UNION BANKSHARES INC
Form 10-Q
November 14, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

OR

( ) TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended: September 30, 2008

Commission file number: 001-15985

UNION BANKSHARES, INC.

VERMONT 03-0283552

P.O. BOX 667
MAIN STREET
MORRISVILLE, VT 05661

Registrant's telephone number: 802-888-6600

Former name, former address and former fiscal year, if changed since last report: Not applicable

Securities registered pursuant to section 12(b) of the Act:

Common Stock, $2.00 par value	Nasdaq Stock Market
(Title of class)	(Exchanges registered on)

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

Large accelerated filer [ ]   Accelerated filer [ ]   Non-accelerated filer [ ]
(Do not check if a 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]

Indicate the number of shares outstanding of each of the issuer's classes of common stock as of September 30, 2008:

Common Stock, $2 par value 4,483,641 shares

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Part l Financial Information

Item 1. Financial Statements

UNION BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED BALANCE SHEETS

	September 30, 2008	December 31, 2007
	(Unaudited)	
Assets	(Dollars in thousands)	
Cash and due from banks	$ 15,789	$ 12,815
Federal funds sold and overnight deposits	3,637	614
Cash and cash equivalents	19,426	13,429
Interest bearing deposits in banks	14,949	11,868
Investment securities available-for-sale	27,417	33,822
Loans held for sale	1,818	7,711
Loans	341,572	310,594
Allowance for loan losses	(3,440)	(3,378)
Unearned net loan fees	(97)	(111)
Net loans	338,035	307,105

Accrued interest receivable	1,769	2,077
Premises and equipment, net	7,391	6,462
Other assets	12,263	10,887
Total assets	$423,068	$393,361
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Noninterest bearing	$ 56,181	$ 56,155
Interest bearing	292,439	267,806
Total deposits	348,620	323,961
Borrowed funds	27,640	20,328
Accrued interest and other liabilities	5,625	6,998
Total liabilities	381,885	351,287
Commitments and Contingencies		
Stockholders' Equity		
Common stock, $2.00 par value; 7,500,000 shares authorized at 9/30/08 and 12/31/07; 4,921,786 shares issued at 9/30/08 and 12/31/07	9,844	9,844
Paid-in capital	207	202
Retained earnings	35,778	35,791
Treasury stock at cost; 438,145 shares at 9/30/08 and 418,817 shares at 12/31/07	(3,326)	(2,939)
Accumulated other comprehensive loss	(1,320)	(824)
Total stockholders' equity	41,183	42,074
Total liabilities and stockholders' equity	$423,068	$393,361

See accompanying notes to unaudited interim consolidated financial statements.

UNION BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)

	Three Months Ended September 30,		N
	2008	2007	2
	(Dollars in thousands except		
Interest income			
Interest and fees on loans	$ 5,718	$ 6,115	$ 1
Interest on debt securities			
Taxable	244	275	
Tax exempt	77	59	

Dividends	15	25	
Interest on federal funds sold and overnight deposits	46	132	
Interest on interest bearing deposits in banks	104	128	
Total interest income	6,204	6,734	1
Interest expense			
Interest on deposits	1,486	1,941	
Interest on borrowed funds	304	182	
Total interest expense	1,790	2,123	
Net interest income	4,414	4,611	1
Provision for loan losses	45	190	
Net interest income after provision for loan losses	4,369	4,421	1
Noninterest income			
Trust income	94	94	
Service fees	885	866	
Net gain on sales of investment securities available-for-sale	-	30	
Write-down of impaired investment securities available-for-sale	(512)	-	
Net gain on sales of loans held for sale	74	48	
Other income	297	45	
Total noninterest income	838	1,083	
Noninterest expense			
Salaries and wages	1,636	1,565	
Pension and employee benefits	481	541	
Occupancy expense, net	214	186	
Equipment expense	287	278	
Other expenses	1,226	1,004	
Total noninterest expense	3,844	3,574	1
Income before provision for income taxes	1,363	1,930	
Provision for income taxes	198	508	
Net income	$ 1,165	$ 1,422	$
Earnings per common share	$ 0.26	$ 0.32	$
Weighted average number of common shares outstanding	4,487,803	4,518,204	4,49
Dividends per common share	$ 0.28	$ 0.28	$

See accompanying notes to unaudited interim consolidated financial statements.

UNION BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY
(Unaudited)

	Common Stock					A
	Shares, net of Treasury	Amount	Paid-in capital	Retained earnings	Treasury stock	co
				(Dollars in thousands)		
Balances, December 31, 2007	4,502,969	$9,844	$202	$35,791	$(2,939)	
Comprehensive income:						
Net income	-	-	-	3,761	-	
Other comprehensive income, net of tax:						
Change in net unrealized gain (loss) on investment securities available-for-sale, net of reclassification adjustment and tax effects	-	-	-	-	-	
Change in net unrealized gain (loss) on unfunded defined benefit plan liability, net of reclassification adjustment and tax effects	-	-	-	-	-	
Total other comprehensive income						
Total comprehensive income						
Cash dividends declared ($0.84 per share)	-	-	-	(3,774)	-	
Stock based compensation expense	-	-	5	-	-	
Purchase of treasury stock	(19,328)	-	-	-	(387)	
Balances, September 30, 2008	4,483,641	$9,844	$207	$35,778	$(3,326)	

See accompanying notes to unaudited interim consolidated financial statements.

UNION BANKSHARES, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)

	Nine Months Ended September 30,	
	2008	2007
	(Dollars in thousands)	
Cash Flows From Operating Activities		
Net Income	$ 3,761	$ 4,143
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation	582	570
Provision for loan losses	185	235
Credit for deferred income taxes	(55)	(236)
Net amortization of investment securities available-for-sale	4	11
Equity in losses of limited partnerships	291	199
Stock based compensation expense	5	7
Write-down of investment securities available-for-sale	512	-
Write-down of other real estate owned and other assets	115	72
Decrease in unamortized loan fees	(14)	(15)
Proceeds from sales of loans held for sale	17,923	13,405
Origination of loans held for sale	(11,784)	(13,777)
Net gain on sales of loans held for sale	(246)	(98)
Net gain on sales of investment securities available-for-sale	(16)	(67)
Net loss on disposals of premises and equipment	50	1
Net loss (gain) on sales of repossessed property	5	(4)
Net loss (gain) on sales of other real estate owned	6	(44)
Decrease in accrued interest receivable	294	83
Decrease (increase) in other assets	124	(778)
(Decrease) increase in income taxes	(343)	23
(Decrease) increase in accrued interest payable	(406)	181
Increase in other liabilities	795	1,498
Net cash provided by operating activities	11,788	5,409
Cash Flows From Investing Activities		
Interest bearing deposits in banks		
Proceeds from maturities and redemptions	11,628	1,183
Purchases	(14,709)	(6,400)
Investment securities available-for-sale		
Proceeds from sales	1,803	546
Proceeds from maturities, calls and paydowns	6,969	1,811
Purchases	(3,645)	(12,870)
Net (purchase) redemption of Federal Home Loan Bank stock	(526)	82
Net (increase) decrease in loans	(32,734)	1,883
Recoveries of loans charged off	40	33
Purchases of premises and equipment	(1,561)	(806)
Investments in limited partnerships	(1,180)	(361)

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Nine Months Ended
September 30,

	2008	2007
	(Dollars in thousands)	
Proceeds from sale of other real estate owned	265	255
Proceeds from sale of premises and equipment	-	22
Proceeds from sale of repossessed property	49	24
Net cash used in investing activities	(33,601)	(14,598)
Cash Flows From Financing Activities		
Net increase in borrowings outstanding	7,312	22
Net increase in noninterest bearing deposits	26	15
Net increase in interest bearing deposits	24,633	13,585
Purchase of treasury stock	(387)	(375)
Dividends paid	(3,774)	(3,803)
Net cash provided by financing activities	27,810	9,444
Net increase in cash and cash equivalents	5,997	255
Cash and cash equivalents		
Beginning	13,429	20,957
Ending	19,426	$ 21,212
Supplemental Disclosures of Cash Flow Information		
Interest paid	$ 5,898	$ 5,976
Income taxes paid	$ 1,050	$ 1,635
Supplemental Schedule of Noncash Investing and Financing Activities		
Change in unrealized (losses) gains on investment securities available-for-sale	$ (777)	$ 20
Change in unrealized loss on unfunded defined benefit pension plan liability	$ 26	$ 21
Other real estate acquired in settlement of loans	$ 1,798	$ 547
Repossessed property acquired in settlement of loans	$ 79	$ 79
Investment in limited partnerships acquired by capital contributions payable	$ -	$ 1,397
Loans originated to finance the sale of other real estate owned	$ 289	$ 115

See accompanying notes to unaudited interim consolidated financial statements.

UNION BANKSHARES, INC. AND SUBSIDIARY
NOTES TO UNAUDITED CONSOLIDATED INTERIM FINANCIAL STATEMENTS

Note 1. Basis of Presentation
The accompanying interim unaudited consolidated financial statements of Union Bankshares, Inc. (the Company) as of September 30, 2008 and 2007, and for the three and nine months then ended have been prepared in conformity with U.S. generally accepted accounting principles (GAAP) for interim financial information, general practices within the banking industry, and the accounting policies described in the Company's Annual Report to Shareholders and Annual Report on Form 10-K for the year ended December 31, 2007. In the opinion of Company's management, all adjustments, consisting only of normal recurring adjustments and disclosures necessary for a fair presentation of the information contained herein have been made. This information should be read in conjunction with the Company's 2007 Annual Report to Shareholders, 2007 Annual Report on Form 10-K, and current reports on Form 8-K. The results of operations for the interim periods are not necessarily indicative of the results of operations to be expected for the full fiscal year ending December 31, 2008, or any other interim period.

Certain amounts in the 2007 unaudited consolidated financial statements have been reclassified to conform to the 2008 presentation.

Note 2. Commitments and Contingencies
In the normal course of business, the Company is involved in various legal proceedings. In the opinion of management, any liability resulting from such proceedings would not have a material adverse effect on the Company's financial condition or results of operations.

Note 3. Per Share Information
Earnings per common share amounts are computed based on the weighted average number of shares of common stock outstanding during the period and reduced for shares held in treasury. The assumed conversion of available outstanding stock options does not result in material dilution.

Note 4. Recent Accounting Pronouncements
In March 2008, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard (SFAS) No. 161, "Disclosures about Derivative Instruments and Hedging Activities - an amendment of FASB Statement No. 133". The objective of this Statement is to amend and expand the disclosure requirements of Statement 133 with the intent to provide users of financial statements with an enhanced understanding of: a) how and why an entity uses derivative instruments, b) how derivative instruments and related hedged items are accounted for under Statement 133 and its related interpretations, and c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The Statement requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about credit-risk related contingent features in derivative agreements. The statement is effective for financial statements issued for quarterly interim reporting periods beginning after November 15, 2008 with earlier adoption encouraged. The Company is in the process of evaluating the impact of this statement on the disclosures in its financial statements but it is not expected to have a material impact.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements - an amendment of Accounting Research Bulletin No.51". The objective of this Statement is to improve the relevance,

comparability, and transparency of the financial information that a reporting entity provides in its consolidated financial statements by establishing accounting and reporting standards that require specific financial statement disclosure, consistent accounting treatment for changes in a parent's ownership interest and fair value measurement on the deconsolidation of a subsidiary. The Statement applies to all entities that prepare consolidated financial statements but will affect only those entities that have an outstanding noncontrolling interest in one or more subsidiaries or that deconsolidate a subsidiary. The Statement is effective for fiscal years and interim periods within those fiscal years, beginning on or after December 15, 2008. Earlier adoption is prohibited. The Company has no noncontrolling interests in a subsidiary and therefore does not expect there to be any impact on the consolidated financial statements.

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In December 2007, the FASB issued Statement No. 141R, (revised) "Business Combinations" which replaces Statement No. 141. The objective of this Statement is to improve the relevance, representational faithfulness, and comparability of the information that a reporting entity provides in its financial reports about a business combination and its effects. To accomplish that, this Statement establishes principles and requirements for how the acquirer: (1) recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest in the acquiree, (2) recognizes and measures the goodwill acquired in the business combination or a gain from a bargain purchase, and (3) determines what information to disclose to enable users of the financial statements to evaluate the nature and financial effects of the business combination. The Statement shall be applied prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Earlier application is prohibited. This Statement would affect the Company for any acquisitions after December 31, 2008.

See Note 7 for recent accounting pronouncements relating to the fair value measurement of assets.

Note 5. Defined Benefit Pension Plan

Union Bank (Union), the Company's sole subsidiary, sponsors a noncontributory defined benefit pension plan covering all eligible employees. The plan provides defined benefits based on years of service and final average salary.

Net periodic pension benefit cost for the three and nine months ended September 30, consisted of the following components:

	Three Months Ended		Nine Months Ended	
	2008	2007	2008	2007
	(Dollars in thousands)			
Service cost	$ 137	$ 130	$ 409	$ 389
Interest cost on projected benefit obligation	167	150	502	452
Expected return on plan assets	(165)	(150)	(494)	(451)
Amortization of prior service cost	2	2	5	5
Amortization of net loss	7	6	21	16
Net periodic benefit cost	$ 148	$ 138	$ 443	$ 411

There were actuarial assumption changes between the first three quarters of 2007 and the first three quarters of 2008 as SFAS No. 87, Employers' Accounting for Pensions states that measurements are based on the assumptions used for the previous year-end measurements unless more recent measurements of both plan assets and obligations are available, or a significant event occurs. Therefore, 2008 net periodic benefit costs are based on December 31, 2007 actuarial assumptions while the 2007 costs are based on December 31, 2006 actuarial assumptions.

Note 6. Other Comprehensive Income (Loss)

The components of accumulated other comprehensive loss, net of tax at September 30, were:

	2008	2007
	(Dollars in thousands)	
Net unrealized loss on investment securities available-for-sale	$ (513)	$(141)
Defined benefit pension plan:		
Net unrealized actuarial loss	(787)	(812)
Net unrealized prior service cost	(20)	(24)
Total	$(1,320)	$(977)

The following is a summary of changes in other comprehensive income (loss) for the three and nine months ended September 30:

	Three Months Ended		Nine Months End	
	2008	2007	2008	20
	(Dollars in thousands)			
Investment securities available-for-sale:				
Change in net unrealized (losses) gains on investment securities available-for-sale	$(1,101)	$ 311	$(1,273)	$ 8
Reclassification adjustment for losses (gains) realized in income	512	(30)	496	(6
Net unrealized (losses) gains	(589)	281	(777)	2
Tax effect	(200)	96	(264)	
Net of tax amount	$ (389)	$ 185	$ (513)	$ 1
Defined benefit pension plan:				
Reclassification adjustment for amortization of net actuarial loss, realized in net income	$ 7	$ 16	$ 21	$ 1
Reclassification adjustment for amortization of prior service cost, realized in net income	2	5	5	
Total	9	21	26	2
Tax effect	3	7	9	

Net of tax amount	$ 6	$ 14	$ 17	$ 1
Total, net of tax	$ (383)	$ 199	$ (496)	$ 2

Note 7: Fair Value Measurements
SFAS No. 157, "Fair Value Measurements", generally establishes the definition of fair value expands disclosures about fair value measurement and establishes a hierarchy of the levels of fair value measurement techniques. SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities," generally permits the measurement of selected eligible financial instruments at fair value at specified election dates. SFAS 157 and SFAS 159 are effective for fiscal years beginning after November 15, 2007. Effective January 1, 2008, the Company adopted SFAS 157 and SFAS 159, but has not elected to apply the fair value option to any financial assets or liabilities other than those situations where other accounting pronouncements require fair value measurements.

In accordance with FASB Staff Position No. 157-2, "Effective Date of FASB Statement No. 157," issued in February 2008, the Company has delayed the application of SFAS No. 157 to nonfinancial assets and nonfinancial liabilities until January 1, 2009. Management does not anticipate that such application will have a material effect on the financial position of the Company.

On October 10, 2008 the FASB issued FASB Staff Position ("FSP") 157-3, Determining the Fair Value of Financial Assets When the Market for that Asset is Not Active, which provides an example that illustrates key considerations in determining the fair value of a financial asset when the market for that asset is not active. The FSP does not change existing GAAP. The FSP provides clarification for how to consider various inputs in determining fair value under current market conditions consistent with the principles of SFAS 157. This FSP was effective upon issuance, including for prior periods for which financial statements have not been issued. The adoption did not have a material impact on the financial position or the results of operations of the Company.

Under SFAS No. 157, the three levels of the fair value hierarchy are:

- Level 1 - Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;
- Level 2 - Quoted prices for similar assets or liabilities in active markets, quoted prices in markets that are not active, or inputs that are observable, either directly or indirectly, for substantially the full term of the asset or liability;
- Level 3 - Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e. supported by little or no market activity).

A financial instrument's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

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The following table presents the fair value measurements of assets recognized in the accompanying balance sheet measured at fair value on a recurring basis and the level within the SFAS No. 157 fair value hierarchy in which the fair value measurements fell at September 30, 2008:

		Fair Value Measurements at Reporting Dat (Dollars in Thousands)		
	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Sign Unobs In (Le
Investment securities available-for-sale	$27,417	$4,580	$22,837	

Fair values for available for sale securities are estimated by an independent pricing service for identical assets or significantly similar securities. The pricing service uses a variety of techniques to arrive at fair value including market maker bids, quotes and pricing models. Inputs to the pricing models include recent trades, benchmark interest rates, spreads and actual and projected cash flows. Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value in the aggregate. The fair value of loans held for sale is determined, when possible, using quoted secondary market prices. If no such quoted price exists, the fair value of a loan is determined using quoted prices for similar asset or assets, adjusted for the specific attributes of that loan. As of September 30, 2008 the carrying amount of loans held for sale was written down to fair market value less cost to sell and is included on the consolidated balance sheet.

Certain other financial assets and financial liabilities are measured at fair value on a nonrecurring basis, that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). Financial assets and financial liabilities measured at fair value on a non-recurring basis were not significant at September 30, 2008.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

GENERAL

The following discussion and analysis by management focuses on those factors that had a material effect on Union Bankshares, Inc.'s (Company) financial position as of September 30, 2008, and as of December 31, 2007, and its results of operations for the three and nine months ended September 30, 2008 and 2007. This discussion is being presented to provide a narrative explanation of the financial statements and should be read in conjunction with the consolidated financial statements and related notes and with other financial data appearing elsewhere in this filing and with the Company's Annual Report on Form 10-K for the year ended December 31, 2007. In the opinion of the Company's management, the interim unaudited data reflects all adjustments, consisting only of normal recurring adjustments, and disclosures necessary to fairly present the Company's consolidated financial position and results of operations for the interim period. Management is not aware of the occurrence of any events between September 30, 2008 and November 7, 2008, which would materially affect the information presented.

CAUTIONARY ADVICE ABOUT FORWARD LOOKING STATEMENTS

The Company may from time to time make written or oral statements that are considered "forward-looking statements" within the meaning of the Private

Securities Litigation Reform Act of 1995. Forward-looking statements may include financial projections, statements of plans and objectives for future operations, estimates of future economic performance and assumptions relating thereto. The Company may include forward-looking statements in its filings with the Securities and Exchange Commission (SEC), in its reports to stockholders, including this Quarterly Report, in press releases, other written materials, and in

statements made by senior management to analysts, rating agencies, institutional investors, representatives of the media and others.

Forward-looking statements reflect management's current expectations and are subject to uncertainties, both general and specific, and risk exists that those predictions, forecasts, projections and other estimates contained in forward-looking statements will not be achieved. When management uses any of the words "believes," "expects," "anticipates," "intends," "plans," "seeks," "estimates", or similar expressions, they are making forward-looking statements. Many possible events or factors, including those beyond the control of management, could affect the future financial results and performance of the Company. This could cause results or performance to differ materially from those expressed in forward-looking statements. The possible events or factors that might affect forward-looking statements include, but are not limited to, the following:

- uses of monetary, fiscal, and tax policy by various governments;
- political, legislative, or regulatory developments in Vermont, New Hampshire, or the United States including changes in laws concerning accounting, taxes, financial reporting, banking, and other aspects of the financial services industry;
- recent disruptions in U.S. and global financial and credit markets;
- developments in general economic or business conditions, globally, nationally, in Vermont, or in northern New Hampshire, including interest rate fluctuations, market fluctuations and perceptions, job creation and unemployment rates, ability to attract new business, and inflation and the effects of such changes on the Company or its customers;
- changes in the competitive environment for financial services organizations, including increased competition from tax-advantaged credit unions, mutual banks and out-of-market competitors offering financial services over the internet;
- the implementation of international financial reporting standards (IFRS) for United States companies;
- impact of governmental interposition in the financial services or other industries;
- the Company's ability to attract and retain key personnel;
- adverse changes in the local real estate market, which negatively impacts collateral values and the Company's ability to recoup loan losses through disposition of real estate collateral;
- changes in technology, including demands for greater automation which could present operational issues or significant capital outlays;
- acts or threats of terrorism or war, and actions taken by the United States or other governments that might adversely affect business or economic conditions for the Company or its customers;
- adverse changes in the securities market generally or in the market for financial institution securities which could adversely affect the value of the Company's stock;
- any actual or alleged conduct which could harm the Company's reputation;
- natural or other disasters which could affect the ability of the Company to operate under normal conditions;
- the Company's ability to retain and attract deposits and loans;

- illegal acts of theft or fraud perpetuated against the Company's subsidiary bank or its customers;
- unanticipated lower revenues or increased cost of funds, loss of customers or business, or higher operating expenses;
- the failure of assumptions underlying the establishment of the allowance for loan losses and estimations of values of collateral and various financial assets and liabilities;
- the amount invested in new business opportunities and the timing of these investments;
- the failure of actuarial, investment, work force, salary, and other assumptions underlying the establishment of reserves for future pension costs or changes in legislative or regulatory requirements;
- future cash requirements might be higher than anticipated due to loan commitments or unused lines of credit being drawn upon or depositors withdrawing their funds;
- assumptions made regarding interest rate movement and sensitivity could vary substantially if actual experience differs from historical experience which could adversely affect the Company's results of operations; and
- the creditworthiness of current loan customers is different from management's understanding or changes dramatically and therefore the allowance for loan losses becomes inadequate.

When evaluating forward-looking statements to make decisions with respect to the Company, investors and others are cautioned to consider these and other risks and uncertainties, including the events and circumstances discussed under "Recent Developments" below, and are reminded not to place undue reliance on such statements. Forward-looking statements speak only as of the date they are made and the Company undertakes no obligation to update them to reflect new or changed information or events, except as may be required by federal securities laws.

RECENT DEVELOPMENTS

The U.S. and global economies have experienced and are experiencing significant stress and disruptions in the financial sector. Dramatic slowdowns in the housing industry with falling home prices and increasing foreclosures and unemployment have resulted in major issues for some financial institutions, including government-sponsored entities and investment banks. These issues have caused many financial institutions to seek additional capital, to merge with larger and stronger institutions and, in some cases, to fail.

Despite the volatile economy, Vermont has the lowest residential foreclosure rate in the country. Also, as northern New England had not experienced the dramatic run up in housing prices, likewise, we have not seen the values drop as far as other parts of the country.

In response to the financial crisis affecting the banking and financial markets, in October 2008, the Emergency Economic Stabilization Act of 2008 (the "EESA") was signed into law. Pursuant to the EESA, the Federal Deposit Insurance Corporation temporarily increased the deposit insurance coverage limits to $250,000 per ownership category at each insured financial institution until December 31, 2009. Also, the U.S. Treasury ("the Treasury") will have the authority to, among other things, purchase up to $700 billion of mortgages, mortgage-backed securities and certain other financial instruments from financial institutions for the purpose of stabilizing and providing liquidity to the U.S. financial markets under the Troubled Asset Purchase Program (the "TARP").

In addition, the Treasury announced that it has been authorized to purchase equity stakes in U.S. financial institutions. Under this program, known as the Troubled Asset Relief Program Capital Purchase Program (the "TARP Capital Purchase Program"), from the $700 billion authorized by the EESA, the Treasury will make $250 billion of capital available to U.S. financial institutions in the form of preferred stock. The purchase of preferred stock investments will be accompanied by the issuance to the Treasury of warrants to purchase common stock with an aggregate market price equal to 15% of the total amount of the preferred stock. Participating financial institutions will be required to adopt the Treasury's standards for executive compensation and corporate governance for the period during which the Treasury holds equity issued under the TARP Capital Purchase Program and be restricted from increasing dividends to common shareholders or repurchasing common stock for three years without the consent of the Treasury.

Further, after receiving a recommendation from the boards of the Federal Deposit Insurance Corporation ("the FDIC") and the Federal Reserve System (the "Federal Reserve"), the Treasury signed the systemic risk exception to the FDIC Act, enabling the FDIC to temporarily provide a 100% guarantee of the senior unsecured debt of all FDIC-insured institutions and their holding companies, as well as 100% of deposits in noninterest bearing transaction deposit accounts under a Temporary Liquidity Guarantee Program. Coverage under the Temporary Liquidity Guarantee Program is available for 30 days without charge and thereafter at a cost of 75 basis points per annum for senior unsecured debt and 10 basis points per annum for noninterest bearing transaction deposits in excess of the $250,000 insured deposit limit.

The Company has made a decision to participate in the Temporary Liquidity Guarantee Program regarding the Noninterest Bearing Deposit Account Guarantee but to opt out of the Senior Unsecured Debt Guaranty portion of that program. The Company has also decided it is not in the best interest of the Company or its shareholders to participate in either the Troubled Asset Purchase Program or the Capital Purchase Program available under TARP given the strength of the Company's capital position, government restrictions and the fact that the Company did not target sub-prime borrowers. Please see the Capital Resources section on page 39 of this Form 10-Q.

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It is not clear at this time what impact the EESA, the TARP Capital Purchase Program, the Temporary Liquidity Guarantee Program, other liquidity and funding initiatives of the Federal Reserve and other agencies that have been previously announced, and any additional programs that may be initiated in the future will have on the Company and the U.S. and global financial markets.

CRITICAL ACCOUNTING POLICIES

The Company has established various accounting policies which govern the application of accounting principles generally accepted in the United States of America in the preparation of the Company's financial statements. Certain accounting policies involve significant judgments and assumptions by management which have a material impact on the reported amount of assets, liabilities, revenues and expenses and related disclosures of contingent assets and liabilities in the consolidated financial statements and accompanying notes. The SEC has defined a company's critical accounting policies as the ones that are most important to the portrayal of the company's financial condition and results of operations, and which require the company to make its most difficult and subjective judgments, often as a result of the need to make estimates of matters that are inherently uncertain. Based on this definition, the Company has identified the accounting policies and judgments most critical to the Company. The judgments and assumptions used by management are based on

historical experience and other factors, which are believed to be reasonable under the circumstances. Because of the nature of the judgments and assumptions made by management, actual results could differ from estimates and have a material impact on the carrying value of assets, liabilities, or the results of operations of the Company.

The Company believes the allowance for loan losses is a critical accounting policy that requires the most significant judgments and estimates used in the preparation of its consolidated financial statements. In estimating the allowance for loan losses, management utilizes historical experience as well as other factors including the effect of changes in the local real estate market on collateral values, the effect on the loan portfolio of current economic indicators and their probable impact on borrowers and changes in delinquent, nonperforming or impaired loans. Changes in these factors may cause management's estimate of the allowance for loan losses to increase or decrease and result in adjustments to the Company's provision for loan losses in future periods. For additional information see, FINANCIAL CONDITION - Allowance for Loan Losses below.

The Company's pension benefit obligations and net periodic benefit cost are actuarially determined based on the following assumptions: discount rate, estimated future return on plan assets, wage base rate, anticipated mortality rates, Consumer Price Index rate, and rate of increase in compensation levels. The annual determination of the pension benefit obligations and net periodic benefit cost is a critical accounting estimate as it requires the use of estimates and judgment related to the amount and timing of expected future cash out flows for benefit payments and cash in flows for maturities and returns on plan assets. Changes in estimates and assumptions could have a material impact to the Company's financial condition or results of operations.

The Company also has other key accounting policies, which involve the use of estimates, judgments and assumptions that are significant to understanding the results including the valuation of deferred tax assets, investment securities and other real estate owned. Given the market volatility and the number and volume of corporate failures and bailouts over the last couple of months, the determination of fair value and other than temporary impairment for investment securities has been especially challenging. See FINANCIAL CONDITION - Investment Activities below. Although management believes that its estimates, assumptions and judgments are reasonable, they are based upon information presently available. Actual results may differ significantly from these estimates under different assumptions, judgments or conditions.

OVERVIEW

The Company's net income was $1.2 million for the quarter ended September 30, 2008, compared with net income of $1.4 million for the same period in 2007, or a $257 thousand or 18.1% decrease between years. The decrease was the cumulative result of a drop in net interest income of $197 thousand and increases in all categories of noninterest expense except pension and employee benefits totaling a net $782 thousand. The largest component of the decrease in taxable income for the third quarter ending

September 30, 2008 was the $512 thousand of writedowns of two impaired corporate bond investment securities available-for-sale that were deemed other than temporarily impaired. The $74 thousand writedown of four other real estate owned (OREO) properties to their fair market value less costs to sell, the write-off of $25 thousand in furniture and fixtures also repossessed as collateral with an OREO property, and the $70 thousand in carrying costs of the OREO properties for the quarter also added to the decrease in taxable income.

These increases were partially offset by a $267 thousand increase in noninterest income, primarily resulting from the receipt of $234 thousand from a nontaxable life insurance benefit, a loan loss provision of $45 thousand for the third quarter of 2008 compared to $190 thousand for the same period in 2007 and a $310 decrease in the provision for income taxes. The decrease in the provision for income taxes was partially a result of the increased nontaxable and reduced taxable income and partially a result of $27 thousand in low income federal tax credits booked during the third quarter of 2008 on a late 2007 investment in a low income housing project.

The Company faced a challenging interest rate environment as the prime rate had been reduced seven times since September 18, 2007 from 8.25% to 5.00% on April 30, 2008, where it remained throughout the balance of the reporting period. Total interest income decreased by $530 thousand, or 7.9% to $6.2 million in the third quarter of 2008 versus the $6.7 million in the third quarter of 2007, while the decrease in interest expense from $2.1 million in 2007 to $1.8 million in 2008 was only $333 thousand between periods. The result of the changes in interest income and expense was that net interest income for the third quarter of 2008 was $4.4 million, down $197 thousand or 4.3% from the third quarter of 2007 of $4.6 million. During the third quarter of 2008, the Company's net interest margin decreased 49 basis points to 4.67%, from 5.16% for the third quarter of 2007, reflecting both the decline in net interest income and the growth in the balance sheet. The Company's net interest spread declined 33 basis points to 4.25% for the third quarter of 2008, compared to 4.58% for the same period last year. The decline in the net interest spread was primarily the result of the decline in average interest rates earned on loans as the 325 basis point drop in the prime rate between the third quarter of 2007 and the third quarter of 2008 had an effect on the repricing of adjustable rate loans and the volume of refinancings, as customers took advantage of the lower rates. Further drops in the prime rate and/or increases in competitors deposit rates could be problematic going forward as the individual instruments re-price.

The Company's total assets increased from $393.4 million at December 31, 2007, to $423.1 million at September 30, 2008, an increase of $29.7 million, or 7.5%. Deposits increased from $324.0 million at December 31, 2007 to $348.6 million at September 30, 2008, an increase of $24.6 million, or 7.6%, with most of that increase in interest-bearing time deposits. Total loans, including loans held for sale, increased $25.1 million, or 7.9%, from $318.3 million at December 31, 2007 to $343.4 million at September 30, 2008. This increase reflects strong loan demand due to lower interest rates, a changing competitive environment due to the sale of a number of our competitors, financial market turmoil and the reluctance of some of our larger competitors to issue loans.

There was a $45 thousand provision for loan losses during the third quarter of 2008 versus a $190 thousand provision for the third quarter of 2007. The $45 thousand provision was deemed appropriate for the third quarter of 2008 in light of net charge-offs for the quarter ended September 30, 2008 of $29 thousand compared to net charge-offs of $120 thousand for the quarter ended September 30, 2007. There is continuing strong loan growth, an upward trend in the dollar amount of commercial real estate loans and a softening of the economy, which has resulted in an increase in nonperforming loans. These factors were partially offset by a decline in classified loans between periods as well as the growth in low risk loans to local municipalities and school districts. For further details see, FINANCIAL CONDITION - "Allowance for Loan Losses" and "Asset Quality" sections below.

The following unaudited per share information and key ratios depict several measurements of performance or financial condition for or at the three and nine

months ended September 30, 2008 and 2007, respectively:

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2008	2007	2008	2007
Return on average assets (ROA) (1)	1.12%	1.46%	1.25%	1.45%
Return on average equity (ROE) (1)	11.27%	13.71%	12.04%	13.29%
Net interest margin (1)(2)	4.67%	5.16%	4.80%	5.18%
Efficiency ratio (3)	68.11%	62.01%	69.05%	64.15%
Net interest spread (4)	4.25%	4.58%	4.34%	4.60%
Loan to deposit ratio	98.50%	95.47%	98.50%	97.20%
Net loan charge-offs to average loans not held for sale (1)	0.03%	0.16%	0.05%	0.08%
Allowance for loan losses to loans not held for sale	1.01%	1.09%	1.01%	1.09%
Non-performing assets to total assets	2.01%	0.96%	2.01%	0.96%
Equity to assets	9.73%	10.55%	9.73%	10.55%
Total capital to risk weighted assets	15.89%	16.82%	15.89%	16.82%
Book value per share	$9.19	$9.29	$9.19	$9.29
Earnings per share	$0.26	$0.32	$0.84	$0.92
Dividends paid per share	$0.28	$0.28	$0.84	$0.84
Dividend payout ratio (5)	107.69%	87.50%	100.00%	91.30%

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(1) Annualized

(2) The ratio of tax equivalent net interest income to average earning assets.

(3) The ratio of noninterest expense to tax equivalent net interest income and noninterest income excluding securities gains and losses.

(4) The difference between the average rate earned on assets minus the average rate paid on liabilities.

(5) Cash dividends declared and paid per share divided by consolidated net income per share.

RESULTS OF OPERATIONS

Net Interest Income. The largest component of the Company's operating income is net interest income, which is the difference between interest and dividend income received from interest-earning assets and the interest expense paid on interest-bearing liabilities. The Company's net interest income decreased $197 thousand, or 4.3%, to $4.4 million for the three months ended September 30, 2008, from $4.6 million for the three months ended September 30, 2007. For the nine months ended September 30, 2008 compared to the nine months ended September 30, 2007, net interest income dropped $369 thousand or 2.7% to $13.1 million from $13.4 million. The net interest spread decreased 33 basis points to 4.25% for the three months ended September 30, 2008, from 4.58% for the three months ended September 30, 2007 while it only dropped 26 basis points to 4.34% from 4.60% for the nine months ended September 30, 2008 and September 30, 2007, respectively. The decline in the net interest spread was primarily the result of the drop in average interest rates earned on loans as the 325 basis point drop in the prime rate between September 18, 2007 to April 30, 2008 affected the repricing of adjustable rate loans as well as the volume of new loans and refinancing activity as customers took advantage of the lower rates. The adverse effect of declining rates on the Company's net interest spread was mitigated somewhat by a 64 basis point decline in the average rate paid on deposits and borrowed funds in the third quarter of 2008 versus the same period

last year. The net interest margin for the third quarter of 2008 decreased 49 basis points to 4.67% from the 2007 period at 5.16% reflecting both a decline in net income and an increase of $24.0 million in average earning assets. Similarly, the net interest margin for the nine months ended September 30, 2008 was 4.80% or 37 basis points lower than the 5.17% for the nine months ended September 30, 2007 while average interest earning assets rose $17.1 million. Further decrease in the prime rate would not necessarily be beneficial to the Company in the near term, especially if funding rates

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did not follow a similar downward trend. See "OTHER FINANCIAL CONSIDERATIONS - Market Risk and Asset and Liability Management."

Yields Earned and Rates Paid. The following table shows, for the periods indicated, the total amount of income recorded from average interest-earning assets and the related average yields, the interest expense associated with average interest-bearing liabilities, the related average rates paid, and the relative net interest spread and net interest margin. Yield and rate information is calculated on an annualized tax equivalent basis. Yield and rate information for a period is average information for the period, and is calculated by dividing the annualized tax equivalent income or expense item for the period by the average balance of the appropriate balance sheet item during the period. Net interest margin is annualized tax equivalent net interest income divided by average interest-earning assets. Nonaccrual loans are included in asset balances for the appropriate periods, but recognition of interest on such loans is discontinued and any remaining accrued interest receivable is reversed in conformity with federal regulations.

	Three months ended Septembe			
	2008			
	Average Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Balance
			(Dollars in thousands)	
Average Assets:				
Federal funds sold and overnight deposits	$ 10,048	$ 46	1.83%	$ 10,261
Interest bearing deposits in banks	9,590	104	4.31%	10,521
Investment securities (1), (2)	27,483	322	5.16%	29,041
Loans, net (1), (3)	337,271	5,718	6.85%	311,071
FHLB of Boston stock	1,922	14	2.87%	1,385
Total interest-earning assets (1)	386,314	6,204	6.51%	362,279
Cash and due from banks	10,597			10,468
Premises and equipment	7,276			6,179
Other assets	10,685			9,727
Total assets	$414,872			$388,653
Average Liabilities and Stockholders' Equity:				
NOW accounts	$ 54,307	$ 71	0.52%	$56,034
Savings/money market accounts	93,911	314	1.33%	92,405

Time deposits	138,267	1,101	3.17%	126,931
Borrowed funds	27,782	304	4.30%	14,479
Total interest bearing liabilities	314,267	1,790	2.26%	289,849
Noninterest bearing deposits	53,441			50,456
Other liabilities	5,797			6,874
Total liabilities	373,505			347,179
Stockholders' equity	41,367			41,474
Total liabilities and stockholders' equity	$414,872			$388,653
Net interest income		$ 4,414		
Net interest spread (1)			4.25%	
Net interest margin (1)			4.67%	

(1)Average yields reported on a tax-equivalent basis.
(2)Average balances of investment securities are calculated on the amortized cost basis.
(3)Includes loans held for sale and is net of unearned income and allowance for loan losses.

	Nine months ended September			
	2008			
	Average Balance	Interest Earned/ Paid	Average Yield/ Rate	Average Balance
			(Dollars in thousands)	
Average Assets:				
Federal funds sold and overnight deposits	$ 6,703	$ 105	2.08%	$ 8,046
Interest bearing deposits in banks	9,512	335	4.69%	9,236
Investment securities (1), (2)	30,038	1,075	5.22%	26,948
Loans, net (1), (3)	324,106	16,997	7.08%	309,432
FHLB of Boston stock	1,795	51	3.74%	1,391
Total interest-earning assets (1)	$372,154	18,563	6.76%	355,053
Cash and due from banks	10,129			10,280
Premises and equipment	7,000			6,122
Other assets	10,925			9,338
Total assets	$400,208			$380,793

Average Liabilities and Stockholders' Equity:				
NOW accounts	$ 53,550	$ 232	0.58%	$ 53,100
Savings/money market accounts	91,327	951	1.39%	93,605
Time deposits	129,617	3,440	3.53%	123,161
Borrowed funds	26,492	868	4.31%	14,765
Total interest bearing liabilities	$300,986	5,491	2.43%	284,631
Noninterest bearing deposits	51,257			48,475
Other liabilities	6,314			6,115
Total liabilities	358,557			339,221
Stockholders' equity	41,651			41,572
Total liabilities and stockholders' equity	$400,208			$380,793
Net interest income		$13,072		
Net interest spread (1)			4.34%	
Net interest margin (1)			4.80%	

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(1)Average yields reported on a tax-equivalent basis.
(2)Average balances of investment securities are calculated on the amortized cost basis.
(3)Includes loans held for sale and is net of unearned income and allowance for loan losses.

Rate/Volume Analysis. The following table describes the extent to which changes in average interest rates and changes in volume of average interest earning assets and interest bearing liabilities have affected the Company's interest income and interest expense during the period indicated. For each category of interest earning assets and interest bearing liabilities information is provided on changes attributable to:

- changes in volume (change in volume multiplied by prior rate);
- changes in rate (change in rate multiplied by prior volume); and
- total change in rate and volume.

Changes attributable to both rate and volume have been allocated proportionately to the change due to volume and the change due to rate.

	Three Months Ended September 30, 2008 Compared to Three Months Ended September 30, 2007 Increase/(Decrease) Due to Change In		
	Volume	Rate	Net
	(Dollars in thousands)		

	Volume	Rate	Net
Interest earning assets:			
Federal funds sold and overnight deposits	$ (3)	$ (82)	$ (85)
Interest bearing deposits in banks	(11)	(13)	(24)
Investment securities	(25)	9	(16)
Loans, net	483	(880)	(397)
FHLB of Boston stock	7	(15)	(8)
Total interest earning assets	$451	(981)	(530)
Interest bearing liabilities:			
NOW accounts	$ (4)	(44)	(48)
Savings/money market accounts	7	(108)	(101)
Time deposits	116	(422)	(306)
Borrowed funds	148	(26)	122
Total interest bearing liabilities	$267	(600)	(333)
Net change in net interest income	$184	$(381)	$(197)

	Nine Months Ended September 30, 2008 Compared to Nine Months Ended September 30, 2007 Increase/(Decrease) Due to Change In		
	Volume	Rate	Net
	(Dollars in thousands)		
Interest earning assets:			
Federal funds sold and overnight deposits	$(45)	$ (162)	$ (207)
Interest bearing deposits in banks	11	-	11
Investment securities	96	48	144
Loans, net	859	(1,821)	(962)
FHLB of Boston stock	17	(38)	(21)
Total interest earning assets	$938	$(1,973)	$(1,035)
Interest bearing liabilities:			
NOW accounts	$ 3	$ (92)	$ (89)
Savings/money market accounts	(29)	(261)	(290)
Time deposits	207	(811)	(604)
Borrowed funds	391	(74)	317
Total interest bearing liabilities	572	(1,238)	(666)
Net change in net interest income	$366	$ (735)	$ (369)

Three Months Ended September 30, 2008, compared to Three Months Ended September 30, 2007.

Interest and Dividend Income. The Company's interest and dividend income decreased $530 thousand, or 7.9%, to $6.2 million for the three months ended September 30, 2008, from $6.7 million for the three months ended September 30, 2007. During the third quarter of 2008, average earning assets increased $24.0 million, or 6.6%, to $386.3 million, from $362.3 million for the three months

ended September 30, 2007. However, the increase in interest income resulting from the rise in average earning assets was more than offset by the lower rates earned on loans, federal funds sold, interest bearing deposits in banks and Federal Home Loan Bank of Boston stock in third quarter of 2008 versus 2007. In particular, interest income on loans decreased during the third quarter of 2008 versus the 2007 comparison period despite an increase in average loan volume between periods. Average loans approximated $337.3 million at an average yield of 6.85% for the three months ended September 30, 2008, up $26.2 million, or 8.4%, from $311.1 million at an average yield of 7.89% for the three months ended September 30, 2007. However,

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the increase in volume was more than offset by an 104 basis point decrease in yield. Loan demand has risen during 2008 due to the lower interest rates, the successful implementation of a call program and the changes in the competitive landscape.

The 325 basis point drop in the prime rate from September 2007 at 8.25% to April 2008 at 5.00% has now impacted the majority of variable rate loans and was not positive for the Company, as adjustable rate loans continue to reprice at lower rates. The further drop in the prime rate of 100 basis points in October 2008 will also negatively impact net interest income for the Company in future periods.

The average balance of investments (including mortgage-backed securities) decreased $1.6 million or 5.4%, to $27.5 million for the three months ended September 30, 2008, from $29.0 million for the three months ended September 30, 2007. The average level of interest bearing deposits in banks for the quarter was $9.6 million, down $931 thousand or 8.8% from the 2007 average level of $10.5 million. Maturing investments and FDIC insured certificates of deposit were utilized to fund loan demand. The average level of federal funds sold and overnight deposits decreased $213 thousand, to $10.1 million or 2.1% for the three months ended September 30, 2008, from $10.3 million for the three months ended September 30, 2007. Interest income from non-loan instruments decreased $133 thousand or 21.5% between periods, with $486 thousand for the third quarter of 2008 versus $619 thousand for the same period of 2007, reflecting the overall decreases in yields on federal funds sold and overnight deposits, as well as on interest bearing deposits in banks and the FHLB of Boston stock, coupled with volume decreases on federal funds sold, interest bearing deposits, and investment securities available-for-sale.

Interest Expense. The Company's interest expense decreased $333 thousand, or 15.7%, to $1.8 million for the three months ended September 30, 2008, from $2.1 million for the three months ended September 30, 2007. Of this decrease, $600 thousand was a result of the decrease in rates, partially offset by the $267 thousand attributable to the increase in volume, primarily related to the rise in borrowed funds to support loan demand as well as the increased volume in time deposits.

Interest expense on deposits decreased $455 thousand or 23.4% to $1.5 million for the quarter ended September 30, 2008, from $1.9 million for the quarter ended September 30, 2007. Competition for deposits has remained strong but growth in average deposits for the quarter at $14.1 million or 4.3% is illustrative of the overall growth in the franchise with the opening of two new branches during the third quarter and some "flight to quality" in September 2008 as the financial markets continued to experience turmoil. Interest rates paid have not dropped as much as anticipated given the drop in the prime rate and the target rate on Federal Funds Sold. Management believes consumers have become more rate sensitive over the last few years due to advertised "specials" and the proliferation of nonlocal financial institutions trying to gather

deposits throughout the Company's market area. Average time deposits rose to $138.3 million for the three months ended September 30, 2008, from $126.9 million for the three months ended September 30, 2007, or an increase of $11.3 million or 8.9%. While the majority of these deposits are new funds for the Company, there has been movement of deposits from lower yielding deposit accounts to higher paying certificates of deposit within its account base. The average rate paid on time deposits decreased 123 basis points, to 3.17% from 4.40% for the three months ended September 30, 2008 and 2007, respectively. The average balances for money market and savings accounts increased $1.5 million, or 1.6%, to $93.9 million for the three months ended September 30, 2008, from $92.4 million for the three months ended September 30, 2007. A $1.7 million or 3.1% decrease in NOW accounts brought the average balance down to $54.3 million from $56.0 million between the two years.

Interest expense on borrowed funds increased from $182 thousand for the quarter ended September 30, 2007 to $304 thousand for the quarter ended, September 30, 2008 as average funds borrowed from the FHLB of Boston increased from $14.4 million to $27.8 million between years, although the average rate paid on borrowed funds declined 63 basis points between periods. The increasing loan demand between the quarters ended September 30, 2007 and September 30, 2008, the match funding of certain loans with FHLB of Boston amortizing advances and the opportunity to lock in some low rate long term funding early in 2008 before the long end of the yield curve rose led the Company to increase its reliance on borrowed funds.

Provision for Loan Losses. There was a $45 thousand loan loss provision for the quarter ended September 30, 2008 and a $190 thousand loan loss provision for the quarter ended September 30, 2007. The lower provision in the third quarter of 2008 versus 2007 was deemed appropriate for the third quarter of 2008 in light of net charge-offs for the quarter ended September 30, 2008 of $29 thousand compared to the quarter ending September 30, 2007 of $120 thousand. There is continuing strong loan growth, an upward trend in the dollar amount of loans with higher risk characteristics and a softening of the economy, which has resulted in an increase in nonperforming loans. However, these factors were partially offset by a decline in classified loans between periods as well as the growth in lower risk loans to local municipalities and school districts. For further details see, FINANCIAL CONDITION -"Allowance for Loan Losses" and "Asset Quality" sections below.

Noninterest income. The following table sets forth changes from the third quarter of 2007 to the third quarter of 2008 for components of noninterest income:

	For The Three Months Ended September 30,			
	2008	2007	$ Variance	% Variance
	(Dollars in thousands)			
Trust income	$ 94	$ 94	$ -	-
Service fees	885	866	19	2.2
Net gains on sales of investment securities	-	30	(30)	(100.0)
Write-down of impaired investment securities	(512)	-	(512)	(100.0)
Net gains on sales of loans held for sale	74	48	26	54.2
Other	297	45	252	560.0
Total noninterest income	$ 838	$1,083	$(245)	(22.6)

Trust Income. Trust income has remained flat for the three months ended September 30, 2008 compared to 2007, despite a number of new trust relationships. Since the Company's trust fees are based largely on the value of assets under management, the positive impact of these new relationships were offset by the lower market value of the assets invested mainly due to market turmoil.

Service fees. The increase resulted primarily from a rise in overdraft fees of $25 thousand, or 7.8% and ATM/Debit Card usage fees increase of $21 thousand, or 11.0%. These increases were partially offset by a decline in foreign exchange fees of $17 thousand, or 83.4% as the price of the U.S. dollar continued to decline and a decrease of $10 thousand, or 12.8%, in loan servicing fees.

Net gains on sales of investment securities. There were no sales of investment securities during the third quarter of 2008.

Write-down of impaired investment securities. Two corporate bonds in the available-for-sale investment portfolio were determined to be other than temporarily impaired and were written down by $512 thousand to reflect the fair value of these securities as of September 30, 2008. See FINANCIAL CONDITION - Investment Activities section below.

Net gains on sales of loans held for sale. Residential real estate loans of $4.8 million were sold for a net gain of $74 thousand during the third quarter of 2008, versus sales of $4.1 million for a net gain of $48 thousand during the third quarter of 2007.

Other. The increase resulted primarily from the recording of a $234 thousand nontaxable death benefit from a Company owned life insurance policy.

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Noninterest expense. The following table sets forth changes from the third quarter of 2007 to the third quarter of 2008 for components of noninterest expense:

	For The Three Months Ended September 30,			
	2008	2007	$ Variance	% Variance
	(Dollars in thousands)			
Salaries and wages	$1,636	$1,565	$ 71	4.5
Pension and employee benefits	481	541	(60)	(11.1)
Occupancy expense, net	214	186	28	15.1
Equipment expense	287	278	9	3.2
Expenses of OREO and other assets owned, net	174	36	138	383.3
Equity in losses of affordable housing investments	97	66	31	47.0
Other	955	902	53	5.9
Total noninterest expense	$3,844	$3,574	$270	7.6

Salaries and wages and related expenses. The increase in 2008 over 2007 was due primarily to regular salary activity and hiring associated with the July and October addition of two branches. This increase was partially offset by a reduction in several staff positions, not withstanding continued growth of the

Company. There was a decrease of $84 thousand or 37.9% in the Company's medical costs from $220 thousand in the third quarter of 2007 to $137 thousand for 2008 as a few large claims were processed during the third quarter of 2007 and were not repeated in the third quarter of 2008. The Company self-insures healthcare costs to a specific individual and aggregate level and carries "excess" coverage for major claims.

Occupancy Expense. The increase between years is mainly due to the addition of two new branch locations during the third quarter of 2008 as well as the lower rental income received due to timing of tenants departures and rental of available space.

Expenses of OREO and other assets owned, net. Four properties that were held as Other Real Estate Owned during the third quarter of 2008 were written down to their fair market value less cost to sell totaling $74 thousand. One of the properties was sold in September 2008 and two more have been sold during the fourth quarter 2008. Furniture and fixtures in one of the OREO properties originally valued as Other Assets Owned at $25 thousand were written down to $0 during the third quarter of 2008. Net carrying costs of OREO and other assets owned for the quarter were $174 thousand.

Equity in losses of affordable housing investments. Two new investments in low income housing partnerships were made in late 2007 which increased the amount of equity in the losses of these projects to be recorded in 2008.

Other. The net change between years has many components of both increases and decreases; the largest four being a $34 thousand increase in professional fees due to the retention of a consulting firm to review director and officer compensation and benefit packages and the outsourcing of stock transfer agent responsibilities effective January 1, 2008, an increase in director's fees due to the increase of one outside director on both the Board of the Company and the Bank, and an increase in the quarter's expenses of foreclosures and other real estate owned which was $21 thousand during the third quarter of 2007 versus $75 thousand during the third quarter of 2008.

Income Tax Expense. The Company has provided for current and deferred federal income taxes for the current and all prior periods presented. The Company's provision for income taxes was $198 thousand for the three months ended September 30, 2008 compared to $508 thousand for the same period in 2007, reflecting the decrease in taxable net income between periods. Nontaxable income from municipal loans and investments grew from $236 thousand to $284 thousand between years. Also, a $234 thousand nontaxable death benefit on one of the Company owned life insurance policies added to third quarter 2008 nontaxable income. There was also an additional $27 thousand in low income tax credits available in 2008 on two low income housing investments made in late 2007. The Company's effective tax rate therefore decreased to just 14.5% for the three months ended September 30, 2008, from 26.3% for the same period in 2007.

Nine Months Ended September 30, 2008, compared to Nine Months Ended September 30, 2007.

Interest and Dividend Income. The Company's interest and dividend income decreased $1.0 million, or 5.3%, to $18.6 million for the nine months ended September 30, 2008, from $19.6 million for the nine months ended September 30, 2007, with average earning assets increasing $17.1 million, or 4.8%, to $372.2 million for the nine months ended September 30, 2008, from $355.1 million for the nine months ended September 30, 2007. However, the increase in interest income resulting from the rise in average earning assets was more than offset

by the lower rates earned on loans, federal funds sold, and FHLB of Boston stock in the first nine months of 2008 versus 2007. Interest income on loans decreased during the nine months of 2008 versus the 2007 comparison period despite an increase in average loan volume between periods. Average loans approximated $324.1 million at an average yield of 7.08% for the first nine months ended September 30, 2008, up $14.7 million from $309.4 million at an average yield of 7.86% for the first nine months ended September 30, 2007. However, the increase in volume was more than offset by a 78 basis point decrease in yield resulting mostly from the 325 basis point drop in the prime rate from 8.25% in September 2007 to 5.00% in April 2008 where it remained throughout the balance of the reporting period. Loan demand has risen during 2008 due to lower interest rates, the successful implementation of a call program and the changes in the competitive landscape.

The average balance of investments (including mortgage-backed securities) increased $3.1 million or 11.5%, to $30.0 million for the nine months ended September 30, 2008, from $26.9 million for the nine months ended September 30, 2007. The average level of interest bearing deposits in banks for the nine months ended September 30, 2008 was $9.5 million up $276 thousand or 3.0% from the 2007 average level of $9.2 million, as FDIC insured certificates of deposit in other financial institutions was one of the highest yielding and safest investment options available. The increase in the investment portfolio and interest bearing deposits in banks from the first nine months of 2007 reflects the slower loan demand of 2007 and early 2008 but that changed during 2008 and cash flows from maturing or called instruments are being utilized to fund loans. The average level of federal funds sold and overnight deposits decreased $1.3 million, to $6.7 million at a rate of 2.08% for the nine months ended September 30, 2008, from $8.0 million at a rate of 5.10% for the nine months ended September 30, 2007, as funds were utilized to support the rising loan demand. Interest income from non-loan instruments decreased $73 thousand or 4.5% between periods, with $1.57 million in income for these items for the nine months ended September 30, 2008 and $1.64 million for the nine months ended September 30, 2007, reflecting the overall increase in yields on investment securities and volume increases on all instruments except federal funds sold.

Interest Expense. The Company's interest expense decreased $666 thousand, or 10.8%, to $5.5 million for the nine months ended September 30, 2008, from $6.2 million for the nine months ended September 30, 2007. Of this decrease, $1.2 million was a result of the decrease in rates, partially offset by a $572 thousand increase attributable to an increase in volume, primarily related to the increase in time deposits as well as borrowed funds to support loan demand.

Interest expense on deposits decreased $983 thousand or 17.5% to $4.6 million for the nine months ended, September 30, 2008, from $5.6 million for the nine months ended September 30, 2007. Competition for deposits has remained strong with growth in average deposits for the nine months ended September 30, 2008 of $7.4 million or 2.3% from the nine months ended September 30, 2007. Volume growth started to improve towards the end of the first half of 2008 as there has been a flight to quality by customers concerned about the stock market declines, Fannie Mae and Freddie Mac issues and bank and brokerage house failures. Average time deposits rose to $129.6 million for the nine months ended September 30, 2008, from $123.2 million for the nine months ended September 30, 2007, or an increase of $6.4 million or 5.2%. While the majority of these deposits are new funds for the Company, there has been movement of deposits from lower yielding savings accounts to higher paying certificates of deposit within its account base. The average rate paid on time deposits decreased 86 basis points, to 3.53% from 4.39% for the nine months ended September 30, 2008 and 2007, respectively. The average balances for money market and savings accounts decreased $2.3 million, or 2.4%, to $91.3 million for the nine months ended September 30, 2008, from $93.6 million for the nine months ended September 30, 2007 as interest rates on time deposits were higher which appeared to motivate customers to move funds into certificates of deposit

and lock in the higher rates, especially given the potential for a steep downward trend in interest rates paid given the drop in the discount rate by the Federal Open Market Committee (FOMC) and the decrease in the prime rate during the first four months of 2008. A $450 thousand or

0.8% increase in NOW accounts brought the average balance up to $53.6 million from $53.1 million between the two years.

Interest expense on borrowed funds increased from $551 thousand for the nine months ended September 30, 2007 to $868 thousand for the nine months ended September 30, 2008, as average funds borrowed from the FHLB of Boston increased from $14.8 million to $26.5 million between years, although the average rate paid on borrowed funds declined 61 basis points between periods. The increasing loan demand, the slow growth in deposits on average between the periods ended September 30, 2007 and September 30, 2008, and the opportunity to lock in some low rate long term FHLB of Boston funding before the long end of the yield curve rose led the Company to increase its reliance on borrowed funds early in 2008.

Provision for Loan Losses. There was a $185 thousand loan loss provision for the nine months ended September 30, 2008 versus a $235 thousand provision for the nine months ended September 30, 2007. Net charge-offs for the first nine months of 2008 were $123 thousand, compared to $177 thousand for the first nine months of 2007. Despite the $31 million growth in loans not held for sale since December 31, 2007 ($10.8 million of the growth was in lower risk municipal loans), and an increase in nonperforming loans of $3.6 million, the provision of $185 thousand was deemed adequate. For further details see, FINANCIAL CONDITION -"Allowance for Loan Losses" below.

Noninterest income. The following table sets forth changes from the first nine months of 2007 to the first nine months of 2008 for components of noninterest income:

	For The Nine Months Ended September 30,			
	2008	2007	$ Variance	% Variance
	(Dollars in thousands)			
Trust income	$ 287	$ 261	$ 26	10.0
Service fees	2,637	2,516	121	4.8
Net gains on sales of investment securities	16	67	(51)	(76.1)
Write-down of impaired investment securities	(512)	-	(512)	(100.0)
Net gains on sales of loans held for sale	246	98	148	151.0
Other	450	211	239	113.3
Total noninterest income	$3,124	$3,153	$ (29)	(0.9)

Trust Income. Trust income has risen for the nine months ended September 30, 2008 mainly due to a number of new trust relationships.

Service fees. The increase resulted primarily from a rise in overdraft fees of $47 thousand, or 5.1%; merchant program income increase of $32 thousand, or 9.5%; and the increase in ATM/Debit Card usage fees of $63 thousand, or 11.5%. These increases were partially offset by a decline in foreign exchange fees of

$38 thousand, or 76.3% as the price of the U.S. dollar compared to most foreign currencies is lower in 2008.

Write-down of impaired investment securities. Two corporate bonds in the available-for-sale investment portfolio were determined to be other than temporarily impaired and were written down by $512 thousand to reflect the fair value of these securities as of September 30, 2008. See FINANCIAL CONDITION - Investment Activities section below.

Net gains on sales of loans held for sale. Residential real estate loans of $17.7 million were sold for a net gain of $246 thousand during the nine months ended September 30, 2008, versus sales of $13.3 million for a net gain of $98 thousand during the nine months ended September 30, 2007.

Other. The receipt of a nontaxable death benefit of $234 thousand from a Company owned life insurance policy during the third quarter of 2008 is the main reason for the increase between years.

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Noninterest expense. The following table sets forth changes from the first nine months of 2007 to the first nine months of 2008 for components of noninterest expense:

	For The Nine Months Ended September 30,			
	2008	2007	$ Variance	% Variance
	(Dollars in thousands)			
Salaries and wages	$ 4,825	$ 4,692	$133	2.8
Pension and employee benefits	1,855	1,721	134	7.8
Occupancy expense, net	705	620	85	13.7
Equipment expense	896	821	75	9.1
Expenses of OREO and other assets owned, net	239	123	116	94.3
Equity in losses of affordable housing investments	291	199	92	46.2
Other	2,787	2,619	168	6.4
Total noninterest expense	$11,598	$10,795	$803	7.4

Salaries and wages and related expenses. The increase in 2008 over 2007 was due primarily to the addition of two new branches in July and October 2008 and regular salary activity offset partially by a reduction in several staff positions, even as the Company continued to grow. An increase in the accrual for pension plan expense of $32 thousand or 7.8% and a $90 thousand or 13.0% increase in the Company's medical costs for which the Company is self insured up to specific individual and aggregate limits were partially offset by a decrease of $11 thousand or 22.8% in the company's dental insurance costs.

Occupancy expense, net. The $85 thousand or 13.7% increase between periods is due primarily to the increase in snowplowing costs between years due to a winter season of heavy snow and ice, the increase in fuel costs despite the mild winter temperatures, the increase in depreciation and real estate taxes in 2008 as the renovation work on two administrative buildings in Morrisville was completed in 2007, a decrease in rental income, and the increase in rental expense which includes the new Danville, Vermont branch which was opened in July 2008.

Equipment Expense. The $75 thousand increase, or 9.1%, between years is

partially due to the purchase of a Microsoft Enterprise license by the Company which allows the Company to increase the number of personal computers on its network and to migrate to future software upgrades, the $23 thousand write-off during the first quarter of 2008 of the undepreciated value of the Company's merchant services equipment which are now being expensed as the value is under the Company's capitalization limit and the write-off during the second quarter of 2008 of $25 thousand for the undepreciated value of the reader/sorter and related equipment and software which are no longer used since the implementation of branch capture imaging hardware and software.

Expenses of OREO and other assets owned, net. Four properties that were held as Other Real Estate Owned were written down to their fair market value less cost to sell totaling $85 thousand. One of those properties was sold in September 2008 and two more have been sold during the fourth quarter 2008. Furniture and fixtures in one of the OREO properties originally valued as Other Assets Owned at $25 thousand were written down to $0 during the third quarter of 2008. Net carrying costs of OREO and other assets owned year to date for 2008 were $239 thousand.

Equity in losses of affordable housing investments. Two new investments in low income housing partnerships were made in late 2007 which increased the amount of equity in the losses of these projects to be recorded in 2008.

Other. The net change between years has many components; including a $28 thousand increase in training and development costs mainly related to the roll out of the new personal computers and related software as well as the new branch imaging system, a $62 thousand increase in professional fees due to the retention of a consulting firm to review director and officer compensation and benefit packages, the outsourcing of stock transfer agent responsibilities effective January 1, 2008 and an increase in audit and

accounting services mainly related to SOX 404, an increase in director's fees due to the increase of one outside director on both the Board of the Company and the Bank, and an increase in the year's expenses of foreclosures and other real estate owned which was $49 thousand during 2007 versus $120 thousand during 2008. These increases were partially offset by a decrease in legal fees paid from $114 thousand in 2007 to $62 thousand in 2008.

Income Tax Expense. The Company has provided for current and deferred federal income taxes for the current and all prior periods presented. The Company's provision for income taxes was $652 thousand for the nine months ended September 30, 2008 compared to $1.4 million for the same period in 2007, reflecting the receipt of federal rehabilitation tax credits of $195 thousand available in 2008 resulting from the completion of affordable housing investment partnership projects, the increase of $80 thousand in annual low income housing credits due to the new projects, the nontaxable death benefit of $234 thousand from one of the Company owned life insurance policies, an increase of $88 thousand in nontaxable income from municipal investment income and the decrease in taxable net income between periods. The Company's effective tax rate decreased to just 14.8% for the nine months ended September 30, 2008, from 25.5% for the same period in 2007, reflecting the federal rehabilitation tax credit, increased low income housing credits and increase in nontaxable income.

FINANCIAL CONDITION

At September 30, 2008 the Company had total consolidated assets of $423.1 million, including gross loans and loans held for sale ("total loans") of $343.4 million, deposits of $348.6 million and stockholders' equity of $41.2

million. The Company's total assets increased $29.7 million or 7.5% to $423.1 million at September 30, 2008, from $393.4 million at December 31, 2007. Net loans and loans held for sale were $339.9 million, or 80.3% of total assets at September 30, 2008, as compared to $314.8 million, or 80.0% of total assets at December 31, 2007.

Cash and cash equivalents, including federal funds sold and overnight deposits, increased $6.0 million, or 44.7%, to $19.4 million at September 30, 2008, from $13.4 million at December 31, 2007. Interest bearing deposits in banks increased $3.1 million or 26.0% from $11.9 million at December 31, 2007 to $14.9 million at September 30, 2008. These included $5 million in non FDIC insured certificates of deposit with a correspondent approved under the Company's Interbank Liability Policy all of which matured within two weeks of September 30, 2008. Investment securities available-for-sale decreased from $33.8 million at December 31, 2007, to $27.4 million at September 30, 2008, a $6.4 million, or 18.9%, decrease. The securities available-for-sale and interest bearing deposits in banks decreased from 11.6% of total assets at December 31, 2007 to 10.0% at September 30, 2008, reflecting deployment of available cash resources to fund loan demand.

Deposits increased $24.7 million, or 7.6%, to $348.6 million at September 30, 2008, from $324.0 million at December 31, 2007. Noninterest bearing deposits remained flat at $56.2 million at December 31, 2007 and September 30, 2008. Interest bearing deposits increased $24.6 million, or 9.2%, from $267.8 million at December 31, 2007, to $292.4 million at September 30, 2008. (See average balances and rates in the Yields Earned and Rates Paid tables on Page 17) Aggressive rate competition from in-market and out-of-market financial institutions makes deposit accounts harder to attract and retain. Noninterest bearing deposits are especially difficult to develop and increase. It is yet to be seen if increased FDIC insurance coverage and continuing financial and credit market volatility will make it easier to attract and retain deposits in the long run.

Total borrowings increased to $27.6 million at September 30, 2008 from $20.3 million, at December 31, 2007 as the Company took advantage of low rate FHLB of Boston advances available during the first two months of the year to support the growing loan demand at rates much lower and achievable with greater administrative ease than medium term time deposits could be gathered, as well as to specifically match fund a large new loan relationship.

Total stockholders' equity decreased $891 thousand to $41.2 million at September 30, 2008 from $42.1 at December 31, 2007, reflecting net income of $3.8 million for the first nine months of 2008, less regular cash dividends paid of $3.8 million, the purchase of Treasury stock totaling $387 thousand, and an

increase of $496 thousand in accumulated other comprehensive loss. (See Capital Resources section on Page 39.)

Loans Held for Sale and Loan Portfolios. At September 30, 2008, the Company's total loan portfolio was $343.4 million, or 81.2% of assets, up from $318.3 million, or 80.9% of assets at December 31, 2007, and up from $315.6 million or 79.4% of assets at September 30, 2007. Total loans (including loans held for sale) have increased $25.1 million since December 31, 2007. Real estate secured loans represented $292.0 million or 85.0% of total loans at September 30, 2008 and $276.5 million or $86.9% of total loans at December 31, 2007. The Company's total loans primarily consist of adjustable-rate and fixed-rate mortgage loans secured by one-to-four family, multi-family residential or commercial real estate. Average net loans (including loans held for sale) were $309.4 million

for the first nine months of 2007 and have increased to $324.1 million for the first nine months of 2008. The Company sold $17.7 million of loans held for sale during the first nine months of 2008 resulting in a gain on sale of loans of $246 thousand, compared with loan sales of $13.3 million and related gain on sale of loans of $98 thousand for the first nine months of 2007. The Company recognizes that competition for good loans is strong, however is able to originate loans to both current and new customers while maintaining credit quality. Municipal loan generation was much stronger in the annual cycle starting July of 2008 and outstanding loans to municipalities and schools at September 30, 2008 were $25.8 million compared to $15.1 million at December 31, 2007 and $16.8 million at September 30, 2007. The Company has seen a pickup in commercial loan demand during 2008 in part due to lower interest rates which has engendered some refinancing activity, loans generated from the Bank's call program and competitive changes in the Bank's marketplace. The good 2008 winter season in both northern Vermont and New Hampshire also encouraged businesses to put some money back into infrastructure and equipment, generating commercial loan activity. Consumer loan demand has remained steady but residential real estate loan refinancing has declined. Loan demand, as anticipated, has also slowed in 2008 for the construction portfolio, which is seasonal.

The following table shows information on the composition of the Company's total loan portfolio as of September 30, 2008 and December 31, 2007:

Loan Type	September 30, 2008		December 31, 2007	
	Amount	Percent	Amount	Percent
	(Dollars in thousands)			
Residential real estate	$123,271	35.9	$115,303	36.2
Construction real estate	22,679	6.6	20,190	6.4
Commercial real estate	144,222	42.0	133,320	41.9
Commercial	18,287	5.3	16,537	5.2
Consumer	7,282	2.1	7,175	2.3
Municipal loans	25,831	7.5	15,069	4.7
Term Federal Funds Sold	-	-	3,000	0.9
Loans Held for Sale	1,818	0.6	7,711	2.4
Total loans	343,390	100.0	318,305	100.0
Deduct:				
Allowance for loan losses	(3,440)		(3,378)	
Unearned net loan fees	(97)		(111)	
Net loans and loans held for sale	$339,853		$314,816	

The Company originates and sells some residential mortgages into the secondary market, with most such sales made to the Federal Home Loan Mortgage Corporation (FHLMC/"Freddie Mac") and the Vermont Housing Finance Agency (VHFA). Recently, the Company entered into a contract with the FHLB of Boston Mortgage Partnership Finance Program (MPF) to sell up to $5 million in loans. To date, the Company has sold $4 million. At September 30, 2008, the Company serviced a $216.3 million residential real estate mortgage portfolio, approximately $93.0 million of which was serviced for unaffiliated third parties. Additionally, the Company originates commercial real estate and commercial loans under various U.S. Small Business Administration, United States Department of Agriculture Rural Development Authority and Vermont Economic Development Authority programs which provide an agency guarantee for a portion of the loan amount. The Company occasionally sells the guaranteed portion of the loan to other financial concerns and will retain servicing rights, which generates fee income. The Company

serviced $5.3 million of commercial and commercial real estate loans for unaffiliated third parties as of September 30, 2008. The Company capitalizes servicing rights for both mortgage and commercial loans sold with servicing retained. The Company recognizes gains and losses on the sale of the principal portion of these loans as they occur. The unamortized balance of servicing rights on loans sold with servicing retained was $305 thousand at September 30, 2008, with an estimated market value in excess of their carrying value.

In the ordinary course of business, the Company occasionally participates out, on a non-recourse basis, a portion of commercial, municipal or real estate loans to other financial institutions for liquidity or credit concentration management purposes. The total of loans participated out as of September 30, 2008 was $13.1 million.

Asset Quality. The Company, like all financial institutions, is exposed to certain credit risks including those related to the value of the collateral that secures its loans and the ability of borrowers to repay their loans. The underlying value of real estate collateral has not seen as much of a decline in Vermont and northwestern New Hampshire as has been experienced in other parts of the country and the Company's conservative loan policies have been prudent for both the Company and its customers. Continued market volatility, rising unemployment and weakness in the general economic condition of the country, especially if a decline in discretionary consumer income adversely affects winter tourism to our market area, may have a negative affect on our customers ability to make their loan payments on a timely basis and/or underlying collateral values. Management closely monitors the Company's loan and investment portfolios, other real estate and other assets owned for potential problems and reports to the Company's and the subsidiary's Boards of Directors at regularly scheduled meetings. Policies set forth portfolio diversification levels to mitigate concentration risk.

The Company's Board of Directors has set forth lending policies (which are periodically reviewed and revised as appropriate) that include conservative individual lending limits for officers, aggregate and advisory board approval levels, Board approval for large credit relationships, a loan review program and other limits or standards deemed necessary and prudent. The Company's loan review department is supervised by an experienced former regulatory examiner and staffed by a Certified Public Accountant as well as other experienced personnel and encompasses a quality control process for loan documentation and underwriting. The Company also maintains a monitoring process to assess the credit quality and degree of risk in the loan portfolio. The Company performs periodic concentration analyses based on various factors such as industries, collateral types, large credit sizes and officer portfolio loads. The Company has established underwriting guidelines to be followed by its officers, exceptions not addressed by the underwriting guidelines are required to be approved by a senior loan officer or the Board of Directors. The Company monitors its delinquency levels for any negative or adverse trends. There can be no assurance, however, that the Company's loan portfolio will not become subject to increasing pressures from deteriorating borrower credit due to general or local economic conditions.

Restructured loans include the Company's troubled debt restructurings that involved forgiving a portion of interest or principal on any loans, refinancing loans at a rate materially less than the market rate, rescheduling loan payments, or granting other concessions to a borrower due to financial or economic reasons related to the debtor's financial difficulties. Restructured loans do not include qualifying restructured loans that have complied with the terms of their restructure agreement for a satisfactory period of time. There were no restructured loans at September 30, 2008 and $184 thousand at December

31, 2007.

Loans on which the accrual of interest has been discontinued are designated as nonaccrual loans. Management reviews the loan portfolio continuously for evidence of problem loans. Such loans are placed under close supervision with consideration given to placing the loan on nonaccrual status. Loans are designated as nonaccrual when reasonable doubt exists as to the full collection of interest and principal. Normally, when a loan is placed on nonaccrual status, all interest previously accrued but not collected is reversed against current period interest income. Income on such loans is then recognized only to the extent that cash is received and where the future collection of interest and principal is probable. Interest accruals are resumed on such loans only when they are brought fully current with respect to interest and principal and when, in the judgment of management, the loans are estimated to be fully collectible as to both principal and interest.

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The Company had loans in nonaccrual status totaling $2.6 million, or 0.77%, of gross loans at September 30, 2008, $3.3 million, or 1.06%, at December 31, 2007, and $2.3 million, or 0.74%, at September 30, 2007. Certain loans in non-accrual status are covered in part by guarantees of U.S. Government or state agencies. Approximately $144 thousand of the balances in this category were covered by such guarantees at September 30, 2008. The aggregate interest income not recognized on nonaccrual loans amounted to approximately $404 thousand and $438 thousand as of September 30, 2008 and 2007, respectively and $457 thousand as of December 31, 2007.

The Company had loans past due 90 days or more and still accruing of $4.4 million, or 1.30%, of gross loans at September 30, 2008, $2.3 million, or 0.74%, at December 31, 2007 and $1.1 million, or 0.34%, at September 30, 2007. Certain loans past due 90 days or more and still accruing interest are covered in part by guarantees of U.S. Government or state agencies. Approximately $1.5 million of the commercial and commercial real estate balances in this category were covered by such guarantees at September 30, 2008. The majority of the increase was in commercial real estate loans with one well secured relationship of $1.9 million comprising the majority of the increase. We are actively working with the borrower to bring the loan back to current status. Our practice as a community bank is, and always will be, to actively work with our troubled borrowers to resolve the borrower's delinquency while maintaining the safe and sound credit practices of the bank and safeguarding our strong capital position.

At September 30, 2008, and December 31, 2007, respectively, the Company had internally classified loans totaling $13 thousand and $21 thousand, respectively. In management's view, such loans represent a higher degree of risk and could become nonperforming loans in the future. While still on a performing status, in accordance with the Company's credit policy, loans are internally classified when a review indicates the existence of any of the following conditions makes the likelihood of collection questionable:

- the financial condition of the borrower is unsatisfactory;
- repayment terms have not been met;
- the borrower has sustained losses that are sizable, either in absolute terms or relative to net worth;
- confidence is diminished;
- loan covenants have been violated;
- collateral is inadequate; or
- other unfavorable factors are present.

The Company has been actively working with customers who may be delinquent or

headed for problems due to the downturn in the economy and the slowdown in the residential real estate market. Northern New England did not experience these issues as soon or to the extent as other parts of the country, however the effects have started to be felt. The downturn in the economy, the price of gasoline and heating fuel, and the potential for less tourist traffic are worrisome. To aid customers in reducing their energy costs, the Company has introduced, late in the second quarter of 2008, a new GreenLend(TM) Program working with Efficiency Vermont and the United States Department of Agriculture Rural Development Agency to offer low interest rate loans to consumer and commercial customers to purchase, install or upgrade energy efficient systems or vehicles or renewable energy sources.

One of the benefits of being a community financial institution is our employees' and Boards' knowledge of the community and borrowers which allows us to be proactive in working closely with our loan customers. The Company's delinquency rates have historically run higher than similar institutions while losses have been lower. The Company did not target sub-prime borrowers.

On occasion real estate properties are acquired through or in lieu of loan foreclosure. These properties are to be sold and are initially recorded at the lesser of the recorded loan or fair value less estimated selling costs at the date of the Company's acquisition of the property, with fair value based on an appraisal for more significant properties and on management's estimate for minor properties. The Company evaluates each property on at least a quarterly basis for changes in the fair value of the property. The Company had four residential real estate properties totaling $293 thousand and three commercial real estate properties totaling $1.1 million classified as OREO at September 30, 2008, compared to a total of two properties composed of $10 thousand of residential real estate and $216 thousand of commercial real estate property at December 31, 2007. There was an allowance for losses

on OREO of $77 thousand at September 30, 2008 and $25 thousand at December 31, 2007 which have been netted out of the values above. The OREO was included in Other Assets on the Consolidated Balance Sheet at both time periods.

One of the residential and one of the commercial properties, held at September 30, 2008, were sold in October 2008. The Company has scheduled auctions for the other OREO properties over the next few months. Due to an apparent softening in the real estate market the potential to recover all principal and related costs for the auctions is uncertain.

Allowance for Loan Losses. Some of the Company's loan customers ultimately do not make all of their contractually scheduled payments, requiring the Company to charge off a portion or all of the remaining principal balance due. The Company maintains an allowance for loan losses to absorb such losses. The allowance is maintained at a level which, by management's best estimate, is adequate to absorb probable credit losses inherent in the loan portfolio; however, actual loan losses may vary from current estimates.

Adequacy of the allowance for loan losses is determined using a consistent, systematic methodology, which analyzes the risk inherent in the loan portfolio. In addition to evaluating the collectibility of specific loans when determining the adequacy of the allowance, management also takes into consideration other factors such as changes in the mix and size of the loan portfolio, historic loss experience, the amount of delinquencies and loans adversely classified, industry trends, and the impact of the local and regional economy on the Company's borrowers. The adequacy of the allowance for loan losses is assessed by an allocation process whereby specific loss allocations are made against certain adversely classified loans and general loss allocations are made

against segments of the loan portfolio which have similar attributes. While the Company allocates the allowance for loan losses based on a percentage by category to total loans, the portion of the allowance for loan losses allocated to each category does not represent the total available for future losses which may occur within the loan category since the total allowance for possible loan losses is a valuation reserve applicable to the entire portfolio.

The allowance for loan losses is increased by a provision for loan losses, which is charged to earnings, and reduced by charge-offs, net of recoveries. The provision for loan losses represents the current period credit cost associated with maintaining an appropriate allowance for loan losses. Based on an evaluation of the loan portfolio, management presents a quarterly analysis of the allowance for loan losses to the Board of Directors, indicating any changes since the last review and any recommendations as to adjustments in the allowance. Additionally, bank regulatory agencies regularly review the Company's allowance for loan losses as an integral part of their examination process.

For the quarter ended September 30, 2008, the methodology used to determine the provision for loan losses was unchanged from the prior quarter or year except that loans totaling $3.7 million secured by deposit accounts have been broken out separately and a lower risk factor assigned. The Company's loan portfolio balance not held for sale increased $31 million from $310.6 million at December 31, 2007 to $341.6 million at September 30, 2008 mainly due to $8.0 million, or 6.9%, growth in residential real estate loans, $10.9 million, or 8.2%, growth in commercial real estate loans and $10.8 million, or 71.4%, growth in municipal loans. All other types of loans also grew between periods with the exception of the maturity of $3.0 million in Term Federal Funds sold; see chart on page 27 for further details.

As a result of the combined changes in volumes among various loan categories and the net charge-offs for the third quarter of $29 thousand, the Company designated a $45 thousand loan loss provision for the quarter ended September 30, 2008, which left the allowance for loan losses at $3.44 million at September 30, 2008, up $62 thousand from December 31, 2007. The $39 thousand in charge-offs for the quarter included $7 thousand due to credit card fraud, and nine small consumer loan chargeoffs. There were no material changes in the lending programs or terms during the quarter.

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The following table reflects activity in the allowance for loan losses for the three and nine months ended September 30, 2008 and 2007:

	Three Months Ended, September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
	(Dollars in thousands)			
Balance at beginning of period	$3,424	$3,326	$3,378	$3,338
Charge-offs				
Real Estate	-	69	50	99
Commercial	-	48	39	48
Consumer and other	39	9	74	63
Total charge-offs	39	126	163	210
Recoveries				
Real Estate	-	1	2	9
Commercial	1	-	5	2

Consumer and other	9	5	33	22
Total recoveries	10	6	40	33
Net charge-offs	(29)	(120)	(123)	(177)
Provision for loan losses	45	190	185	235
Balance at end of period	$3,440	$3,396	$3,440	$3,396

The following table (net of loans held for sale) shows the internal breakdown of the Company's allowance for loan losses by category of loan and the percentage of loans in each category to total loans in the respective portfolios at the dates indicated:

	September 30, 2008		December 31, 2007	
	Amount	Percent	Amount	Percent
	(Dollars in thousands)			
Real Estate				
Residential	$ 762	36.1	$ 710	35.7
Commercial	1,906	42.2	2,011	42.9
Construction	227	6.6	202	6.5
Other Loans				
Commercial	423	5.4	277	5.3
Consumer installment	77	2.1	112	2.3
Municipal, Other and Unallocated	45	7.6	66	7.3
Total	$3,440	100.0	$3,378	100.0
Ratio of net charge offs to average loans not held for sale (1)		0.05%		0.07%
Ratio of allowance for loan losses to loans not held for sale		1.01%		1.09%
Ratio of allowance for loan losses to nonperforming loans (2)		48.59%		60.47%

(1) Annualized
(2) Non-performing loans include loans in non-accrual status and loans past due 90 days or more and still accruing.

Notwithstanding the categories shown in the table above, all funds in the allowance for loan losses are available to absorb loan losses in the portfolio, regardless of loan category.

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Management of the Company believes, in their best estimate, that the allowance for loan losses at September 30, 2008, is adequate to cover probable credit losses inherent in the Company's loan portfolio as of such date. However, there can be no assurance that the Company will not sustain losses in future periods, which could be greater than the size of the allowance for loan losses at September 30, 2008. See CRITICAL ACCOUNTING POLICIES. While the Company recognizes that an economic slowdown and financial and credit market turmoil

may adversely impact its borrowers' financial performance and ultimately their ability to repay their loans, management continues to be cautiously optimistic about the collectability of the Company's loan portfolio.

Investment Activities. At September 30, 2008, the reported value of investment securities available-for-sale was $27.4 million or 6.5% of assets. The amount in investment securities available-for-sale decreased from $33.8 million, or 8.6% of assets at December 31, 2007 as maturing funds were utilized to fund increased loan demand or placed into FDIC insured certificates of deposits. The Company has no investment in either Fannie Mae or Freddie Mac preferred or common stock or in their subordinated debt.

The Company had no securities classified as held-to-maturity or trading. The reported value of investment securities available-for-sale at September 30, 2008 reflects net unrealized losses of $777 thousand compared to a net unrealized loss of $1 thousand as of December 31, 2007. The offset of the unrealized losses, net of income tax effect, was a $513 thousand loss reflected in the Company's accumulated other comprehensive income (loss) component of stockholders' equity at September 30, 2008.

Information (dollars in thousands) pertaining to investment securities available-for-sale with gross unrealized losses at September 30, 2008 and December 31, 2007; aggregated by investment category and length of time that individual securities have been in a continuous loss position, follows:

September 30, 2008:	Less Than 12 Months		Over 12 Months	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss
Debt securities:				
U.S. Government sponsored enterprises	$ 1,498	$ (3)	$ -	$ -
Mortgage-backed	4,466	(34)	1,257	(44)
State and political subdivisions	4,999	(229)	-	-
Corporate	8,384	(487)	202	(48)
Total debt securities	19,347	(753)	1,459	(92)
Marketable equity securities	-	-	11	(3)
Total	$19,347	$(753)	$1,470	$ (95)

December 31, 2007:	Less Than 12 Months		Over 12 Months	
	Fair Value	Gross Unrealized Loss	Fair Value	Gross Unrealized Loss
Debt securities:				
Mortgage-backed	$ -	$ -	$6,701	$ (86)
State and political subdivisions	1,600	(15)	190	(1)
Corporate	2,926	(53)	1,875	(78)
Total debt securities	4,526	(68)	8,766	(165)
Marketable equity securities	14	(1)	-	-
Total	$4,540	$ (69)	$8,766	$(165)

The Company evaluates all investment securities on a quarterly basis, and more

frequently when economic conditions warrant additional evaluations to determine if an other-than-temporary impairment ("OTTI") exists pursuant to guidelines established in FSP 115-1, The Meaning of Other-Than-Temporary Impairment and Its Application to Certain Investments. In evaluating the possible impairment of securities, consideration is given to the length of time and the extent to which fair value has been less than amortized cost, the financial conditions and near-term prospects of the issuer, and the ability and intent of the Company to retain its investment in the issuer for a period of time sufficient to allow for any

anticipated recovery in fair value. In analyzing an issuer's financial condition, the Company may consider whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, and the results of management's review of the issuer's financial position. If management determines that an investment experienced an OTTI, the loss is recognized in the income statement as a realized loss. Any recoveries related to the value of these securities are recorded as an unrealized gain in other comprehensive income (loss) in stockholder's equity and not recognized in income until the security is ultimately sold.

Based upon an evaluation performed as of September 30, 2008, the Company recorded an impairment charge of $512 thousand related to fixed maturity bonds of American General Finance (an AIG subsidiary) and Lehman Brothers Holdings which were considered to be OTTI at September 30, 2008.

The Company has both the ability and intent to hold debt securities in an unrealized loss position until such time as the value recovers or the securities mature. Management believes that the unrealized losses on debt securities at September 30, 2008 represent temporary impairments. Also, at September 30, 2008, the Company held one marketable equity security that was also in an unrealized loss position and the Company has the ability and intent to hold this security until market recovery. Therefore, management has determined that the unrealized loss on marketable equity securities at September 30, 2008 is temporary.

Further deterioration in credit quality and/or the continuation of the current imbalances in liquidity that exist in the financial marketplace might adversely affect the fair values of the Company's investment portfolio and may increase the potential that certain unrealized losses will be designated as other than temporary in future periods and the Company would incur additional write-downs.

Deposits. The following table shows information concerning the Company's average deposits by account type and weighted average nominal rates at which interest was paid on such deposits for the periods ended September 30, 2008, and December 31, 2007:

	Nine Months Ended September 30, 2008			Year Ended December 3	
	Average Amount	Percent of Total Deposits	Average Rate	Average Amount	Percent of Total Deposits
			(Dollars in thousands)		
Non-time deposits:					
Noninterest bearing deposits	$ 51,257	15.7	-	$ 49,727	15.5
NOW accounts	53,550	16.5	0.58%	55,046	17.2

Money Market accounts	51,268	15.7	2.10%	51,470	16.0
Savings accounts	40,059	12.3	0.48%	41,377	12.9
Total non-time deposits	196,134	60.2	0.81%	197,620	61.6
Time deposits:					
Less than $100,000	81,319	25.0	3.35%	78,237	24.4
$100,000 and over	48,298	14.8	3.88%	45,138	14.0
Total time deposits	129,617	39.8	3.53%	123,375	38.4
Total deposits	$325,751	100.0	1.42%	$320,995	100.0

The Company continues to see some slight erosion of nontime interest bearing deposits, which is more than offset by growth in time deposits.

As a participant in the Certificate of Deposit Account Registry Service (CDARS) of Promontory Interfinancial Network, LLC, there were $13.1 million of time deposits $100,000 or less on the balance sheet at September 30, 2008 which are considered to be "brokered" deposits. The deposits are matched dollar for dollar with Union's customer deposits which have been placed in other financial institutions in order to provide those customers with full FDIC insurance coverage.

The following table sets forth information regarding the Company's time deposits in amounts of $100,000 and over at September 30, 2008 and December 31, 2007 that mature during the periods indicated:

	September 30, 2008	December 31, 2007
	(Dollars in thousands)	
Within 3 months	$15,333	$15,443
3 to 6 months	4,924	16,706
6 to 12 months	19,929	11,859
Over 12 months	11,453	2,135
	$51,639	$46,143

The majority of time deposits held by municipalities and school districts mature each year on June 30th which primarily explains the difference between the 3 to 6 months category and the 6 to 12 months category from December 31, 2007 to September 30, 2008. The increase in time deposits over $100,000 maturing in over one year is mainly due to one municipal customer which opened two certificates of deposit maturing during the first quarter of 2010 with balances totaling $8.2 million as of September 30, 2008.

Borrowings. Borrowings from the FHLB of Boston were $27.6 million at September 30, 2008, at a weighted average rate of 4.31%, and $20.3 million at December 31, 2007, at a weighted average rate of 4.83%. Borrowings were up at September 30, 2008 as the Company took advantage of some medium term, low-rate advances to fund increasing loan demand at lower interest rates and easier generation than time deposits could be gathered, as well as to match fund a large new loan relationship.

OTHER FINANCIAL CONSIDERATIONS

Market Risk and Asset and Liability Management. Market risk is the potential of loss in a financial instrument arising from adverse changes in market prices, interest rates, foreign currency exchange rates, commodity prices, and equity prices. The Company's market risk arises primarily from interest rate risk inherent in its lending, investing, deposit taking and borrowing activities as yields on assets change in a different time period or in a different amount from that of interest costs on liabilities. Many other factors also affect the Company's exposure to changes in interest rates, such as general and local economic and financial conditions, competitive pressures, customer preferences, and historical pricing relationships.

The earnings of the Company and its subsidiary are affected not only by general economic conditions, but also by the monetary and fiscal policies of the United States and its agencies, particularly the Federal Reserve System. The monetary policies of the Federal Reserve System influence to a significant extent the overall growth of loans, investments, deposits and borrowings; the level of interest rates earned on assets and paid for liabilities; and including interest rates charged on loans and paid on deposits. The nature and impact of future changes in monetary policies are often not predictable.

Recent developments in the U.S. and global financial and credit markets, as well as U.S. government measures to address the situation, may also affect the Company's exposure to market risk. See "RECENT DEVELOPMENTS" at page 13.

A key element in the process of managing market risk involves direct involvement by senior management and oversight by the Board of Directors as to the level of risk assumed by the Company in its balance sheet. The Board of Directors reviews and approves all risk management policies, including risk limits and guidelines and reviews quarterly the current position in relationship to those limits and guidelines. Daily oversight functions are delegated to the Asset Liability Management Committee ("ALCO"). The ALCO, consisting of senior business and finance officers, actively measures, monitors, controls and manages the interest rate risk exposure that can significantly impact the Company's financial condition and operating results. The ALCO sets liquidity targets based on the Company's financial position and existing and projected economic and market conditions. The Company does not have any market risk sensitive instruments acquired for trading purposes. The Company attempts to structure its balance sheet to maximize net interest income and shareholder value while controlling its exposure to interest rate risk. Strategies might include selling or participating out loans held for sale or investments available-for-sale.

The ALCO formulates strategies to manage interest rate risk by evaluating the impact on earnings and capital of such factors as current interest rate forecasts and economic indicators, potential changes in such forecasts and indicators, liquidity, competitive pressures and various business strategies. The ALCO's methods for evaluating interest rate risk include an analysis of the Company's interest rate sensitivity "gap", which provides a static analysis of the maturity and repricing characteristics of the Company's entire balance sheet, and a simulation analysis, which calculates projected net interest income based on alternative balance sheet and interest rate scenarios, including "rate shock" scenarios involving immediate substantial increases or decreases in market rates of interest.

Members of ALCO meet at least weekly to set loan and deposit rates, make investment decisions, monitor liquidity and evaluate the loan demand pipeline. Deposit runoff is monitored daily and loan prepayments evaluated monthly. The Company historically has maintained a substantial portion of its loan portfolio on a variable-rate basis and plans to continue this Asset/Liability Management

(ALM) strategy in the future. Portions of the variable-rate loan portfolio have interest rate floors and caps which are taken into account by the Company's ALM modeling software to predict interest rate sensitivity, including prepayment risk. As of September 30, 2008, the investment portfolio is all classified as available-for-sale and the modified duration was relatively short and there was no investment in either Fannie Mae or Freddie Mac preferred or common stock or in their subordinated debt. The Company does not utilize any derivative products or invest in any "high risk" instruments.

The Company's interest rate sensitivity analysis (simulation) as of December 2007 for a 200 basis point declining rate environment (prime at December 31, 2007 was 7.25% and 5.00% at September 30, 2008) projected the following for the nine months ended September 30, 2008, compared to the actual results:

	September 30, 2008		
	Projected	Actual	Percentage Difference
	(Dollars in thousands)		
Net Interest Income	$12,355	$13,072	5.8%
Net Income	$ 3,217	$ 3,761	16.9%
Return on Assets	1.11%	1.25%	12.6%
Return on Equity	10.32%	12.04%	16.7%

Actual net income is higher than projected mainly due to the higher actual net interest income than projected as interest rates did not drop on January 1st as an immediate shock would imply but the prime rate dropped 75 basis points to 6.5% on January 22, 2008, another 50 basis points to 6.0% on January 30, 2008, a third drop of 75 basis points on March 18, 2008 to 5.25% and a fourth 25 basis point prime rate drop on April 30, 2008 to bring the Prime Rate down to 5.00%. Also, contributing to higher than expected net income was the gain on sale of loans projected at $109 thousand and actual gain for the nine months ending September 30, 2008 was $246 thousand. Proceeds from a Company owned life insurance policy of $234 thousand during the third quarter of 2008 was unanticipated. In addition, the federal rehabilitation tax credits received in the first six months of 2008 of $195 thousand from late 2007 investments in affordable housing partnerships had not been projected in the simulation. Partially offsetting the above mentioned increases were a write down on impaired securities available-for-sale of $512 thousand and write downs and carrying costs of foreclosures and other real estate owned of $222 thousand compared to the projected expense of $51 thousand.

Commitments, Contingent Liabilities, and Off-Balance Sheet Arrangements. The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers, to reduce its own exposure to fluctuations in interest rates, and to implement its strategic objectives. These financial instruments include commitments to extend credit, standby letters of credit, interest rate caps and floors written on adjustable-rate loans, commitments to participate in or sell loans, credit enhancements on sold loans, and commitments to buy or sell securities, certificates of deposit or other investment instruments. Such instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized on the balance sheet. The contract or notional amounts of these instruments reflect the extent of involvement the Company has in a particular class of financial instruments.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and

standby letters of credit is represented by the contractual notional amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. For interest rate caps and floors written on adjustable-rate loans, the contract or notional amounts do not represent the Company's exposure to credit loss. The Company controls the risk of interest rate cap agreements through credit approvals, limits, and monitoring procedures.

The Company generally requires collateral or other security to support financial instruments with credit risk. As of September 30, 2008 and December 31, 2007, the contract or notional amount of financial instruments that represent credit risk was as follows:

	September 30, 2008	December 31, 2007
	(Dollars in thousands)	
Commitments to originate loans	$ 9,288	$ 7,084
Unused lines of credit	37,924	35,784
Standby letters of credit	1,772	1,248
Credit card arrangements	1,648	1,633
Equity investment commitment to housing limited partnership	214	214
FHLB of Boston MPF credit enhancement obligation, net	62	-
Commitment to purchase treasury stock	43	-
Commitment to purchase interest bearing deposits	98	-
Total	$51,049	$45,963

Commitments to originate loans are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the loan commitments are expected to expire without being drawn upon and not all credit lines will be utilized, the total commitment amounts do not necessarily represent future cash requirements.

The Company's subsidiary bank is required (as are all banks) to maintain vault cash or a noninterest bearing reserve balance (interest bearing as of October 1, 2008) as established by Federal Reserve regulations. The Bank's average total reserve for the 14 day maintenance period including September 30, 2008 was $451 thousand and for December 31, 2007 was $387 thousand, both of which were satisfied by vault cash. The Company has also committed to maintain a noninterest bearing contracted clearing balance of $1.0 million at September 30, 2008 with the Federal Reserve Bank of Boston.

Interest Rate Sensitivity "Gap" Analysis. An interest rate sensitivity "gap" is defined as the difference between interest earning assets and interest bearing liabilities maturing or repricing within a given time period. A gap is considered positive when the amount of interest rate sensitive assets exceeds the amount of interest rate sensitive liabilities. A gap is considered negative when the amount of interest rate sensitive liabilities exceeds the amount of interest rate sensitive assets. During a period of rising interest rates, a negative gap would tend to adversely affect net interest income, while a positive gap would tend to result in an increase in net interest income. During a period of falling interest rates, a negative gap would tend to result in an increase in net interest income, while a positive gap would tend to affect net interest income adversely. Because different types of assets and liabilities with the same or similar maturities may react differently to changes in overall market interest rates or conditions, changes in interest rates may affect net interest income positively or negatively even if an institution were perfectly

matched in each maturity category.

The Company prepares its interest rate sensitivity "gap" analysis by scheduling interest earning assets and interest bearing liabilities into periods based upon the next date on which such assets and liabilities could mature or reprice. The amounts of assets and liabilities shown within a particular period were determined in accordance with the contractual terms of the assets and liabilities, except that:

- adjustable-rate loans, investment securities, variable-rate time deposits, and FHLB of Boston advances are included in the period when they are first scheduled to adjust and not in the period in which they mature;
- fixed-rate mortgage-related securities and loans reflect estimated prepayments, which were estimated based on analyses of broker estimates, the results of a prepayment model utilized by the Company, and empirical data;
- other nonmortgage related fixed-rate loans reflect scheduled contractual amortization, with no estimated prepayments; and
- NOW, money markets, and savings deposits, which do not have contractual maturities, reflect estimated levels of attrition, which are based on detailed studies by the Company of the sensitivity of each such category of deposit to changes in interest rates.

Management believes that these assumptions approximate actual experience and considers them reasonable. However, the interest rate sensitivity of the Company's assets and liabilities in the tables could vary substantially if different assumptions were used or actual experience differs from the historical experience on which the assumptions are based.

The following table shows the Company's rate sensitivity analysis as of September 30, 2008:

	Cumulative repriced			
	3 Months or Less	4 to 12 Months	1 to 3 Years	3 to Yea
	(Dollars in thousands, by r			
Interest sensitive assets:				
Federal funds sold and overnight deposits	$ 3,637	$ -	$ -	$
Interest bearing deposits in banks	5,594	3,460	3,633	2,
Investment securities available-for-sale (1)(3)	1,170	3,422	8,349	4,
FHLB Stock	-	-	-	
Loans and loans held for sale (2)(3)	93,571	59,453	69,877	66,
Total interest sensitive assets	$103,972	$66,335	$81,859	$ 73,
Interest sensitive liabilities:				
Time deposits	$ 43,581	$66,432	$22,788	$ 3,
Money markets	8,828	-	-	
Regular savings	3,251	-	-	
NOW accounts	17,660	-	-	
Borrowed funds	223	680	3,592	7,

Total interest sensitive liabilities	$ 73,543	$67,112	$26,380	$ 10,
Net interest rate sensitivity gap	$ 30,429	$ (777)	$55,479	$ 62,
Cumulative net interest rate sensitivity gap	$ 30,429	$29,652	$85,131	$148,
Cumulative net interest rate sensitivity gap as a percentage of total assets	7.2%	7.0%	20.1%	35
Cumulative net interest rate sensitivity gap as a percentage of total Interest sensitive assets	7.8%	7.6%	21.8%	37
Cumulative net interest rate sensitivity gap as a percentage of total Interest sensitive liabilities	9.5%	9.3%	26.6%	46

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(1) Investment securities available-for-sale exclude marketable equity securities with a fair value of $11 thousand and mutual funds with a value of $41 thousand that may be sold by the Company at any time.

(2) Balances shown net of unearned income of $97 thousand.

(3) Estimated repayment assumptions considered in Asset/Liability model.

Simulation Analysis. In its simulation analysis, the Company uses computer software to simulate the estimated impact on net interest income and capital (Net Fair Value) under various interest rate scenarios, balance sheet trends, and strategies over a relatively short time horizon. These simulations incorporate assumptions about balance sheet dynamics such as loan and deposit growth, product pricing, prepayment speeds on mortgage related assets, principal maturities on other financial instruments, and changes in funding mix. While such assumptions are inherently uncertain as actual rate changes rarely follow any given forecast and asset-liability pricing and other model inputs usually do not remain constant in their historical relationships, management believes that these assumptions are reasonable. Based on the results of these simulations, the Company is able to quantify its estimate of interest rate risk and develop and implement appropriate strategies.

The following chart reflects the cumulative results of the Company's latest simulation analysis for the next twelve months on net interest income, net income, return on assets, return on equity and net fair value ratio. Shocks are intended to capture interest rate risk under extreme conditions by immediately shifting to the new level. The projection utilizes a proportional rate shock, of up and down 300 basis points from the September 30, 2008 prime rate of 5.00%, this is the highest and lowest internal slopes monitored. This slope range was determined to be the most relevant during this economic cycle. It should be noted that given the low current prime rate and other key rates at September 30, 2008, the floor rates on various loan and deposit rates may be hit in the down 300 point environment which is handled by the simulation model. What the model can not take into account is what rates the Company will be pressured to accept on loans or pay on deposits given the competitive environment of the financial markets.

INTEREST RATE SENSITIVITY ANALYSIS MATRIX
(Dollars in thousands)

12 Months Ending	Prime Rate	Net Interest Income	Change %	Net Income	Return on Assets %	Return on Equity %

September-09	8.00%	$21,114	15.33	$6,759	1.65	16.54
	5.00%	$18,308	0.00	$4,874	1.15	11.76
	2.00%	$15,189	(17.04)	$2,777	0.58	6.11

The resulting projected cumulative effect of these estimates on net interest income and the net fair value ratio for the twelve month period ending September 30, 2009, are within approved ALCO guidelines for interest rate risks but the return on assets and equity in a down 300 basis point shock scenario are lower than Board guidelines. The simulations of earnings do not incorporate any management actions, which might moderate the negative consequences of interest rate deviations. Therefore, they do not reflect likely actual results, but serve as conservative estimates of interest rate risk under different rate scenarios.

Liquidity. Managing liquidity risk is essential to maintaining both depositor confidence and stability in earnings. Liquidity is a measurement of the Company's ability to meet potential cash requirements, including ongoing commitments to fund deposit withdrawals, repay borrowings, fund investment and lending activities, and for other general business purposes. The Company's principal sources of funds are deposits, amortization and prepayment of loans and securities, maturities of investment securities and other short-term investments, sales of securities and loans available-for-sale, earnings and funds provided from operations. Maintaining a relatively stable funding base, which is achieved by diversifying funding sources, competitively pricing deposit products, and extending the contractual maturity of liabilities, reduces the Company's exposure to rollover risk on deposits and limits reliance on volatile short-term purchased funds. Short-term funding needs arise from declines in deposits or other funding sources, funding of loan commitments, draws on unused lines of credit and requests for new loans. The Company's strategy is to fund assets, to the maximum extent possible, with core deposits that provide a

sizable source of relatively stable and low-cost funds. For the quarter ended, September 30, 2008, the Company's ratio of average loans to average deposits was 99.2% compared to the prior year of 95.5%.

In addition, as Union Bank is a member of the FHLB of Boston, it had access to unused lines of credit up to $3.7 million at September 30, 2008 over and above the $27.6 million term advances already drawn on the lines, based on FHLB of Boston estimate as of that date; with the purchase of required FHLB of Boston capital stock that amount would rise to $50.1 million. This line of credit could be used for either short or long term liquidity or other needs. In addition to its borrowing arrangements with the FHLB of Boston, Union Bank maintains a $7.5 million pre-approved Federal Funds line of credit with an upstream correspondent bank and a small repurchase agreement line with a selected brokerage house. There were no balances outstanding on either line at September 30, 2008. Union is a member of the Certificate of Deposit Account Registry Service ("CDARS") of Promontory Interfinancial Network which allows Union to provide higher FDIC deposit insurance to customers by exchanging deposits with other members and allows Union to purchase deposits from other members as another source of funding. There were no purchased deposits at either September 30, 2008 or December 31, 2007, although Union had exchanged $13.1 million and $6.6 million of deposits, respectively, with other CDARS members at those dates.

While scheduled loan and securities payments and FHLB of Boston advances are

relatively predictable sources of funds, deposit flows and prepayments on loans and mortgage-backed securities are greatly influenced by general interest rates, economic conditions, and competition. The Company's liquidity is actively managed on a daily basis, monitored by the ALCO, and reviewed periodically with the subsidiary's Board of Directors. The ALCO measures the Company's marketable assets and credit available to fund liquidity requirements and compares the adequacy of that aggregate amount against the aggregate amount of the Company's interest sensitive or volatile liabilities, such as core deposits and time deposits in excess of $100,000, borrowings and term deposits with short maturities, and credit commitments outstanding. The primary objective is to manage the Company's liquidity position and funding sources in order to ensure that it has the ability to meet its ongoing commitment to its depositors, to fund loan commitments and unused lines of credit, and to maintain a portfolio of investment securities.

The Company's management monitors current and projected cash flows and adjusts positions as necessary to maintain adequate levels of liquidity. Although approximately 81.0% of the Company's time deposits will mature within twelve months, management believes, based upon past experience, (percentage of time deposits to mature within twelve months has ranged from 72.3% to 87.8% over the preceding eight years) the relationships developed with local municipalities, and the variety of deposit products, that Union Bank will retain a substantial portion of these deposits. Management has started to see a trend for renewing customers to place their funds in longer term certificates of deposit during 2008 as rates have continued to fall and the stock market has seen unparalleled volatility. Management will continue to offer a competitive but prudent pricing strategy to facilitate retention of such deposits. The proliferation of certificate of deposit specials, the ever increasing utilization of the internet to shop for the best rate and the general economic uncertainty have contributed to the relatively slow growth of the Company's deposit base. A reduction in total deposits could be offset by purchases of federal funds, purchases of deposits, short-or-long-term FHLB borrowings, utilization of the repurchase agreement line, or liquidation of investment securities, purchased brokerage certificates of deposit or loans held for sale. Such steps could result in an increase in the Company's cost of funds or a decrease in the yield earned on assets and therefore adversely impact the net interest spread and margin. Management believes the Company has sufficient liquidity to meet all reasonable borrower, depositor, and creditor needs in the present economic environment. However, any projections of future cash needs and flows are subject to substantial uncertainty. Management continually evaluates opportunities to buy/sell securities available-for-sale and loans held for sale, obtain credit facilities from lenders, or restructure debt for strategic reasons or to further strengthen the Company's financial position.

Capital Resources. Capital management is designed to maintain an optimum level of capital in a cost-effective structure that meets target regulatory ratios; supports management's internal assessment of economic capital; funds the Company's business strategies; and builds long-term stockholder value. Dividends are generally increased in line with long-term trends in earnings per share growth and conservative earnings projections, while sufficient profits are retained to support anticipated business growth, fund strategic investments and provide continued support for deposits. However, for the three

months ended September 30, 2008, dividends per share exceeded earnings per share resulting in a dividend payout ratio of 107.7% and to 100.0% for the nine months ended September 30, 2008. The Company and its subsidiary are considered well capitalized under the capital adequacy requirements to which they are subject even with these payout ratios. The Company continues to evaluate growth opportunities both through internal growth or potential acquisitions. The

higher dividend payouts and treasury stock purchases of the last few years reflects the Board's desire to utilize our capital for the benefit of the shareholders until the right opportunities are found.

The total dollar value of the Company's stockholders' equity at September 30, 2008 was down $891 thousand from December 31, 2007 at $42.1 million, reflecting net income of $3.8 million for the first nine months of 2008, less cash dividends paid of $3.8 million, the purchase of 19,328 shares of Treasury stock totaling $387 thousand, and an increase of $496 thousand in accumulated other comprehensive loss.

Union Bankshares, Inc. has 7,500,000 shares of $2.00 par value common stock authorized. As of September 30, 2008, the Company had 4,921,786 shares issued, of which 4,483,641 were outstanding and 438,145 were held in Treasury.

The Board of Directors has authorized the repurchase of up to 100,000 shares of common stock, or approximately 2.2% of the Company's outstanding shares at the authorization date, for an aggregate repurchase cost not to exceed $2.15 million. Shares can be repurchased in the open market or in negotiated transactions. The repurchase program is open for an unspecified period of time and was reauthorized by the Board of Directors at their March 19, 2008 meeting. As of September 30, 2008 the Company had repurchased 19,328 shares under this program, for a total cost of $387 thousand during the first nine months of 2008, and 77,197 shares at a total cost of $1.6 million since the inception of the program in November 2005.

As of September 30, 2008, there were outstanding employee incentive stock options with respect to shares of the Company's common stock, granted pursuant to Union Bankshares' 1998 Incentive Stock Option Plan. As of such date, 10,000 options for 10,000 shares were currently exercisable; however none of those options were "in the money". Of the 75,000 shares authorized for issuance under the 1998 Plan, 42,200 shares that had been available for future option grants were taken out of reserve when the 1998 Plan expired in May 2008. During the third quarter of 2008, 3,500 of these options lapsed as a retired executive officer chose not to exercise the options since none were "in the money." A new plan called the 2008 Incentive Stock Option Plan of Union Bankshares, Inc. and Subsidiary was approved by the shareholders at the 2008 annual meeting. The stock to be issued upon exercise of options granted under this Plan consists of authorized but unissued shares of the common stock and/or shares held in treasury. Subject to standard anti-dilution adjustments the aggregate number of shares of common stock that may be delivered upon exercise of all options granted under the Plan may not exceed fifty thousand (50,000) shares. The Corporation will at all times reserve and keep available such number of shares of common stock as shall be sufficient to satisfy the requirements of the Plan. During the third quarter of 2008, no incentive stock options were granted or exercised pursuant to either the 2008 or the 1998 plans.

Union Bankshares, Inc. and Union Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Management believes, as of September 30, 2008, that both companies met all capital adequacy requirements to which they are subject. As of September 30, 2008, the most recent calculation categorizes Union Bank as well capitalized under the regulatory framework for prompt corrective action. The prompt corrective action capital category framework applies to FDIC insured depository institutions such as Union but does not apply directly to bank holding companies such as the Company. To be categorized as well capitalized, Union Bank must maintain minimum total risk-based, Tier I risk-based, and Tier I leverage ratios as set forth in the table below. As a bank holding company, the Company is subject to substantially similar capital adequacy requirements of the Federal Reserve Board.

There are no conditions or events between September 30, 2008 and November 7,

2008 that management believes have changed either company's category.

Union Bank's and the Company's actual capital amounts and ratios as of September 30, 2008, are presented in the following table:

	Actual		Minimums For Capital Requirements		Minim To Be Capitalize Prompt Cor Action Pro
	Amount	Ratio	Amount	Ratio	Amount
			(Dollars in thousands)		
Total capital to risk weighted assets					
Union Bank	$45,783	15.7%	$23,374	8.0%	$29,217
Company	$46,527	15.9%	$23,425	8.0%	N/A
Tier I capital to risk weighted assets					
Union Bank	$42,343	14.5%	$11,681	4.0%	$17,521
Company	$43,078	14.7%	$11,714	4.0%	N/A
Tier I capital to average assets					
Union Bank	$42,343	10.2%	$16,556	4.0%	$20,696
Company	$43,078	10.9%	$15,823	4.0%	N/A

Regulatory Matters. The Company and Union are subject to periodic examinations by the various regulatory agencies. These examinations include, but are not limited to, procedures designed to review lending practices, risk management, credit quality, liquidity, compliance and capital adequacy. During 2008, the Vermont State Department of Banking performed an examination of Union Bank pursuant to their regular, periodic regulatory reviews. No comments were received from these various bodies that would have a material adverse effect on the Company's liquidity, financial position, capital resources, or results of operations.

Item 3. Quantitative and Qualitative Disclosures About Market Risk.

Information called for by this item is incorporated by reference in Management's Discussion and Analysis of Financial Condition and Results of Operations under the caption "OTHER FINANCIAL CONSIDERATIONS" on pages 34 through 38 in this Form 10-Q.

Item 4T. Controls and Procedures.

Evaluation of Disclosure Controls and Procedures. The Company's chief executive officer and chief financial officer, with the assistance of the Disclosure Control Committee, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) as of September 30, 2008. Based on this evaluation they concluded that those disclosure controls and procedures are effective to ensure that information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by the Company in the reports that it files with the

Commission is accumulated and communicated to the Company's management, including its principal executive and principal financial officer, or persons performing similar functions, as appropriate to allow timely decisions regarding required information.

Changes in Internal Controls over Financial Reporting. There was no change in the Company's internal control over financial reporting, as defined in Rule 13a-15(f) of the Exchange Act, during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the Company's internal control over financial reporting.

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PART II OTHER INFORMATION

Item 1. Legal Proceedings.

There are no known pending legal proceedings to which the Company or its subsidiary is a party, or to which any of their properties is subject, other than ordinary litigation arising in the normal course of business activities. Although the amount of any ultimate liability with respect to such proceedings cannot be determined, in the opinion of management, any such liability would not have a material effect on the consolidated financial position or results of operations of the Company and its subsidiary.

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

ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Numbers of Shares Purchased as Part of Publicly Announced Plans or Programs (1)
July 2008	-	$ -	-
August 2008	1,481	$20.46	1,481
September 2008	3,700	$20.49	3,700

(1) Since November 18, 2005, the Company has maintained an informal stock repurchase program pu Company may repurchase up to $2.15 million or 100,000 shares of common stock, or approximat Company's outstanding shares as of the authorization date. Shares can be repurchased in the negotiated transactions. The repurchase program is open for an unspecified period of time a reauthorized by the Board of Directors at their March 19, 2008 meeting. As of September 30, repurchased 19,328 shares under this program for a total cost of $387 thousand during 2008. program, the Company has repurchased 77,197 shares at a total cost of $1.6 million.

Item 6. Exhibits.

31.1 Certification of the Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

31.2 Certification of the Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.

32.1 Certification of the Chief Executive Officer pursuant to Section

906 of the Sarbanes-Oxley Act of 2002.

32.2 Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

SIGNATURES

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

Union Bankshares, Inc.

November 7, 2008 /s/ Kenneth D. Gibbons

Kenneth D. Gibbons
Director, President and
Chief Executive Officer

November 14, 2008 /s/ Marsha A. Mongeon

Marsha A. Mongeon
Chief Financial Officer and Treasurer
(Principal Financial Officer)

EXHIBIT INDEX

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