

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

	At December 31,					
	2015		2014		2013	
	60-89 Days Past Due	90 + Days Past Due	60-89 Days Past Due	90 + Days Past Due	60-89 Days Past Due	90 + Days Past Due
	(Dollars in thousands)					
Real estate loans:						
Residential, one- to four-family	$ 789	$ 1,291	$ 467	$ 1,059	$ 825	$ 880
Home equity	32	354	136	206	32	156
Commercial	-	1,248	-	1,891	-	1,911
Construction	-	-	-	-	-	-
Other loans:						
Commercial	-	30	9	37	-	41
Consumer	5	28	5	13	1	4
Total	$ 826	$ 2,951	$ 617	$ 3,206	$ 858	$ 2,992

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 qualitative and environmental factors as part of this evaluation: historical loan loss experience; payment status; the estimated value of the underlying collateral; changes in lending policies, procedures and loan review system; changes in the experience, ability, and depth of lending management and other relevant staff; trends in loan volume and the nature of the loan portfolio; and national and local economic conditions. There may be other factors that may warrant consideration in maintaining an allowance at a level sufficient to provide for probable loan losses. Although our management believes that it has established and maintained the allowance for loan losses to reflect losses inherent in our loan portfolio, based on its evaluation of the factors noted above, future additions may be necessary if economic and other conditions differ substantially from the current operating environment.

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

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

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

The following table details the number and recorded investment of impaired loans for the dates indicated:

	At December 31,			
	2015		2014	
	Number of Loans	Recorded Investment	Number of Loans	Recorded Investment
	(Dollars in thousands)			
Real estate loans:				
Residential, one- to four-family	5	$ 202	5	$ 211
Home equity	2	8	2	10
Commercial	3	1,545	3	2,312
Construction	-	-	-	-
Other loans:				
Commercial	2	80	3	10
Consumer	-	-	-	-
Total	12	$ 1,835	13	$ 2,543

Refer to Note 5 in the Notes to the Consolidated Financial Statements for more information on our impaired loans.

Provision for loan losses increased by $178,000, or 80.2%, to $400,000 for the year ended December 31, 2015 from $222,000 for the year ended December 31, 2014. The increase in provision for loan losses was primarily due to an increase in our commercial and construction loan portfolios and a charge-off on a previously impaired commercial real estate loan during 2015. Our credit quality continues to remain strong. The ratio of nonperforming loans to total net loans was 1.57% as of December 31, 2015 which was a decrease from 1.66% at December 31, 2014. The majority of our non-performing loans are one- to four-family residential mortgage loans or commercial real estate loans backed by first lien collateral on real estate held in the Western New York region. Western New York's real estate market has consistently demonstrated price stability. Furthermore, the Company has conservative underwriting standards and its residential lending policies and procedures ensure that its one- to four-family residential mortgage loans generally conform to secondary market guidelines. In light of current economic conditions, we will continue to closely monitor our loan portfolio.

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

	At or for the Year Ended December 31,				
	2015	2014	2013	2012	2011
	(Dollars in thousands)				
Balance at beginning of year:	$ 1,921	$ 1,813	$ 1,806	$ 1,366	$ 953
Provision for loan losses	400	222	105	656	415
Charge-offs:					
Real estate loans:					
Residential, one- to four-family	(64)	(26)	(51)	(134)	-
Home equity	(29)	(39)	-	(14)	(29)
Commercial	(267)	-	(21)	-	(15)
Construction	-	-	-	-	-
Other loans:					
Commercial	(9)	(25)	(47)	(80)	(1)
Consumer	(46)	(44)	(32)	(11)	(17)
Total charge-offs	(415)	(134)	(151)	(239)	(62)
Recoveries:					
Real estate loans:					
Residential, one- to four-family	13	6	35	1	4
Home equity	8	1	5	-	-
Commercial	32	-	9	20	52
Construction	-	-	-	-	-
Other loans:					
Commercial	18	-	3	1	-
Consumer	8	13	1	1	4
Total recoveries	79	20	53	23	60
Net charge-offs	(336)	(114)	(98)	(216)	(2)
Balance at end of year	$ 1,985	$ 1,921	$ 1,813	$ 1,806	$ 1,366
Average loans outstanding	$ 292,240	$ 276,360	$ 271,705	$ 268,265	$ 270,697
Allowance for loan losses as a percent of total net loans	0.67%	0.67%	0.65%	0.66%	0.50%
Allowance for loan losses as a percent of non-performing loans	42.52%	40.62%	39.36%	74.63%	48.82%
Ratio of net charge-offs to average loans outstanding	0.11%	0.04%	0.04%	0.08%	0.01%

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

	At December 31, 2015			2014			2013			2012	
	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
	(Dollars in thousands)										
Real Estate Loans:											
Residential, one- to four-family	$ 351	17.7%	53.1%	$ 446	23.2%	59.1%	$ 355	19.6%	61.8%	$ 393	21.7%
Home equity	120	6.0%	11.1%	106	5.5%	11.4%	80	4.4%	11.5%	79	4.4%
Commercial (1)	1,204	60.7%	28.4%	1,163	60.5%	24.0%	1,104	60.9%	21.3%	1,118	61.9%
Construction	59	3.0%	1.6%	-	-	0.2%	-	-	0.3%	-	-
	1,734	87.4%	94.2%	1,715	89.2%	94.7%	1,539	84.9%	94.9%	1,590	88.0%
Other loans:											
Commercial	197	9.9%	5.3%	184	9.6%	4.7%	218	12.0%	4.6%	202	11.2%
Consumer	22	1.1%	0.5%	22	1.2%	0.6%	9	0.5%	0.5%	14	0.8%
	219	11.0%	5.8%	206	10.8%	5.3%	227	12.5%	5.1%	216	12.0%
Total allocated	$ 1,953	98.4%	100.0%	$ 1,921	100.0%	100.0%	$ 1,766	97.4%	100.0%	$ 1,806	100.0%
Total unallocated	32	1.6%		-	-		47	2.6%		-	-
Balance at end of year	$ 1,985	100.0%		$ 1,921	100.0%		$ 1,813	100.0%		$ 1,806	100.0%

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

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 President and Chief

Executive Officer and the Chief Financial Officer. Our President and Chief Executive Officer or our Chief Financial Officer are responsible for making securities portfolio decisions in accordance with established policies and have the authority to purchase and sell securities within the specific guidelines established by the investment policy. In addition, all transactions are reviewed by the Asset/Liability Committee of the Board of Directors which meets at least quarterly.

All of our securities carry market risk, as increases in market rates of interest may cause a decrease in the fair value of the securities. Our investment policy is designed primarily to manage the interest rate sensitivity of our assets and liabilities, to generate a favorable return without incurring undue interest rate or credit risk, to complement our lending activities and to provide and maintain liquidity within established guidelines. Our investment policy outlines the pre-purchase analysis, credit, and interest rate risk assessment guidelines and due diligence documentation required for all permissible investments. In addition, our policy requires management to routinely monitor the investment portfolio as well as the markets for changes which may have a material, negative impact on the credit quality of our holdings.

In establishing our investment strategies, we consider our interest rate sensitivity, the types of securities to be held, liquidity and other factors. The Company's current investment strategy utilizes a risk management approach of diversified investing among three categories: short-, intermediate-, and long-term. The emphasis of this approach is to increase overall investment securities yields while managing interest rate risk. The Company has engaged an independent financial advisor to recommend investment securities according to a plan which has been approved by the Asset/Liability Committee and the Board of Directors. Federal savings banks have authority to invest in various types of assets, including U.S. Government obligations, securities of various federal agencies, obligations of states and municipalities, mortgage-backed and asset-backed securities, collateralized-mortgage obligations, certain time deposits of insured banks and savings institutions, certain bankers' acceptances, repurchase agreements, loans of federal funds, and, subject to certain limits, corporate debt and commercial paper.

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

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

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

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

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

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

Our determination as to the classification of our investments is subject to review by our regulators. We regularly review our investment portfolio to determine whether any investments require classification in accordance with applicable regulations. Our review of our investment portfolio at December 31, 2015 resulted in four private-label asset-backed securities that were considered for classification, as the issuer may not have an adequate capacity to meet its financial commitments over the projected life of the investment or the risk of default by the obligor was possible, resulting in an expectation that the Bank would not receive the full and timely repayment of principal and interest as expected. These four securities had an amortized cost of $1.1 million and fair value of $1.5 million. All four securities were classified as "Substandard." These securities were also evaluated for other-than-temporary impairment and as noted in the Other than Temporary Impairment section of Part II, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations and we concluded that no other than temporary impairment charges needed to be recorded during the years ended December 31, 2015 and 2014. An additional $180,000 of other-than-temporary impairment needed to be recorded for one private-label asset-backed security during the year ended December 31, 2013. During the years ended December 31, 2015, 2014 and 2013, we recaptured $160,000, $175,000 and $3,000, respectively of prior year other-than-temporary impairment charges. The recaptured amounts are reflected in the "recovery on previously impaired investment securities" line item in the Consolidated Statements of Income shown in "Part IV Exhibits and Financial Schedules."

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

	At December 31,					
	2015		2014		2013	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(Dollars in thousands)					
Securities available for sale:						
U.S. Treasury bonds	$ 12,778	$ 14,111	$ 12,817	$ 14,361	$ 12,857	$ 13,848
Municipal bonds	49,064	51,808	57,158	60,786	57,199	58,044
Mortgage-backed securities:						
Collateralized mortgage obligations -private label	48	48	61	61	77	81
Collateralized mortgage obligations -government sponsored entities	38,838	38,342	50,465	49,992	63,840	62,625
Government National Mortgage Association	396	427	524	571	2,153	2,219
Federal National Mortgage Association	4,355	4,542	7,107	7,473	11,452	11,634
Federal Home Loan Mortgage Corporation	2,217	2,301	2,650	2,767	5,774	5,816
Asset-backed securities-private label	1,099	1,501	1,546	2,023	3,637	3,498
Asset-backed securities-government sponsored entities	89	97	111	122	130	134
Equity securities	22	36	22	46	22	65
Total available for sale	$ 108,906	$ 113,213	$ 132,461	$ 138,202	$ 157,141	$ 157,964

At December 31, 2015, we did not have any non-U.S. Government and Government agency securities that exceeded 10.0% of our equity.

Investment Securities Portfolio, Maturities and Yields. The following table sets forth the scheduled maturities, amortized cost and weighted average yields for our investment portfolio, with the exception of equity securities, at December 31, 2015. Due to repayments of the underlying loans, the average life maturities of mortgage-backed and asset-backed securities generally are substantially less than the final maturities. The weighted average yield does not include the impact of a tax-equivalent adjustment for bank qualified municipals.

	More than One Year through Five Years		More than Five Years through Ten Years		More than Ten Years		Total Securities		
	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Weighted Average Yield	Amortized Cost	Fair Value	Weighted Average Yield
	(Dollars in thousands)								
Securities available for sale:									
U.S. Treasury bonds	$ 6,089	3.13%	$ 4,488	3.84%	$ 2,201	4.46%	$ 12,778	$ 14,111	3.61%
Municipal bonds	1,929	4.04%	26,803	3.64%	20,332	3.59%	49,064	51,808	3.64%
Mortgage-backed securities	548	3.72%	2,364	3.36%	42,942	2.42%	45,854	45,660	2.48%
Asset-backed securities	-	-	-	-	1,188	5.05%	1,188	1,598	5.05%
Total securities available for sale	$ 8,566	3.37%	$ 33,655	3.65%	$ 66,663	2.89%	$ 108,884	$ 113,177	3.16%

Sources of Funds

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 savings and checking accounts, interest bearing and non-interest bearing checking accounts (i.e., demand deposits), health savings accounts, retirement accounts, time deposits and Interest on Lawyer Accounts (“IOLA”). In addition to accounts for individuals, we also offer commercial accounts designed for the businesses operating in our market area.

Deposit flows are influenced significantly by general and local economic conditions, changes in prevailing interest rates, pricing of deposits, and competition. Our deposits are 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. At December 31, 2015 and 2014, we had $4.2 million of brokered deposits which were part of the Certificate of Deposit Account Registry Service (“CDARS”).

When we determine our deposit rates, we consider local competition, U.S. Treasury securities offerings, our liquidity needs, and the rates charged on other sources of funds. We generally review our deposit mix and pricing on a weekly basis. Our deposit pricing strategy has generally been to offer competitive rates and to be towards the top of the local market for rates on most types of deposit products. Core deposits (defined as savings deposits, money market accounts, demand deposit accounts and other interest bearing checking accounts) represented 57.0% and 52.9% of total deposits on December 31, 2015 and 2014, respectively.

Deposits are our major source of funds for lending and other investment purposes. We may also borrow funds, primarily from the FHLBNY, to supplement the amount of funds available for lending and daily operations. In addition, we derive funds from loan and mortgage-backed security principal repayments and prepayments and from interest and proceeds from the maturity and call of investment securities. Loans and securities payments are a relatively stable source of funds, while deposit inflows and outflows are significantly influenced by pricing strategies and money market conditions.

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

	At December 31, 2015		2014		2013	
	Amount	Percent of total deposits	Amount	Percent of total deposits	Amount	Percent of total deposits
	(Dollars in thousands)					
Deposit type:						
Savings	$ 44,613	12.09%	$ 42,507	10.99%	$ 38,833	10.00%
Money market	76,231	20.64%	78,457	20.28%	77,990	20.09%
Interest bearing demand	44,512	12.06%	46,685	12.07%	44,517	11.47%
Non-interest bearing demand	45,224	12.25%	37,162	9.60%	34,320	8.84%
Total core deposits	210,580	57.04%	204,811	52.94%	195,660	50.40%
Time deposits with original maturities of:						
Three months or less	1,817	0.49%	1,466	0.38%	1,925	0.50%
Over three months to twelve months	31,954	8.66%	32,515	8.40%	40,569	10.45%
Over twelve months to twenty-four months	28,835	7.81%	30,671	7.93%	31,417	8.09%
Over twenty-four months to thirty-six months	7,853	2.13%	10,303	2.66%	10,668	2.75%
Over thirty-six months to forty-eight months	3,503	0.95%	2,695	0.70%	3,673	0.95%
Over forty-eight months to sixty months	84,358	22.85%	104,073	26.89%	103,390	26.62%
Over sixty months	255	0.07%	405	0.10%	933	0.24%
Total time deposits	158,575	42.96%	182,128	47.06%	192,575	49.60%
Total deposits	$ 369,155	100.00%	$ 386,939	100.00%	$ 388,235	100.00%

At December 31, 2015 and 2014, time deposits with remaining terms to maturity of less than one year amounted to $81.0 million and $104.8 million, respectively. The following table presents our time deposit accounts categorized by interest rates which mature during each of the years set forth below and the amounts of such time deposits by interest rate at December 31, 2015, 2014 and 2013.

	Period to maturity at December 31, 2015				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	2015	2014	2013
	(Dollars in thousands)						
Interest Rate Range							
0.49% and below	$ 40,926	$ 1,884	$ -	$ -	$ 42,810	$ 46,007	$ 53,515

0.50% and 0.99%	14,176	9,606	2,238	-	26,020	29,510	29,540
1.00% and 1.99%	23,264	17,373	7,655	36,685	84,977	56,706	52,316
2.00% to 2.99%	2,642	-	-	2,126	4,768	49,730	56,474
3.00% to 5.99%	-	-	-	-	-	175	730
Total	$ 81,008	$ 28,863	$ 9,893	$ 38,811	$ 158,575	$ 182,128	$ 192,575

At December 31, 2015, we had $62.2 million in time deposits with balances of $100,000 or more maturing as follows:

Maturity Period	Amount (In thousands)
Three months or less	$ 8,857
Over three months through six months	8,390
Over six months to twelve months	12,579
Over twelve months	32,392
Total	$ 62,218

Additional information regarding our deposits is included in Note 7 in the Notes to our Consolidated Financial Statements beginning on page F-1. Also, refer to "Part II, Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations—Liquidity and Capital Resources" for additional information on sources of funds.

Short-term Borrowings. Historically, our borrowings have consisted of a mix of short-term and long-term Federal Home Loan Bank of New York ("FHLBNY") advances. At December 31, 2015 and 2014, we did not hold any short-term borrowings on our balance sheet. We have a written agreement with the FHLBNY which allows us to borrow the maximum lending values designated by the type of collateral pledged. As of December 31, 2015, our maximum lending value was $116.3 million and was collateralized by a pledge of certain fixed-rate one- to four-family real estate loans. At December 31, 2015, securities with a book value of $11.1 million and fair value of $11.7 million were pledged for potential borrowings at the Federal Reserve Bank discount window. There were no balances outstanding with the Federal Reserve Bank at December 31, 2015. The Bank has also established lines of credit with correspondent banks, currently totaling $22.0 million, of which $20.0 million is unsecured and the remaining $2.0 million is secured by a pledge of the Bank's securities when a draw is made. The lines of credit provide for overnight borrowings through the purchase of Fed Funds, at an interest rate equal to the Fed Funds rate plus a spread. At December 31, 2015, there were no balances outstanding on these lines of credit.

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

	2015	2014	2013
	(Dollars in thousands)		
At December 31			
Amount outstanding	$ -	$ -	$ 11,650
Weighted average interest rate	- %	- %	0.39 %

For the year ended December 31						
Highest amount at a month-end	$ -		$ 12,350		$ 14,450	
Daily average amount outstanding	-		5,383		12,794	
Weighted average interest rate	-	%	0.38	%	0.38	%

Additional information regarding our borrowings is included in Note 8 in the Notes to our Consolidated Financial Statements beginning on page F-1.

Subsidiary Activities

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

Personnel

As of December 31, 2015, we had 104 full-time employees and 11 part-time employees. The employees are not represented by a collective bargaining unit and we consider our relationship with our employees to be good.

Supervision and Regulation

General

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

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

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

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

In addition to eliminating the OTS and creating the CFPB, the Dodd-Frank Act, among other things, directed changes in the way that institutions are assessed for deposit insurance, mandated the imposition of consolidated capital requirements on savings and loan holding companies, required originators of securitized loans to retain a percentage of the risk for the transferred loans, regulated rate-setting for certain debit card interchange fees, repealed restrictions on the payment of interest on commercial demand deposits and contained a number of reforms related to mortgage originations. The Dodd-Frank Act increased shareholder influence over boards of directors by requesting companies to give shareholders a non-binding vote on executive compensation and so called “Golden Parachute” payments. In addition, the CFPB has finalized a rule implementing the “Ability to Pay” requirements of the Dodd-Frank Act. The regulations generally require creditors to make a reasonable, good faith determination as to a borrower's ability to repay most residential mortgage loans. The ruling also sets standards for mortgage servicing, loan originator compensation, and requirements for high-cost mortgages, appraisal and escrow standards. The final rule establishes a safe harbor for certain "Qualified Mortgages," which contain certain features deemed less risky and omit certain other characteristics considered to enhance risk. The Ability to Repay final rules were effective January 1, 2014.

On October 3, 2015, the new TILA-RESPA Integrated Disclosure ("TRID") rules for mortgage closings took effect for new loan applications. These new loan forms may have the effect of lengthening the time it takes to approve mortgage loans in the short term following implementation of the rule.

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

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

Federal Banking Regulation

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

Capital Requirements. Federal regulations require a federal savings bank to meet certain minimum capital standards. In July 2013, the federal banking agencies issued a final rule that revised the leverage and risk-based capital requirements and the method for calculating risk-weighted assets to make them consistent with the agreements that were reached by the Basel Committee on Banking Supervision in "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" ("Basel III") and the Dodd-Frank Act, which became effective on January 1, 2015.

The revised rule established a new common equity Tier 1 ("CET1") minimum capital requirement (4.5% of risk-weighted assets), established a uniform minimum leverage ratio of 4%, increased the minimum Tier 1 capital to risk-weighted assets requirement (from 4% to 6% of risk-weighted assets) and maintained the total capital ratio of at least 8% of risk-weighted assets. Under the new standards, in order to be considered well-capitalized, the Bank must have a CET1 ratio of 6.5%, a Tier 1 ratio of 8%, a total risk-based capital ratio of 10% and a leverage ratio of 5%. The final rule requires unrealized gains and losses on certain "available for sale" securities holdings to be included for purposes of calculating regulatory capital unless a one-time opt-out is exercised. Lake Shore Savings Bank has exercised this one-time opt-out and therefore excluded unrealized gains and losses on certain “available-for-sale” securities holdings for purposes of calculating regulatory capital. Additional restraints are also imposed on the inclusion in regulatory capital of mortgage-servicing assets, deferred tax assets and minority interests.

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

In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet assets, are multiplied by a risk-weight factor of 0% to 1,250%, assigned by federal regulations based on the risks believed inherent in the type of asset. The new capital requirements assigns a higher risk weight (150%) to exposures that are more than 90 days past due or are on nonaccrual status and to certain commercial real estate facilities that finance the acquisition, development or construction of real property.

The final rule limits a banking organization's capital distributions and certain discretionary bonus payments if the banking organization does not hold a "capital conservation buffer" consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets in addition to the amount necessary to meet its minimum risk-based capital requirements. The capital conservation buffer requirement will be phased in beginning January 1, 2016 at 0.625% and ending January 1, 2019, when the full capital conservation buffer requirement will be effective. At December 31, 2015, Lake Shore Savings Bank's capital exceeded all applicable minimal capital requirements.

Loans to One Borrower. Generally, a federal savings bank may not make a loan or extend credit to a single or related group of borrowers in excess of 15% of unimpaired capital and surplus. An additional amount may be loaned, equal to 10% of unimpaired capital and surplus, if the loan is secured by readily marketable collateral, which generally does not include real estate. As of December 31, 2015, Lake Shore Savings Bank was in compliance with the loans-to-one borrower limitations.

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

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

A savings bank that fails the QTL test must either convert to a commercial bank charter or operate under specified restrictions. The Dodd-Frank Act makes noncompliance with the QTL Test potentially subject to agency enforcement action for violation of law. At December 31, 2015, Lake Shore Savings Bank satisfied the QTL test.

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

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

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

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

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

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

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

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

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

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

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

At December 31, 2015, Lake Shore Savings is in compliance with Regulation O.

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

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

Prompt Corrective Action Regulations. Under the prompt corrective action regulations, the OCC is required and authorized to take supervisory actions against undercapitalized federal savings banks. For this purpose, a savings bank is placed in one of the following five categories (which were amended effective January 1, 2015 to reflect the revised regulatory capital requirements discussed earlier) based on the savings bank's capital:

- well-capitalized (at least 5% leverage capital, 6.5% common equity Tier 1 risk-based capital, 8% Tier 1 risk-based capital and 10% total risk-based capital);

- adequately capitalized (at least 4% leverage capital, 4.5% common equity Tier 1 risk-based capital, 6% Tier 1 risk-based capital and 8% total risk-based capital);
- undercapitalized (less than 4% leverage capital, 4.5% common equity Tier 1 risk-based capital, 6% Tier 1 risk-based capital or 8% total risk-based capital);
- significantly undercapitalized (less than 3% leverage capital, 3% common equity Tier 1 risk-based capital, 4% Tier 1 risk-based capital or 6% total risk-based capital); and
- critically undercapitalized (less than 2% tangible capital).

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

At December 31, 2015, Lake Shore Savings met the criteria for being considered "well-capitalized."

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

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

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

Insurance of deposits may be terminated by the FDIC upon a finding that an institution has engaged in unsafe or unsound practices, is in an unsafe or unsound condition to continue operations or has violated any

applicable law, regulation, rule, order or condition imposed by the FDIC. We do not currently know of any practice, condition or violation that may lead to termination of our deposit insurance.

In addition to the FDIC assessments, the Financing Corporation ("FICO") is authorized to impose and collect, with the approval of the FDIC, assessments for anticipated payments, issuance costs and custodial fees on bonds issued by the FICO in the 1980s to recapitalize the former Federal Savings and Loan Insurance Corporation. The bonds issued by the FICO are due to mature in 2017 through 2019. For the quarter ended December 31, 2015, the annualized FICO assessment was equal to 0.60 basis points of total assets less tangible capital.

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

Federal Home Loan Bank System. Lake Shore Savings is a member of the Federal Home Loan Bank System, which consists of twelve regional Federal Home Loan Banks. The Federal Home Loan Bank System provides a central credit facility primarily for member institutions. As a member of the Federal Home Loan Bank of New York, Lake Shore Savings is required to acquire and hold shares of capital stock in the Federal Home Loan Bank. As of December 31, 2015, Lake Shore Savings was in compliance with this requirement.

Other Regulations

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

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

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

- Right to Financial Privacy Act, which imposes a duty to maintain confidentiality of consumer financial records and prescribes procedures for complying with administrative subpoenas of financial records;

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

Holding Company Regulation

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

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

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

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

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

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

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

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

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

(viii)acting as trustee under deeds of trust;

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

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

(xi)purchasing, holding, or disposing of stock acquired in connection with a qualified stock issuance if the purchase of such stock by such savings and loan holding company is approved by the Federal Reserve Board.

If a mutual holding company acquires or merges with another holding company, the holding company acquired or the holding company resulting from such merger or acquisition may only invest in assets and engage in activities listed in (i) through (xi) above, and has a period of two years to cease any nonconforming activities and divest of any nonconforming investments.

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

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

Capital. Historically, savings and loan holding companies have not been subject to regulatory capital requirements. The Dodd-Frank Act, however, required the Federal Reserve Board to promulgate consolidated capital requirements for all depository institution holding companies that are no less stringent, both quantitatively and in terms of components of capital, than those applicable to institutions themselves. On January 29, 2015, the Federal Reserve Board revised its Small Bank Holding Company Policy Statement ("Policy Statement") as directed by recent federal legislation to generally raise the total consolidated asset limit for the exemption from holding company capital requirements from $500 million to $1 billion, and expand the scope of the Policy Statement to include savings and loan holding companies (SLHCs). In conjunction with these revisions, the Federal Reserve Board proposed changes to regulatory reports effective in 2015 to lessen the reporting burden on smaller institutions. Prior to these revisions, beginning January 1, 2015, the top-tier savings and loan holding company, Lake Shore, MHC would have been subject to the holding company capital reporting requirements when the MHC's total consolidated assets exceeded $500 million. However, as a result of these revisions, the MHC will be exempt from the regulatory capital requirements until consolidated assets exceed $1 billion.

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

Waivers of Dividends by Lake Shore, MHC. The Dodd-Frank Act requires federally-chartered mutual holding companies to give the Federal Reserve Board notice before waiving the receipt of dividends, and provides that in the case of “grandfathered” mutual holding companies, like Lake Shore, MHC, the Federal Reserve Board “may not object” to a dividend waiver if the board of directors of the mutual holding company waiving dividends determines that the waiver: (i) would not be detrimental to the safe and sound operation of the subsidiary savings bank; and (ii) is consistent with the board’s fiduciary duties to members of the mutual holding company. To qualify as a grandfathered mutual holding company, a mutual holding company must have been formed, issued stock and waived dividends prior to December 1, 2009. Lake Shore, MHC qualifies as a grandfathered mutual holding company. The Dodd-Frank Act further provides that the Federal Reserve Board may not consider waived dividends in determining an appropriate exchange ratio upon the conversion of a grandfathered mutual holding company to stock form. The Federal Reserve Board has issued an interim final rule that also requires, as a condition to waiving dividends, that each mutual holding company obtain the approval of a majority of the eligible votes of its members within 12 months prior to the declaration of the dividend being waived. Lake Shore, MHC solicited its members (depositors of Lake Shore Savings Bank) to vote on the proposal to waive the MHC’s receipt of quarterly cash dividends aggregating up to $0.28 per share to be declared by the Company for the four quarters ending September 30, 2016. On February 3, 2016, the members approved the waiver of dividends. The Board of Directors of Lake Shore, MHC subsequently approved a dividend waiver in accordance with the regulations and submitted it to the Federal Reserve Board for their non-objection. As of March 2, 2016, Lake Shore, MHC received notice of the non-objection of the Federal Reserve Board to waive its right to receive dividends paid by the Company during the twelve months ending February 2, 2017. It is expected that Lake Shore, MHC will continue to waive future dividends, except to the extent dividends are needed to fund Lake Shore, MHC’s continuing operations, subject to the ability of Lake Shore, MHC to obtain regulatory approval of its requests to waive dividends and its ability to obtain future member approval of dividend waivers. For more information, see Item 1A, “Risk Factors – Our ability to pay dividends is subject to the ability of Lake Shore Savings to make capital distributions to Lake Shore Bancorp and the waiver of dividends by Lake Shore, MHC.”

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

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

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

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

Federal Securities Laws

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

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

Sarbanes-Oxley Act of 2002

The Sarbanes-Oxley Act of 2002 addresses, among other issues, corporate governance, auditing and accounting, executive compensation, and enhanced and timely disclosure of corporate information. As directed by the Sarbanes-Oxley Act, the Chief Executive Officer and Chief Financial Officer of Lake Shore Bancorp, Inc. are required to certify that its quarterly and annual reports filed with the Securities and Exchange Commission do not contain any untrue statement of a material fact. The rules adopted by the Securities and Exchange Commission under the Sarbanes-Oxley Act have several requirements, including having these officers certify that: they are responsible for establishing, maintaining and regularly evaluating the effectiveness of internal control over financial reporting; they have made certain disclosures to its auditors and the audit/risk committee of the Board of Directors about internal control over financial reporting; and they have included information in the quarterly and annual reports about their evaluation and whether there have been changes in internal control over financial reporting or in other factors that could materially affect internal control over financial reporting. Lake Shore Bancorp, Inc. has existing policies, procedures and systems

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designed to comply with these regulations, and is further enhancing and documenting such policies, procedures and systems to ensure continued compliance with these regulations.

Item 1A. Risk Factors.

In analyzing whether to make or to continue an investment in the Company, investors should consider, among other factors, the following:

Risks Related To Our Business

Our loan portfolio includes loans with a higher risk of loss. We originate commercial real estate loans, commercial business loans, consumer loans, and residential real estate loans (including home equity loans) primarily within our market area. Commercial real estate, commercial business, and consumer loans, which comprised in the aggregate 35.7% of our total loan portfolio at December 31, 2015, may expose a lender to greater credit risk than loans secured by residential real estate because the collateral securing these loans may not be sold as easily as residential real estate. In addition, commercial real estate and commercial business loans may also involve relatively large loan balances to individual borrowers or groups of borrowers. These loans also have greater credit risk than residential real estate for the following reasons:

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

Deterioration in economic conditions in our market areas could affect the performance of our loan portfolio. Higher prices for businesses and consumers and high unemployment could negatively affect our loan portfolio, if business owners or consumers are not able to make loan payments. A 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 our borrowers’ businesses thereby increasing the risk of non-performing loans.

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

Material additions to our allowance for loan losses also would materially decrease our net income, and the charge-off of loans may cause us to increase the allowance for loan losses. Our provision for loan losses in 2015 increased by $178,000, or 80.2%, to $400,000 as compared to 2014. The increase over 2014 was partially due to a $22.6 million, or 27.6%, increase in the size of our commercial and construction loan portfolios during 2015 and due to a $79,000 charge-off related to a single impaired commercial real estate loan during 2015. We make various assumptions and judgments about the collectability of our loan portfolio, including the creditworthiness of our borrowers and the value of the real estate and other assets serving as collateral for the repayment of many of our loans. We rely on our loan quality reviews, our experience and our evaluation of economic conditions, among other factors, in determining the amount of the allowance for loan losses. If our assumptions prove to be incorrect, our allowance for loan losses may not be sufficient to cover losses inherent in our loan portfolio, resulting in additions to our allowance. The increased focus on commercial loan originations has been one of the more significant factors we have taken into account in evaluating our allowance for loan losses and provision for loan losses. If we were to further increase the amount of commercial loans in our portfolio, we may decide to make increased provisions for loan losses. In addition, bank regulators periodically review our allowance for loan losses and may require us to increase our provision for loan losses or recognize further loan charge-offs, which may have a material adverse effect on our financial condition and results of operations.

Low demand for real estate loans may lower our profitability. Making loans secured by real estate, including one- to four-family and commercial real estate, is our primary business and primary source of revenue. If customer demand for real estate loans decreases, our profits may decrease because our alternative investments, primarily securities, generally earn less income than real estate loans. Customer demand for loans secured by real estate could be reduced due to weaker economic conditions, an increase in unemployment, a decrease in real estate values or an increase in interest rates. Interest rates on deposit products steadily declined between 2008 and 2012 at a greater pace than the rate decline on loan products, resulting in a positive net interest margin during that time period. Furthermore, we experienced commercial loan growth during 2010 through 2015, especially in the Erie County market area, which had a positive impact on net interest income. However, loan demand for retail customers slowed down during 2010 through 2015, which resulted in decreasing loan interest income. If rates begin to rise, loan demand may continue to be low, and deposit expenses may increase, which could lower our profitability.

The results of our operations may be adversely affected by environmental conditions. During the course of making loans secured by real estate, we have acquired and may acquire in the future, property securing loans that are in default. There is a risk that we could be required to investigate and clean-up hazardous or toxic substances or chemical releases at such properties after acquisition in a foreclosure action, and that we may be held liable to a governmental entity or third parties for property damage, personal injury and investigation and clean-up costs incurred by such parties in connection with such contamination. In addition, the owner or former owners of contaminated sites may be subject to common law claims by third parties based on damages and costs resulting from environmental contamination emanating from such property. We complete an environmental assessment of commercial real estate loans at the time of application. To date, we have not been required to perform any investigation or clean-up activities, nor have we been subject to any environmental claims. There can be no assurance, however, that this will remain the case in the future.

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

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

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

From an interest rate risk perspective, we have generally been liability sensitive, which indicates that our liabilities generally re-price faster than assets. Our earnings may be adversely impacted by an increase in interest rates because the majority of our interest-earning assets are long-term, fixed rate mortgage-related assets that will not re-price as long-term interest rates increase. As rates rise, we expect loan applications to decrease, prepayment speeds to slow down and the interest rate on our loan portfolio to remain static. Conversely, a majority of our interest-bearing liabilities have much shorter contractual maturities and are expected to re-price, resulting in increased interest expense. A significant portion of our deposits have no contractual maturities and are likely to re-price quickly as short-term interest rates increase. Therefore, in an increasing rate environment, our cost of funds is expected to increase more rapidly than the yields earned on our loan and securities portfolios. An increasing rate environment is expected to cause a decrease in our net interest rate spread and a decrease in our earnings.

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

In a decreasing interest rate environment, our earnings may increase or decrease. If long-term interest-earning assets do not re-price and interest rates on short-term deposits begin to decrease, earnings may rise. However, low interest rates on 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 products. The net effect of these circumstances is reduced net interest income and possibly net interest rate spread.

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

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

Our information systems may experience an interruption or breach in security. We rely heavily on communications and information systems to conduct our business. Any failure, interruption or breach in security of these systems could result in failures or disruptions in our customer accounts, general ledger, deposit, loan and other systems. There have been increasing efforts to breach data security at financial institutions through cyber attacks. Recently, there have been several instances involving financial services and

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consumer-based companies reporting the unauthorized disclosure of customer information or the destruction or theft of corporate data. We may be unable to proactively address these types of security breaches or to implement adequate preventative measures because the techniques used to cause these breaches change frequently, often are not recognized until launched against a target and may originate from less regulated and remote areas throughout the world. While we have policies and procedures designed to prevent or limit the effect of the possible failure, interruption or security breach of our information systems, there can be no assurance that any such failure, interruption or security breach will not occur or, if any does occur, that it will be adequately addressed. Additionally, we outsource our data processing to third parties. If the third party provider encounters difficulties or if we have difficulty in communicating with such third party, it will significantly affect our ability to adequately process and account for customer transactions, which would significantly affect our business operations. Furthermore, breaches of such third party's technology may also cause reimbursable loss to our consumer and business customers, through no fault of our own. Fraud attacks targeting customer-controlled devices, plastic payment card terminals, and merchant data collection points provide another source of potential loss, again through no fault of our own. The occurrence of any failures, interruptions or security breaches of information systems used to process customer transactions could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our financial condition, results of operations and cash flows.

The Company has developed a disaster recovery plan, which includes plans to maintain or resume operations in the event of an emergency, such as a power outage or natural disaster, and contingency plans in the event that operations or systems cannot be resumed or restored. The disaster recovery plan is periodically reviewed and updated, and components of the disaster recovery plan are periodically tested and validated. The Company also reviews and evaluates the disaster recovery programs of vendors which provide certain third-party systems that the Company considers critical.

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

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

If we fail to maintain an effective system of internal control over financial reporting, we may not be able to accurately report our financial results or prevent fraud, and, as a result, shareholders 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. The Company has established a process to document and evaluate its internal controls over financial reporting in order to satisfy the Sarbanes-Oxley Act and related regulations, which require management consideration of the Company's internal controls over financial reporting on an annual basis. In this regard, management has dedicated internal resources and adopted a detailed work plan to (i) assess and document the adequacy of internal controls over financial reporting, (ii) take steps to improve control processes, where appropriate, (iii) validate through testing that controls are functioning as documented and (iv) maintain a continuous internal reporting and improvement process for internal control over financial reporting. The Company's management and audit/risk committee have made the Company's compliance with Section 404 a high priority. The Company cannot be certain that these measures will ensure that the Company implements and maintains adequate controls over its financial processes and reporting in the future. Any failure to implement appropriate new or improved controls in response to changes in financial processes or reporting, or difficulties encountered in their implementation could harm the Company's operating results or cause the Company to fail to meets its reporting obligations. If the Company fails to correct any significant deficiencies in the design or operating effectiveness of internal controls over financial reporting or fails to prevent fraud, current and potential shareholders and depositors could lose confidence in the Company's financial reporting, which could harm its business and the trading price of its stock.

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

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

Risks Related To Recent Developments And The Banking Industry Generally

Changes in laws and regulations and the cost of regulatory compliance with new laws and regulations may adversely affect our operations and/or increase our costs of operations. Lake Shore Savings and Lake Shore Bancorp and Lake Shore, MHC are subject to extensive regulation, supervision and examination by the OCC and the Federal Reserve Board. Such regulation and supervision governs the activities in which an institution and its holding companies may engage and are intended primarily for the protection of federal deposit insurance funds and the depositors and borrowers of Lake Shore Savings, rather than for our stockholders. Regulatory authorities have extensive discretion in their supervisory and enforcement activities, including the imposition of restrictions on our operations, the classification of our assets and determination of the level of our allowance for loan losses. These regulations, along with existing tax, accounting, securities, insurance and monetary laws, rules, standards, policies, and interpretations control the methods by which financial institutions conduct business, implement strategic initiatives and tax compliance, and govern financial reporting and disclosures. Any change in such regulation and oversight, whether in the form of regulatory policy, regulations, legislation or supervisory action, may have a material impact on our operations. Further, changes in accounting standards can be both difficult to predict and involve judgment and discretion in their interpretation by us and our independent accounting firms. These changes could materially impact, potentially even retroactively, how we report our financial condition and results of operations, and our interpretation of those changes.

The Dodd-Frank Act has significantly changed the bank regulatory structure and affects the lending, deposit, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new implementing rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies have been given significant discretion in drafting the implementing rules and regulations, many of which are not in final form. The Dodd-Frank Act created a new Consumer Financial Protection Bureau with broad powers to supervise and enforce consumer protection laws. The Consumer Financial Protection Bureau has broad rule-making authority for a wide range of consumer protection laws that apply to all banks and savings institutions, including the authority to prohibit “unfair, deceptive or abusive” acts and practices. The Consumer Financial Protection Bureau has examination and enforcement authority over all banks with more than $10 billion in assets. Banks with $10 billion or less in assets continue to be examined for compliance with consumer laws by their primary bank regulators. The Dodd-Frank Act also weakened the federal preemption rules that have been applicable for national banks and federal savings banks, and gives state attorneys general the ability to enforce federal consumer protection laws.

The full impact of the Dodd-Frank Act on our business will not be known until all regulations affecting community banks under the statute are implemented. As a result, at this time we do not know the full extent to which the Dodd-Frank Act will impact our business, operations or financial condition. However, compliance with the Dodd-Frank Act and its implementing regulations and policies has already resulted in changes to our business and operations, as well as additional costs, and has diverted management’s time from other business activities, which adversely affects our financial condition and results of operations.

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

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

Lake Shore, MHC solicited its members (the depositors of Lake Shore Savings Bank) to vote on the proposal to waive dividends and on February 3, 2016, the members approved the waiver of dividends. The Board of Directors of Lake

Shore, MHC subsequently approved a dividend waiver in accordance with the regulations and submitted it to the Federal Reserve Board for their non-objection. As of March 2, 2016, Lake Shore, MHC received notice of the non-objection of the Federal Reserve Board to waive its right to receive dividends paid by the Company during the twelve months ending February 3, 2017. It is expected that Lake

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Shore, MHC will continue to waive future dividends, except to the extent dividends are needed to fund Lake Shore, MHC's continuing operations, subject to the ability of Lake Shore, MHC to obtain regulatory approval of its requests to waive dividends and its ability to obtain future member approval of dividend waivers.

While Lake Shore, MHC is grandfathered for purposes of the dividend waiver provisions of Regulation MM and has complied with all additional requirements imposed, we cannot predict whether the Federal Reserve Board will grant a dividend waiver request and, if granted, there can be no assurance as to the conditions, if any, the Federal Reserve Board will place on future dividend waiver requests by grandfathered mutual holding companies such as Lake Shore, MHC. If Lake Shore, MHC is unable to waive the receipt of dividends, our ability to pay dividends to our shareholders may be substantially impaired and the amounts of any such dividends may be significantly reduced.

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

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

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

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

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

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

Lenders must also verify and document the income and financial resources relied upon to qualify the borrower for the loan, and underwrite the loan based on a fully amortizing payment schedule and maximum interest rate during the first five years, among other requirements. The CFPB's rule on qualified mortgages could limit our ability or desire to make certain types of loans or loans to certain borrowers, or could make it more expensive and/or time consuming to make these loans, which could limit our growth or profitability.

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

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

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

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

Our stock price may be volatile due to limited trading volume. Our common stock is traded on the NASDAQ Global Market. However, the average daily trading volume in Lake Shore Bancorp's common stock has been relatively small, averaging less than 3,000 shares per day during 2015. As a result, trades involving a relatively small number of shares may have a significant effect on the market price of the common stock, and it may be difficult for investors to acquire or dispose of large blocks of stock without significantly affecting the market price.

Item 1B. Unresolved Staff Comments.

None.

Item 2. Properties.

We conduct our business through our corporate headquarters, administrative offices, and eleven branch offices. At December 31, 2015, the net book value of the computer equipment and other furniture, fixtures, and equipment at our offices totaled $1.2 million. For more information, see Note 6 and Note 9 in the Notes to our Consolidated Financial Statements.

Location	Leased or Owned	Original Date Acquired		Net Book Value December 31, 2015
	(Dollars in thousands)			
Corporate Headquarters				
31 East Fourth Street				
Dunkirk, NY 14048	Owned	2003	$	798
Branch Offices:				
Chautauqua County branches				
128 East Fourth Street				
Dunkirk, NY 14048	Owned/Leased(1)	1930		696
30 East Main Street				
Fredonia, NY 14063	Owned	1996		612
1 Green Avenue, WE				
Jamestown, NY 14701	Owned/Leased(2)	1996		544
115 East Fourth Street				
Jamestown, NY 14701	Owned	1997		376
106 East Main Street				
Westfield, NY 14787	Owned/Leased(3)	1998		118
Erie County branches				
5751 Transit Road				
East Amherst, NY 14051	Owned	2003		972
3111 Union Road				
Orchard Park, NY 14127	Leased(4)	2003		400
59 Main Street				
Hamburg, NY 14075	Leased(5)	2005		737
3438 Delaware Avenue				
Kenmore, NY 14217	Owned	2008		1,090
570 Dick Road				
Depew, NY 14043	Leased(6)	2009		60
4950 Main Street				
Snyder, NY 14226	Owned	2012		1,242
Administrative Offices:				
125 East Fourth Street				
Dunkirk, NY 14048	Owned	1995		155
123 East Fourth Street				
Dunkirk, NY 14048	Owned	1995		80
415 Washington Avenue				

Dunkirk, NY 14048	Owned	2010	53

(1) The building is owned. Additional parking lot is leased. The lease expires in 2019.
(2) The building is owned. The land is leased. The lease expires in 2020.
(3) The building is owned. Additional parking lot is leased. The lease expires in 2016, but has an automatic one-year renewal option.
(4) The lease expires in 2017.

(5) The lease expires in 2028.

(6) The lease expires in 2019.

Item 3. Legal Proceedings.

At December 31, 2015, we are not involved in any pending legal proceedings other than routine legal proceedings occurring in the ordinary course of business. We believe that these routine legal proceedings, in the aggregate, are immaterial to our financial condition and results of operations.

Item 4. Mine Safety Disclosures.

Not applicable.

PART II

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

Market Information

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

	Sales Price		Dividend Information	
Period	High	Low	Amount Per Share	Date of Payment
2014				
First quarter	$ 12.52	$ 12.20	$ 0.07	March 18, 2014
Second quarter	12.50	12.25	0.07	May 21, 2014
Third quarter	13.02	11.95	0.07	August 19, 2014
Fourth quarter	14.00	12.50	0.07	November 18, 2014
2015				
First quarter	$ 14.00	$ 13.00	$ 0.07	March 10, 2015
Second quarter	15.85	13.20	0.07	May 22, 2015
Third quarter	14.35	13.08	0.07	August 18, 2015
Fourth quarter	13.80	13.15	0.07	November 19, 2015

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

As of March 24, 2016 there were approximately 806 stockholders of record (excluding the number of persons or entities holding stock in street name through various brokerage firms) of Lake Shore Bancorp, Inc. common stock.

The following table reports information regarding repurchases by Lake Shore Bancorp of its common stock in each month of the quarter ended December 31, 2015:

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) (2)
October 1 through October 31, 2015	10,000	$ 13.55	10,000	6,510
November 1 through November 30, 2015	-	-	-	6,510
December 1 through December 31, 2015	5,100	13.55	5,100	117,701
Total	15,100	$ 13.55	15,100	117,701

(1) On November 17, 2010, our Board of Directors approved a new stock repurchase plan pursuant to which we can repurchase up to 116,510 shares of our outstanding common stock. This amount represented 5% of our outstanding stock not owned by the MHC as of November 23, 2010. The plan ended on December 11, 2015 with 1,410 shares remaining to be purchased.

(2) On December 11, 2015, our Board of Directors approved a new stock repurchase plan pursuant to which we can repurchase up to 117,701 shares of our outstanding common stock. This amount represented approximately 5% of our outstanding stock not owned by the MHC as of December 11, 2015. The repurchase plan does not have an expiration date and superseded all of the prior stock repurchase programs.

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Item 6. Selected Financial Data.

Our selected consolidated financial and other data is set forth below, which is derived in part from, and should be read in conjunction with, our audited consolidated financial statements and notes thereto as of December 31, 2015 and 2014 and for the years ended December 31, 2015, 2014 and 2013, beginning on page F-1 of this Form 10-K. Our selected consolidated financial and other data as of December 31, 2013, 2012 and 2011 and for the years ended December 31, 2012 and 2011 are from audited consolidated financial statements and notes not included in this Form 10-K.

	As of December 31,				
	2015	2014	2013	2012	2011
	(Dollars in thousands)				
Selected financial condition data:					
Total assets	$ 473,385	$ 487,471	$ 482,167	$ 482,387	$ 488,597
Loans, net	297,101	284,853	277,345	272,933	275,068
Securities available for sale	113,213	138,202	157,964	159,368	164,165
Federal Home Loan Bank stock	1,454	1,375	1,560	1,852	2,219
Total cash and cash equivalents	34,227	35,811	17,202	19,765	23,704
Total deposits	369,155	386,939	388,235	378,543	379,798
Short-term borrowings	-	-	11,650	11,200	6,910
Long-term debt	21,150	18,950	7,850	14,400	27,230
Total stockholders' equity	73,876	71,630	65,271	66,985	63,947
Allowance for loan losses	1,985	1,921	1,813	1,806	1,366
Non-performing loans	4,668	4,729	4,606	2,420	2,798
Non-performing assets	5,380	5,130	5,187	3,000	3,113

	For the year ended December 31,				
	2015	2014	2013	2012	2011
	(Dollars in thousands, except per share data)				
Selected operating data:					
Interest income	$ 17,587	$ 17,879	$ 18,614	$ 19,650	$ 20,765
Interest expense	2,757	3,348	3,556	4,603	5,636
Net interest income	14,830	14,531	15,058	15,047	15,129
Provision for loan losses	400	222	105	656	415
Net interest income after provision for loan losses	14,430	14,309	14,953	14,391	14,714
Total non-interest income	2,707	2,235	2,092	2,030	1,666
Total non-interest expense	13,083	12,819	12,334	11,811	11,307
Income before income taxes	4,054	3,725	4,711	4,610	5,073
Income taxes	716	567	968	984	1,393
Net income	$ 3,338	$ 3,158	$ 3,743	$ 3,626	$ 3,680

Basic earnings per common share	$ 0.57	$ 0.55	$ 0.66	$ 0.64	$ 0.65
Diluted earnings per common share	$ 0.56	$ 0.55	$ 0.65	$ 0.64	$ 0.65
Dividends declared per share	$ 0.28	$ 0.28	$ 0.28	$ 0.25	$ 0.28

	At or for the year ended December 31,				
	2015	2014	2013	2012	2011
Selected financial ratios and other data					
Performance ratios:					
Return on average assets	0.70%	0.65%	0.77%	0.74%	0.76%
Return on average equity	4.57%	4.58%	5.64%	5.47%	6.15%
Dividend payout ratio(1)	50.00%	50.91%	43.08%	39.06%	43.08%
Interest rate spread(2)	3.18%	3.06%	3.19%	3.07%	3.14%
Net interest margin(3)	3.34%	3.21%	3.34%	3.26%	3.34%
Efficiency ratio(4)	74.60%	76.46%	71.92%	69.16%	67.32%
Non-interest expense to average total assets	2.73%	2.63%	2.55%	2.40%	2.34%
Average interest-earning assets to average interest-bearing liabilities	125.03%	120.93%	119.39%	119.69%	116.58%
Book value per share(5)	$ 12.31	$ 11.96	$ 11.03	$ 11.32	$ 10.77
Capital ratios:					
Common Equity Tier 1 capital to risk-weighted assets(6)(7)	24.21%	n/a	n/a	n/a	n/a
Total risk-based capital to risk-weighted assets(6)	24.93%	25.71%	25.08%	23.77%	21.81%
Tier 1 risk-based capital to risk-weighted assets(6)	24.21%	24.95%	24.36%	23.04%	21.27%
Tangible capital to tangible assets(6)	14.31%	13.16%	12.75%	12.14%	11.18%
Tier 1 leverage (core) capital to adjustable tangible assets(6)	14.31%	13.16%	12.75%	12.14%	11.18%
Equity to total assets	15.61%	14.69%	13.54%	13.89%	13.09%
Asset quality ratios:					
Non-performing loans as a percent of total net loans	1.57%	1.66%	1.66%	0.89%	1.02%
Non-performing assets as a percent of total assets	1.14%	1.05%	1.08%	0.62%	0.64%
Allowance for loan losses as a percent of total net loans	0.67%	0.67%	0.65%	0.66%	0.50%
Allowance for loan losses as a percent of non-performing loans	42.52%	40.62%	39.36%	74.63%	48.82%
Other data:					
Number of full service offices	11	11	11	10	10
Number of full-time equivalent employees	109	108	109	109	108

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

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

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

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

(5)Represents shareholders equity divided by outstanding shares.

(6)Represents the capital ratios of Lake Shore Savings Bank since Lake Shore Bancorp, Inc., as a savings and loan holding company with less than $1.0 billion in consolidated assets is not subject to formula-based capital requirements at the holding company level.

(7)Effective January 1, 2015, Lake Shore Savings Bank became subject to new capital requirements adopted by the OCC. The new requirements resulted in the creation of a new required ratio for common equity Tier 1 ("CET1") capital.

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

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

Important Note Regarding Forward-Looking Statements

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

General

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

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

Financial institutions like us, in general, are significantly affected by economic conditions, competition, and the monetary and fiscal policies of the federal government. Lending activities are influenced by the demand for and supply of housing, competition among lenders, interest rate conditions, and funds availability. Our operations and lending are principally concentrated in the Western New York area, and our operations and earnings are influenced by local economic conditions. Deposit balances and cost of funds are influenced by prevailing market rates on competing investments, customer preferences, and levels of personal income and savings in our primary market area. Operations are also significantly impacted by government policies and actions of regulatory authorities. Future changes in applicable law, regulations or government policies may materially impact the Company.

Due to improvements in the housing market and unemployment rate, the Federal Reserve increased the Federal Funds rate by 25 basis points to 0.25%-0.50% at its December 2015 meeting, the first increase in seven years. The Federal Reserve has indicated that it will continue to assess both realized and expected progress towards its dual mandates of maximum employment and a 2% inflation rate prior to future rate increases. At the December 2015 meeting, the Federal Reserve indicated that economic conditions may, for some time, warrant keeping the target federal funds rate below normal. As a result, there is uncertainty about the timing of future rate increases.

Furthermore, the Federal Reserve will maintain its existing policy to reinvest cash flow received on its investment portfolio back into agency mortgage backed securities and treasury bonds until the level of the federal funds rate stabilizes. This action will continue to exert downward pressure on long-term rates. Current interest rates on residential mortgage loans remain very low compared to historical yields. We will continue to closely monitor the impact of the national and regional economy on our net interest margin, results of operations and critical risk areas, including interest rate risk and credit risk.

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

Management Strategy

Our Reputation. Our primary management strategy has been to retain our perceived image as one of the most respected and recognized community banks in Western New York with over 124 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. Our offices are located in Dunkirk, Fredonia, Jamestown, Lakewood and Westfield in Chautauqua County, New York and in Depew, East Amherst, Hamburg, Kenmore, Orchard Park, and Snyder in Erie County, New York. Saturation of the market in Chautauqua County led to our expansion plan in Erie County, which is a critical component of our future profitability and growth.

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

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

Lending. Historically, our lending portfolio has consisted predominantly of residential one- to four-family mortgage loans. At December 31, 2015 and 2014, we held $157.6 million and $167.8 million of residential one- to four-family mortgage loans (including loans to finance the construction of one- to four-family homes), respectively, which constituted 53.2% and 59.1% of our total loan portfolio, at such respective dates. Due to the interest rate risk inherent in holding long-term, fixed rate one- to four-family real estate loans in our portfolio in a potential rising interest rate environment, we have been strategically focused on increasing the originations of commercial real estate loans to finance the purchase of real property, which generally consists of developed real estate. We have also focused on commercial business lending to small businesses, including business installment loans, lines of credit and other commercial loans. These types of commercial loans are generally made at higher interest rates and for shorter terms than one- to four-family real estate loans, which reduced the Bank's interest rate risk. At December 31, 2015 and 2014, our commercial real estate loan portfolio (including loans to finance the construction of commercial real estate) consisted of loans totaling

$88.5 million and $68.2 million, respectively, or 29.9% and 24.0%, respectively, of total loans. At December 31, 2015 and 2014, our commercial business loan portfolio consisted of loans totaling $15.7 million and $13.5 million, respectively, or 5.3% and 4.7%, respectively, of total loans. Other loan products offered to our customers include home equity lines of credit, construction loans and consumer loans, including automobile loans, overdraft lines of credit and share loans. In the fourth quarter of 2014 and throughout 2015, we sold low-yield long-term (generally 30 years) conforming fixed rate one- to four-family residential loans that we originated, as part of our interest rate risk strategy and asset/liability management, and plan to continue to do so in the future, as it is deemed appropriate. We typically retain servicing rights when we sell one- to four-family residential mortgage loans.

Investment Strategy. Our investment policy is designed primarily to manage the interest rate sensitivity of our assets and liabilities, to generate a favorable return without incurring undue interest rate and credit risk, to complement our lending activities and to provide and maintain liquidity within established guidelines. We employ a third party financial advisor to assist us in managing our investment portfolio and developing balance sheet strategies.

At December 31, 2015 and 2014, we had $113.2 million and $138.2 million, respectively, invested in securities available for sale, the majority of which are Treasury securities, agency collateralized mortgage obligation securities (“CMOs”), agency mortgage-backed securities and municipal securities. During 2015, we sold $9.8 million of our investment securities to manage interest rate risk, fund loans and offset decreases in time deposit balances. Furthermore, payments received on the investment portfolio were not reinvested into securities, but were used instead for liquidity purposes to fund loans and manage interest rate risk. These actions resulted in a $25.0 million, or 18.1%, decrease in the investment portfolio. At December 31, 2015, we had a net unrealized gain in the investment portfolio of $4.3 million.

Asset-Liability Strategy. Our business consists primarily of originating one- to four-family residential real estate loans and commercial real estate loans secured by property in our market area and investing in residential mortgage backed securities, CMOs and municipal securities. One- to four-family residential real estate loans generally involve a lower degree of credit risk and carry a lower yield than commercial real estate and commercial business loans. The average maturity of residential real estate loans is longer than that for commercial loans. Our loans are primarily funded by time deposits, which typically mature within 2 years on average and core deposits (i.e. checking, savings and money market accounts). As a result, we are exposed to interest rate risk, as our interest-bearing liabilities will mature or re-price more quickly than our interest-earning assets in a rising rate environment. We maintain substantial liquid resources to help mitigate interest rate risk. Although we plan to continue to originate one- to four-family residential mortgage loans going forward, we have been and intend to continue to increase our focus on the origination of commercial real estate loans and commercial business loans, which generally have higher returns and shorter durations than one- to four-family residential real estate loans. As part of our asset liability strategy, we review the duration of assets on our balance sheet, and if necessary, we may sell loans or securities to help manage our interest rate risk. Our strategy also involves managing interest expense. During 2015, we have decreased the amount of higher rate time deposits and have concentrated on building lower-cost core deposits, with a focus on building commercial relationships, in order to help reduce and control our cost of funds. As part of our strategy to expand our commercial loan portfolio, we expect to attract lower cost core deposits as part of these borrower relationships. We offer competitive rates on a variety of deposit products to meet the needs of our customers and we promote long term deposits, where necessary, to meet asset-liability goals. We also consider borrowed funds or derivatives as an opportunity to extend the duration of liabilities, as needed. On March 17, 2016, the Company sold U.S. treasury bonds with an amortized cost of $12.8 million and gross gains of $1.6 million during the ordinary course of business. The sale of these securities will allow the Company to reinvest the proceeds into higher yield, shorter duration commercial loans.

We are actively involved in managing our balance sheet through the direction of our Asset-Liability Committee and the assistance of a third party advisor. Recent economic conditions have underscored the importance of a strong balance sheet. We strive to achieve this through managing our interest rate risk and maintaining strong capital levels, putting aside adequate loan loss reserves and keeping liquid assets on hand.

Diversifying our asset mix may improve the net interest margin and may also reduce the exposure of our net interest income and earnings to interest rate risk. We will continue to manage our interest rate risk by diversifying the type and maturity of assets in our loan and investment portfolios and monitoring the maturities in our deposit portfolio and borrowing facilities.

Critical Accounting Policies

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

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

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

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

Other than Temporary Impairment on Investment

During 2013, a $180,000 OTTI write-down was recorded on one private-label asset-backed security, as management concluded that there was substantial doubt about the ability of the issuer to meet the financial commitments under the security for the projected life of the investment, due to an increased risk of default or risk that full and timely repayment of principal and interest would not be achieved. This conclusion was reached through calculating expected returns using a discounted cash flow model with assumptions that were either equal to or more conservative than actual prepayment speeds, annual default rates and loss severity ratios. In 2014, management sold this particular private-label, asset-backed security due to the ongoing uncertainty surrounding its value. The bond was sold in March 2014 with an overall loss on the sale of approximately $101,000. The loss on sale was recorded in the non-interest income section of the Consolidated Statements of Income, within the “Net gain on sale of securities available for sale” line item. There were no OTTI write-downs during 2015 or 2014.

Analysis of Net Interest Income

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

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

	For the Year Ended December 31, 2015			For the Year Ended December 31, 2014			For the Year Ended December 31, 2013		
	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate	Average Balance	Interest Income/ Expense	Yield/ Rate
	(Dollars in thousands)								
Interest-earning assets:									
Interest-earning deposits & federal funds sold	$ 23,375	$ 22	0.09%	$ 26,832	$ 17	0.06%	$ 18,922	$ 14	0.07%
Securities(1)	129,043	3,813	2.95%	149,389	4,522	3.03%	159,854	4,793	3.00%
Loans	292,240	13,752	4.71%	276,360	13,340	4.83%	271,705	13,807	5.08%
Total interest-earning assets	444,658	17,587	3.96%	452,581	17,879	3.95%	450,481	18,614	4.13%
Other assets	33,903			34,143			34,100		
Total assets	$ 478,561			$ 486,724			$ 484,581		

Interest-bearing liabilities									
Demand & NOW accounts	$ 44,631	$ 39	0.09%	$ 45,582	$ 54	0.12%	$ 42,285	$ 48	0.11%
Money market accounts	75,879	167	0.22%	78,690	260	0.33%	73,923	269	0.36%
Savings accounts	44,340	30	0.07%	41,496	43	0.10%	38,797	40	0.10%
Time deposits	170,411	2,044	1.20%	188,180	2,585	1.37%	198,529	2,833	1.43%
Borrowed funds	19,349	391	2.02%	19,194	304	1.58%	22,608	262	1.16%
Other interest-bearing liabilities	1,043	86	8.25%	1,110	102	9.19%	1,174	104	8.86%
Total interest-bearing liabilities	355,653	2,757	0.78%	374,252	3,348	0.89%	377,316	3,556	0.94%
Other non-interest bearing liabilities	49,914			43,489			40,867		
Stockholders' equity	72,994			68,983			66,398		
Total liabilities & stockholders' equity	$ 478,561			$ 486,724			$ 484,581		
Net interest income		$ 14,830			$ 14,531			$ 15,058	
Interest rate spread			3.18%			3.06%			3.19%
Net interest margin			3.34%			3.21%			3.34%

(1) The tax equivalent adjustment for bank qualified municipals results in rates of 3.76%, 3.76% and 3.64% for the years ended December 31, 2015, 2014 and 2013, respectively.

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

	Year Ended December 31, 2015 Compared to Year Ended December 31, 2014			Year Ended December 31, 2014 Compared to Year Ended December 31, 2013		
	Rate	Volume	Net Change	Rate	Volume	Net Change
	(Dollars in thousands)					
Interest-earning assets:						
Interest-earning deposits & federal funds sold	$ 7	$ (2)	$ 5	$ (2)	$ 5	$ 3
Securities	(106)	(603)	(709)	45	(316)	(271)
Loans, including fees	(341)	753	412	(701)	234	(467)
Total interest-earning assets	(440)	148	(292)	(658)	(77)	(735)
Interest-bearing liabilities:						
Demand & NOW accounts	(14)	(1)	(15)	2	4	6
Money market accounts	(84)	(9)	(93)	(26)	17	(9)
Savings accounts	(16)	3	(13)	-	3	3
Time deposits	(310)	(231)	(541)	(104)	(144)	(248)
Total deposits	(424)	(238)	(662)	(128)	(120)	(248)
Other interest-bearing liabilities:						
Borrowed funds & other	75	(4)	71	90	(50)	40
Total interest-bearing liabilities	(349)	(242)	(591)	(38)	(170)	(208)
Total change in net interest income	$ (91)	$ 390	$ 299	$ (620)	$ 93	$ (527)

Comparison of Financial Condition at December 31, 2015 and December 31, 2014

Total assets at December 31, 2015 were $473.4 million, a decrease of $14.1 million, or 2.9%, from $487.5 million at December 31, 2014. The decrease in total assets was primarily due to a $25.0 million decrease in securities available for sale and a $1.6 million decrease in cash and cash equivalents partially offset by a $12.2 million increase in loans receivable, net.

Cash and cash equivalents decreased by $1.6 million, or 4.4%, from $35.8 million at December 31, 2014 to $34.2 million at December 31, 2015. The decrease was primarily attributed to a $57.4 million cash outflow for loan originations and a $17.8 million decrease in total deposits, partially offset by a $64.2 million cash inflow from receipt of principal paydowns and maturities on the investment and loan portfolios and $9.8 million in proceeds from sales of available for sale securities that were not subsequently re-invested into the investment portfolio.

Securities available for sale decreased by $25.0 million, or 18.1%, to $113.2 million at December 31, 2015 compared to $138.2 million at December 31, 2014. The decrease was primarily due to the receipt of $14.0 million in principal paydowns and maturities on the investment portfolio and proceeds from $9.8 million in sales of available for sale securities that were not subsequently re-invested into the investment portfolio. The Company currently maintains higher levels of liquid assets to position itself to take advantage of shifts in market interest rates and to manage interest rate risk. The decrease was also due to a $1.5 million decrease in the market value (before taxes) of the securities available for sale portfolio during the year ended December 31, 2015 due to an increase in market interest rates.

Net loans receivable increased during the year ended December 31, 2015 as shown in the table below:

	At December 31, 2015	At December 31, 2014	Change $	%	
	(Dollars in thousands)				
Real Estate Loans:					
Residential, one- to four-family	$ 157,307	$ 167,840	$ (10,533)	(6.3)	%
Home equity	32,770	32,337	433	1.3	%
Commercial	83,967	68,238	15,729	23.1	%
Construction	4,849	449	4,400	980.0	%
Total real estate loans	278,893	268,864	10,029	3.7	%
Other Loans:					
Commercial	15,741	13,467	2,274	16.9	%
Consumer	1,507	1,495	12	0.8	%
Total gross loans	296,141	283,826	12,315	4.3	%
Allowance for loan losses	(1,985)	(1,921)	(64)	3.3	%
Net deferred loan costs	2,945	2,948	(3)	(0.1)	%
Loans receivable, net	$ 297,101	$ 284,853	$ 12,248	4.3	%

The increase in net loans receivable was primarily due to an increase in commercial real estate loans, construction loans and commercial business loans, partially offset by a decrease in residential, one- to four-family real estate loans. As fixed rate one- to four-family residential real estate loans present additional interest rate risk to our loan portfolio as a result of the longer duration of these types of assets, we remained strategically focused in 2015 on originating shorter duration commercial real estate and commercial business loans to diversify our asset mix, to reduce interest rate risk, to take advantage of the opportunities available to serve small businesses in our market area, and to maintain the net interest margin. In 2015, we sold low-yield long-term (generally 30 years) conforming fixed rate one- to four-family residential loans that we originated, as part of our interest rate risk strategy and asset/liability management, and plan to continue to do so in the future, as it is deemed appropriate.

The table below shows changes in deposit balances by type of deposit account between December 31, 2015 and December 31, 2014:

	At December 31, 2015	At December 31, 2014	Change $	%
	(Dollars in thousands)			
Demand deposits and NOW accounts:				
Non-interest bearing	$ 45,224	$ 37,162	$ 8,062	21.7 %
Interest bearing	44,512	46,685	(2,173)	(4.7) %
Money market	76,231	78,457	(2,226)	(2.8) %
Savings	44,613	42,507	2,106	5.0 %
Time deposits	158,575	182,128	(23,553)	(12.9) %
Total deposits	$ 369,155	$ 386,939	$ (17,784)	(4.6) %

The decrease in total deposits was primarily due to a decrease in time deposits, partially offset by net growth in core deposits during 2015. Time deposits have decreased as certificate of deposit customers have sought higher yields elsewhere. The growth in core deposits was the result of the Company's continued strategic focus on growing low-cost core deposits among its retail and commercial customers in an effort to manage interest expenses.

Our borrowings, consisting of advances from the FHLBNY, increased by $2.2 million, or 11.6%, from $19.0 million at December 31, 2014 to $21.2 million at December 31, 2015. The increase was due to $2.2 million of new long-term debt that the Company incurred in order to lock in fixed interest rates. The Company plans to use the funds received from the borrowing to pay off long-term debt scheduled to mature during the first quarter of 2016.

Total stockholders' equity increased by $2.2 million, or 3.1%, from $71.6 million at December 31, 2014 to $73.9 million at December 31, 2015. The increase in stockholders' equity was primarily due to net income of $3.3 million and a $615,000 increase in additional paid in capital resulting from stock option exercises during the year ended December 31, 2015, partially offset by $746,000 of common stock purchases, $611,000 in cash dividends paid and $677,000 in other comprehensive income during the year ended December 31, 2015.

Comparison of Results of Operations for the Years Ended December 31, 2015 and 2014

General. Net income was $3.3 million for the year ended December 31, 2015, or $0.56 per diluted share, an increase of $180,000, or 5.7%, compared to net income of $3.2 million, or $0.55 per diluted share, for the year ended December 31, 2014. The increase in net income was due to a $472,000 increase in non-interest income and a $299,000 increase in net interest income, partially offset by a $264,000 increase in non-interest expenses, a $178,000 increase in provision for loan losses and a $149,000 increase in income tax expense.

Net Interest Income. Net interest income increased by $299,000, or 2.1%, to $14.8 million for the year ended December 31, 2015 compared to $14.5 million for the year ended December 31, 2014. Interest income and interest expense both decreased for the year ended December 31, 2015 when compared to the year ended December 31, 2014. Interest rate spread and net interest margin were 3.18% and 3.34%, respectively, for the year ended December 31, 2015 compared to 3.06% and 3.21%, respectively, for the year ended December 31, 2014. The increase in the interest rate spread and net interest margin for the year ended December 31, 2015 as compared to the year ended December 31, 2014 was due to an 11 basis points decrease in the average interest rate paid on interest-bearing liabilities and to a lesser extent by a 1 basis point increase in the average interest rate earned on interest earning assets.

Interest Income. Interest income decreased by $292,000, or 1.6%, to $17.6 million for the year ended December 31, 2015 compared to $17.9 million for the year ended December 31, 2014 primarily due to a decrease in investment interest income. Investment interest income decreased by $709,000, or 15.7%, from $4.5 million for the year ended December 31, 2014 to $3.8 million for the year ended December 31, 2015 due to a decrease in the average balance of the investment portfolio from $149.4 million for the year ended December 31, 2014 to $129.0 million for the year ended December 31, 2015. The decrease in the average balance of the investment portfolio was partially due to the Company's strategy to reinvest paydowns received on the securities portfolio into loan originations and shorter term cash and cash equivalents in order to be in a better position to take advantage of future increases in market interest rates. The Company also sold $9.8 million of securities during the year ended December 31, 2015. The sale of securities allowed the Bank to improve its liquidity position and to shorten the duration of its assets in order to reduce interest rate risk. The average yield on the investment portfolio decreased by eight basis points from 3.03% for the year ended December 31, 2014 to 2.95% for the year ended December 31, 2015, as a result of the declining portfolio balance of higher yielding securities. Loan interest income increased by $412,000, or 3.1%, to $13.8 million for the year ended December 31, 2015 compared to the year ended December 31, 2014, primarily due to an increase in the average balance of the loan portfolio from $276.4 million for the year ended December 31, 2014 to $292.2 million for the year ended December 31, 2015. The increase in the average balance of the loan portfolio was primarily due to increases in the average balances of commercial real estate loans, commercial loans, home equity and construction loans partially offset by a decrease in the average balance of one- to four-family real estate loans. The average yield on the loan portfolio decreased 12 basis points from 4.83% for the year ended December 31, 2014 to 4.71% for the year ended December 31, 2015. The average yield on the loan portfolio decreased as new loans were originated or existing loans were refinanced at lower yields than the rates earned on loans which had paid off or on legacy loans remaining in the portfolio, as a result of the current low interest rate environment.

Interest Expense. Interest expense decreased $591,000, or 17.7% for the year ended December 31, 2015 to $2.8 million compared to $3.3 million for the year ended December 31, 2014. The interest paid on deposits decreased by $662,000, or 22.5%, to $2.3 million for the year ended December 31, 2015 when compared to the year ended December 31, 2014, primarily due to a 15 basis points decrease in the average rate paid on deposits and an $18.7 million decrease in average deposits. The average balance of deposits for the year ended December 31, 2015 was $335.3 million with an average rate of 0.68% compared to the average balance of deposits of $353.9 million and an average rate of 0.83% for the year ended December 31, 2014. The decrease in the average balance of deposits was primarily due to a decrease in time deposits as customers have sought higher yields elsewhere. The decrease in the average rate paid on deposits was due to the continued low interest rate environment during 2015 and due to the shift in the deposit mix towards low cost core deposits. The interest expense related to advances from the FHLBNY increased $87,000, or 28.6%, to $391,000 for the year ended December 31, 2015 when compared to $304,000 for the year ended December 31, 2014 as a result of an increase in the average rate paid on FHLBNY advances. The increase in the average rate paid on FHLBNY advances from 1.58% for the year ended December 31, 2014 to 2.02% for the year ended December 31, 2015 was primarily due to the refinancing of short-term borrowings into long-term debt during 2014 to lock in low long-term fixed rates and manage interest rate risk. The average balance in advances from FHLBNY increased $155,000 from $19.2 million for the year ended December 31, 2014 to $19.3 million for the year ended December 31, 2015.

Provision for Loan Losses. A provision to the allowance for loan losses of $400,000 was recorded during the year ended December 31, 2015, which was a $178,000 increase in comparison to the provision recorded during the year ended December 31, 2014. Net charge-offs were $336,000 for the year ended December 31, 2015 compared to $114,000 for the year ended December 31, 2014. Non-performing loans remained steady at $4.7 million at December 31, 2015 and 2014, representing 1.57% and 1.66%, respectively, of total loans.

During the year ended December 31, 2015, the Company recorded a $276,000 provision for loan losses on commercial real estate loans. This provision included $197,000 to reflect losses inherent in new loan originations based on historical loss ratios and other qualitative factors, as well as $79,000 for a charge-off related to a single impaired commercial real estate loan. The Company recorded a $38,000 provision for loan losses on consumer loans to reflect net charge-offs recorded during the year ended December 31, 2015. A $59,000 provision for loan losses was recorded on construction loans to reflect losses inherent in new loan originations based on historical loss ratios and other qualitative factors. The provision for loan losses was offset by a $44,000 credit for loan losses on one- to four-family real estate loans during the year ended December 31, 2015, primarily due to a review of the historical losses relating to these types of loans. The Company determined an adjustment was necessary due to a decrease in the historical average net charge-off rate on one- to four-family real estate loans for the last five years. This decrease was also partially due to a decrease in one- to four-family real estate loan balances during the year ended December 31, 2015. The Company recorded a $35,000 provision for loan losses related to charge-offs on home equity loans and a $4,000 provision primarily related to an increase in commercial business loan balances. During the year ended December 31, 2015, the Company recorded an unallocated provision for loan losses of $32,000. This unallocated provision reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating allocated and general losses in the portfolio.

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

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

Non-interest Income. Non-interest income increased $472,000, or 21.1%, from $2.2 million for the year ended December 31, 2014 to $2.7 million for the year ended December 31, 2015. The increase was primarily due to a $381,000 increase in the net gain on the sales of securities during the year ended December 31, 2015. The increase was also due to a $66,000 increase in the net gain on sale of loans resulting from a $7.7 million increase in the sale of one- to four-family real estate loans during the year ended December 31, 2015 as compared to the prior year. Furthermore, there was a $22,000 increase in service charges and fees during the year ended December 31, 2015 as compared to the year ended December 31, 2014.

Non-interest Expenses. Non-interest expenses increased $264,000, or 2.1%, from $12.8 million for the year ended December 31, 2014 to $13.1 million for the year ended December 31, 2015. Salaries and employee benefits expense increased $267,000, or 4.0%, for the year ended December 31, 2015 compared to the year ended December 31, 2014. This increase was primarily due to annual salary increases, the hiring of an executive vice president for commercial lending in August 2014, higher health insurance costs and additional expense for stock grants awarded during 2014 and 2015, partially offset by a higher volume of deferred salaries related to commercial loan originations. Data processing expenses increased $221,000, or 27.6%, for the year ended December 31, 2015 compared to the year ended December 31, 2014 primarily due to the costs associated with the implementation of new mobile banking, online banking and loan origination technology and related software. Occupancy and equipment expense increased $91,000, or 4.2%, for the year ended December 31, 2015 compared to the year ended December 31, 2014, primarily due to increases in software maintenance costs and depreciation expense related to the implementation of new or updated bank technology. Professional services decreased by $222,000, or 19.1%, for the year ended December 31, 2015 when compared to the year ended December 31, 2014 primarily due to lower consulting costs and transfer of third party item processing and online banking services to our core processor, resulting in transfer of associated expenses to the Data Processing line item. Advertising expenses decreased $67,000, or 15.6%, from $429,000 for the year ended December 31, 2014 to $362,000 for the year ended December 31, 2015, primarily due to higher costs in 2014 related to the development of a new marketing campaign. Postage and supplies increased $47,000, or 19.3%, from $244,000 for the year ended December 31, 2014 to $291,000 for the year ended December 31, 2015, primarily due to costs related to the production of EMV (Europay, MasterCard, and Visa) chip enabled debit cards. Other expenses decreased $78,000, or 7.0%, for the year ended December 31, 2015 compared to the year ended December 31, 2014, primarily due to an increase in net gains on the sale of foreclosed properties in 2015.

Income Taxes Expense. Income tax expense increased by $149,000, or 26.3%, from $567,000 for the year ended December 31, 2014 to $716,000 for the year December 31, 2015, resulting in an effective tax rate of 17.7%. The increase in income tax expense was primarily due to an increase in taxable income during the year ended December 31, 2015. Beginning in 2015, due to recent reforms in New York State that merged the bank and corporate tax laws, the Company became eligible for a deduction that allows the Company to subtract half of the net interest income received from qualifying loans. This change effectively eliminated the

Company's New York State tax on income, resulting in it being taxed on its apportioned capital. However, because of the change in New York State corporate tax law, the Company will not generate sufficient taxable income within New York State to realize its state deferred tax assets. Accordingly, management believes that it is more likely than not that the Company will not realize its state deferred tax asset and a valuation allowance was recorded during the year ended December 31, 2015, resulting in a one-time tax expense of $79,000 for state deferred tax assets recorded before 2015. The Company continued in 2015 to record an additional valuation allowance of $85,000 related to New York State tax and additional deferred taxes created in 2015. Without the one-time tax effect for 2015, the effective tax rate would have increased to 15.7% for the year ended December 31, 2015, compared to 15.2% for the year ended December 31, 2014. This increase would have been primarily a result of a decrease in the mix of tax-exempt income derived from our municipal bond portfolio and bank-owned life insurance related to the pre-tax income for 2015, partially offset by the elimination of the New York State tax on income resulting from the reform in New York State corporate tax law.

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

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

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

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

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year ended December 31, 2013 to 3.03% for the year ended December 31, 2014. The average yield on the investment portfolio increased due to the purchase of higher yielding investments during the second half of 2013.

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

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

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

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

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

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

Non-interest Expenses. Non-interest expenses increased $485,000, or 3.9%, from $12.3 million for the year ended December 31, 2013 to $12.8 million for the year ended December 31, 2014. Salaries and employee benefits expense increased $409,000, or 6.6%, for the year ended December 31, 2014 compared to the year ended December 31, 2013. This was primarily due to annual salary increases, the hiring of an executive vice president for commercial lending, increased staffing expenses for our newest branch office in Snyder, NY which opened in April 2013 and additional expense for stock grants awarded during the year ended December 31, 2014. Occupancy and equipment expense increased $148,000, or 7.3%, for the year ended December 31, 2014 compared to the year ended December 31, 2013, primarily due to increases in software maintenance costs, property taxes, maintenance and repairs of buildings and equipment and the opening of the Snyder branch office in the second quarter of 2013. Data processing expenses increased $147,000, or 22.5%, during the year ended December 31, 2014 primarily due to the costs associated with the implementation of new mobile banking, online banking and loan origination technology and related software as well as consulting fees related to the negotiation of our core processing contract. FDIC insurance expense increased $20,000, or 7.6%, for the year ended December 31, 2014 compared to the year ended December 31, 2013, due to an increase in assessed fees. Professional services decreased $104,000, or 8.2%, for the year ended December 31, 2014 when compared to the year ended December 31, 2013, primarily due to lower legal and consulting expenses. Advertising expenses decreased $11,000, or 2.5%, for the year ended December 31, 2014 when compared to the year ended December 31, 2013, primarily due to additional expenses incurred in 2013 to create an advertising campaign related to the opening of the Snyder branch office. Other expenses decreased $123,000, or 10.0%, for the year ended December 31, 2014 when compared with the year ended December 31, 2013 primarily due to decreased expenses related to collections and foreclosed properties.

Income Tax Expense. Income tax expense decreased by $401,000, or 41.4%, from $968,000 for the year ended December 31, 2013 to $567,000 for the year December 31, 2014. The decrease was primarily due to a decrease in income before income taxes of $986,000, or 20.9%, during the year ended December 31, 2014, as well as a decrease in the effective tax rate from 20.5% for the year ended December 31, 2013 to 15.2% for the year ended December 31, 2014. The decrease in the effective tax rate was primarily due to a decrease in income as well as a disproportionate increase in tax exempt income.

Liquidity and Capital Resources

Liquidity describes our ability to meet the financial obligations that arise during the ordinary course of business. Liquidity is primarily needed to fund loan commitments, to pay the deposit withdrawal requirements of our customers as well as to fund current and planned expenditures. Our primary sources of funds consist of deposits, fed funds balances, scheduled amortization and prepayments of loans and securities, maturities and sales of investments and loans, interest earning deposits at other financial institutions and funds provided from operations. We have written agreements with the FHLBNY, which allows us to borrow the maximum lending values designated by the type of collateral pledged. As of December 31, 2015, our maximum lending value was $116.3 million and was collateralized by a pledge of certain fixed-rate residential, one- to four-family loans. At December 31, 2015, we had outstanding advances under this agreement of $21.2 million. We have a written agreement with the Federal Reserve Bank discount window for overnight borrowings which is collateralized by a pledge of our securities, and allows us to borrow up to the value of the securities pledged, which was equal to a book value of $11.1 million and a fair value of $11.7 million as of December 31, 2015. There were no balances outstanding with the Federal Reserve Bank at December 31, 2015. We have also established lines of credits with correspondent banks for $22.0 million, of which $20.0 million is unsecured and the remaining $2.0 million will be secured by a pledge of our securities when a draw is made. There were no borrowings on these lines as of December 31, 2015.

Historically, loan repayments and maturing investment securities were a relatively predictable source of funds. However, in light of the current economic environment, there are now more risks related to loan repayments and the valuation and maturity of investment securities. In addition, deposit flows, calls of investment securities, and prepayments of loans and mortgage-backed securities are strongly influenced by interest rates, general and local economic conditions, and competition in the marketplace. These factors and the current economic environment reduce the predictability of the timing of these sources of funds. To the extent possible, the Bank manages the cash flows of its loan and deposit portfolios by the rates it offers customers.

Our primary investing activities include the origination of loans and the purchase of investment securities. For the year ended December 31, 2015, we originated loans of approximately $69.6 million in comparison to approximately $53.8 million of loans originated during the year ended December 31, 2014. Loan originations exceeded principal repayments and other deductions in 2015 by $12.3 million. The loan originations were funded through principal payments received on loans and securities, cash reserves and proceeds from the sales of $9.8 million of available for sale securities. We did not purchase any investment securities during the years ended December 31, 2015 or 2014.

At December 31, 2015, we had loan commitments to borrowers of approximately $12.2 million and overdraft lines of protection and unused home equity lines of credit of approximately $34.8 million. Total deposits were $369.2 million at December 31, 2015, as compared to $386.9 million at December 31, 2014. The decrease in total deposits was primarily due to a decrease in time deposits, partially offset by net growth in core deposits during 2015. Time deposits have decreased as certificate of deposit customers have sought higher yields elsewhere. The Company's strategic focus is on growing low-cost core deposits among its retail and commercial customers in an effort to manage interest expenses. Time deposit accounts scheduled to mature within one year were $81.0 million at December 31, 2015. Based on our deposit retention experience, current pricing strategy, and competitive pricing policies, we anticipate that a significant portion of these time deposits will remain with us following their maturity.

We are committed to maintaining a strong liquidity position; therefore, we monitor our liquidity position on a daily basis. We anticipate that we will have sufficient funds to meet our current funding commitments. The marginal cost of new funding, however, whether from deposits or borrowings from the Federal Home Loan Bank, will be carefully considered as we monitor our liquidity needs. Therefore, in order to minimize our cost of funds, we may consider additional borrowings from the Federal Home Loan Bank in the future.

We do not anticipate any material capital expenditures during 2016. We do not have any balloon or other payments due on any long-term obligations or any off-balance sheet items other than loan commitments as described in Note 16 in the Notes to our Consolidated Financial Statements and the borrowing agreements noted above.

Off-Balance Sheet Arrangements

Other than loan commitments, we do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, revenues or expenses, results of operations, liquidity, capital expenditures, or capital resources that is material to investors. Refer to Note 16 in the Notes to our Consolidated Financial Statements for a summary of commitments outstanding as of December 31, 2015.

Accounting Polices, Standards and Pronouncements

Refer to Note 2 in the Notes to our Consolidated Financial Statements for a discussion of significant accounting policies, the impact of the adoption of new accounting standards and recent accounting pronouncements.

Item 7A. Quantitative and Qualitative Disclosures About Market Risk

Not required for smaller reporting companies.

Item 8. Financial Statements and Supplementary Data.

See pages F - 1 through F - 54 following the signature page of this Annual Report on Form 10-K.

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure.

None.

Item 9A. Controls and Procedures.

Disclosure Controls and Procedures

The Company maintains disclosure controls and procedures designed to ensure that the information required to be disclosed in the reports that it files or submits under the Securities Exchange Act of 1934, as amended, are recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Securities Exchange Act of 1934 is accumulated and communicated to the issuer's management, including its principal executive and principal financial officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure. The Company's management, with the participation of its Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Rules 13(a)-15(e) and 15d-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based upon such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures were effective.

Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting for the Company. Our internal control over financial reporting is a process designed under the supervision of our Chief Executive Officer and Chief Financial Officer to provide reasonable assurance regarding the reliability of financial reporting and the preparation of our financial statements for external purposes in accordance with U.S. generally accepted accounting principles.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Our management has made a comprehensive review, evaluation, and assessment of our internal control over financial reporting as of December 31, 2015. In making its assessment of internal control over financial reporting, management used the criteria issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in Internal Control-Integrated Framework (2013). Based on that assessment, management concluded that, as of December 31, 2015, our internal control over financial reporting was effective.

This annual report does not include an attestation report of the Company's registered public independent accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public independent accounting firm pursuant to rules of the SEC that permits the Company to provide only management's report in this annual report.

Changes in Internal Control over Financial Reporting

There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Securities Exchange Act of 1934) during the quarter ended December 31, 2015 to which this report relates that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting.

Item 9B. Other Information.

None.

PART III

Item 10. Directors, Executive Officers and Corporate Governance.

The information required by this item is incorporated herein by reference to our Proxy Statement for our 2016 Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission within 120 days of our December 31, 2015 fiscal year end.

Item 11. Executive Compensation.

The information required by this item is incorporated herein by reference to our Proxy Statement for our 2016 Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission within 120 days of our December 31, 2015 fiscal year end.

Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

The information required by this item is incorporated herein by reference to our Proxy Statement for our 2016 Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission within 120 days of our December 31, 2015 fiscal year end.

Item 13. Certain Relationships and Related Transactions, and Director Independence.

The information required by this item is incorporated herein by reference to our Proxy Statement for our 2016 Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission within 120 days of our December 31, 2015 fiscal year end.

Item 14. Principal Accounting Fees and Services.

The information required by this item is incorporated herein by reference to our Proxy Statement for our 2016 Annual Meeting of Shareholders, which will be filed with the Securities and Exchange Commission within 120 days of our December 31, 2015 fiscal year end.

PART IV

Item 15. Exhibits and Financial Statement Schedules.

15(a)(1) Financial Statements. The following are included in Item 8 of Part II of this Annual Report on Form 10-K.

- Report of Independent Registered Public Accounting Firm
- Consolidated Statements of Financial Condition as of December 31, 2015 and 2014
- Consolidated Statements of Income for the years ended December 31, 2015, 2014 and 2013
- Consolidated Statements of Comprehensive Income (Loss) for the years ended December 31, 2015, 2014 and 2013
- Consolidated Statements of Stockholders' Equity for the years ended December 31, 2015, 2014 and 2013
- Consolidated Statements of Cash Flows for the years ended December 31, 2015, 2014 and 2013
- Notes to Consolidated Financial Statements

15(a)(2) Financial Statement Schedules. Schedules are omitted because they are not required or the information is provided elsewhere in the Consolidated Financial Statements or Notes thereto included in Item 8 of Part II of this Annual Report on Form 10-K.

15(a)(3) Exhibits. The following exhibits are filed as part of this Annual Report on Form 10-K or are incorporated herein by reference.

3.1	Charter of Lake Shore Bancorp, Inc.1
3.2	Amended and Restated Bylaws of Lake Shore Bancorp, Inc.6
4.1	Form of Stock Certificate of Lake Shore Bancorp, Inc.2
4.2	Form of Restricted Stock Award Notice4
4.3	Form of Stock Option Certificate4
10.1	Employment Agreement between Daniel P. Reininga and Lake Shore Bancorp, Inc.8
10.2	Employment Agreement between Daniel P. Reininga and Lake Shore Savings Bank9
10.3	Amended and Restated Change of Control Agreement between Rachel A. Foley and Lake Shore Bancorp, Inc.7
10.4	Amended and Restated Severance Pay Plan of Lake Shore Savings Bank5

10.5	2015 Executives Supplemental Benefit Plan I*
10.6	Amended and Restated 2015 Executives Supplemental Benefit Plan II*
10.7	2015 Directors Supplemental Benefit Plan I*
10.8	Amended and Restated 2015 Directors Supplemental Benefit Plan II*
10.9	Lake Shore Bancorp, Inc. 2006 Stock Option Plan3
10.10	Lake Shore Bancorp, Inc. 2006 Recognition and Retention Plan3
10.11	2012 Supplemental Executive Retirement Plan10
10.12	Lake Shore Bancorp, Inc. 2012 Equity Incentive Plan11
21.1	Subsidiaries of Lake Shore Bancorp, Inc.*
23.1	Consent of Baker Tilly Virchow Krause, LLP*
31.1	Certification by the Chief Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002*
31.2	Certification by the Chief Financial Officer

	Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002*
32.1	Certification by the Chief Executive Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002*
32.2	Certification by the Chief Financial Officer Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002*
101.INS	XBRL Instance Document*
101.SCH	XBRL Taxonomy Extension Schema Document*
101.CAL	XBRL Taxonomy Calculation Linkbase Document*
101.DEF	XBRL Taxonomy Extension Definition Linkbase Document*
101.LAB	XBRL Taxonomy Label Linkbase Document*

101.PRE	XBRL Taxonomy Presentation Linkbase Document*

*Filed herewith.

[1] Incorporated herein by reference to the Exhibits to the Registration Statement on Form S-1, filed with the Securities and Exchange Commission on November 4, 2005 (Registration No. 333-129439).
[2] Incorporated herein by reference to the Exhibits to Amendment No. 2 to the Registration Statement on Form S-1/A, filed with the Securities and Exchange Commission on February 8, 2006 (Registration No. 333-129439).
[3] Incorporated herein by reference to the Proxy Statement for our October 24, 2006 special meeting of shareholders filed with the Securities and Exchange Commission on September 7, 2006.
[4] Incorporated herein by reference to the Exhibits to the Registration Statement on Form S-8, filed with the Securities and Exchange Commission on April 3, 2007 (Registration No. 333-141829).
[5] Incorporated herein by reference to the Exhibits to Form 8-K, filed with the Securities and Exchange Commission on November 16, 2007.
[6] Incorporated herein by reference to Exhibit 3.2 to Form 8-K, filed with the Securities and Exchange Commission on May 20, 2015.

[7] Incorporated herein by reference to Exhibit 10.3 to Form 8-K, filed with the Securities and Exchange Commission on February 3, 2011.
[8] Incorporated herein by reference to Exhibits 10.1 to Form 8-K, filed with the Securities and Exchange Commission on February 3, 2011.
[9] Incorporated herein by reference to Exhibits 10.2 to Form 8-K, filed with the Securities and Exchange Commission on February 3, 2011.
[10] Incorporated herein by reference to Exhibit 10.1 to Form 8-K, filed with the Securities and Exchange Commission on June 29, 2012.
[11] Incorporated herein by reference to Appendix A to the Proxy Statement for our May 23, 2012 annual meeting of shareholders filed with the Securities and Exchange Commission on April 11, 2012.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on March 25, 2016.

Lake Shore Bancorp, Inc.
By:/s/ Daniel P. Reininga
Daniel P. Reininga
President and Chief Executive Officer

Date: March 25, 2016

Pursuant to the requirements of the Securities Act of 1933, as amended, and any rules and regulations promulgated there under, this Annual Report on Form 10-K, has been signed by the following persons in the capacities and on the dates indicated.

Name	Title	Date
/s/ Susan C. Ballard	Director	
Susan C. Ballard		March 25, 2016
/s/ Tracy S. Bennett	Director	
Tracy S. Bennett		March 25, 2016
/s/ Sharon E. Brautigam	Director	
Sharon E. Brautigam		March 25, 2016
/s/ Reginald S. Corsi	Director	
Reginald S. Corsi		March 25, 2016
/s/ David C. Mancuso	Director	
David C. Mancuso		March 25, 2016
/s/ Daniel P. Reininga	President, Chief Executive Officer and Director (Principal Executive Officer)	
Daniel P. Reininga		March 25, 2016
/s/ Kevin M. Sanvidge	Director	
Kevin M. Sanvidge		March 25, 2016
/s/ Gary W. Winger	Chairman of the Board	
Gary W. Winger		March 25, 2016
/s/ Nancy L. Yocum	Vice Chairperson of the Board	
Nancy L. Yocum		March 25, 2016
/s/ Rachel A. Foley	Chief Financial Officer and Treasurer (Principal Accounting and Financial Officer)	

Rachel A. Foley March 25, 2016

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Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
Lake Shore Bancorp, Inc.

We have audited the accompanying consolidated statements of financial condition of Lake Shore Bancorp, Inc. and subsidiary (the “Company”) as of December 31, 2015 and 2014, and the related consolidated statements of income, comprehensive income (loss), stockholders’ equity, and cash flows for each of the years in the three-year period ended December 31, 2015. These consolidated financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Lake Shore Bancorp, Inc. and subsidiary as of December 31, 2015 and 2014, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2015, in conformity with accounting principles generally accepted in the United States of America.

/s/Baker Tilly Virchow Krause, LLP

Pittsburgh, Pennsylvania
March 25, 2016

Lake Shore Bancorp, Inc. and Subsidiary

Consolidated Statements of Financial Condition

	December 31, 2015	December 31, 2014
	(Dollars in thousands, except share data)	
Assets		
Cash and due from banks	$ 7,296	$ 7,460
Interest earning deposits	12,714	19,575
Federal funds sold	14,217	8,776
Cash and Cash Equivalents	34,227	35,811
Securities available for sale	113,213	138,202
Federal Home Loan Bank stock, at cost	1,454	1,375
Loans receivable, net of allowance for loan losses 2015 $1,985; 2014 $1,921	297,101	284,853
Premises and equipment, net	9,144	9,519
Accrued interest receivable	1,648	1,716
Bank owned life insurance	14,938	14,666
Other assets	1,660	1,329
Total Assets	$ 473,385	$ 487,471
Liabilities and Stockholders' Equity		
Liabilities		
Deposits:		
Interest bearing	$ 323,931	$ 349,777
Non-interest bearing	45,224	37,162
Total Deposits	369,155	386,939
Long-term debt	21,150	18,950
Advances from borrowers for taxes and insurance	3,285	3,415
Other liabilities	5,919	6,537
Total Liabilities	$ 399,509	$ 415,841
Commitments and Contingencies	-	-
Stockholders' Equity		
Common stock, $0.01 par value per share, 25,000,000 shares authorized; 6,727,428 shares issued and 6,003,416 shares outstanding at December 31, 2015 and 6,673,940 shares issued and 5,990,042 shares outstanding at December 31, 2014	$ 67	$ 67
Additional paid-in capital	29,359	28,684
Treasury stock, at cost (724,012 shares at December 31, 2015 and 683,898 shares at December 31, 2014)	(7,026)	(6,420)
Unearned shares held by ESOP	(1,706)	(1,791)

Unearned shares held by compensation plans	(580)	(622)
Retained earnings	50,919	48,192
Accumulated other comprehensive income	2,843	3,520
Total Stockholders' Equity	73,876	71,630
Total Liabilities and Stockholders' Equity	$ 473,385	$ 487,471

See notes to consolidated financial statements.

Lake Shore Bancorp, Inc. and Subsidiary

Consolidated Statements of Income

	Years Ended December 31,		
	2015	2014	2013
	(Dollars in thousands, except per share data)		
Interest Income			
Loans, including fees	$ 13,752	$ 13,340	$ 13,807
Investment securities, taxable	1,789	2,403	2,804
Investment securities, tax-exempt	2,024	2,119	1,989
Other	22	17	14
Total Interest Income	17,587	17,879	18,614
Interest Expense			
Deposits	2,280	2,942	3,190
Short-term borrowings	-	20	48
Long-term debt	391	284	214
Other	86	102	104
Total Interest Expense	2,757	3,348	3,556
Net Interest Income	14,830	14,531	15,058
Provision for Loan Losses	400	222	105
Net Interest Income after Provision for Loan Losses	14,430	14,309	14,953
Non-Interest Income			
Service charges and fees	1,632	1,610	1,667
Earnings on bank owned life insurance	272	259	283
Recovery on previously impaired investment securities	160	175	3
Net gain on sale of securities available for sale	440	59	206
Net gain on sale of loans	97	31	-
Total other-than-temporary impairment (“OTTI”) losses	-	-	(613)
Portion of OTTI losses recognized in other comprehensive income (loss) (before taxes)	-	-	433
Net OTTI losses recognized in earnings	-	-	(180)
Other	106	101	113
Total Non-Interest Income	2,707	2,235	2,092
Non-Interest Expenses			
Salaries and employee benefits	6,878	6,611	6,202
Occupancy and equipment	2,268	2,177	2,029
Data processing	1,022	801	654
Professional services	941	1,163	1,267
Advertising	362	429	440
Postage and supplies	291	244	245
FDIC Insurance	288	283	263
Other	1,033	1,111	1,234
Total Non-Interest Expenses	13,083	12,819	12,334
Income before Income Taxes	4,054	3,725	4,711
Income Tax Expense	716	567	968
Net Income	$ 3,338	$ 3,158	$ 3,743
Basic earnings per common share	$ 0.57	$ 0.55	$ 0.66

Diluted earnings per common share	$ 0.56	$ 0.55	$ 0.65
Dividends declared per share	$ 0.28	$ 0.28	$ 0.28

See notes to consolidated financial statements.

Lake Shore Bancorp, Inc. and Subsidiary

Consolidated Statements of Comprehensive Income (Loss)

	Years Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
Net Income	$ 3,338	$ 3,158	$ 3,743
Other Comprehensive Income (Loss), net of tax (expense) benefit:			
Unrealized holding (losses) gains on securities available for sale, net of tax benefit (expense)	(281)	3,158	(4,938)
Reclassification adjustments related to:			
Recovery on previously impaired investment securities included in net income, net of tax expense	(106)	(107)	(2)
Net gains on sale of securities included in net income, net of tax expense	(290)	(36)	(126)
Impairment charge for losses included in net income, net of tax benefit	-	-	110
Total Other Comprehensive (Loss) Income	(677)	3,015	(4,956)
Total Comprehensive Income (Loss)	$ 2,661	$ 6,173	$ (1,213)

See notes to consolidated financial statements.

Lake Shore Bancorp, Inc. and Subsidiary

Consolidated Statements of Stockholders' Equity

Years Ended December 31, 2015, 2014 and 2013

	Common Stock	Additional Paid-In Capital	Treasury Stock	Unearned Shares Held by ESOP	Unearned Shares Held by Compensation Plans	Retained Earnings	Accumulated Other Comprehensive Income	Total
	(Dollars in thousands, except share and per share data)							
Balance - January 1, 2013	$ 66	$ 27,973	$ (6,469)	$ (1,961)	$ (553)	$ 42,468	$ 5,461	$ 66,985
Net income	-	-	-	-	-	3,743	-	3,743
Other comprehensive loss, net of tax benefit of $3,128	-	-	-	-	-	-	(4,956)	(4,956)
Stock options exercised (6,703 shares)	-	73	-	-	-	-	-	73
ESOP shares earned (7,935 shares)	-	6	-	85	-	-	-	91
Stock based compensation	-	4	-	-	-	-	-	4
Compensation plan shares earned (4,035 shares)	-	(17)	-	-	54	-	-	37
Purchase of treasury stock, at cost (10,000 shares)	-	-	(119)	-	-	-	-	(119)
Cash dividends declared ($0.28 per share)	-	-	-	-	-	(587)	-	(587)
Balance - December 31, 2013	$ 66	$ 28,039	$ (6,588)	$ (1,876)	$ (499)	$ 45,624	$ 505	$ 65,271
Net income	-	-	-	-	-	3,158	-	3,158
Other comprehensive income, net of tax expense of $1,903	-	-	-	-	-	-	3,015	3,015
Stock options exercised (54,737 shares)	1	628	-	-	-	-	-	629
ESOP shares earned (7,935 shares)	-	14	-	85	-	-	-	99
	-	9	-	-	-	-	-	9

Stock based compensation								
Compensation plan shares granted (24,570 shares)	-	-	230	-	(230)	-	-	-
Compensation plan shares earned (9,576 shares)	-	(6)	-	-	107	-	-	101
Purchase of treasury stock, at cost (5,100 shares)	-	-	(62)	-	-	-	-	(62)
Cash dividends declared ($0.28 per share)	-	-	-	-	-	(590)	-	(590)
Balance - December 31, 2014	$ 67	$ 28,684	$ (6,420)	$ (1,791)	$ (622)	$ 48,192	$ 3,520	$ 71,630
Net income	-	-	-	-	-	3,338	-	3,338
Other comprehensive loss, net of tax benefit of $757	-	-	-	-	-	-	(677)	(677)
Stock options exercised (53,488 shares)	-	615	-	-	-	-	-	615
ESOP shares earned (7,935 shares)	-	22	-	85	-	-	-	107
Stock based compensation	-	1	-	-	-	-	-	1
Compensation plan shares granted (14,886 shares)	-	-	140	-	(140)	-	-	-
Compensation plan shares earned (12,909 shares)	-	37	-	-	182	-	-	219
Purchase of treasury stock, at cost (55,000 shares)	-	-	(746)	-	-	-	-	(746)
Cash dividends declared ($0.28 per share)	-	-	-	-	-	(611)	-	(611)
Balance - December 31, 2015	$ 67	$ 29,359	$ (7,026)	$ (1,706)	$ (580)	$ 50,919	$ 2,843	$ 73,876

See notes to consolidated financial statements.

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Lake Shore Bancorp, Inc. and Subsidiary

Consolidated Statements of Cash Flows

	Years Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
CASH FLOWS FROM OPERATING ACTIVITIES			
Net income	$ 3,338	$ 3,158	$ 3,743
Adjustments to reconcile net income to net cash provided by operating activities:			
Net amortization of investment securities	283	303	488
Net amortization of deferred loan costs	552	462	518
Provision for loan losses	400	222	105
Impairment of investment securities	-	-	180
Recovery on previously impaired investment securities	(160)	(175)	(3)
Net gain on sale of investment securities	(440)	(59)	(206)
Originations of loans held for sale	(9,450)	(1,737)	(1,436)
Proceeds from sales of loans held for sale	9,547	1,768	1,436
Net gain on sale of loans	(97)	(31)	-
Net loss on disposal of premises and equipment	-	-	1
Depreciation and amortization	834	750	699
Deferred income tax expense (benefit)	257	(26)	(46)
Increase in bank owned life insurance	(272)	(259)	(283)
ESOP shares committed to be released	107	99	91
Stock based compensation expense	220	110	41
Decrease in accrued interest receivable	68	71	15
(Increase) decrease in other assets	(141)	(219)	65
Writedowns of foreclosed real estate	35	43	57
Decrease in other liabilities	(118)	(133)	(83)
Net Cash Provided by Operating Activities	4,963	4,347	5,382
CASH FLOWS FROM INVESTING ACTIVITIES			
Activity in available for sale securities:			
Sales	9,846	10,337	4,381
Maturities, prepayments and calls	14,026	14,274	25,863
Purchases	-	-	(35,973)
Purchases of Federal Home Loan Bank Stock	(353)	(353)	-
Redemptions of Federal Home Loan Bank Stock	274	538	292
Loan origination and principal collections, net	(14,274)	(8,600)	(5,606)
Proceeds from sale of foreclosed real estate	849	601	551
Additions to premises and equipment	(459)	(627)	(657)
Net Cash Provided by (Used in) Investing Activities	9,909	16,170	(11,149)
CASH FLOWS FROM FINANCING ACTIVITIES			
Net (decrease) increase in deposits	(17,784)	(1,296)	9,692
Net (decrease) increase in advances from borrowers for taxes and insurance	(130)	(39)	245
Net (decrease) increase in short term borrowings	-	(11,650)	450
Proceeds from issuance of long-term debt	10,450	15,200	1,750
Repayment of long-term debt	(8,250)	(4,100)	(8,300)
Proceeds from stock options exercised	615	629	73

Purchase of treasury stock	(746)	(62)	(119)
Cash dividends paid	(611)	(590)	(587)
Net Cash (Used in) Provided by Financing Activities	(16,456)	(1,908)	3,204
Net (Decrease) Increase in Cash and Cash Equivalents	(1,584)	18,609	(2,563)
CASH AND CASH EQUIVALENTS - BEGINNING	35,811	17,202	19,765
CASH AND CASH EQUIVALENTS - ENDING	$ 34,227	$ 35,811	$ 17,202

	Years Ended December 31,		
	2015	2014	2013
	(Dollars in thousands)		
SUPPLEMENTARY CASH FLOWS INFORMATION			
Interest paid	$ 2,759	$ 3,334	$ 3,574
Income taxes paid	$ 580	$ 828	$ 1,131
SUPPLEMENTARY SCHEDULE OF NONCASH INVESTING ACTIVITIES			
Foreclosed real estate acquired in settlement of loans	$ 1,178	$ 448	$ 704

See notes to consolidated financial statements.

Lake Shore Bancorp, Inc. and Subsidiary

Notes to Consolidated Financial Statements

Note 1 - Organization and Nature of Operations

Organizational Structure

Lake Shore Bancorp, Inc. (the “Company”, “us,” “our,” or “we”) and the parent mutual holding company, Lake Shore, MHC (the “MHC”) were formed on April 3, 2006 to serve as the stock holding companies for Lake Shore Savings Bank (the “Bank”) as part of the Bank’s conversion and reorganization from a New York State chartered mutual savings and loan association to the federal mutual holding company form of organization.

The MHC, whose activity is not included in these consolidated financial statements, held 3,636,875 shares, or 60.6% of the Company’s outstanding common stock as of December 31, 2015.

The Bank is engaged primarily in the business of retail banking in Erie and Chautauqua Counties of New York State. Its primary deposit products are savings and term certificate accounts and its primary lending products are residential mortgages and commercial real estate loans.

Charter

Lake Shore Bancorp, Inc. and the parent mutual holding company, Lake Shore, MHC are federally chartered and, effective July 2012, regulated by the Federal Reserve Board. Lake Shore Savings Bank, subsidiary of Lake Shore Bancorp, Inc., is a federally chartered savings bank and, effective July 2012, regulated by the Office of the Comptroller of the Currency (the “OCC”). These changes in regulators from the Office of Thrift Supervision (“OTS”) are due to the passage of the Dodd-Frank Act.

Regulations of the Board of Governors of the Federal Reserve System (the "Federal Reserve") prohibit the waiver of dividends by the MHC unless the waiver has been approved by its members, consisting of depositors of the Bank. The MHC held a special meeting on February 3, 2016 of its members to vote on a proposal to authorize the MHC to waive its right to receive dividends aggregating up to $0.28 per share that may be declared by the Company in the twelve months subsequent to the approval of the proposal by members. At the special meeting, a majority of the eligible member votes of the MHC approved the waiver of the receipt of dividends on shares owned by the MHC. Lake Shore, MHC submitted the results of this vote along with other information to the Federal Reserve for final approval of the dividend waiver. As of March 2, 2016, Lake Shore, MHC received notice of the non-objection of the Federal Reserve Board to waive its right to receive dividends paid by the Company during the twelve months ending February 2, 2017. In prior periods, the MHC elected to waive its right to receive cash dividends upon receipt of regulatory approval prior to change in regulation. The waiving of dividends by the MHC will increase Company resources available for stock repurchases, payment of dividends to minority stockholders, and investments. As of December 31, 2015, the MHC elected to waive approximately $7.5 million on a cumulative basis. The dividends waived by the MHC are considered a restriction on the retained earnings of the Company.

Note 2 - Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements include the accounts of the Company and the Bank. All material inter-company accounts and transactions have been eliminated. The accompanying consolidated financial statements have been prepared in conformity with generally accepted accounting principles in the United States of America ("GAAP").

Use of Estimates

To prepare these consolidated financial statements in conformity with GAAP, management of the Company made a number of estimates and assumptions relating to the reporting of assets and liabilities, the reporting of revenue and expenses and notes to the consolidated financial statements. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, securities valuation estimates, evaluation of impairment of securities, income taxes and deferred compensation liabilities.

Cash and Cash Equivalents

Cash and cash equivalents include cash on hand, amounts due from banks, interest earning deposits and federal funds which are generally sold for one to three-day periods.

Investment Securities

All investment securities are classified as available for sale and are carried at fair value with unrealized gains and losses, net of the related deferred income tax effect, excluded from earnings and reported as a separate component of accumulated other comprehensive income until realized. Realized gains and losses are determined using the specific identification method.

Declines in the fair value of available for sale securities are evaluated for other-than-temporary impairment ("OTTI") on a quarterly basis. Impairment is assessed at the individual security level. An investment security is subject to a review for OTTI if the fair value of the security is less than its cost or amortized cost basis by more than 20%, as stated in the Company's internal policy. The Company's OTTI evaluation process is performed in a consistent and systematic manner and includes an evaluation of all available evidence. Documentation of the process is as extensive as necessary to support a conclusion as to whether a decline in fair value below cost or amortized cost is other-than-temporary and includes documentation supporting both observable and unobservable inputs and a rationale for conclusions reached. This process considers factors such as the severity, length of time and anticipated recovery period of the impairment, recent events specific to the issuer, including investment downgrades by rating agencies and economic conditions of its industry, and the issuer's financial condition, capital strength, the presence of credit enhancements, if any, and near-term prospects. The Company also considers its intent and ability to retain the security for a period of time sufficient to allow for a recovery in fair value, or until maturity. Among the factors that are considered in determining the Company's intent and ability to retain the security is a review of its capital adequacy, interest rate risk position and liquidity. The assessment of a security's ability to recover any decline in fair value, the ability of the issuer to meet contractual obligations, and the Company's intent and ability to retain the security require considerable judgment.

All securities are reviewed for OTTI under the guidance of the Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 320, "Investments - Debt and Equity Securities" ("ASC 320"). The Company uses the cash flow expected to be realized from the security, which includes assumptions about interest rates, timing and severity of defaults, estimate of potential recoveries, and other factors, then applies a discounting rate equal to the effective yield of the security. When impairment of a debt security is considered other-than-temporary, the amount of OTTI recorded as a loss within non-interest income and thereby recognized in earnings depends on whether the Company intends to sell the security or whether it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis. If the Company intends to (has decided to) sell the debt security or more likely than not will be required to sell the security before recovery of its amortized cost basis, OTTI is recognized in earnings equal to the entire difference between the investment’s amortized cost basis and its fair value. If the Company does not intend to sell the debt security and it is not more likely than not the Company will be required to sell the security before recovery of its amortized cost basis, OTTI is separated into the amount representing credit loss and the amount related to all other market factors. The amount related to credit loss is recognized against earnings. The amount related to other market factors is recognized in other comprehensive income, net of applicable taxes.

Federal Home Loan Bank Stock

Federal law requires a member institution of the Federal Home Loan Bank ("FHLB") system to hold restricted stock of its district Federal Home Loan Bank according to a predetermined formula. The restricted stock is carried at cost.

Management's determination of whether these investments are impaired is based on an assessment of the ultimate recoverability of the 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 years ended December 31, 2015, 2014 and 2013.

Loans Receivable

Loans receivable that management has the intent and ability to hold until maturity or payoff are stated at their outstanding unpaid principal balances, net of allowance for loan losses and any deferred fees and costs. Interest income is accrued on the unpaid principal balance. Loan origination fees and costs are deferred and recognized as an adjustment of the yield (interest income) of the related loans. The Company is generally amortizing these amounts over the contractual life of the loan.

Management considers a loan to be in delinquency status when the contractual payment of principal or interest has become greater than 30 days past due. The accrual of interest is generally discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectability of principal or interest, even though the loan is currently performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. When a loan is placed on non-accrual status, unpaid interest credited to income is reversed in the current year. Interest received on non-accrual loans generally is either applied against principal or reported as interest income, according to management's judgment as to the collectability of principal. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time, and the ultimate collectability of the total contractual principal and interest is no longer in doubt.

Allowance for Loan Losses

The allowance for loan losses is established through provisions for loan losses charged against income. Loans deemed to be uncollectible are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance.

Management estimates the allowance for loan losses pursuant to FASB ASC Topic 450, "Contingencies" ("ASC 450"), and FASB ASC Topic 310, "Receivables" ("ASC 310"). Commercial and commercial real estate loans that are considered impaired as defined in ASC 310 are reviewed individually to assess the likelihood and severity of loss exposure. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis. Factors considered by management in determining impairment include payment status, collateral value, cash flow and the probability of collecting scheduled principal and interest payments when due. Loans subject to individual review are, where appropriate, reserved for according to the present value of expected future cash flows available to repay the loan or the estimated fair value less estimated selling costs of the collateral, if the loan is collateral dependent. Commercial loans excluded from individual assessment, as well as smaller balance homogeneous loans, such as consumer, residential real estate and home equity loans, are evaluated for loss exposure under

ASC 450 based upon historical loss rates for each of these categories of loans, adjusted for qualitative factors. The Company does not separately identify individual consumer, home equity, or residential real estate loans for impairment disclosure, unless the loan has been modified as a troubled debt restructuring.

The Company records cash receipts on impaired loans that are non-performing as a reduction to principal before applying amounts to interest or late charges unless specifically directed otherwise by the Bankruptcy Court. The Company may continue to recognize interest income on impaired loans where there is no confirmed loss.

Loans may be periodically modified in a troubled debt restructuring ("TDR") to make concessions to help a borrower remain current on the loan and/or to avoid foreclosure, in accordance with FASB Accounting Standard Update ("ASU") 2012-02, "Receivables ("Subtopic 310"): "A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring" ("ASU 2012-02"). Generally, we do not forgive principal or interest on a loan or modify the interest rate on loans that are below market rates. When we modify loans in a TDR, we evaluate any possible impairment similar to other impaired loans. If we determine that the value of a modified loan is less than the recorded investment in the loan, impairment is recognized through a specific allowance estimate or charge-off to the allowance.

The allowance for loan losses is maintained at a level to provide for losses that are inherent within the loan portfolio. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant change, including the amounts and timing of future cash flows expected to be received on impaired loans.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as either special mention, doubtful, substandard or loss. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value for that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

Premises and Equipment

Land is carried at cost. Buildings, improvements, furniture and equipment are carried at cost, net of accumulated depreciation. Depreciation is computed on the straight-line basis over the estimated useful lives of assets (generally thirty-nine years for buildings and three to fifteen years for furniture and equipment). Leasehold improvements are amortized on the straight-line method over the lesser of the life of the improvements or the lease term. Maintenance and repairs are charged to expense as incurred, while major improvements are capitalized and amortized to operating expense over the identified useful life.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Foreclosed Real Estate

Foreclosed real estate consists of property acquired in settlement of loans which is carried at its fair value less estimated selling costs. Write-downs from cost to fair value less estimated selling costs are recorded at the date of acquisition or repossession and are charged to the Allowance for Loan Losses. Subsequent write-downs to fair value, net of estimated selling costs, are recorded in non-interest expense along with direct operating expenses. Gains or losses not previously recognized, resulting from the sale of foreclosed assets are recognized in non-interest expense on the date of sale.

Foreclosed real estate was $712,000 and $401,000 at December 31, 2015 and 2014, respectively, and was included as a component of other assets in the consolidated statement of financial condition. Proceeds from the sale of foreclosed real estate for the years ended December 31, 2015, 2014 and 2013 were $849,000, $601,000, and $551,000, respectively.   This resulted in a net gain on sale of $122,000, $64,000 and $38,000 for the years ended December 31, 2015, 2014 and 2013, respectively, and was included as a component of other non-interest expenses in the consolidated statement of income.

Bank Owned Life Insurance

The Company invests in bank owned life insurance (“BOLI”) as a source of funding for employee benefit expenses (see Note 11). BOLI involves the purchasing of life insurance by the Company on a chosen group of employees. The Company is the owner and beneficiary of the policies. This life insurance investment is carried at the cash surrender value of the underlying policies. Income from the increase in the cash surrender value of the underlying policies is included in non-interest income in the consolidated statements of income.

Advertising Costs

The Company follows the policy of charging the costs of advertising to expense as incurred. Total advertising expense for the years ended December 31, 2015, 2014 and 2013 was $362,000, $429,000, and $440,000, respectively.

Income Taxes

The Company files a consolidated federal income tax return. The provision for federal and state income taxes is based on income reported on the consolidated financial statements, rather than the amounts reported on the respective income tax returns. Deferred taxes are recorded using the liability method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

The Company makes certain estimates and judgments in determining income tax expense for financial statement purposes. These estimates and judgments are applied in the calculation of certain tax credits and in the calculation of deferred income tax expense or benefit associated with certain deferred tax assets and liabilities. Significant changes to these estimates may result in an increase or decrease to the Company’s tax provision in a subsequent period. The Company recognizes interest and/or penalties related to income tax matters in income tax expense.

The Company periodically reviews its tax positions and applies a “more likely than not” recognition threshold for all tax uncertainties. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the “more likely than not” test, no tax benefit is recorded.

Employee Stock Ownership Plan (“ESOP”)

Compensation expense is recognized based on the current market price of shares committed to be released to employees. All shares released and committed to be released are deemed outstanding for purposes of earnings per share calculations. Dividends declared and paid on allocated shares held by the ESOP are charged to retained earnings. The value of unearned shares to be allocated to ESOP participants for future services not yet performed is reflected as a reduction of stockholders' equity. Dividends declared on unallocated shares held by the ESOP are recorded as a reduction of the ESOP's loan payment to the Company.

Stock Compensation Plans

At December 31, 2015, the Company had stock-based employee and non-employee compensation plans, which are described more fully in Note 12. The Company accounts for these plans under FASB ASC Topic 718 “Compensation – Stock Compensation” (“ASC Topic 718”). The Company accounts for the plans using a fair value-based method, which measures compensation cost at the grant date based on the fair value of the award. Compensation is then recognized over the service period, which is usually the vesting period. The fair value of stock option grants are estimated on the date of grant using the Black-Scholes options-pricing model. Common shares are issued from the Company’s authorized common shares when a share option is exercised. Common shares awarded under the restricted stock plan are expensed based on the fair market value at the grant date. Common shares awarded under the equity incentive plan as restricted stock are also accounted for in this manner. The stock option plan, restricted stock plan and equity incentive plan expenses are recognized in salaries and employee benefits expense on the consolidated statement of income.

Earnings per Common Share

Basic earnings per share is computed by dividing net income by the weighted average number of common shares outstanding, less unallocated shares held by the Company’s ESOP, Recognition and Retention Plan (“RRP”) and Equity Incentive Plan (“EIP”), during the period. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed conversion. Potential common shares that may be issued by the Company relate solely to outstanding stock options and restricted stock awards, and are determined using the treasury stock method.

Off-Balance Sheet Credit Related Financial Instruments

In the ordinary course of business, the Company has entered into commitments to extend credit. Such commitments are recorded in the consolidated statement of financial condition when they are funded.

Comprehensive Income (Loss)

Accounting principles generally require that recognized revenue, expenses, gains, and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities and OTTI related to non-credit factors, are reported as a separate component of the stockholders’ equity section of the consolidated statement of financial condition, such items, along with net income, are components of comprehensive income (loss).

Restrictions on Cash and Due from Banks

The Company is required to maintain reserve funds in cash or on deposit with the Federal Reserve Bank. The required reserve at December 31, 2015 and 2014 was $2,172,000 and $2,077,000, respectively.

Subsequent Events

The Company follows FASB ASC Topic 855, “Subsequent Events”, in accounting for and disclosure of events that occur after the balance sheet date but before financial statements are issued. The Company evaluated events occurring subsequent to December 31, 2015 through the date the consolidated financial statements are being issued, and other than as set forth in Note 21, did not identify any subsequent events requiring disclosure pursuant to the provisions of

FASB ASC Topic 855.

New Accounting Standards

In May 2014, the FASB issued ASU 2014-09, "Revenue from Contracts with Customers" ("ASU 2014-09"). ASU 2014-09 is intended to clarify and simplify revenue recognition principles, develop a common revenue standard across industries and accounting frameworks, and improve the usefulness and consistency of revenue reporting. In response to stakeholders' requests to defer the effective date of the guidance in ASU 2014-09 and in consideration of feedback received through extensive outreach with preparers, practitioners, and users of financial statements, the FASB issued ASU 2015-14, “Revenue from Contracts with Customers: Deferral of the Effective Date” (“ASU 2015-14”) in August 2015. ASU 2015-14 defers the effective date of ASU 2014-09 for all entities by one year. ASU 2014-09 is now effective for annual reporting periods, including interim reporting periods within those periods, beginning after December 15, 2017 for all public business entities. Early application is permitted as of annual reporting periods after December 15, 2016. Management is currently evaluating the impact the adoption of ASU 2014-09 will have on its consolidated financial statements and results of operations.

In June 2014, the FASB issued ASU 2014-12, “Compensation – Stock Compensation (Topic 718): Accounting for Share-Based Payments When the Terms of an Award Provide That a Performance Target Could Be Achieved after the Requisite Service Period” (“ASU 2014-12”). ASU 2014-12 applies to all reporting entities that grant their employees share-based payments in which the terms of the award provide that a performance target that affects vesting could be achieved after the requisite service period. The update requires that a performance target be treated as a performance condition. Compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved and should represent the compensation cost attributable to the period(s) for which the requisite service has already been rendered. If the performance target becomes probable of being achieved before the end of the requisite service period, the remaining unrecognized compensation cost should be recognized prospectively over the remaining requisite service period. The total amount of compensation cost recognized during and after the requisite service period should reflect the number of awards that are expected to vest and should be adjusted to reflect those awards that ultimately vest. The requisite service period ends when the employee can cease rendering service and still be eligible to vest in the award if the performance target is achieved. ASU 2014-12 is effective for the reporting periods beginning after December 15, 2015. Management does not expect the adoption of this update to have a material impact on the Company’s consolidated financial statements or results of operations.

In November 2015, the FASB issued ASU 2015-17, “Income Taxes (Topic 740): Balance Sheet Classification of Deferred Taxes” (“ASU 2015-17”). ASU 2015-17 was issued to simplify the presentation of deferred income taxes. The amendments in ASU 2015-17 require that deferred tax liabilities and assets be classified as noncurrent in a classified statement of financial position. The amendments in ASU 2015-17 apply to all entities that present a classified statement of financial position. The current requirement that deferred tax liabilities and assets of a tax-paying component of an entity be offset and presented as a single amount is not affected by the amendments in ASU 2015-17. ASU 2015-17 is effective for the reporting periods beginning after December 15, 2016. Management does not expect the adoption of this update to have a material impact on the Company’s consolidated financial statements or results of operations.

In January 2016, the FASB issued ASU 2016-01, “Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities” (“ASU 2016-01”). ASU 2016-01 was issued in order to enhance the reporting model for financial instruments to provide users of financial statements with more decision-useful information.

The amendments in ASU 2016-01 make the following changes to GAAP:

1. Require equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. However, an entity may choose to measure equity investments that do not have readily determinable fair values at cost minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer.
2. Simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment. When a qualitative assessment indicates that impairment exists, an entity is required to measure the investment at fair value.
3. Eliminate the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet.

4. Require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes.
5. Require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements.
6. Clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets.

ASU 2016-01 is effective for the reporting periods beginning after December 15, 2017. The Company has not yet determined the impact the adoption of ASU 2016-01 will have on its financial condition and results of operations.

In February 2016, the FASB issued ASU 2016-02, "Leases (Topic 842): Amendments to the FASB Accounting Standards Codification" ("ASU 2016-02"). ASU 2016-02 was issued to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The main difference between previous GAAP and ASU 2016-02 is the recognition of lease assets and lease liabilities by lessees for those leases classified as operating leases under previous GAAP. ASU 2016-02 requires qualitative disclosures along with specific quantitative disclosures for lessees and lessors in order to enable users of financial statements to assess the amount, timing, and uncertainty of cash flows arising from leases. ASU 2016-02 is effective for the reporting periods beginning after December 15, 2018. The Company has not yet determined the impact the adoption of ASU 2016-01 will have on its financial condition and results of operations.

Reclassifications

Certain amounts in the 2014 and 2013 consolidated financial statements have been reclassified to conform with the 2015 presentation format. These reclassifications had no effect on net income.

Note 3 – Investment Securities

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

	December 31, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
SECURITIES AVAILABLE FOR SALE:				
U.S. Treasury bonds	$ 12,778	$ 1,333	$ -	$ 14,111
Municipal bonds	49,064	2,746	(2)	51,808
Mortgage-backed securities:				
Collateralized mortgage obligations-private label	48	-	-	48
Collateralized mortgage obligations-government sponsored entities	38,838	124	(620)	38,342
Government National Mortgage Association	396	31	-	427

Federal National Mortgage Association	4,355	187	-	4,542
Federal Home Loan Mortgage Corporation	2,217	84	-	2,301
Asset-backed securities-private label	1,099	464	(62)	1,501
Asset-backed securities-government sponsored entities	89	8	-	97
Equity securities	22	14	-	36
	$ 108,906	$ 4,991	$ (684)	$ 113,213

	December 31, 2014			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
SECURITIES AVAILABLE FOR SALE:				
U.S. Treasury bonds	$ 12,817	$ 1,544	$ -	$ 14,361
Municipal bonds	57,158	3,635	(7)	60,786
Mortgage-backed securities:				
Collateralized mortgage obligations-private label	61	-	-	61
Collateralized mortgage obligations-government sponsored entities	50,465	237	(710)	49,992
Government National Mortgage Association	524	47	-	571
Federal National Mortgage Association	7,107	366	-	7,473
Federal Home Loan Mortgage Corporation	2,650	117	-	2,767
Asset-backed securities-private label	1,546	584	(107)	2,023
Asset-backed securities-government sponsored entities	111	11	-	122
Equity securities	22	24	-	46
	$ 132,461	$ 6,565	$ (824)	$ 138,202

All of our collateralized mortgage obligations are backed by residential mortgages.

At December 31, 2015 and 2014, equity securities consisted of 22,368 shares of Federal Home Loan Mortgage Corporation ("FHLMC") common stock.

At December 31, 2015, thirty-four municipal bonds with a cost of $11.1 million and fair value of $11.7 million were pledged under a collateral agreement with the Federal Reserve Bank ("FRB") of New York for liquidity borrowing. At December 31, 2014 thirty-one municipal bonds with a cost of $10.7 million and fair value of $11.4 million were pledged for liquidity borrowing. In addition, at December 31, 2015, nine municipal bonds with a cost and fair value of $2.0 million and $2.1 million, respectively, were pledged as collateral for customer deposits in excess of the Federal Deposit Insurance Corporation ("FDIC") insurance limits. At December 31, 2014, six municipal bonds with a cost and fair value of $1.5 million and $1.6 million, respectively were pledged as collateral for customer deposits in excess of the FDIC insurance limits.

The following table sets forth the Company's investment in securities available for sale with gross unrealized losses of less than twelve months and gross unrealized losses of twelve months or more and associated fair values as of the dates indicated: