STEWARDSHIP FINANCIAL CORP
Form 10-Q
November 13, 2008

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2008

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

For the transition period from ______ to ______

Commission file number 0-21855

Stewardship Financial Corporation
(Exact name of registrant as specified in its charter)

| New Jersey | 22-3351447 |
|---|---|
| (State or other jurisdiction of incorporation or organization) | (I.R.S. Employer Identification No.) |
| 630 Godwin Avenue, Midland Park, NJ | 07432 |
| (Address of principal executive offices) | (Zip Code) |

(201) 444-7100
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by a checkmark 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 ý No o

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

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

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

The number of shares outstanding, net of treasury stock, of the Issuer's Common Stock, no par value, as of November 5, 2008 was 5,585,659.

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Stewardship Financial Corporation

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Stewardship Financial Corporation and Subsidiary
Consolidated Statements of Financial Condition
(Unaudited)

| | September 30, 2008 | December 31, 2007 |
|---|---|---|
| Assets | | |
| | | |
| Cash and due from banks | $ 13,365,000 | $ 11,789,000 |
| Other interest-earning assets | 124,000 | 143,000 |
| Cash and cash equivalents | 13,489,000 | 11,932,000 |
| | | |
| Securities available for sale | 96,547,000 | 76,957,000 |
| Securities held to maturity; estimated fair value of $35,029,000 (2008) and $41,508,000 (2007) | 35,646,000 | 41,189,000 |
| FHLB-NY stock, at cost | 2,856,000 | 1,983,000 |
| Loans, net of allowance for loan losses of $5,930,000 (2008) and $4,457,000 (2007) | 436,963,000 | 415,690,000 |
| Mortgage loans held for sale | 895,000 | 1,284,000 |
| Premises and equipment, net | 7,520,000 | 7,950,000 |
| Accrued interest receivable | 3,241,000 | 3,112,000 |
| Intangible assets | 46,000 | 70,000 |
| Bank owned life insurance | 8,517,000 | 8,273,000 |
| Other assets | 4,417,000 | 3,465,000 |
| Total assets | $ 610,137,000 | $ 571,905,000 |
| | | |
| Liabilities and stockholders' equity | | |
| | | |
| Liabilities | | |
| Deposits: | | |
| Noninterest-bearing | $ 96,804,000 | $ 101,993,000 |
| Interest-bearing | 395,306,000 | 370,306,000 |
| Total deposits | 492,110,000 | 472,299,000 |
| | | |
| Other borrowings | 46,575,000 | 28,645,000 |
| Subordinated debentures | 7,217,000 | 7,217,000 |
| Securities sold under agreements to repurchase | 16,297,000 | 17,283,000 |
| Accrued interest payable | 1,465,000 | 2,080,000 |
| Accrued expenses and other liabilities | 4,714,000 | 3,291,000 |
| Total liabilities | 568,378,000 | 530,815,000 |
| | | |
| Commitments and contingencies | - | - |
| | | |
| Stockholders' equity | | |
| Common stock, no par value; 10,000,000 shares authorized; 5,585,659 and 5,306,828 shares issued: 5,575,268 and 5,306,828 shares outstanding at September 30, 2008 and December 31, 2007, respectively | 38,285,000 | 34,871,000 |
| Treasury stock, 10,391 shares outstanding at September 30, 2008 | (138,000) | - |

| | | |
|---|---|---|
| Retained earnings | 4,248,000 | 5,943,000 |
| Accumulated other comprehensive income (loss) | (636,000) | 276,000 |
| Total stockholders' equity | 41,759,000 | 41,090,000 |
| | | |
| Total liabilities and stockholders' equity | $ 610,137,000 | $ 571,905,000 |

See notes to unaudited consolidated financial statements.

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Stewardship Financial Corporation and Subsidiary
Consolidated Statements of Income
(Unaudited)

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| Interest income: | | | | |
| Loans | $ 7,217,000 | $ 7,004,000 | $ 21,478,000 | $ 20,289,000 |
| Securities held to maturity | | | | |
| Taxable | 170,000 | 227,000 | 560,000 | 691,000 |
| Non-taxable | 210,000 | 195,000 | 627,000 | 551,000 |
| Securities available for sale | | | | |
| Taxable | 1,194,000 | 1,031,000 | 3,301,000 | 2,868,000 |
| Non-taxable | 53,000 | 20,000 | 121,000 | 50,000 |
| FHLB dividends | 46,000 | 29,000 | 128,000 | 87,000 |
| Other interest-earning assets | 20,000 | 20,000 | 62,000 | 39,000 |
| Total interest income | 8,910,000 | 8,526,000 | 26,277,000 | 24,575,000 |
| | | | | |
| Interest expense: | | | | |
| Deposits | 2,533,000 | 3,189,000 | 8,055,000 | 8,810,000 |
| Borrowed money | 567,000 | 425,000 | 1,694,000 | 1,378,000 |
| Total interest expense | 3,100,000 | 3,614,000 | 9,749,000 | 10,188,000 |
| | | | | |
| Net interest income before provision for loan losses | 5,810,000 | 4,912,000 | 16,528,000 | 14,387,000 |
| Provision for loan losses | 1,175,000 | 90,000 | 1,535,000 | 280,000 |
| Net interest income after provision for loan losses | 4,635,000 | 4,822,000 | 14,993,000 | 14,107,000 |
| | | | | |
| Noninterest income: | | | | |
| Fees and service charges | 370,000 | 375,000 | 1,067,000 | 1,160,000 |
| Bank owned life insurance | 85,000 | 80,000 | 244,000 | 240,000 |
| Gain on sales of mortgage loans | 47,000 | 73,000 | 156,000 | 259,000 |
| Gain on calls of securities | 4,000 | - | 61,000 | - |
| Merchant processing | 340,000 | 353,000 | 1,070,000 | 1,070,000 |
| Life insurance proceeds | - | - | - | 459,000 |
| Miscellaneous | 48,000 | 34,000 | 289,000 | 229,000 |
| Total noninterest income | 894,000 | 915,000 | 2,887,000 | 3,417,000 |
| | | | | |
| Noninterest expenses: | | | | |
| Salaries and employee benefits | 1,968,000 | 1,781,000 | 6,078,000 | 5,425,000 |
| Occupancy, net | 477,000 | 406,000 | 1,354,000 | 1,122,000 |
| Equipment | 276,000 | 239,000 | 842,000 | 696,000 |
| Data processing | 300,000 | 240,000 | 897,000 | 869,000 |
| Advertising | 106,000 | 111,000 | 342,000 | 311,000 |
| FDIC insurance premium | 77,000 | 24,000 | 223,000 | 50,000 |
| Amortization of intangible assets | 8,000 | 8,000 | 24,000 | 24,000 |
| Charitable contributions | 126,000 | 178,000 | 474,000 | 546,000 |
| Stationery and supplies | 87,000 | 63,000 | 316,000 | 256,000 |

| | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Merchant processing | | 299,000 | | 315,000 | | 944,000 | | 965,000 |
| Bank-card related services | | 84,000 | | 71,000 | | 238,000 | | 240,000 |
| Miscellaneous | | 554,000 | | 437,000 | | 1,671,000 | | 1,546,000 |
| Total noninterest expenses | | 4,362,000 | | 3,873,000 | | 13,403,000 | | 12,050,000 |
| | | | | | | | | |
| Income before income tax expense | | 1,167,000 | | 1,864,000 | | 4,477,000 | | 5,474,000 |
| Income tax expense | | 329,000 | | 635,000 | | 1,399,000 | | 1,705,000 |
| Net income | | 838,000 | | 1,229,000 | | 3,078,000 | | 3,769,000 |
| | | | | | | | | |
| Basic earnings per share | $ | 0.15 | $ | 0.22 | $ | 0.55 | $ | 0.68 |
| Diluted earnings per share | $ | 0.15 | $ | 0.22 | $ | 0.55 | $ | 0.68 |
| | | | | | | | | |
| Weighted average number of common shares outstanding | | 5,573,982 | | 5,569,912 | | 5,576,987 | | 5,553,499 |
| Weighted average number of diluted common shares outstanding | | 5,583,909 | | 5,587,857 | | 5,589,608 | | 5,583,632 |

Share data has been restated to reflect a 5% stock dividend declared on September 18, 2007 and paid November 15, 2007, and a 5% stock dividend declared on September 16, 2008 and payable November 17, 2008.

See notes to unaudited consolidated financial statements.

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Stewardship Financial Corporation and Subsidiary
Consolidated Statements of Cash Flows
(Unaudited)

| | Nine Months Ended September 30, 2008 | 2007 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net income | $ 3,078,000 | $ 3,769,000 |
| Adjustments to reconcile net income to | | |
| net cash provided by operating activities: | | |
| Depreciation and amortization of premises and equipment | 696,000 | 569,000 |
| Amortization of premiums and accretion of discounts, net | 89,000 | 102,000 |
| Accretion of deferred loan fees | (216,000) | (71,000) |
| Provision for loan losses | 1,535,000 | 280,000 |
| Valuation reserve on other real estate | - | 32,000 |
| Originations of mortgage loans held for sale | (15,869,000) | (24,308,000) |
| Proceeds from sale of mortgage loans | 16,414,000 | 25,335,000 |
| Gain on sale of loans | (156,000) | (259,000) |
| Gain on calls of securities | (61,000) | - |
| Loss on sale of equipment | 12,000 | - |
| Deferred income tax benefit | (639,000) | (32,000) |
| Amortization of intangible assets | 24,000 | 24,000 |
| Nonqualified stock option expense | 36,000 | 38,000 |
| Increase in bank owned life insurance | (244,000) | (240,000) |
| Gain from bank owned life insurance proceeds | - | (459,000) |
| Increase in accrued interest receivable | (129,000) | (281,000) |
| Decrease in other assets | 259,000 | 120,000 |
| (Decrease) increase in accrued interest payable | (615,000) | 207,000 |
| Decrease in other liabilities | (465,000) | (37,000) |
| Net cash provided by operating activities | 3,749,000 | 4,789,000 |
| | | |
| Cash flows from investing activities: | | |
| Purchase of securities available for sale | (41,754,000) | (15,628,000) |
| Proceeds from maturities and principal repayments on securities available for sale | 5,973,000 | 8,815,000 |
| Proceeds from calls on securities available for sale | 16,197,000 | 300,000 |
| Purchase of securities held to maturity | (1,798,000) | (7,450,000) |
| Proceeds from maturities and principal repayments on securities held to maturity | 3,191,000 | 6,471,000 |
| Proceeds from calls on securities held to maturity | 4,520,000 | 152,000 |
| (Purchase) redemption of FHLB-NY stock | (873,000) | 294,000 |
| Net increase in loans | (22,592,000) | (26,171,000) |
| Additional investment in other real estate owned | - | (324,000) |
| Proceeds from life insurance payout | - | 1,030,000 |
| Additions to premises and equipment | (282,000) | (1,138,000) |
| Sale of equipment | 4,000 | - |
| Net cash used in investing activities | (37,414,000) | (33,649,000) |
| | | |
| Cash flows from financing activities: | | |

| | | |
|---|---|---|
| Net (decrease) increase in noninterest-bearing deposits | (5,189,000) | 4,292,000 |
| Net increase in interest-bearing deposits | 25,000,000 | 20,056,000 |
| Net (decrease) increase in securities sold under agreements to repurchase | (986,000) | 7,781,000 |
| Proceeds from term borrowings | 65,000,000 | - |
| Net decrease in short term borrowings | (10,800,000) | (6,400,000) |
| Payments on long term borrowings | (36,270,000) | (1,230,000) |
| Cash dividends paid on common stock | (1,460,000) | (1,358,000) |
| Payment of discount on dividend reinvestment plan | (34,000) | (33,000) |
| Purchase of treasury stock | (131,000) | - |
| Options exercised | 49,000 | 59,000 |
| Tax benefit of stock options | 2,000 | 2,000 |
| Issuance of common stock | 41,000 | 42,000 |
| Net cash provided by financing activities | 35,222,000 | 23,211,000 |
| | | |
| Net increase (decrease) in cash and cash equivalents | 1,557,000 | (5,649,000) |
| Cash and cash equivalents - beginning | 11,932,000 | 15,697,000 |
| Cash and cash equivalents - ending | $ 13,489,000 | $ 10,048,000 |

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Stewardship Financial Corporation and Subsidiary
Consolidated Statements of Cash Flows (continued)
(Unaudited)

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2008 | 2007 |
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the period for interest | $ 10,364,000 | $ 9,980,000 |
| Cash paid during the period for income taxes | $ 1,814,000 | $ 1,699,000 |
| Noncash investing activities - security purchases due brokers | $ 1,890,000 | $ - |
| - transfer of loan to ORE | $ - | $ 61,000 |

See notes to unaudited consolidated financial statements.

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Stewardship Financial Corporation and Subsidiary
Consolidated Statement of Changes in Stockholders' Equity
(Unaudited)

For the Period Ended September 30, 2008

| | Common Stock | | Treasury Stock | | Retained | Accumulated Other Comprehensive Gain (Loss), | |
|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | Earnings | Net | Total |
| Balance -- December 31, 2007 | 5,306,828 | $ 34,871,000 | - | $ - | $ 5,943,000 | $ 276,000 | $ 41,090,000 |
| Dividends Paid | - | - | - | - | (1,460,000) | - | (1,460,000) |
| 5% stock dividend (declared on September 16, 2008 and payable November 17, 2008) | 265,984 | 3,319,000 | (495) | (6,000) | (3,313,000) | - | - |
| Payment of discount on dividend reinvestment plan | - | (34,000) | - | - | - | - | (34,000) |
| Common stock issued under stock plans | 1,667 | 21,000 | 1,603 | 20,000 | - | - | 41,000 |
| Stock option compensation expense | - | 36,000 | - | - | - | - | 36,000 |
| Stock options exercised | 11,180 | 70,000 | (1,499) | (21,000) | - | - | 49,000 |
| Tax benefit on stock options exercised | - | 2,000 | - | - | - | - | 2,000 |
| Repurchase common stock | - | - | (10,000) | (131,000) | - | - | (131,000) |
| Comprehensive income: | | | | | | | |
| Net income | - | - | - | - | 3,078,000 | - | 3,078,000 |
| Unrealized holding losses on | | | | | | | |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| securities available for sale arising during the period (net tax benefit of $597,000) | - | - | - | - | - | (949,000) | (949,000) |
| Reclassification adjustment for gains in net income (net of taxes of $24,000) | - | - | - | - | - | 37,000 | 37,000 |
| Total comprehensive income, net of tax | | | | | | | 2,166,000 |
| Balance -- September 30, 2008 | 5,585,659 | $ 38,285,000 | (10,391) | $ (138,000) | $ 4,248,000 | $ (636,000) | $ 41,759,000 |

For the Period Ended September 30, 2007

| | Common Stock | | Treasury Stock | | | Accumulated Other Comprehensive Loss, | |
|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | Retained Earnings | Net | Total |
| Balance -- December 31, 2006 | 5,017,919 | $ 31,148,000 | - | $ - | $ 6,750,000 | $ (592,000) | $ 37,306,000 |
| Dividends Paid | - | - | - | - | (1,358,000) | - | (1,358,000) |
| 5% stock dividend (declared on September 18, 2008 and payable November 15, 2007) | 253,054 | 3,631,000 | (392) | (5,000) | (3,626,000) | - | - |
| Payment of discount on dividend reinvestment plan | - | (33,000) | - | - | - | - | (33,000) |
| Common stock issued under stock plans | 1,810 | 22,000 | 1,462 | 20,000 | - | - | 42,000 |

| | | | | | | | |
|---|---|---|---|---|---|---|---|
| Stock option compensation expense | - | 38,000 | - | - | - | - | 38,000 |
| Stock options exercised | 41,359 | 186,000 | (9,302) | (127,000) | - | - | 59,000 |
| Tax benefit on stock options exercised | - | 2,000 | - | - | - | - | 2,000 |
| Comprehensive income: | | | | | | | |
| Net income | - | - | - | - | 3,769,000 | - | 3,769,000 |
| Unrealized holding gains on securities | | | | | | | |
| available for sale arising during the | | | | | | | |
| period (net tax benefit of $249,000) | - | - | - | - | - | 255,000 | 255,000 |
| Total comprehensive income, net of tax | | | | | | | 4,024,000 |
| | | | | | | | |
| Balance -- September 30, 2007 | 5,314,142 | $ 34,994,000 | (8,232) | $ (112,000) | $ 5,535,000 | $ (337,000) | $ 40,080,000 |

See notes to unaudited consolidated financial statements.

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Stewardship Financial Corporation and Subsidiary
Notes to Consolidated Financial Statements
September 30, 2008
(Unaudited)

Note 1. Summary of Significant Accounting Policies

Certain information and footnote disclosures normally included in the unaudited consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission ("SEC"). These unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in the Annual Report on Form 10-K for the fiscal year ended December 31, 2007.

Principles of consolidation

The consolidated financial statements include the accounts of Stewardship Financial Corporation (the "Corporation") and its wholly owned subsidiary, Atlantic Stewardship Bank (the "Bank"). The Bank includes its wholly owned subsidiaries, Stewardship Investment Corp., Stewardship Realty, LLC and Atlantic Stewardship Insurance Company, LLC. All significant intercompany accounts and transactions have been eliminated in the consolidated financial statements. Certain prior period amounts have been reclassified to conform to the current presentation. The consolidated financial statements of the Corporation have been prepared in conformity with accounting principles generally accepted in the United States of America. In preparing the financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the dates of the statements of financial condition and revenues and expenses during the reporting periods. Actual results could differ significantly from those estimates.

Material Estimates

Material estimates that are particularly susceptible to significant changes relate to the determination of the allowance for loan losses. Management believes that the allowance for loan losses is adequate. While management uses available information to recognize probable incurred losses on loans, future additions to the allowance for loan losses may be necessary based on changes in economic conditions in the market area.

Basis of presentation

The interim unaudited consolidated financial statements included herein have been prepared in accordance with instructions for Form 10-Q and the rules and regulations of the SEC and, therefore, do not include information or footnotes necessary for a complete presentation of consolidated financial condition, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States of America. However, all adjustments, consisting only of normal recurring adjustments, which in the opinion of management are necessary for a fair presentation of the consolidated financial statements, have been included. The results of operations for the nine months ended September 30, 2008 are not necessarily indicative of the results which may be expected for the entire year. All share and per share amounts have been restated for stock splits and stock dividends.

Note 2. Share-based Payment Cost

The Corporation records all share-based payment cost in accordance with Statement of Financial Accounting Standards No. 123 (revised 2004), "Share-Based Payment" ("SFAS No. 123(R)").

At September 30, 2008, the Corporation had four types of stock award programs referred to as the Employee Stock Bonus Plan, the Director Stock Plan, the Employee Stock Option Plan and the Stock Option Plan for Non-Employee Directors.

The Employee Stock Bonus Plan is intended to provide incentives which will retain highly competent key management by providing them with a bonus in the form of shares of common stock of the Corporation. The Corporation did not grant shares under this plan during the nine months ended September 30, 2008 or 2007.

The Director Stock Plan permits members of the Board of Directors of the Bank to receive any monthly Board of Directors' fees in shares of the Corporation's common stock, rather than in cash. The Corporation recorded $60,000 and $53,000 for the nine months ended September 30, 2008 and 2007, respectively, and $18,000 for each of the three month periods ended September 30, 2008 and 2007 relating to this plan.

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The Employee Stock Option Plan provides for options to purchase shares of Common Stock to be issued to employees of the Corporation at the discretion of the Compensation Committee of the Board of Directors. The following table represents the stock activity for the nine months ended September 30, 2008 and 2007:

| | 2008 | | 2007 | |
|---|---|---|---|---|
| | Shares | Weighted Average Exercise Price | Shares | Weighted Average Exercise Price |
| Outstanding at beginning of year | 38,238 | $ 7.20 | 83,153 | $ 5.42 |
| Exercised | (9,425) | 4.57 | (43,283) | 3.68 |
| Forfeited | (1,531) | 11.37 | (1,454) | 9.92 |
| Outstanding at end of period | 27,282 | $ 7.88 | 38,416 | $ 7.23 |
| Options exercisable | 27,282 | | 38,416 | |
| Weighted average remaining contractual life | 2.28 years | | 2.78 years | |
| Aggregate intrinsic value | $ 109,000 | | $ 199,000 | |
| Intrinsic value of options exercisable | $ 109,000 | | $ 199,000 | |

The 2001 Stock Option Plan for Non-Employee Directors provided for options to purchase shares of common stock to be issued to Non-Employee Directors of the Corporation. In accordance with the provisions of SFAS No. 123(R), the Corporation recorded director's compensation expense for share-based payments of $36,000 and $38,000 for the nine months ended September 30, 2008 and 2007, respectively, and $12,000 for each of the three months ended September 30, 2008 and 2007. This expense relates to non-qualified stock options that were outstanding but not yet vested as of September 30, 2008 and 2007. Due to the relatively small amount of compensation expense, basic and diluted earnings per share, income from continuing operations, income before taxes, net income, cash flow from operations and cash flow from financing activities were not significantly impacted. There was approximately $125,000 and $177,000 of total unrecognized compensation costs related to nonvested stock options outstanding as of September 30, 2008 and 2007, respectively. The costs outstanding as of September 30, 2008 are expected to be recognized over the next 2.6 years.

The following table represents the stock activity for non-employee Directors for the nine months ended September 30, 2008 and 2007:

| | 2008 | | 2007 | |
|---|---|---|---|---|
| | Shares | Weighted Average Exercise Price | Shares | Weighted Average Exercise Price |
| Outstanding at beginning of year | 60,318 | $ 11.76 | 63,791 | $ 11.76 |
| Exercised | (2,314) | 12.24 | (2,315) | 11.66 |
| Outstanding at end of period | 58,004 | $ 11.76 | 61,476 | $ 11.76 |

| | | |
|---|---|---|
| Options exercisable | 24,432 | 14,889 |
| Weighted average remaining contractual life | 3.46 years | 4.48 years |
| Aggregate intrinsic value | $ 7,000 | $ 77,000 |
| Intrinsic value of options exercisable | $ - | $ 14,000 |

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Note 3. Securities Available for Sale

The fair value of the available for sale securities and the related gross unrealized gains and losses recognized in accumulated other comprehensive income were as follows:

| | September 30, 2008 | | |
|---|---|---|---|
| | Fair Value | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses |
| U.S. government-sponsored agencies | $ 51,691,000 | $ 194,000 | $ 811,000 |
| Obligations of state and political subdivisions | 5,707,000 | 3,000 | 303,000 |
| Mortgage-backed securities | 36,357,000 | 155,000 | 249,000 |
| Other securities | 2,792,000 | 1,000 | 28,000 |
| | $ 96,547,000 | $ 353,000 | $ 1,391,000 |

| | December 31, 2007 | | |
|---|---|---|---|
| | Fair Value | Gross Unrealized Holding Gains | Gross Unrealized Holding Losses |
| U.S. government-sponsored agencies | $ 35,693,000 | $ 495,000 | $ 4,000 |
| Obligations of state and political subdivisions | 2,903,000 | 2,000 | 29,000 |
| Mortgage-backed securities | 37,131,000 | 205,000 | 205,000 |
| Other securities | 1,230,000 | - | 17,000 |
| | $ 76,957,000 | $ 702,000 | $ 255,000 |

On a quarterly basis, the Corporation makes an assessment to determine whether there have been any events or economic circumstances to indicate that a security is impaired on an other-than-temporary basis. The Corporation considers many factors including the length of time the security has had a market value less than the cost basis; the intent and ability of the Corporation to hold the security for a period of time sufficient for a recovery in value; and recent events specific to the issuer or industry. Management considers the decline in market value of these securities to be temporary.

Mortgage-backed securities are comprised primarily of government agencies such as the Government National Mortgage Association ("GNMA") and government-sponsored agencies such as the Federal National Mortgage Association ("FNMA") and the Federal Home Loan Mortgage Corporation ("FHLMC").

Note 4. Securities Held to Maturity

The following is a summary of the held to maturity securities and related unrecognized gains and losses:

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| | September 30, 2008 | | | |
|---|---|---|---|---|
| | Carrying Value | Gross Unrecognized Holding Gains | Gross Unrecognized Holding Losses | Fair Value |
| U.S. Treasury securities | $ 500,000 | $ 2,000 | $ - | $ 502,000 |
| U.S. government-sponsored agencies | 6,790,000 | 31,000 | 37,000 | 6,784,000 |
| Obligations of state and political subdivisions | 23,450,000 | 39,000 | 675,000 | 22,814,000 |
| Mortgage-backed securities | 4,906,000 | 48,000 | 25,000 | 4,929,000 |
| | $ 35,646,000 | $ 120,000 | $ 737,000 | $ 35,029,000 |

| | December 31, 2007 | | | |
|---|---|---|---|---|
| | Carrying Value | Gross Unrecognized Holding Gains | Gross Unrecognized Holding Losses | Fair Value |
| U.S. Treasury securities | $ 501,000 | $ 5,000 | $ - | $ 506,000 |
| U.S. government-sponsored agencies | 12,331,000 | 135,000 | 1,000 | 12,465,000 |
| Obligations of state and political subdivisions | 22,569,000 | 204,000 | 40,000 | 22,733,000 |
| Mortgage-backed securities | 5,788,000 | 48,000 | 32,000 | 5,804,000 |
| | $ 41,189,000 | $ 392,000 | $ 73,000 | $ 41,508,000 |

On a quarterly basis, the Corporation makes an assessment to determine whether there have been any events or economic circumstances to indicate that a security is impaired on an other-than-temporary basis. The Corporation considers many factors including the length of time the security has had a market value less than the cost basis; the intent and ability of the Corporation to hold the security for a period of time sufficient for a recovery in value; and recent events specific to the issuer or industry. Management considers the decline in market value of these securities to be temporary.

Mortgage-backed securities are comprised primarily of government agencies such as GNMA and government-sponsored agencies such as FNMA and FHLMC.

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Note 5. Loans

The Corporation's primary market area for lending is the small and medium sized business and professional community, as well as the individuals residing and working in Bergen, Passaic and Morris counties, New Jersey. The following table sets forth the composition of loans as of the periods indicated.

| | | September 30, 2008 | December 31, 2007 |
|---|---|---|---|
| Mortgage | | | |
| | Residential | $ 40,624,000 | $ 44,719,000 |
| | Commercial | 230,529,000 | 209,082,000 |
| Commercial | | 96,647,000 | 89,845,000 |
| Equity | | 20,972,000 | 19,723,000 |
| Installment | | 53,996,000 | 56,796,000 |
| Other | | 543,000 | 424,000 |
| | Total loans | 443,311,000 | 420,589,000 |
| | | | |
| Less: | Deferred loan fees | 418,000 | 442,000 |
| | Allowance for loan losses | 5,930,000 | 4,457,000 |
| | | 6,348,000 | 4,899,000 |
| | | | |
| | Loans, net | $ 436,963,000 | $ 415,690,000 |

Note 6. Allowance for Loan Losses

| | Nine Months Ended September 30, | |
|---|---|---|
| | 2008 | 2007 |
| Balance, beginning of period | $ 4,457,000 | $ 4,101,000 |
| Provision charged to operations | 1,535,000 | 280,000 |
| Recoveries of loans charged off | 21,000 | 8,000 |
| Loans charged off | (83,000) | (140,000) |
| | | |
| Balance, end of period | $ 5,930,000 | $ 4,249,000 |

Note 7. Loan Impairment

The Corporation has defined the population of impaired loans to include all nonaccrual loans. The following table sets forth information regarding the impaired loans as of the periods indicated.

| | September 30, 2008 | December 31, 2007 |
|---|---|---|
| Impaired loans | | |
| With related allowance for loan losses | $ 3,468,000 | $ 222,000 |
| Without related allowance for loan losses | 3,416,000 | 233,000 |
| Total impaired loans | $ 6,884,000 | $ 455,000 |

| | | |
|---|---|---|
| Related allowance for loan losses | $ 1,262,000 | $ 39,000 |

Note 8. Fair Value

Statement of Financial Accounting Standard No. 157, “Fair Value Measurements“, establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

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Level 1: Quoted prices (unadjusted) or identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing and asset or liability.

The fair values of securities available for sale are determined by matrix pricing, which is a mathematical technique widely used to in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs).

The Company measures impairment of collateralized loans based on the estimated fair value of the collateral less estimated costs to sell, incorporating assumptions that experienced parties might use in estimating the value of such collateral (Level 3 inputs).

Assets and Liabilities Measured on a Recurring Basis

Assets and liabilities measured at fair value on a recurring basis are summarized below:

| | | Fair Value Measurements at September 30, 2008 Using | | |
|---|---|---|---|---|
| | September 30, 2008 | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Assets: | | | | |
| Available for sale securities | $ 96,547,000 | $ - | $ 96,547,000 | $ - |
| Impaired loans | $ 6,884,000 | $ - | $ - | $ 6,884,000 |

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a carrying amount of $6,884,000, with a valuation allowance of $1,262,000, resulting in an additional provision for loan losses of $1,223,000 for the nine months ended September 30, 2008.

Note 9. Recent Accounting Pronouncements

FASB Statement of Financial Accounting Standard No. 157, "Fair Value Measurements"

In September 2006, the Financial Accounting Standards Board ("FASB") issued the Statement No. 157, "Fair Value Measurements." This Statement defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. This Statement establishes a fair value hierarchy about the assumptions used to measure fair value and clarifies assumptions about risk and the effect of a restriction on the sale or use of an

asset. In February 2008, FASB issued Staff Position 157-2, "Effective Date of FASB Statement 157 ("FSP"). The FSP delays the effective date of SFAS No. 157 for all nonfinancial assets and nonfinancial liabilities, except those that are recognized or disclosed at fair value on a recurring basis (at least annually) to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years. The adoption of this statement, effective January 1, 2008, has not had a material impact on the Corporation's consolidated financial position or results of operation.

FASB Statement of Financial Accounting Standard No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities"

In February 2007, the FASB issued Statement No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities." The standard provides companies with an option to report selected financial assets and liabilities at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between companies that choose different measurement attributes for similar types of assets and liabilities. The Corporation did not elect the fair value option for any financial assets or financial liabilities as of January 1, 2008, the effective date of the standard.

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FASB Emerging Issues Task Force Issue No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements"

In September 2006, the FASB Emerging Issues Task Force finalized Issue No. 06-4, "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements". This issue requires that a liability be recorded during the service period when a split-dollar life insurance agreement continues after participants' employment or retirement. The required accrued liability will be based on either the post-employment benefit cost for the continuing life insurance or based on the future death benefit depending on the contractual terms of the underlying agreement. The adoption of this statement, effective January 1, 2008, has not had a material impact on the Corporation's consolidated financial position or results of operation.

Note 10. Earnings Per Share

Basic earnings per share is calculated by dividing net income by the average daily number of common shares outstanding during the period. Common stock equivalents are not included in the calculation. Diluted earnings per share is computed similar to that of basic earnings per share except that the denominator is increased to include the number of additional common shares that would have been outstanding if all potential dilutive common shares were issued.

The following is a reconciliation of the calculation of basic and diluted earnings per share.

| | Three Months Ended September 30, | | Nine Months Ended September 30, | |
|---|---|---|---|---|
| | 2008 | 2007 | 2008 | 2007 |
| | (in thousands, except per share data) | | | |
| Net income | $ 838 | $ 1,229 | $ 3,078 | $ 3,769 |
| Weighted average shares | 5,574 | 5,570 | 5,577 | 5,553 |
| Effect of dilutive stock options | 10 | 18 | 13 | 31 |
| Total weighted average dilutive shares | 5,584 | 5,588 | 5,590 | 5,584 |
| Basic earnings per share | $ 0.15 | $ 0.22 | $ 0.55 | $ 0.68 |
| Diluted earnings per share | $ 0.15 | $ 0.22 | $ 0.55 | $ 0.68 |

Stock options to purchase 59,161 and 56,686 average shares of common stock were not considered in computing diluted earnings per share for the three months ended September 30, 2008 and 2007, respectively because they were antidilutive. Stock options to purchase 53,881 and 57,461 average shares of common stock were not considered in computing diluted earnings per share for the nine months ended September 30, 2008 and 2007, respectively because they were antidilutive.

All share and per share amounts have been restated to reflect a 5% stock dividend declared on September 18, 2007 and paid November 15, 2007, and a 5% stock dividend declared on September 16, 2008 and payable November 17, 2008.

Note 11. Comprehensive Income

Total comprehensive income includes net income and other comprehensive income which is comprised of unrealized holding gains and losses on securities available for sale, net of taxes. The Corporation's total comprehensive income for the three and nine months ended September 30, 2008 was $575,000 and $2.2 million, respectively. For the three and nine months ended September 30, 2007, total comprehensive income was $1.9 million and $4.0 million, respectively. The difference between the Corporation's net income and total comprehensive income for these periods relates to the change in the net unrealized holding gains and losses on securities available for sale during the applicable period of time.

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Stewardship Financial Corporation
Management's Discussion and Analysis of
Financial Condition and Results of Operations

This Form 10-Q contains certain "forward looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, and may be identified by the use of such words as "believe," "expect," "anticipate," "should," "planne "estimated," and "potential." Examples of forward looking statements include, but are not limited to, estimates with respect to the financial condition, results of operations and business of the Corporation that are subject to various factors which could cause actual results to differ materially from these estimates. These factors include: changes in general, economic, and market conditions, legislative and regulatory conditions, or the development of an interest rate environment that adversely affects the Corporation's interest rate spread or other income anticipated from operations and investments. As used in this Form 10-Q, "we" and "us" and "our" refer to Stewardship Financial Corporation and its consolidated subsidiary, Atlantic Stewardship Bank, depending on the context.

Critical Accounting Policies and Estimates

"Management's Discussion and Analysis of Financial Condition and Results of Operations," as well as disclosures found elsewhere in this Form 10-Q, are based upon the Corporation's consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America. The preparation of these financial statements requires the Corporation to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses. Note 1 to the Corporation's Audited Consolidated Financial Statements for the year ended December 31, 2007 included in our Annual Report on Form 10-K for the year ended December 31, 2007, as supplemented by this report, contains a summary of the Corporation's significant accounting policies. Management also believes the Corporation's policy with respect to the methodology for the determination of the allowance for loan losses involves a higher degree of complexity and requires management to make difficult and subjective judgments which often require assumptions or estimates about highly uncertain matters. Changes in these judgments, assumptions or estimates could materially impact results of operations. The Audit Committee and the Board of Directors periodically review this critical policy and its application.

The allowance for loan losses is based upon management's evaluation of the adequacy of the allowance, including an assessment of known and inherent risks in the portfolio, giving consideration to the size and composition of the loan portfolio, actual loan loss experience, level of delinquencies, detailed analysis of individual loans for which full collectability may not be assured, the existence and estimated net realizable value of any underlying collateral and guarantees securing the loans, and current economic and market conditions. Although management uses the best information available, the level of the allowance for loan losses remains an estimate that is subject to significant judgment and short-term change. Various regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses. Such agencies may require the Corporation to make additional provisions for loan losses based upon information available to them at the time of their examination. Furthermore, the majority of the Corporation's loans are secured by real estate in the State of New Jersey. Accordingly, the collectability of a substantial portion of the carrying value of the Corporation's loan portfolio is susceptible to changes in local market conditions and may be adversely affected should real estate values decline or the northern New Jersey area experience a deteriorating economic environment. Future adjustments to the allowance for loan losses may be necessary due to economic, operating, regulatory and other conditions beyond the Corporation's control.

Financial Condition

Total assets increased by $38.2 million, or 6.7%, from $571.9 million at December 31, 2007 to $610.1 million at September 30, 2008. Net loans increased $21.3 million, or 5.1%, to $437.0 million, with the growth in the loan portfolio seen in commercial mortgages and commercial loans. Securities available for sale increased $19.6 million and securities held to maturity decreased $5.5 million.

Deposits totaled $492.1 million at September 30, 2008, an increase of $19.8 million, or 4.2%, from $472.3 million at December 31, 2007. Noninterest-bearing deposits decreased $5.2 million, or 5.1%, to $96.8 million at September 30, 2008 and interest-bearing deposits increased $25.0 million, or 6.8%, to $395.3 million at September 30, 2008. The Corporation continues to experience strong competition in attracting deposits. Although short-term rates declined in early 2008 and again recently, the deposit market has historically been slow to react in adjusting rates downward. The Corporation utilized its borrowing capabilities with the Federal Home Loan Bank to lower borrowing costs during the first quarter of the year. The Corporation continues to see positive trends in core deposits with its new branches opened during 2007. The Corporation successfully delivered its E-Statement services to online banking customers during the second quarter of 2008 and has developed a new tiered interest-bearing checking account with online banking and E-Statement

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functionality. A new commercial cash management product is currently in testing with rollout to customers anticipated in early 2009. These products and services will allow us to continue to attract new personal and business core deposits.

Results of Operations

General

The Corporation reported net income of $838,000, or $0.15 diluted earnings per share for the three months ended September 30, 2008, compared to $1.2 million, or $0.22 diluted earnings per share for the comparable prior year period. For the nine months ended September 30, 2008, net income was $3.1 million, or $0.55 diluted earnings per share. These results compare to net income of $3.8 million, or $0.68 diluted earnings per share for the nine months ended September 30, 2007. Results for the current year periods include an increased provision for loan losses. Net income for the nine months ended September 30, 2007 included $459,000 of a death benefit payment on an officer of the Corporation.

Net Interest Income

Net interest income for the three and nine months ended September 30, 2008 was $5.8 million and $16.5 million, respectively, compared to $4.9 million and $14.4 million recorded in the prior year periods. The increases in the current year periods are primarily due to an increase in the net yield on interest earning assets. The net interest rate spread and net yield on interest earning assets for the three months ended September 30, 2008 were 3.53% and 4.04%, respectively, an increase from 3.11% and 3.89% for the three months ended September 30, 2007. For the nine months ended September 30, 2008, the net interest rate spread and net yield on interest earning assets were 3.40% and 3.98%, respectively, an increase from 3.18% and 3.95% for the nine months ended September 30, 2007. The increase in the net yield on interest earning assets during the current year periods has been the result of a period where the interest rates on deposits and borrowings have declined at a faster pace than loan interest rates.

The following tables reflect the components of the Corporation's net interest income for the three and nine months ended September 30, 2008 and 2007 including, (1) average assets, liabilities, and stockholders' equity, (2) interest income earned on interest-earning assets and interest expense paid on interest-bearing liabilities, (3) average yields earned on interest-earning assets and average rates paid on interest-bearing liabilities, and (4) net yield on interest-earning assets. Nontaxable income from investment securities and loans is presented on a tax-equivalent basis assuming a statutory tax rate of 34%. This was accomplished by adjusting non-taxable income upward to make it equivalent to the level of taxable income required to earn the same amount after taxes.

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Analysis of Net Interest Income (Unaudited)
For the Three Months Ended September 30,

| | 2008 | | | 2007 | | |
|---|---|---|---|---|---|---|
| | Average Balance | Interest Income/ Expense | Average Rates Earned/ Paid | Average Balance | Interest Income/ Expense | Average Rates Earned/ Paid |
| | (Dollars in thousands) | | | | | |
| Assets | | | | | | |
| Interest-earning assets: | | | | | | |
| Loans (1) (2) | $ 447,028 | $ 7,229 | 6.43% | $ 388,936 | $ 7,003 | 7.14% |
| Taxable investment securities (1) | 106,452 | 1,411 | 5.27 | 96,633 | 1,288 | 5.29 |
| Tax-exempt investment securities (1) (2) | 28,737 | 383 | 5.33 | 24,085 | 313 | 5.20 |
| Other interest-earning assets | 2,998 | 20 | 2.65 | 1,242 | 19 | 6.07 |
| Total interest-earning assets | 585,215 | $ 9,043 | 6.15 | 510,896 | $ 8,623 | 6.70 |
| Non-interest-earning assets: | | | | | | |
| Allowance for loan losses | (4,832) | | | (4,217) | | |
| Other assets | 34,959 | | | 33,564 | | |
| Total assets | $ 615,342 | | | $ 540,243 | | |
| Liabilities and Stockholders' Equity | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing demand deposits | $ 169,545 | $ 636 | 1.49% | $ 140,991 | $ 973 | 2.74% |
| Savings deposits | 38,158 | 57 | 0.59 | 36,816 | 71 | 0.77 |
| Time deposits | 187,083 | 1,841 | 3.91 | 186,397 | 2,144 | 4.56 |
| Repurchase agreements | 16,241 | 135 | 3.31 | 11,855 | 127 | 4.25 |
| FHLB borrowing | 52,590 | 314 | 2.38 | 16,802 | 176 | 4.16 |
| Subordinated debenture | 7,217 | 117 | 6.45 | 7,217 | 122 | 6.71 |
| Total interest-bearing liabilities | 470,834 | $ 3,100 | 2.62 | 400,078 | $ 3,613 | 3.58 |
| Non-interest-bearing liabilities: | | | | | | |
| Demand deposits | 98,358 | | | 96,431 | | |
| Other liabilities | 4,147 | | | 4,444 | | |
| Stockholders' equity | 42,003 | | | 39,290 | | |
| Total liabilities and stockholders' equity | $ 615,342 | | | $ 540,243 | | |
| Net interest income (taxable equivalent basis) | | $ 5,943 | | | $ 5,010 | |

| | | | | |
|---|---|---|---|---|
| Tax Equivalent adjustment | (133) | | (97) | |
| Net interest income | $ 5,810 | | $ 4,913 | |
| | | | | |
| Net interest spread (taxable equivalent basis) | | 3.53% | | 3.11% |
| | | | | |
| Net yield on interest-earning assets (taxable equivalent basis) (3) | | 4.04% | | 3.89% |

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(1) For purpose of these calculations, nonaccruing loans are included in the average balance. Fees are included in loan interest. Loans and total interest-earning assets are net of unearned income. Securities are included at amortized cost.

(2) The tax equivalent adjustments are based on a marginal tax rate of 34%.

(3) Net interest income (taxable equivalent basis) divided by average interest-earning assets.

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Analysis of Net Interest Income (Unaudited)
For the Nine Months Ended September 30,

| | 2008 | | | 2007 | | |
|---|---|---|---|---|---|---|
| | Average Balance | Interest Income/ Expense | Average Rates Earned/ Paid | Average Balance | Interest Income/ Expense | Average Rates Earned/ Paid |
| | (Dollars in thousands) | | | | | |
| **Assets** | | | | | | |
| Interest-earning assets: | | | | | | |
| Loans (1) (2) | $ 435,554 | $ 21,513 | 6.60% | $ 379,189 | $ 20,289 | 7.15% |
| Taxable investment securities (1) | 101,304 | 3,990 | 5.26 | 93,092 | 3,646 | 5.24 |
| Tax-exempt investment securities (1) (2) | 27,353 | 1,091 | 5.32 | 22,880 | 872 | 5.08 |
| Other interest-earning assets | 3,307 | 62 | 2.50 | 744 | 39 | 7.01 |
| Total interest-earning assets | 567,518 | $ 26,656 | 6.27 | 495,905 | $ 24,846 | 6.70 |
| Non-interest-earning assets: | | | | | | |
| Allowance for loan losses | (4,649) | | | (4,147) | | |
| Other assets | 34,397 | | | 33,395 | | |
| Total assets | $ 597,266 | | | $ 525,153 | | |
| **Liabilities and Stockholders' Equity** | | | | | | |
| Interest-bearing liabilities: | | | | | | |
| Interest-bearing demand deposits | $ 163,435 | $ 2,102 | 1.72% | $ 127,765 | $ 2,353 | 2.46% |
| Savings deposits | 38,394 | 180 | 0.63 | 37,363 | 211 | 0.76 |
| Time deposits | 181,398 | 5,773 | 4.25 | 183,801 | 6,246 | 4.54 |
| Repurchase agreements | 16,391 | 414 | 3.37 | 10,534 | 351 | 4.45 |
| FHLB borrowing | 46,217 | 917 | 2.65 | 20,281 | 662 | 4.36 |
| Subordinated debenture | 7,217 | 363 | 6.72 | 7,217 | 365 | 6.76 |
| Total interest-bearing liabilities | 453,052 | $ 9,749 | 2.87 | 386,961 | $ 10,188 | 3.52 |
| Non-interest-bearing liabilities: | | | | | | |
| Demand deposits | 97,704 | | | 95,602 | | |
| Other liabilities | 4,600 | | | 4,014 | | |
| Stockholders' equity | 41,910 | | | 38,576 | | |
| Total liabilities and stockholders' equity | $ 597,266 | | | $ 525,153 | | |
| Net interest income (taxable equivalent basis) | | $ 16,907 | | | $ 14,658 | |
| Tax Equivalent adjustment | | (379) | | | (271) | |
| Net interest income | | $ 16,528 | | | $ 14,387 | |

| | | |
|---|---|---|
| Net interest spread (taxable equivalent basis) | 3.40% | 3.18% |
| Net yield on interest-earning assets (taxable equivalent basis) (3) | 3.98% | 3.95% |

(1) For purpose of these calculations, nonaccruing loans are included in the average balance. Fees are included in loan interest. Loans and total interest-earning assets are net of unearned income. Securities are included at amortized cost.

(2) The tax equivalent adjustments are based on a marginal tax rate of 34%.

(3) Net interest income (taxable equivalent basis) divided by average interest-earning assets.

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For the three months ended September 30, 2008, total interest income on a tax equivalent basis increased $420,000, or 4.9%, when compared to the three months ended September 30, 2007 primarily due to an increase in the average earning assets, partially offset by a decrease in the total yield on interest-earning assets. Total interest income on a tax equivalent basis increased $1.8 million for the nine months ended September 30, 2008, or 7.3%, compared to the same period for 2007. Consistent with the interest income increase for the current three month period, the increase in the current nine month period is due to an increase in the average earning assets, partially offset by a decrease in the overall yield on interest-earning assets. Average interest-earning assets increased $74.3 million and $71.6 million for the three and nine months ended September 30, 2008, respectively, when compared to the prior year periods. The increases are attributable to strong loan demand, an increase in taxable and tax-exempt investment securities and an increase in short-term interest earning assets. Average loans increased $58.1 million to an average of $447.0 million for the three months ended September 30, 2008, from an average of $388.9 million for the comparable period in 2007. For the nine months ended September 30, 2008, average loans were $435.6 million, a $56.4 million increase from the average loans of $379.2 million for the nine months ended September 30, 2007. Taxable investment securities of $106.5 million and $101.3 million for the three and nine months ended September 30, 2008, respectively, represent increases of $9.8 million and $8.2 million when compared to the same prior year periods. Tax-exempt securities increased $4.7 million and $4.5 million for the three and nine months ended September 30, 2008 when compared to the same prior year periods. The most significant impact on yields was experienced in the loan portfolio, which experienced decreases of 71 basis points and 55 basis points when comparing the three months and nine months ended September 30, 2008, respectively, to the comparable prior year period. Through September 30, 2008, short-term interest rates, such as the federal funds and the lending prime rate, have decreased 225 basis points since the beginning of 2008. This, in turn, contributed to the decline in yields on earning assets.

Interest paid on deposits and borrowed money decreased $513,000, or 14.2%, and $439,000, or 4.3%, for the three and nine months ended September 30, 2008, compared to the same period for 2007. The decline is due to a decrease in rates paid on deposits and borrowings, partially offset by an increase in average interest-bearing liabilities. The average balance of total interest-bearing deposits and borrowings increased $70.8 million and $66.1 million for the three and nine months ended September 30, 2008, respectively, from the comparable 2007 periods. The increase in average interest-bearing liabilities was primarily a result of the Corporation’s expanding customer base and the use of the wholesale funding market. Yields on deposits and borrowed money decreased 96 basis points from 3.58% for the three month period ended September 30, 2007 to 2.62% for the comparable period in 2008. For the nine months ended September 30, 2008, the total cost for interest-bearing liabilities declined to 2.87% representing a 65 basis points decrease when compared to the same prior year period.

Net interest income for the three and nine months ended September 30, 2008 reflects the Corporation’s utilization of the wholesale market to borrow funds at significantly lower yields than available in the retail market. The lowering of short-term interest rates during the last nine months has helped the Corporation blend its borrowing and deposit funds, providing for lower costs of funds and a more stable funding base. Historically, customers have been very interest rate sensitive and were looking for high yielding interest-bearing demand deposit accounts, money market accounts and short-term time deposits. The Corporation anticipates utilizing a blend of borrowings and core deposits to meet the funding needs for the organization. New branches opened in 2007 continue to grow and help support the overall funding structure of the organization.

Provision for Loan Losses

The Corporation maintains an allowance for loan losses at a level considered by management to be adequate to cover the probable incurred losses associated with its loan portfolio, after giving consideration to changes in general market conditions, current charge-off experience, level of nonperforming loans and in the nature and volume of the Corporation’s loan activity. The allowance for loan losses is based on estimates, and provisions are charged to operations during the period in which such additions are deemed necessary.

The provision charged to operations totaled $1.2 million and $1.5 million for the three and nine months ended September 30, 2008, respectively. For the three and nine months ended September 30, 2007 the provision for loan losses was $90,000 and $280,000, respectively. Impaired loans increased from $455,000 at December 31, 2007 to $6.9 million at September 30, 2008. The allowance for loan losses related to the impaired loans increased from $39,000 at December 31, 2007 to $1.2 million at September 30, 2008. The most significant portion of the increase in the loan loss provision was related to a group of loans to one borrower. In addition, increases in the provision reflect the growth in the loan portfolio. The Corporation monitors its loan portfolio and intends to continue to provide for loan loss reserves based on its ongoing periodic review of the loan portfolio and general market conditions.

See "Asset Quality" section for summary of allowance for loan losses and nonperforming assets.

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Noninterest Income

For the three and nine months ended September 30, 2008, noninterest income was $894,000 and $2.9 million, respectively, compared to $915,000 and $3.4 million for the prior year periods. Gains on sales of mortgage loans were $47,000 and $156,000 for the three and nine months ended September 30, 2008, respectively, a decrease when compared to $73,000 and $259,000 for the three and nine months ended September 30, 2007, respectively. For the nine months ended September 30, 2008, the Corporation has experienced a decrease in mortgage activity due to the challenging real estate market. This decrease in activity resulted in a decline in the volume of loans sold and ultimately, a decline in gains on mortgages sold.

Noninterest income for the prior year included a $459,000 death benefit insurance payment received during the nine months ended September 30, 2007.

Noninterest Expense

Noninterest expenses for the three and nine months ended September 30, 2008 were $4.4 million and $13.4 million, respectively. For the comparable prior year periods, noninterest expenses were $3.9 million and $12.1 million, respectively. Expenses include increased costs associated with the Westwood and North Haledon branches which opened in the second half of 2007. In addition, FDIC insurance premiums increased $53,000 and $173,000 in the three and nine months ended September 30, 2008 when compared to the three and nine months ended September 30, 2007, respectively. FDIC premiums in 2008 reflected a full assessment of insurance, while FDIC premiums assessed in 2007 were significantly reduced by the utilization of a one-time credit issued to deposit institutions in 2007. The one-time credit received by Stewardship Financial Corporation helped reduced premiums for the first nine months of 2007.

Income Tax Expense

Income tax expense totaled $329,000 for the three months ended September 30, 2008 compared to an income tax expense of $635,000 for the three months ended September 30, 2007. Income tax expense was $1.4 million for the nine months ended September 30, 2008 compared to $1.7 million for the nine months ended September 30, 2007. The effective tax rate for the three and nine months ended September 30, 2008 was 28.2% and 31.2%, respectively, compared to 34.1% and 31.1% for the three and nine months ended September 30, 2007.

Asset Quality

The Corporation's principal earning assets are its loans to businesses and individuals located in northern New Jersey. Inherent in the lending function is the risk of deterioration in the borrowers' ability to repay their loans under their existing loan agreements. Risk elements include nonaccrual loans, past due and restructured loans, potential problem loans, loan concentrations and other real estate owned. The following table shows the composition of nonperforming assets at the end of the last four quarters:

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| | September 30, 2008 | June 30, 2008 | March 31, 2008 | December 31, 2007 |
|---|---|---|---|---|
| | (Dollars in Thousands) | | | |
| Nonaccrual loans: (1) | $ 6,884 | $ 451 | $ 360 | $ 455 |
| Loans past due 90 days or more: (2) | 268 | 840 | 703 | 26 |
| Total nonperforming loans | $ 7,152 | $ 1,291 | $ 1,063 | $ 481 |
| | | | | |
| Other real estate owned | $ - | $ - | $ - | $ - |
| | | | | |
| Total nonperforming loans | $ 7,152 | $ 1,291 | $ 1,063 | $ 481 |
| | | | | |
| Allowance for loan losses | $ 5,930 | $ 4,768 | $ 4,571 | $ 4,457 |
| | | | | |
| Nonaccrual loans to total loans | 1.55% | 0.10% | 0.08% | 0.11% |
| Nonperforming loans to total loans | 1.61% | 0.29% | 0.25% | 0.11% |
| Nonperforming loans to total assets | 1.17% | 0.21% | 0.18% | 0.08% |
| Nonperforming assets to total assets | 1.17% | 0.21% | 0.18% | 0.08% |
| Allowance for loan losses to total loans | 1.34% | 1.09% | 1.07% | 1.06% |
| Allowance for loan losses to nonperforming loans | 82.91% | 369.30% | 430.13% | 926.61% |

(1) Generally represents loans to which the payments of interest or principal are in arrears for a period of more than 90 days. Interest previously accrued on these loans and not yet paid is reversed and charged against income during the current period. Interest earned thereafter is only included in income to the extent that it is received in cash.

(2) Represents loans to which payments of interest or principal are contractually past due 90 days or more but which are currently accruing income at the contractually stated rates. A determination is made to continue accruing income on those loans which are sufficiently collateralized and on which management believes all interest and principal owed will be collected.

There were no loans at September 30, 2008, other than those included in the above table, where the Corporation was aware of any credit conditions of any borrowers that would indicate a strong possibility of the borrowers not complying with the present terms and conditions of repayment and which may result in such loans being included as non-accrual, past due or restructured at a future date.

The Corporation's lending activities are concentrated in loans secured by real estate located in northern New Jersey. Accordingly, the collectability of a substantial portion of the Corporation's loan portfolio is susceptible to changes in real estate market conditions in northern New Jersey.

Market Risk

The Corporation's primary exposure to market risk arises from changes in market interest rates ("interest rate risk"). The Corporation's profitability is largely dependent upon its ability to manage interest rate risk. Interest rate risk can be defined as the exposure of the Corporation's net interest income to adverse movements in interest rates. Although the Corporation manages other risks, such as credit and liquidity risk, in the normal course of its business, management considers interest rate risk to be its most significant market risk and it could potentially have the largest material effect

on the Corporation's financial condition. The Corporation manages its interest rate risk by utilizing an asset/liability simulation model and by measuring and managing its interest sensitivity gap. The simulation model analyzes the sensitivity of net interest income to movements in interest rates. The simulation model projects net interest income, net income, net yield on interest earning assets, and capital to asset ratios based on various interest rate scenarios over a twelve-month period. The model is based on the actual maturity and repricing characteristics of all rate sensitive assets and liabilities. Management incorporates into the model certain assumptions regarding prepayments of certain assets and liabilities. The model assumes an immediate rate shock to interest rates without management's ability to proactively change the mix of assets or liabilities. According to reports generated for the quarter ended September 30, 2008, an immediate interest rate increase of 200 basis points would have resulted in a decrease in net interest income of 12.9%, or $3.3 million, while an immediate decrease of 200 basis points would have resulted in a decrease in net interest income of 0.1%, or $19,000. Management has a goal to maintain a percentage change of no more than 17.5% given a 200 basis point change in interest rates. Management cannot provide any assurance about the actual effect of changes in interest rates on the Corporation's net interest income. Assumptions have been built into the model for prepayments for assets and decay rates for non-maturity deposits such as savings and interest bearing demand. The Asset Liability Committee reviews and discusses these measurements on a monthly basis.

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The Corporation does not have any material exposure to foreign currency exchange rate risk or commodity price risk. The Corporation did not enter into any market sensitive instruments for trading purposes nor did it engage in any hedging transactions utilizing derivative financial instruments during the nine months ended September 30, 2008.

The Corporation is, however, a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These instruments, which include commitments to extend credit and standby letters of credit, involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated statement of condition. Commitments to extend credit 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 and may require collateral from the borrower if deemed necessary by the Corporation. Standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party up to a stipulated amount and with specified terms and conditions. Commitments to extend credit and standby letters of credit are not recorded on the Corporation's consolidated balance sheet until the instrument is exercised.

Capital Adequacy

The Corporation is subject to capital adequacy guidelines promulgated by the Board of Governors of the Federal Reserve System ("FRB"). The Bank is subject to similar capital adequacy requirements imposed by the Federal Deposit Insurance Corporation. The FRB has issued regulations to define the adequacy of capital based upon the sensitivity of assets and off-balance sheet exposures to risk factors. Four categories of risk weights (0%, 20%, 50%, and 100%) were established to be applied to different types of balance sheet assets and off-balance sheet exposures. The aggregate of the risk-weighted items (risk-based assets) is the denominator of the ratio, the numerator is risk-based capital. Under the regulations, risk-based capital has been classified into two categories. Tier 1 capital includes common and qualifying perpetual preferred stockholders' equity less goodwill. Tier 2 capital includes mandatory convertible debt, allowance for loan losses, subject to certain limitations, and certain subordinated and term debt securities. Total qualifying capital consists of Tier 1 capital and Tier 2 capital; however; the amount of Tier 2 capital may not exceed the amount of Tier 1 capital. At September 30, 2008, the minimum risk-based capital requirements to be considered adequately capitalized were 4% for Tier 1 capital and 8% for total capital.

Federal banking regulators have also adopted leverage capital guidelines to supplement the risk-based measures. The leverage ratio is determined by dividing Tier 1 capital as defined under the risk-based guidelines by average total assets (non risk-adjusted) for the preceding quarter. At September 30, 2008 the minimum leverage ratio requirement to be considered well capitalized was 4%. The following table reflects the Corporation's capital ratios at September 30, 2008.

| | Required | Actual | Excess |
|---|---|---|---|
| Leverage Ratio | 4.00% | 8.02% | 4.02% |
| Risk-based Capital | | | |
| Tier 1 | 4.00% | 10.47% | 6.47% |
| Total | 8.00% | 11.72% | 3.72% |

Liquidity and Capital Resources

The Corporation's primary sources of funds are deposits, repayments of loans and mortgage-backed securities, maturities of investment securities and funds provided from operations. While scheduled loan and mortgage-backed securities amortization and maturities of investment securities are a relatively predictable source of funds, deposit

flow and prepayments on loans and mortgage-backed securities are greatly influenced by market interest rates, economic conditions and competition. The Corporation's liquidity, represented by cash and cash equivalents, is a product of its operating, investing and financing activities.

The primary source of cash from operating activities is net income. Liquidity management is both a daily and long-term function of business management. Excess liquidity is generally invested in short-term investments, such as federal funds sold. At September 30, 2008, the Corporation has outstanding loan commitments of $16.2 million and unused lines and letters of credit totaling $89.8 million. The Corporation anticipates that it will have sufficient funds available to meet its current loan commitments. Certificates of deposit scheduled to mature in one year or less, at September 30, 2008, totaled $132.6 million. Management believes that a significant portion of such deposits will remain with the Corporation. Cash and cash equivalents increased $1.6 million during the first nine months of 2008. Net financing and operating activities provided $35.2 million and $3.8 million, respectively and investing activities used $37.4 million.

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ITEM 3. Quantitative and Qualitative Disclosures about Market Risk

Not applicable to smaller reporting companies.

ITEM 4. Controls and Procedures

(a) Evaluation of internal controls and procedures

Based on their evaluation as of the end of the period covered by this Quarterly Report on Form 10-Q, our principal executive officer and principal financial officer have concluded that our internal controls and procedures (as defined in Rules 13a-14(c) and 15d-14(c) under the Securities Exchange Act of 1934 (the "Exchange Act")) are effective to ensure that information required to be disclosed by us in reports that we file or submit 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.

(b) Management's Report on Internal Control over Financial Reporting

Our management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) of the Exchange Act. Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements and can only provide reasonable assurance with respect to financial statement preparation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

We assessed the effectiveness of our internal control over financial reporting as of September 30, 2008. In making this assessment, we used the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO") in Internal Control—Integrated Framework. Based on our assessment using those criteria, our management (including our Chief Executive Officer and Principal Accounting Officer) concluded that our internal control over financial reporting was effective as of September 30, 2008.

This Quarterly Report on Form 10-Q does not include an attestation report of the Corporation's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Corporation's registered public accounting firm pursuant to temporary rules of the Securities and Exchange Commission that permit the Corporation to provide only management's report in this Quarterly Report on Form 10-Q

(c) Changes in internal controls.

There were no significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

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Stewardship Financial Corporation
Part II -- Other Information

Item 4. Submission of Matters to a Vote of Security Holders
None.

Item 6. Exhibits

(a) Exhibits
See Exhibit Index following this report.

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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.

Stewardship Financial Corporation

| | | |
|---|---|---|
| Date: November 13, 2008 | By: | /s/ Paul Van Ostenbridge<br>Paul Van Ostenbridge<br>President and Chief Executive Officer<br>(Principal Executive Officer) |
| Date: November 13, 2008 | By: | /s/ Claire M. Chadwick<br>Claire M. Chadwick<br>Senior Vice President and Chief Financial Officer<br>(Principal Financial and Accounting Officer) |

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EXHIBIT INDEX

| EXHIBIT NUMBER | DESCRIPTION |
| --- | --- |
| 31.1 | Certification of Paul Van Ostenbridge required by Rule 13a-14(a) or Rule 15d-14(a) |
| 31.2 | Certification of Claire M. Chadwick required by Rule 13a-14(a) or Rule 15d-14(a) |
| 32.1 | Certification of Paul Van Ostenbridge and Claire M. Chadwick required by Rule 13a-14(b) or Rule 15d-14(b) and Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350 |