

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

**FORM 10-K**

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

**For the Fiscal Year Ended December 31, 2008**

OR

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission File Number: 000-50810

**Monadnock Bancorp, Inc.**

(Exact Name of Registrant as specified in its Charter)

**Maryland**

(State or Other Jurisdiction of Incorporation or Organization)

**20-4649880**

(I.R.S. Employer Identification Number)

**One Jaffrey Road, Peterborough, New Hampshire**

(Address of Principal Executive Offices)

**03458**

(Zip Code)

**(603) 924-9654**

(Registrant's Telephone Number including area code)

Securities Registered Pursuant to Section 12(b) of the Act:

**None**

Securities Registered Pursuant to Section 12(g) of the Act:

**Common Stock, par value \$0.01 per share**

(Title of Class)

Indicate by check mark if the Registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES  NO

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

Indicate by check mark whether the Registrant: (1) filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act 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 requirements for the past 90 days. YES  NO

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

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 the 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 [ ] Smaller Reporting Company [X]

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES [ ] NO [X]

As of March 1, 2009, there were 1,293,608 shares issued and 1,163,958 shares outstanding of the Registrant’s Common Stock. The aggregate market value of the voting and non-voting common equity held by non-affiliates of the Registrant, computed by reference to the closing price of the Common Stock as of June 30, 2008 (\$5.90) was \$5,864,075.

#### **DOCUMENTS INCORPORATED BY REFERENCE**

1. Portions of Annual Report to Stockholders (Part II)
2. Proxy Statement for the 2009 Annual Meeting of Stockholders (Part III)

**MONADNOCK BANCORP, INC.**

**FORM 10-K**

**INDEX**

<b>PART I</b>		2
<i>ITEM 1</i>	<i>Business</i>	2
<i>ITEM 1A.</i>	<i>Risk Factors</i>	27
<i>ITEM 1B.</i>	<i>Unresolved Staff Comments</i>	27
<i>ITEM 2.</i>	<i>Properties</i>	28
<i>ITEM 3.</i>	<i>Legal Proceedings</i>	28
<i>ITEM 4.</i>	<i>Submission of Matters to a Vote of Security Holders</i>	28
<b>PART II</b>		28
<i>ITEM 5.</i>	<i>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</i>	28
<i>ITEM 6.</i>	<i>Selected Financial Data</i>	29
<i>ITEM 7.</i>	<i>Management's Discussion and Analysis of Financial Condition and Results of Operations</i>	29
<i>ITEM 7A.</i>	<i>Quantitative and Qualitative Disclosures About Market Risk</i>	29
<i>ITEM 8.</i>	<i>Financial Statements and Supplementary Data</i>	29
<i>ITEM 9.</i>	<i>Changes In and Disagreements With Accountants on Accounting and Financial Disclosure</i>	29
<i>ITEM 9A(T).</i>	<i>Controls and Procedures</i>	29
<i>ITEM 9B.</i>	<i>Other Information</i>	29
<b>PART III</b>		30
<i>ITEM 10.</i>	<i>Directors, Executive Officers and Corporate Governance</i>	30
<i>ITEM 11.</i>	<i>Executive Compensation</i>	30
<i>ITEM 12.</i>	<i>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</i>	30
<i>ITEM 13.</i>	<i>Certain Relationships and Related Transactions, and Director Independence</i>	30
<i>ITEM 14.</i>	<i>Principal Accountant Fees and Services</i>	30
<b>PART IV</b>		30
<i>ITEM 15.</i>	<i>Exhibits and Financial Statement Schedules</i>	30
SIGNATURES		32

## **PART I**

### **ITEM 1. Business**

#### **Forward Looking Statements**

This Annual Report on Form 10-K contains certain “forward-looking statements” which may be identified by the use of words such as “believe,” “expect,” “anticipate,” “should,” “planned,” “estimated” and “potential.” Examples of forward-looking statements include, but are not limited to, estimates with respect to our financial condition, results of operations and business that are subject to various factors which could cause actual results to differ materially from these estimates and most other statements that are not historical in nature. These factors include, but are not limited to, general and local economic conditions, the impact of the U.S. Government’s Economic Stimulus Program and its various financial institution rescue plans, changes in interest rates, deposit flows, demand for mortgage, and other loans, real estate values, competition, changes in accounting principles, policies, or guidelines, changes in legislation or regulation, and other economic, competitive, governmental, regulatory, and technological factors affecting our operations, pricing products and services.

#### **Monadnock Bancorp, Inc.**

Monadnock Bancorp, Inc. (or the “Company”) is a Maryland chartered stock holding company, organized in March 2006, that owns all of the outstanding shares of common stock of Monadnock Community Bank, a federal savings bank with two full-service offices. At December 31, 2008, Monadnock Bancorp, Inc. had consolidated assets of \$127.6 million, deposits of \$61.8 million and stockholders’ equity of \$10.9 million. As of December 31, 2008, Monadnock Bancorp, Inc. had 1,163,958 shares of common stock issued and outstanding.

During the fourth quarter of 2008, Monadnock Bancorp, Inc. completed a \$1.834 million Capital Purchase Program (“CPP”) transaction with the U.S. Treasury Department. The CPP is part of the U.S. Treasury’s Troubled Asset Relief Program authorized under the Emergency Economic Stabilization Act of 2008 to stabilize the U.S. financial system. The Company sold to the U.S. Treasury Department in exchange for the capital infusion: (i) 1,834 shares of the Company’s Fixed Rate Cumulative Perpetual Preferred Stock, Series A, par value \$0.01 per share (the “Series A Preferred Stock”), having a liquidation amount per share of \$1,000, for a total purchase price of \$1,834,000, and (ii) a warrant (the “Warrant”) to purchase 92.00092 shares of the Company’s Fixed Rate Cumulative Perpetual Preferred Stock, Series B, par value \$0.01 per share (the “Series B Preferred Stock”), with a liquidation amount of \$1,000 per share, at an exercise price per share of \$.01. The Warrant had a ten year term and was immediately exercisable. Immediately following the issuance of the Series A Preferred Stock and the Warrant, the U.S. Treasury Department exercised its rights under the Warrant to acquire 92 shares of the Series B Preferred Stock through a cashless exercise.

The Series A Preferred Stock pays cumulative dividends at a rate of 5% per 360 day year for the first five years and thereafter at a rate of 9% per 360 day year. As a result of the American Recovery and Reinvestment Act of 2009, the Company may redeem the Series A Preferred Stock at any time at the liquidation amount plus accrued and unpaid dividends. The Series A Preferred Stock is generally non-voting. The Series B Preferred Stock pays cumulative dividends at a rate of 9% per 360 day year. The Series B Preferred Stock generally has the same rights and privileges as the Series A Preferred Stock. The Securities Purchase Agreement with the U.S. Treasury Department provides for certain restrictions on dividend payments and stock repurchases by the Company while the securities are outstanding including: (1) the payment of dividends on its common stock without the approval of the U.S. Treasury and (2) repurchase of its common stock without approval of the U.S. Treasury during the 10-year period following its issuance (unless the securities have been transferred to a third party). We do not believe the compensation restriction imposed under the CPP will have a material effect on the Company. The CPP program will allow us to continue our growth strategy and further support individuals and businesses in our local market areas. We believe that the CPP will allow us to improve our franchise and stockholder value over the long term. See Note 2 – Preferred Stock to our 2008 Audited Consolidated Financial Statements contained in our 2008 Annual Report to Stockholders.

Monadnock Bancorp, Inc.’s executive offices are located at One Jaffrey Road, Peterborough, New Hampshire 03458. Its telephone number at this address is (603) 924-9654.

#### **Monadnock Community Bank**

Monadnock Community Bank (or the “Bank”) is a federal stock savings bank that was organized in 1971 as a Vermont chartered credit union to serve the companies that were members of the Automobile Wholesalers Association of New England and the employees of such businesses. In May 1996, the credit union converted its charter to a federal mutual savings bank and, as a result, began to serve the general public. In June 2004, we completed our mutual holding company reorganization and stock offering through the organization of Monadnock Mutual Holding Company and its majority owned subsidiary, Monadnock Community Bancorp, Inc., followed by our acquisition of a branch office located in Winchendon, Massachusetts in October 2004. On June 28, 2006, in accordance with a Plan of Conversion and Reorganization, Monadnock Community Bank became the wholly-owned subsidiary of

Monadnock Bancorp, Inc. Further, Monadnock Mutual Holding Company sold its majority ownership interest in Monadnock Community Bancorp, Inc. to the public in a “second step” offering and both companies ceased to exist. Monadnock Bancorp, Inc. sold 707,681 shares of common stock, par value of \$.01 per share, or the maximum of the offering range, to the public raising \$4.8 million in net proceeds. As part of the conversion, existing public stockholders of Monadnock Community Bancorp, Inc. received 1.3699 shares of Monadnock Bancorp, Inc. common stock in exchange for each share of their existing shares of Monadnock Community Bancorp, Inc. common stock.

Monadnock Community Bank’s executive offices are located at One Jaffrey Road, Peterborough, New Hampshire 03458. Its telephone number at this address is (603) 924-9654.

## **General**

Our principal business consists of attracting retail deposits from the general public and investing those funds primarily in permanent one- to four-family residential mortgage loans as well as home equity loans and mortgage-backed securities. We also originate commercial real estate loans and commercial business loans, and to a lesser extent, we originate multi-family residential loans, construction and land development loans and consumer loans, primarily mobile home and automobile loans. We obtain loans through our staff, as well as through advertising in various publications and through our relationship with a mortgage banking company.

Our revenues are derived principally from interest on loans and mortgage-backed and other securities. We also generate revenue from service charges, sales of loans and investments and other income.

We offer a variety of deposit accounts having a wide range of interest rates and terms, which generally include savings accounts, money market accounts, demand deposit accounts and certificate of deposit accounts with varied terms ranging from 90 days to seven years. We solicit deposits in our primary market area of western Hillsborough and eastern Cheshire Counties, New Hampshire and northern Worcester County, Massachusetts.

## **Competition**

We face strong competition in originating real estate and other loans. Competition in originating real estate loans comes primarily from mortgage bankers. We also face competition from other commercial banks with respect to commercial business loans.

We also face competition in attracting deposits. In the past, we have attracted all of our deposits through our home office. With the acquisition of a branch in Winchendon, Massachusetts in October 2004, we began attracting deposits in this area as well as through our Peterborough, New Hampshire location. Competition for our deposits are principally from savings institutions, commercial banks, brokerage firms, credit unions and mutual funds. We compete for these deposits by offering superior service and a variety of deposit accounts at competitive rates. As of December 31, 2008, we believe that we held less than 1% of the deposits in each of Hillsborough and Cheshire Counties in New Hampshire and Worcester County in Massachusetts. We also had less than a 1% share of the lending market in each of these counties.

## **Market Area**

We intend to continue to be a community oriented financial institution offering a variety of financial services to primarily meet the needs of the market areas of western Hillsborough and eastern Cheshire Counties in New Hampshire and northern Worcester County in Massachusetts. Our market area is predominately rural in nature. The employer base is varied with manufacturing, retail, educational and service companies, with the service industry being the largest. Population growth in our market area has slightly increased over the past few years, and in the past five years generally tracked the trends of the United States and the state of New Hampshire. Unemployment rates, not seasonally adjusted, in December 2008 for Hillsborough and Cheshire Counties, were 4.2% and 4.0%, respectively, compared with 7.1% and 4.3% for the United States and the state of New Hampshire, respectively. Unemployment rates, not seasonally adjusted, in December 2008 for Worcester County, Massachusetts was 6.8% compared with 6.5% for the Commonwealth of Massachusetts.

## **Lending Activities**

*General.* We originate one- to four-family residential loans and home equity loans. We also originate commercial real estate loans and commercial business loans and to a lesser extent, multi-family residential loans, construction and land development loans and consumer loans, primarily mobile home and automobile loans. At December 31, 2008, our gross loan portfolio totaled \$70.8 million. One- to four-family residential real estate mortgage loans represented \$32.1 million, or 45.3%, of our loan portfolio at December 31, 2008. Commercial real estate and commercial business loans totaled \$17.2 million and \$10.5 million, respectively, and represented 24.3% and 14.9%, respectively, of the total loan portfolio at December 31, 2008. Home equity loans totaled \$6.0 million and represented 8.4% of the total loan portfolio at December 31, 2008.

At December 31, 2008, the maximum amount which we could have loaned to any one borrower and the borrower's related entities under applicable regulations was generally \$1.6 million (which is 15% of our total regulatory capital). We also utilize credit enhancements provided by the United States Small Business Administration, the United States Department of Agriculture and other agencies which guarantee a major portion of specific loans. Our largest lending relationships at December 31, 2008 were as follows: (1) a \$1.6 million loan to fund a full service hotel of which \$1.2 million is guaranteed by the New Hampshire Business Finance Administration; (2) a \$1.3 million loan relationship to fund three five-unit townhouses as well as equipment and business assets of a road and bridge construction company; and (3) a \$1.1 million loan relationship to fund a dental office and several buildings to be used as a wellness boutique business. These loan relationships, as discussed above, are performing in accordance with their original terms and conditions as of December 31, 2008.

**Loan Portfolio Composition.** The following table presents information concerning the composition of our loan portfolio in dollar amounts and in percentages as of the dates indicated.

	<b>At December 31,</b>			
	<b>2008</b>		<b>2007</b>	
	<b>Amount</b>	<b>Percent</b>	<b>Amount</b>	<b>Percent</b>
	<b>(Dollars in Thousands)</b>			
<b>Real Estate</b>				
One- to four-family	\$32,088	45.32 %	\$31,527	49.19 %
Home equity	5,973	8.44	5,350	8.35
Commercial real estate	17,178	24.26	14,693	22.93
Multi-family	1,108	1.56	1,705	2.66
Construction and land development	570	0.81	1,141	1.78
Total real estate loans	<u>56,917</u>	<u>80.39</u>	<u>54,416</u>	<u>84.91</u>
<b>Other Loans</b>				
Commercial business	10,512	14.85	7,066	11.02
Consumer	3,373	4.76	2,607	4.07
Total other loans	<u>13,885</u>	<u>19.61</u>	<u>9,673</u>	<u>15.09</u>
Total loans	<u>70,802</u>	<u>100.00 %</u>	<u>64,089</u>	<u>100.00 %</u>
<b>Add (Deduct):</b>				
Net deferred loan origination costs (1)	313		332	
Allowance for loan losses	(413)		(390)	
Total loans, net	<u>\$70,702</u>		<u>\$64,031</u>	

(1) See Note 2 to our Financial Statements as presented in our annual report to stockholders.

**Loan Maturity and Yields.** The following table sets forth certain information at December 31, 2008 regarding the dollar amount of loans maturing in our portfolio based on their contractual terms to maturity, but does not include scheduled payments or potential prepayments. Demand loans, loans having no stated schedule of repayments and no stated maturity are reported as due in one year or less. Loan balances do not include undisbursed loan proceeds, unearned discounts, unearned income and allowance for loan losses.

	<b>Real Estate</b>									
	<b>One- to-Four Family</b>		<b>Home Equity</b>		<b>Commercial Real Estate</b>		<b>Multi-Family</b>		<b>Construction and Land Development</b>	
	<b>Weighted Average</b>		<b>Weighted Average</b>		<b>Weighted Average</b>		<b>Weighted Average</b>		<b>Weighted Average</b>	
	<b>Amount</b>	<b>Rate</b>	<b>Amount</b>	<b>Rate</b>	<b>Amount</b>	<b>Rate</b>	<b>Amount</b>	<b>Rate</b>	<b>Amount</b>	<b>Rate</b>
(Dollars in Thousands)										
Due										
Within 1 year	\$ 30	6.47 %	\$ --	-- %	\$ 997	7.70 %	\$ --	-- %	\$ --	-- %
After 1 Year through 3 Years	136	5.46	--	--	297	6.73	--	--	--	--
After 3 Years through 5 Years	1,090	5.32	--	--	1,685	8.96	--	--	42	8.50
After 5 Years through 10 Years	4,463	5.31	--	--	986	6.38	--	--	--	--
After 10 Years through 15 Years	6,086	6.07	394	4.27	2,265	6.65	344	6.40	180	6.24
Over 15 Years	20,283	6.26	5,579	3.76	10,923	6.95	764	7.45	348	6.35
<b>Total</b>	<b>\$32,088</b>	<b>6.06 %</b>	<b>\$5,973</b>	<b>3.79 %</b>	<b>\$17,153</b>	<b>7.11 %</b>	<b>\$1,108</b>	<b>7.13 %</b>	<b>\$570</b>	<b>6.47 %</b>

	<b>Commercial Business</b>		<b>Consumer</b>		<b>Total</b>	
	<b>Weighted Average</b>		<b>Weighted Average</b>		<b>Weighted Average</b>	
	<b>Amount</b>	<b>Rate</b>	<b>Amount</b>	<b>Rate</b>	<b>Amount</b>	<b>Rate</b>
(Dollars in Thousands)						
Due						
Within 1 year	\$ 1,802	5.41 %	\$ 146	5.44 %	\$ 2,975	6.19 %
After 1 Year through 3 Years	2,219	4.14	402	7.67	3,054	4.92
After 3 Years through 5 Years	1,808	7.63	513	7.67	5,138	7.59
After 5 Years through 10 Years	4,042	7.79	458	5.54	9,949	6.43
After 10 Years through 15 Years	167	8.25	823	8.29	10,259	6.35
Over 15 Years	499	7.59	1,031	7.92	39,427	6.88
<b>Total</b>	<b>\$10,537</b>	<b>6.58 %</b>	<b>\$3,373</b>	<b>7.63 %</b>	<b>\$70,802</b>	<b>6.97 %</b>

The following table sets forth the scheduled repayments of fixed- and adjustable-rate loans at December 31, 2008 that are contractually due after December 31, 2009.

	<b>Due After December 31, 2009</b>		
	<b>Fixed</b>	<b>Adjustable</b> <b>(In Thousands)</b>	<b>Total</b>
One- to four-family	\$26,672	\$ 5,386	\$32,058
Home equity	--	5,973	5,973
Commercial real estate	3,788	12,368	16,156
Multi-family	--	1,108	1,108
Construction and land development	390	180	570
Commercial business	3,447	5,288	8,735
Consumer	3,227		3,227
<b>Total loans</b>	<b>\$37,524</b>	<b>\$30,303</b>	<b>\$67,827</b>

**One- to Four-Family Residential Lending.** During 2008 and 2007, we continued to portfolio 15-year and 30-year fixed-rate mortgages as well as all adjustable-rate single family loans. Given the current interest rate environment, we have decided to originate and sell production of 30-year fixed rate mortgages beginning in 2009.

At December 31, 2008, our one- to four-family residential mortgage loans totaled \$32.1 million, or 45.3%, of our gross loan portfolio. The Bank does not originate any subprime loans or stated income loans.

One- to four-family residential loans are underwritten based on the applicant's employment and credit history and the appraised value of the subject property. Loans are generally made up to 80% of the lesser of the appraised value or the purchase price of the property. Should a loan be granted with a loan-to-value ratio in excess of 80%, private mortgage insurance is generally required in order to reduce the debt exposure below 80%. Properties securing our one- to four-family loans are generally appraised by independent state licensed fee appraisers approved by the Board of Directors. Borrowers are required to obtain title and hazard insurance, as well as flood insurance, if necessary, in an amount not less than the value of the property.

One- to four-family mortgage loans are originated on a fixed-rate and adjustable-rate basis. The pricing strategy for mortgage loans includes setting interest rates that are competitive with other local financial institutions and consistent with our internal needs. Adjustable-rate loans are tied to a variety of indices including a rate based on U.S. Treasury securities adjusted to a constant maturity of one year. A majority of the adjustable rate loans carry an initial fixed rate of interest for either three or five years which then convert to an interest rate that is adjusted annually based upon the applicable index. Home mortgages are structured with up to a 30 year maturity. Our one- to four-family loans originated or purchased are secured by properties located primarily in Hillsborough and Cheshire Counties, New Hampshire. All our real estate loans contain a "due on sale" clause allowing us to declare the unpaid principal balance due and payable upon the sale of the security property.

Any direct costs of origination, primarily salaries and wages, will be deferred and amortized over the contractual life of the loans. Any origination fees collected from the borrower will be deferred as a reduction of the loan balance and amortized over the contractual life of the loan.

We also originate, to a lesser extent, fixed rate home equity loans for portfolio. We generally underwrite these loans based on the applicant's employment and credit history. Presently, we generally lend up to 80% of the real estate tax assessment value or appraised value less any first liens, but may lend up to 90% for high credit quality borrowers. We require our borrowers to obtain hazard insurance and flood insurance, if necessary, in an amount not less than the value of the property improvements. All home equity loans have a maximum maturity of up to 15 years. We currently retain and service these loans.

**Home-Equity Residential Lending.** We currently originate home equity lines of credit. At December 31, 2008, such loans totaled approximately \$6.0 million, or 8.4%, of our gross loan portfolio. We generally underwrite these loans based on the applicant's employment and credit history. Presently, we generally lend up to 80% of the real estate tax assessment value or appraised value less any first liens, but may lend up to 90% for high credit quality borrowers. We require our borrowers to obtain hazard insurance and flood insurance, if necessary, in an amount not less than the value of the

property improvements. Our home equity lines of credit carry adjustable interest rates based upon the prime rate of interest. All home equity lines of credit have a maturity of up to 20 years with a ten year draw period. We currently retain and service these loans.

**Commercial Real Estate Lending.** We offer commercial real estate loans. These loans are secured primarily by small retail establishments and small office buildings located in our primary market area. At December 31, 2008, commercial real estate loans totaled approximately \$17.2 million, or 24.3%, of our gross loan portfolio. Our largest commercial real estate loan relationship at December 31, 2008 consisted of a \$1.6 million loan to fund a full service hotel of which \$1.2 million is guaranteed by the New Hampshire Business Finance Administration. The loan was performing in accordance with its original terms and conditions as of that date.

We originate fixed- and adjustable-rate commercial real estate loans. The interest rate on the adjustable-rate commercial real estate loans is tied to a variety of indices, including the prime rate as published in the Wall Street Journal as well as a rate based on the constant maturity of one year U.S. Treasury securities. A majority of our adjustable-rate loans carry an initial fixed rate of interest for either three or five years which then converts to an interest rate that is adjusted annually based upon the index. Loan-to-value ratios on our commercial real estate loans do not exceed 80% of the appraised value of the property securing the loan. These loans require monthly payments, amortize up to 25 years and may carry pre-payment penalties.

Loans secured by commercial real estate are underwritten based on the income producing potential of the property, the financial strength of the borrower and any guarantors. The net operating income, which is the income derived from the operation of the property less all operating expenses, must be sufficient to cover the payments related to the outstanding debt. We typically require an assignment of rents or leases in order to be assured that the cash flow from the project will be used to repay the debt. Appraisals on properties securing commercial real estate loans are generally performed by independent state licensed fee appraisers approved by the Board of Directors. The properties securing our commercial real estate loans are primarily located in New Hampshire or Massachusetts.

Loans secured by commercial real estate properties may be larger and involve a greater degree of credit risk than one- to four-family residential mortgage loans. Because payments on loans secured by commercial real estate properties are often dependent on the successful operation or management of the properties, repayment of such loans may be subject to adverse conditions in the real estate market or the economy. If the cash flow from the project is reduced, or if leases are not obtained or renewed, the borrower's ability to repay the loan may be impaired. Our loan portfolio possesses increased risk due to our substantial number of commercial real estate loans, which could increase the level of our provision for loan losses.

**Multi-Family Residential Lending.** We also offer multi-family residential loans. These loans are secured by real estate located in our primary market area. At December 31, 2008, multi-family residential loans totaled \$1.1 million, or 1.6%, of our gross loan portfolio. Our largest multi-family loan relationship at December 31, 2008, was three loans totaling \$386,000 secured by three 5 unit townhouses. The loans were performing in accordance with its original terms and conditions as of that date.

We originate fixed- and adjustable-rate multi-family residential real estate loans. We use a number of indices to set the interest rate, including a rate based on the constant maturity of one year U.S. Treasury securities. A majority of our adjustable-rate loans carry an initial fixed rate of interest for either three or five years which then converts to an interest rate that is adjusted annually based upon the applicable index. Loan-to-value ratios on our multi-family residential loans do not exceed 80% of the appraised value of the property securing the loan. These loans require monthly payments and amortize over a period of up to 25 years. We originate these loans through our staff. Although we generally retain all of the multi-family loans we originate, we may sell participations to manage our exposure to any one borrower.

Loans secured by multi-family residential real estate are underwritten based on the income producing potential of the property and the financial strength of the borrower. The net operating income, which is the income derived from the operation of the property less all operating expenses, must be sufficient to cover the payments related to the outstanding debt. We require an assignment of rents or leases in order to be assured that the cash flow from the project will be used to repay the debt. Appraisals on properties securing multi-family residential loans are performed by independent state licensed fee appraisers approved by the Board of Directors.

Loans secured by multi-family residential properties are generally larger and involve a greater degree of credit risk than one- to four-family residential mortgage loans and home equity loans. Because payments on loans secured by multi-family residential properties are often dependent on the successful operation or management of the properties, repayment of such loans may be subject to adverse conditions in the real estate market or the economy. If the cash flow from the project is reduced, or if leases are not obtained or renewed, the borrower's ability to repay the loan may be impaired.

**Construction and Land Development.** We also offer construction and land development loans. At December 31, 2008, construction and land development loans totaled \$570,000, or 0.8%, of our gross loan portfolio. Residential construction loans are generally originated as fixed rate loans. These loans are made to finance one- to four-family, owner-occupied, primary residences only. Financing is limited to a maximum loan to value ratio of 80%. Residential construction loans generally are written with permanent financing terms of up to 30 years and the construction period is generally the first eight months of the loan. Once the construction of the residential project is complete, the loan is taken out of the construction category and placed into the one- to four-family residential loan category for reporting purposes. We originate residential construction loans through our staff. Commercial construction loans are generally originated as adjustable rate loans. These loans are generally for the new construction of a special or limited use property where the primary use will be for commercial purposes. We use a number of indices to set the interest rate, including a rate based on the constant maturity of one year U.S. Treasury securities. A majority of our adjustable-rate loans carry an initial fixed rate of interest for either three or five years which then converts to an interest rate that is adjusted annually based upon the applicable index. Loan-to-value ratios on our commercial construction loans do not exceed 75% of the appraised value of the property securing the loan. These loans require monthly payments and amortize over a period of up to 25 years with the construction period of interest only being the first twelve months. Once the construction period for the commercial project is complete, the loan is taken out of the construction category and placed into the correct commercial category for reporting purposes. We originate these loans through our staff. We also originate residential land development loans. We originate fixed- and adjustable-rate residential land development loans. We use a number of indices to set the interest rate, including the prime rate as published in the Wall Street Journal. Loan-to-value ratios on our residential land development loans do not exceed 65% of the appraised value of the property securing the loan. These loans require monthly payments and amortize over a period of up to 15 years. We originate these loans through our staff.

**Commercial Business Lending.** We also offer commercial business loans. These loans are secured primarily by the assets of the business such as equipment, receivables and inventory. At December 31, 2008, commercial business loans totaled \$10.5 million, or 14.9%, of our gross loan portfolio. Our largest commercial business loan relationship at December 31, 2008 consisted of a loan totaling \$883,000 to the New Hampshire Higher Education Loan Corporation to support funding for student loans in New Hampshire. The loan has a guaranty from the New Hampshire Higher Education Authority for approximately \$856,000, or 97% of the loan balance. The loan is performing in accordance with its original terms and conditions as of December 31, 2008. We also originate commercial business loans guaranteed by the United States Small Business Administration. Repayment of the principal of such loans is partially guaranteed by the United States Small Business Administration in a range from 50% to 90% of the principal depending upon the type of loan, the amount of the loan and the business of the borrower. At December 31, 2008, we had \$1.9 million in commercial small business loans of which \$1.5 million were guaranteed by the United States Small Business Administration.

We originate fixed- and adjustable-rate commercial business loans. The interest rate on these loans is tied to a variety of indices, including the prime rate as published in the Wall Street Journal. A majority of our adjustable-rate loans carry an initial fixed rate of interest for either three or five years which then converts to an interest rate that is adjusted annually based upon the index.

Commercial loans involve a greater degree of credit risk than one- to four-family residential mortgage loans. Because payments on these loans are often dependent on the successful operation or management of the business, repayment of such loans may be subject to adverse conditions in the economy. If the cash flow from the business is reduced, the borrower's ability to repay the loan may be impaired. Interest rates on these loans are generally higher than interest rates charged on one- to four-family residential mortgage loans to compensate us for the greater degree of credit risk involved in this type of lending. Our loan portfolio possesses increased risk due to the number of commercial business loans, which could increase the level of our provision for loan losses.

**Consumer Loans.** Currently we offer loans secured by mobile homes, new and used automobiles, and deposit accounts as well as a limited number of unsecured loans. Consumer loans, with the exception of mobile home loans, generally have shorter terms to maturity than mortgage loans, which reduces our exposure to changes in interest rates, and

carry higher rates of interest than do one- to four-family residential mortgage loans. At December 31, 2008, our consumer loan portfolio totaled \$3.4 million, or 4.8%, of our gross loan portfolio.

Consumer loans may entail greater risk than do one- to four-family residential mortgage loans, particularly in the case of consumer loans which are unsecured or secured by rapidly depreciable assets, such as automobiles. We generally charge higher rates of interest for this type of lending as compared to one- to four-family residential mortgage loans to compensate us for the added credit risk. Repossessed collateral for a defaulted loan may not provide an adequate source of repayment of the outstanding loan balance. As a result, consumer loan collections are dependent on the borrower's continuing financial stability and, thus, are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy.

#### **Loan Originations, Purchases, Sales and Repayments**

All loan applications are taken through employees located at our offices. Following approval of a loan application, we issue a loan commitment containing certain terms and conditions which must be complied with by the borrower before we fund the loan. Walk-in customers and referrals from our current customer base, advertisements and real estate brokers are also important sources of loan originations. While we originate both adjustable and fixed-rate loans, our ability to originate loans is dependent upon customer demand for loans in our market area. Demand is affected by local competition and the interest rate environment. We have sold participation interests in commercial real estate loans, commercial business loans and multi-family loans to manage our limitation on loans-to-one borrower.

We account for the sale of participation interests in loans in accordance with paragraphs 9 to 11 of SFAS No. 140, "Accounting for Transfers and Servicing of Financial Assets." In accordance with SFAS No. 140, we account for a transfer of financial assets, or a portion of a financial asset, as a sale when we surrender control of the transferred assets. Servicing rights and other retained interests in the sold assets are recorded by allocating the previously recorded investment between the assets sold and interest retained based on their relative fair values at the date of transfer. We determine the fair values of servicing rights and other retained interests at the date of transfer using the present value of estimated future cash flows, using assumptions that market participants would use in their estimates of values. Our loan purchases for 2008 and 2007 primarily consisted of commercial real estate and commercial business loan participations with other financial institutions.

The following table shows the loan origination, purchase, sale and repayment activities of Monadnock Community Bank for the periods indicated.

	<b>Year Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
	<b>(In Thousands)</b>	
<u>Originations by type:</u>		
<u>Adjustable rate:</u>		
Real estate - one-to four-family	\$ 85	\$ --
- home equity	1,258	946
- commercial	4,313	3,265
- multi-family	105	811
- construction and land development	94	361
Non-real estate - commercial business	3,060	1,200
- consumer	20	--
Total adjustable-rate	<u>8,935</u>	<u>6,583</u>
 <u>Fixed rate:</u>		
Real estate - one-to four-family	5,370	6,483
- commercial	1,891	3,192
- construction and land development	348	574
Non-real estate - commercial business	3,489	2,337
- consumer	1,684	1,771
Total fixed-rate	<u>12,782</u>	<u>14,357</u>
Total loans originated	21,717	20,940
 <u>Purchases:</u>		
Real estate - one-to four-family	--	130
- commercial	--	882
Non-real estate - commercial business	900	--
- consumer	12	64
Total loans purchased	<u>912</u>	<u>1,076</u>
 <u>Sales and Repayments:</u>		
Sales and loan participations sold	1,416	516
Principal repayments	14,500	11,155
Total reductions	<u>15,916</u>	<u>11,671</u>
Net increase	<u>\$ 6,713</u>	<u>\$10,345</u>

### **Loan Approval Authority and Underwriting**

The loan approval process is intended to assess the borrower's ability to repay the loan, the viability of the loan, and the adequacy of the value of the property that will secure the loan. To assess the borrower's ability to repay, we review the employment and credit history and information on the historical and projected income and expenses of borrowers. Loans of up to \$650,000 to any borrower and the borrower's related interests may be approved by the loan committee, consisting of senior management. All loans in excess of \$650,000 must be approved by the Board of Directors.

We require appraisals or valuations of real property securing loans. Appraisals are performed by independent state licensed fee appraisers, who are approved by the Board of Directors annually. We require hazard insurance in amounts adequate to protect our principal balance. Where appropriate, flood insurance is also required. Private mortgage insurance is required for all residential mortgage loans with loan-to-value ratios greater than 80%.

## Asset Quality

**Collection Procedures.** We have established a loan collection policy for delinquent loans. For one- to four-family residential, home equity, multi-family, commercial real estate, construction and land development loans and commercial business loans serviced by us, a delinquency notice is sent to the borrower when the loan is eight days past due. When the loan is 20 days past due, we contact the borrower requesting payment of the delinquent amount in full, or the establishment of an acceptable repayment plan to bring the loan current. If an acceptable repayment plan has not been agreed upon, loan personnel will generally take action to foreclose on the real estate collateral or seize the other security for the loan. The notice of intent to foreclose allows the borrower up to 30 days to bring the account current in the case of a residential mortgage loan and 10 days in the case of a commercial mortgage loan. Once the loan becomes 60 days delinquent, and an acceptable repayment plan has not been agreed upon, the servicing officer will initiate foreclosure or repossession of the collateral in the case of a non-real estate loan.

When a borrower fails to make a timely payment on a consumer loan, a delinquency notice is sent when the loan is over 10 or 15 days past due, depending on the type of loan. Following such time, and generally within 20 days of the delinquency, our staff contacts the borrower by telephone to determine the reason for delinquency and to request payment of the delinquent amount in full or the establishment of an acceptable repayment plan to bring the loan current. If the borrower is unable to make or keep payment arrangements, additional collection action is taken in the form of repossession of collateral for secured loans and small claims or legal action for unsecured loans.

**Delinquent Loans.** The following table sets forth our loans delinquent 60 to 89 days and 90 days or more past due by type, number, amount and percentage of delinquent loans to total gross loans at December 31, 2008 and 2007.

	Loans Delinquent For				Total	
	60-89 Days		90 Days and Over		Number	Amount
	Number	Amount	Number	Amount		
	(Dollars in Thousands)					
<b>At December 31, 2008</b>						
One- to four-family	--	\$ --	--	\$ --	--	\$ --
Home equity	--	--	--	--	--	--
Commercial real estate	--	--	1	380	1	380
Multi-family	--	--	--	--	--	--
Construction and land development	1	112	--	--	1	112
Commercial business	2	83	2	129	4	212
Consumer	1	49	--	--	1	49
<b>Total</b>	<b>4</b>	<b>\$244</b>	<b>3</b>	<b>\$509</b>	<b>7</b>	<b>\$753</b>
Delinquent loans to total gross loans		0.34 %		0.72 %		1.06 %
<b>At December 31, 2007</b>						
One- to four-family	--	\$ --	--	\$ --	--	\$ --
Home equity	--	--	--	--	--	--
Commercial real estate	1	60	--	--	1	60
Multi-family	--	--	--	--	--	--
Construction and land development	--	--	--	--	--	--
Commercial business	--	--	4	270	4	270
Consumer	--	--	--	--	--	--
<b>Total</b>	<b>1</b>	<b>\$ 60</b>	<b>4</b>	<b>\$270</b>	<b>5</b>	<b>\$330</b>
Delinquent loans to total gross loans		0.09 %		0.42 %		0.51 %

**Non-Performing Assets.** The table below sets forth the amounts and categories of non-performing assets in our loan portfolio. Loans to a customer whose financial condition has deteriorated are considered for non-accrual status whether or not the loan is 90 days and over past due. Generally, all loans past due 90 days and over are classified as non-accrual. On non-accrual loans, interest income is not recognized until actually collected. At the time the loan is placed on non-accrual status, interest previously accrued but not collected is reversed and charged against current income.

Foreclosed assets consist of real estate and other assets which have been acquired through foreclosure on loans. At the time of foreclosure, assets are recorded at the lower of their estimated fair value less selling costs or the loan balance, with any write-down charged against the allowance for loan losses.



At both dates presented, we had no troubled debt restructurings which involve forgiving a portion of interest or principal on any loans or making loans at a rate materially less than that of market rates.

	<b>At December 31,</b>	
	<b>2008</b>	<b>2007</b>
	<b>(Dollars in Thousands)</b>	
Non-accrual loans:		
One- to four-family	\$ --	\$ --
Home equity	--	--
Commercial real estate	380	--
Multi-family	--	--
Construction and land development	--	--
Commercial business	129	270
Consumer	--	--
Total	<u>\$ 509</u>	<u>\$270</u>
Loans 90 days or more delinquent and still accruing:		
One- to four-family	\$ --	\$ --
Home equity	--	--
Commercial real estate	--	--
Multi-family	--	--
Construction and land development	--	--
Commercial business	--	--
Consumer	--	--
Total	<u>--</u>	<u>--</u>
Total non-performing loans	<u>\$ 509</u>	<u>\$270</u>
Real estate owned:		
One- to four-family	\$ --	\$ --
Home equity	--	--
Commercial real estate	474	--
Multi-family	--	--
Construction and land development	--	--
Commercial business	--	--
Consumer	47	--
Reposessed assets	--	--
Total	<u>521</u>	<u>--</u>
Total non-performing assets	<u>\$1,030</u>	<u>\$270</u>
Ratios:		
Non-performing loans to total loans	0.72 %	0.42 %
Non-performing assets to total assets	0.81 %	0.26 %

For the year ended December 31, 2008 and 2007, \$15,636 and \$14,025, respectively, of gross interest income would have been recorded had the non-accruing loans been current in accordance with their original terms. No interest income was recorded on non-accruing loans during the respective periods. See “—Classified Assets.”

**Classified Assets.** Regulations provide for the classification of loans and other assets, such as debt and equity securities considered by regulators to be of lesser quality, as “substandard,” “doubtful” or “loss.” An asset is considered “substandard” if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. “Substandard” assets include those characterized by the “distinct possibility” that the insured institution will sustain “some loss” if the deficiencies are not corrected. Assets classified as “doubtful” have all of the weaknesses inherent in those classified “substandard,” with the added characteristic that the weaknesses present make “collection or liquidation in full,” on the basis of currently existing facts, conditions, and values, “highly questionable and improbable.” Assets classified as “loss” are those considered “uncollectible” and of such little value that their continuance as assets without the establishment of a specific loss reserve is not warranted. Assets that do not expose us to risk sufficient to warrant classification in one of the aforementioned categories, but which possess some weaknesses are designated as “special mention” by management.



When an insured institution classifies problem assets as either substandard or doubtful, it may establish general allowances for loan losses in an amount deemed prudent by management and approved by the Board of Directors. General allowances represent loss allowances which have been established to recognize the inherent risk associated with lending activities, but which, unlike specific allowances, have not been allocated to particular problem assets. When an insured institution classifies problem assets as “loss,” it is required either to establish a specific allowance for losses equal to 100% of that portion of the asset so classified or to charge off such amount. An institution’s determination as to the classification of its assets and the amount of its valuation allowances is subject to review by the Office of Thrift Supervision and the Federal Deposit Insurance Corporation, which may order the establishment of additional general or specific loss allowances.

In connection with the filing of our periodic reports with the Office of Thrift Supervision and in accordance with our classification of assets policy, we regularly review the problem assets in our portfolio to determine whether any assets require classification in accordance with applicable regulations. The total amount of classified assets represented 14.71% of our equity capital and 1.25% of our total assets at December 31, 2008. Monadnock Community Bank also had \$1.6 million and \$2.1 million of special mention assets at December 31, 2008 and 2007, respectively. The special mention assets had government guarantees from the United States Small Business Administration of \$303,000 and \$737,000, respectively, at December 31, 2008 and 2007, and the amounts presented above include only the non-government guaranteed portion of the loans.

The aggregate amount of our classified assets at the dates indicated were as follows:

	<b>At December 31,</b>	
	<b>2008</b>	<b>2007</b>
	<b>(In Thousands)</b>	
Loss	\$ --	\$ --
Doubtful	--	--
Substandard	1,599	216
Total	<u>\$1,599</u>	<u>\$216</u>

Monadnock Community Bank’s management has focused on improving credit monitoring of these loans. The substandard assets shown in the table above had government guarantees from the United States Small Business Administration of \$138,000 and \$290,000, respectively, at December 31, 2008 and 2007 and the amounts presented in the table include only the non-government guaranteed portion of the loans. The largest classified asset as of December 31, 2008 was a \$474,000 commercial loan relationship secured by an inn which was transferred to other real estate owned at the end of the second quarter of 2008.

**Allowance for Loan Losses.** We maintain an allowance for loan losses to absorb losses inherent in the loan portfolio. The allowance is based on ongoing, quarterly assessments of the estimated losses inherent in the loan portfolio. Our methodology for assessing the appropriateness of the allowance consists of several key elements, which include loss ratio analysis by type of loan and specific allowances for identified problem loans. In addition, the allowance incorporates the results of measuring impaired loans as provided in Statement of Financial Accounting Standards (“SFAS”) No. 114, “Accounting by Creditors for Impairment of a Loan” and SFAS No. 118, “Accounting by Creditors for Impairment of a Loan – Income Recognition and Disclosures.” These accounting standards prescribe the measurement methods, income recognition and disclosures related to impaired loans.

The formula allowance is calculated by applying loss factors to outstanding loans based on the internal risk evaluation of the loans or pools of loans. Changes in risk evaluations of both performing and nonperforming loans affect the amount of the formula allowance. Loss factors are based both on our historical loss experience as well as on significant factors that, in management’s judgment, affect the collectibility of the portfolio as of the evaluation date.

The appropriateness of the allowance is reviewed and established by management quarterly based on then-existing economic and business conditions affecting our key lending areas and other conditions, such as credit quality trends (including trends in nonperforming loans expected to result from existing conditions), collateral values, loan volumes and concentrations, specific industry conditions within portfolio segments and recent loss experience in particular segments of the portfolio that existed as of the balance sheet date and the impact that such conditions were believed to have had on the collectibility of the loan. Senior management reviews these conditions quarterly in discussions with our senior credit officers. To the extent that any of these conditions is evidenced by a known identifiable problem credit or portfolio segment as of the evaluation date, management's estimate of the effect of such condition may be reflected as a specific allowance applicable to such credit or portfolio segment. Where any of these conditions is not evidenced by a known identifiable problem credit or portfolio segment as of the evaluation date, management's evaluation of the loss related to this condition is reflected in the general allowance. The evaluation of the inherent loss with respect to these conditions is subject to a higher degree of uncertainty because they are not identified with known problem credits or portfolio segments.

Management also evaluates the adequacy of the allowance for loan losses based on a review of individual loans, historical loan loss experience, the value and adequacy of collateral and economic conditions in our market area. This evaluation is inherently subjective as it requires material estimates, including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. For all specifically reviewed loans for which it is probable that we will be unable to collect all amounts due according to the terms of the loan agreement, we determine impairment by computing a fair value either based on discounted cash flows using the loan's initial interest rate or the fair value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogenous loans that are collectively evaluated for impairment and are excluded from specific impairment evaluation, and their allowance for loan losses is calculated in accordance with the allowance for loan losses policy described above.

Because the allowance for loan losses is based on estimates of losses inherent in the loan portfolio, actual losses can vary significantly from the estimated amounts. Our methodology as described permits adjustments to any loss factor used in the computation of the formula allowance in the event that, in management's judgment, significant factors which affect the collectibility of the portfolio as of the evaluation date are not reflected in the loss factors. By assessing the estimated losses inherent in the loan portfolio on a quarterly basis, we are able to adjust known and inherent loss estimates based upon any more recent information that has become available. In addition, management's determination as to the amount of our allowance for loan losses is subject to review by the Office of Thrift Supervision and the Federal Deposit Insurance Corporation, which may require the establishment of additional general or specific allowances based upon their judgment of the information available to them at the time of their examination of Monadnock Community Bank.

At December 31, 2008 and 2007, our allowance for possible loan losses was \$413,000 and \$390,000, respectively, and the ratio of the allowance to total loans outstanding was 0.58% and 0.61%, respectively. At December 31, 2008 and 2007, the allowance for loan losses represented 81.14% and 144.44%, respectively, of nonperforming loans. The ratio of the allowance for loan losses to nonperforming loans in the table below includes nonperforming loans with government guarantees from the United States Small Business Administration. The non-guaranteed portion of nonperforming loans was \$105,000 at December 31, 2007, and the allowance for loan losses represented 371.43% at December 31, 2007 of the non-guaranteed portion of the nonperforming loans. We recorded a provision for loan losses of \$156,000 for the year ended December 31, 2008 compared with a provision for loan losses of \$112,000 for the year ended December 31, 2007. The increase in the provision for loan losses was primarily due to an increase in the level of net charge-offs of \$133,000 for the year ended December 31, 2008 compared with \$61,000 for the year ended December 31, 2007. In addition, the increase in the provision was necessary due to additional weakness we identified in a commercial loan for a retail sporting goods establishment for the year ended December 31, 2008. The increase in the provision for loan losses was partially offset by the classification of certain loans into more favorable risk ratings during 2008 due to the seasoning of real estate owner-occupied first mortgage loans. The allowance for loan losses as of December 31, 2008 was maintained at a level that represents management's best estimate of losses inherent in the loan portfolio. Although we believe that we have established the allowance for loan losses at levels to absorb probable and estimable losses, future additions or deductions may be necessary if economic or other conditions in the future differ from the current environment. Provisions to the allowance may be necessary if the market in which we operate deteriorates, or the composition of our loan portfolio changes. Additionally, as noted above, regulatory agencies review our allowance for loan losses as part of their examination process. Such agencies may require us to recognize additions to the allowance based on judgments which may be different from those of management.

The following table sets forth an analysis of our allowance for loan losses.

	<b>Years Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
	<b>(Dollars in Thousands)</b>	
Balance at beginning of year	\$ 390	\$ 335
<i>Charge-offs:</i>		
One- to four-family	--	--
Home equity	--	--
Commercial real estate	(60)	--
Multi-family	--	--
Construction and land development	--	--
Commercial business	(60)	(46)
Consumer	(18)	(15)
<i>Recoveries:</i>		
One- to four-family	--	--
Home equity	--	--
Commercial real estate	--	--
Multi-family	--	--
Construction and land development	--	--
Commercial business	2	--
Consumer	3	4
Net (charge-offs) recoveries	(133)	(57)
Provision (benefit) for loan losses	156	112
Balance at end of year	<u>\$ 413</u>	<u>\$ 390</u>
Net charge-offs (recoveries) to average loans outstanding during year (1)	0.20 %	0.10 %
<i>Ratios:</i>		
Net charge-offs (recoveries) to average non-performing loans during year	27.14 %	23.55 %
Allowance for loan losses to non-performing loans	81.14 %	144.44 %
Allowance as a percent of total gross loans (end of year)(1)	0.58 %	0.61 %

(1) Total loans are net of deferred fees and costs.

The distribution of the allowance for losses on loans at the dates indicated is summarized as follows.

	At December 31,					
	2008			2007		
	Amount	Percent of Allowance to Total Allowance	Percent of Gross Loans in Each Category to Total Gross Loans (Dollars in Thousands)	Amount	Percent of Allowance to Total Allowance	Percent of Gross Loans in Each Category to Total Gross Loans
One- to four-family	\$ 57	13.80 %	45.32 %	\$ 66	16.92 %	49.19 %
Home equity	12	2.91	8.44	13	3.33	8.35
Commercial real estate	131	31.72	24.26	140	35.90	22.93
Multi-family	6	1.45	1.56	14	3.59	2.66
Construction and land development	1	0.24	0.81	9	2.31	1.78
Commercial business	183	44.31	14.85	124	31.80	11.02
Consumer	23	5.57	4.76	24	6.15	4.07
Total Allowance for Loan Losses	<u>\$413</u>	<u>100.00 %</u>	<u>100.00 %</u>	<u>\$390</u>	<u>100.00 %</u>	<u>100.00 %</u>

#### Investment Activities

**General.** Under the direction and guidance of the asset/liability management committee and Board policy, our president has the basic responsibility for the management of our investment portfolio. Various factors are considered when making decisions, including the marketability, maturity and tax consequences of the proposed investment. The maturity structure of investments will be affected by various market conditions, including the current and anticipated short and long term interest rates, the level of interest rates, the trend of new deposit inflows, and the anticipated demand for funds via deposit withdrawals and loan originations and purchases.

**Liquidity.** We are required by federal regulations to maintain liquid assets in an amount necessary to support our operations and are also permitted to make certain other securities investments. Cash flow projections are regularly reviewed and updated to assure that adequate liquidity is provided.

We are authorized to invest in various types of liquid assets, including U.S. Treasury obligations, securities of various federal agencies, certain certificates of deposit of insured banks and savings institutions, certain bankers' acceptances, repurchase agreements and federal funds. Subject to various restrictions, federal savings banks may also invest their assets in investment grade commercial paper and corporate debt securities and mutual funds whose assets conform to the investments that a federally chartered savings bank is otherwise authorized to make directly.

**Mortgage-Backed Securities.** We invest in mortgage-backed securities as part of our asset liability management strategy. Management believes that mortgage-backed securities represent attractive investment opportunities relative to other investments due to the wide variety of maturity and repayment options available through such investments. Our mortgage-backed securities are purchased as an alternative to mortgage loans. At December 31, 2008, we held approximately \$51.1 million of mortgage-backed securities. Our mortgage-backed securities are guaranteed by either Ginnie Mae, Fannie Mae or Freddie Mac.

SFAS No. 115, "Accounting for Certain Investments in Debt and Equity Securities," requires that investments be categorized as "held-to-maturity," "trading securities" or "available-for-sale," based on management's intent as to the ultimate disposition of each security. SFAS No. 115 allows debt securities to be classified as "held-to-maturity" and reported in financial statements at amortized cost only if the reporting entity has the positive intent and ability to hold those securities to maturity. Our current strategy is to hold all securities as available-for-sale, recorded at fair value.

The following table sets forth the composition of our investment portfolio at the dates indicated.

	<b>At December 31,</b>			
	<b>2008</b>		<b>2007</b>	
	<b>Carrying Value</b>	<b>Percent of Total</b>	<b>Carrying Value</b>	<b>Percent of Total</b>
<b>(Dollars in Thousands)</b>				
Securities Available for Sale:				
Mortgage-backed securities:				
Ginnie Mae	\$ 8,832	17.26 %	\$14,445	39.47 %
Fannie Mae	26,140	51.08	13,753	37.58
Freddie Mac	16,199	31.66	8,398	22.95
Total mortgage-backed securities	<u>51,171</u>	<u>100.00</u>	<u>36,596</u>	<u>100.00</u>
Total	<u>\$51,171</u>	<u>100.00 %</u>	<u>\$36,596</u>	<u>100.00 %</u>
Other earnings assets:				
Interest-earning deposits in other financial institutions	\$ --	-- %	\$ --	-- %
Federal Home Loan Bank stock	2,568	92.77	1,608	94.15
Other investments	200	7.23	100	5.85
Total	<u>2,768</u>	<u>100.00 %</u>	<u>1,708</u>	<u>100.00 %</u>
Total	<u>\$53,939</u>		<u>\$38,304</u>	

While our mortgage-backed securities carry a reduced credit risk as compared to whole loans due to their issuance under government agency sponsored programs, they remain subject to the risk that a fluctuating interest rate environment, along with other factors like the geographic distribution of the underlying mortgage loans, may alter the prepayment rate of the mortgage loans and so affect both the prepayment speed, and value, of the investment securities. As a result of these factors, the estimated average lives of these securities will be shorter than the contractual maturities as shown on the following table. The investments in the Company's investment portfolio that are temporarily impaired as of December 31, 2008 and 2007 consist of debt securities issued by U.S. government agencies and a U.S. government sponsored enterprise with strong credit ratings. The unrealized losses are attributable to changes in market interest rates. Company management does not intend to sell these securities in the near term future, and due to the securities relative short duration, anticipates that the unrealized losses that currently exist will be dramatically reduced going forward. As management believes the Company has the ability to hold debt securities for the foreseeable future, no declines are deemed to be other than temporary.

The maturities of the investment securities portfolio and the amortized cost and fair value, excluding Federal Home Loan Bank stock, as of December 31, 2008, were as follows:

	<b>At December 31, 2008</b>					
	<b>One Year or Less</b>	<b>After One to Five Years</b>	<b>After Five to 10 Years</b>	<b>Over 10 Years</b>	<b>Total Securities</b>	
	<b>Amortized Cost</b>	<b>Amortized Cost</b>	<b>Amortized Cost</b>	<b>Amortized Cost</b>	<b>Amortized Cost</b>	<b>Fair Value</b>
<b>(Dollars in Thousands)</b>						
Ginnie Mae	\$ --	\$ --	\$ --	\$ 8,960	\$ 8,960	\$ 8,832
Fannie Mae	--	--	--	26,176	26,176	26,140
Freddie Mac	--	--	--	16,182	16,182	16,199
Total mortgage-backed securities	<u>\$ --</u>	<u>\$ --</u>	<u>\$ --</u>	<u>\$51,318</u>	<u>\$51,318</u>	<u>\$51,171</u>
Total investment securities	<u>\$ --</u>	<u>\$ --</u>	<u>\$ --</u>	<u>\$51,318</u>	<u>\$51,318</u>	<u>\$51,171</u>
Weighted average yield	-- %	-- %	-- %	4.97 %	4.97 %	

## Sources of Funds

**General.** Our sources of funds are deposits, payment of principal and interest on loans, interest earned on or maturation or sales of other investment securities, borrowings, and funds provided from operations.

**Deposits.** We offer a variety of deposit accounts to consumers with a wide range of interest rates and terms. Our deposits consist of certificates of deposit, money market demand accounts, demand accounts, NOW accounts and savings accounts. We have historically paid market rates on our deposit accounts. We primarily rely on competitive pricing policies, marketing and customer service to attract and retain these deposits. We have not solicited brokered deposits, but may consider using them in the future.

The flow of deposits is influenced significantly by general economic conditions, changes in money market and prevailing interest rates. The variety of deposit accounts we offer has allowed us to be competitive in obtaining funds and to respond with flexibility to changes in consumer demand. We have become more susceptible to short-term fluctuations in deposit flows, as customers have become more interest rate conscious. We try to manage the pricing of our deposits in keeping with our asset/liability management, liquidity and profitability objectives, subject to competitive factors. Based on our experience, we believe that our deposits are relatively stable sources of funds. Despite this stability, our ability to attract and maintain these deposits and the rates paid on them has been and will continue to be significantly affected by market conditions. We expect to maintain a substantial majority of our certificates of deposit that are maturing in 2009 by continuing to pay market rates, providing quality service and promoting our Bank as a local community bank. Our liquidity could be reduced, however, if a significant portion of the certificates of deposit are not renewed. Paying market rates to retain these deposits may increase our cost of funds and could decrease our net interest income and net interest margin. We will be able to use a combination of Federal Home Loan Bank advances as well as Federal Reserve discount window borrowings to provide an alternative source of funds for certificates of deposit that mature and are not renewed.

The following table sets forth the distribution of total deposit accounts, by account type, at the dates indicated.

	At December 31,					
	2008			2007		
	Balance	Percent	Weighted Average Rate	Balance	Percent	Weighted Average Rate
	(Dollars in Thousands)					
<b>Deposit type:</b>						
Non-interest bearing demand	\$ 4,526	7.33 %	-- %	\$ 5,286	8.15 %	-- %
Savings accounts	2,292	3.71	0.25	2,448	3.78	0.50
NOW accounts	13,772	22.29	3.14	7,613	11.75	2.76
Money market demand accounts	8,135	13.17	0.63	8,345	12.87	1.58
Total transaction accounts	28,725	46.50	1.70	23,692	36.55	1.49
Certificates of deposit	33,047	53.50	3.43	41,126	63.45	4.75
Total deposits	<u>\$61,772</u>	<u>100.00 %</u>	2.63 %	<u>\$64,818</u>	<u>100.00 %</u>	3.56 %

The following table sets forth, by interest rate ranges, information concerning certificates of deposit at the dates indicated.

At December 31, 2008						
Period to Maturity						
Less than One Year	One to Two Years	Two to Three Years	More than Three Years	Total	Percent of Total	
(Dollars in Thousands)						
<b>Interest Rate Range:</b>						
0.01% to 1.00%	\$ 134	\$ --	\$ --	\$ --	\$ 134	0.40 %
1.01% to 2.00%	2,192	--	87	--	2,279	6.90
2.01% to 3.00%	10,408	486	60	11	10,965	33.18
3.01% to 4.00%	8,866	2,063	958	952	12,839	38.85
4.01% to 5.00%	1,711	1,122	556	1,248	4,637	14.03
5.01% to 6.00%	1,136	205	198	654	2,193	6.64
Total	<u>\$24,447</u>	<u>\$3,876</u>	<u>\$1,859</u>	<u>\$2,865</u>	<u>\$33,047</u>	<u>100.00 %</u>

As of December 31, 2008, the aggregate amount of outstanding certificates of deposit in amounts greater than or equal to \$100,000 was \$9.2 million. The following table sets forth the maturity of those certificates as of December 31, 2008.

At December 31, 2008 (In Thousands)	
Three months or less	\$1,932
Over three months through six months	1,337
Over six months through one year	3,562
Over one year to three years	1,342
Over three years	<u>1,011</u>
Total	<u>\$9,184</u>

**Borrowings.** Although deposits are our primary source of funds, we may utilize borrowings primarily as part of our asset/liability management strategy, when we desire additional capacity to purchase loans or to fund loan demand. Our borrowings historically have consisted of advances from the Federal Home Loan Bank of Boston. We may obtain advances from the Federal Home Loan Bank of Boston upon the security of our mortgage loans and mortgage-backed securities. These advances may be made using several different credit programs, each of which has its own interest rate, range of maturities and call or put features. At December 31, 2008, we had \$53.1 million in Federal Home Loan Bank advances outstanding. At December 31, 2008, we had an additional borrowing capacity with the Federal Home Loan Bank of Boston of \$9.8 million based on our collateral with the Federal Home Loan Bank as well as our internal policy which limits FHLB advances to 50% of total assets.

During the fourth quarter of 2008, the Bank began borrowing from the Federal Reserve Bank discount window for a term of one month or less. The borrowings are secured by certain unencumbered investment securities totaling \$2.9 million in fair value at December 31, 2008.

On April 15, 2008, the Monadnock Community Bank Employee Stock Ownership Plan Trust entered into a loan agreement with Rollstone Bank & Trust to refinance the ESOP loan which was previously held by Monadnock Bancorp, Inc. The loan was refinanced with a third party lender in order to provide additional liquidity for Monadnock Bancorp, Inc. The newly refinanced loan has been guaranteed by Monadnock Bancorp, Inc. The amount of the refinanced ESOP loan was for \$400,000 at an interest rate of 5.25%, floating quarterly at a rate of interest tied to the Prime Rate. The interest rate on the loan as of December 31, 2008 was 5% and the loan has an interest rate floor of 5%. Interest only payments under this loan agreement were made beginning May 15, 2008 and continuing monthly through December 15, 2008. Beginning January 15, 2009, principal and interest payments are scheduled to be made and continue through April 15, 2018. The outstanding term of the loan was reduced from thirteen years to ten years. Principal and interest payments totaled \$58,202 for 2008.

The following table sets forth information as to our Federal Home Loan Bank advances and other borrowings for the years indicated.

	<b>At or For the Year</b>	
	<b>Ended December 31,</b>	
	<b>2008</b>	<b>2007</b>
	<b>(Dollars in Thousands)</b>	
Balance at end of year	\$54,526	\$30,538
Average balance during year	41,654	26,370
Maximum month-end balance	54,526	30,538
Weighted average interest rate during the year	4.01 %	4.40 %
Weighted average interest rate at end of year	3.30 %	4.34 %

## Employees

At December 31, 2008, we had 23 full-time employees and eight part-time employees. Our employees are not represented by any collective bargaining group. Management believes that we have a good relationship with our employees.

## Subsidiary Activities

At December 31, 2008, Monadnock Bancorp, Inc. did not have any subsidiaries other than Monadnock Community Bank.

## Federal Taxation

**General.** Monadnock Bancorp, Inc. and Monadnock Community Bank are subject to federal income taxation in the same general manner as other corporations, with some exceptions discussed below. The following discussion of taxation is intended only to summarize pertinent federal income tax matters and is not a comprehensive description of the tax rules applicable to Monadnock Bancorp, Inc. or Monadnock Community Bank. Our federal income tax returns have never been audited by the IRS. We have elected to file a consolidated federal income tax return since the formation of the Company.

**Method of Accounting.** For federal income tax purposes, we currently report our income and expenses on the accrual method of accounting and use a fiscal year ending on December 31, for filing our federal income tax return.

**Net Operating Loss Carryovers.** A financial institution may carry back net operating losses to the preceding five taxable years and forward to the succeeding twenty taxable years. At December 31, 2008, Monadnock Community Bank had operating loss carryforwards for state income tax purposes of approximately \$174,000 which will expire in the years 2015 through 2016.

**Corporate Dividends-Received Deduction.** Monadnock Bancorp, Inc. may exclude from its income dividends received from Monadnock Community Bank as a wholly owned subsidiary of Monadnock Bancorp, Inc. The corporate dividends-received deduction is 100% or 80%, in the case of dividends received from corporations with which a corporate recipient does not file a consolidated tax return, depending on the level of stock ownership of the payor of the dividend. Corporations which own less than 20% of the stock of a corporation distributing a dividend may deduct 70% of dividends received or accrued on their behalf.

## State Taxation

The two state taxes that materially impact Monadnock Bancorp, Inc. and Monadnock Community Bank in New Hampshire are the New Hampshire Business Profits tax and the New Hampshire Business Enterprise tax. The New Hampshire Business Profits tax is assessed at the rate of 8.5%. For this purpose, gross business profits generally means federal taxable income subject to certain modifications provided for in New Hampshire law. The New Hampshire Business

Enterprise tax is assessed at 0.75% of the total amount of payroll and certain employee benefits expense, interest expense, and dividends paid to stockholders. The New Hampshire Business Enterprise tax is applied as a credit towards the New Hampshire Business Profits tax. With the acquisition of a branch in Winchendon, Massachusetts during the fourth quarter of 2004, Monadnock Bancorp, Inc. and Monadnock Community Bank became subject to a Massachusetts excise tax rate of 10.5% based on an apportionment of income derived from Massachusetts sources, solely. Other applicable state taxes include generally applicable sales, use and real property taxes.

As a Maryland business corporation, Monadnock Bancorp, Inc. is required to file annual returns with the State of Maryland.

## **Regulation**

As a federally chartered savings bank, Monadnock Community Bank is regulated and supervised by the Office of Thrift Supervision and the Federal Deposit Insurance Corporation. This regulation and supervision establishes a comprehensive framework of activities in which we may engage, and is intended primarily for the protection of the Federal Deposit Insurance Corporation's deposit insurance funds and depositors. Under this system of federal regulation, financial institutions are periodically examined to ensure that they satisfy applicable standards with respect to their capital adequacy, assets, management, earnings, liquidity and sensitivity to market interest rates. After completing an examination, the federal agency critiques the financial institution's operations and assigns its rating (known as an institution's CAMELS). Under federal law, an institution may not disclose its CAMELS rating to the public. Monadnock Community Bank also is a member of, and owns stock in, the Federal Home Loan Bank of Boston, which is one of the twelve regional banks in the Federal Home Loan Bank System. Monadnock Community Bank also is regulated, to a lesser extent, by the Board of Governors of the Federal Reserve System, governing reserves to be maintained against deposits and other matters. The Office of Thrift Supervision periodically examines Monadnock Community Bank and prepares reports for consideration by our Board of Directors on any operating deficiencies. Monadnock Community Bank's relationship with our depositors and borrowers also is regulated to a great extent by both federal and state laws, especially in matters concerning the ownership of deposit accounts and the form and content of our loan documents.

There can be no assurance that changes to existing laws, rules and regulations, or any other new laws, rules or regulations, will not be adopted in the future, which could make compliance more difficult or expensive or otherwise adversely affect our business, financial condition or prospects. Any change in these laws or regulations, or in regulatory policy, whether by the Federal Deposit Insurance Corporation, the Office of Thrift Supervision or the United States Congress, could have a material adverse impact on our business, financial condition or operations.

## **Federal Banking Regulation**

**Business Activities.** A federal savings bank derives its lending and investment powers from the Home Owners' Loan Act, and the regulations of the Office of Thrift Supervision. Under these laws and regulations, Monadnock Community Bank may invest in mortgage loans secured by residential and commercial real estate, commercial business and consumer loans, certain types of debt securities and certain other loans and assets subject to applicable limits. Monadnock Community Bank also may establish subsidiaries that may engage in activities not otherwise permissible for Monadnock Community Bank directly, including real estate investment.

**Capital Requirements.** Office of Thrift Supervision regulations require savings banks to meet three minimum capital standards: a 1.5% tangible capital ratio, a 4% leverage ratio (3% for institutions receiving the highest CAMELS rating) and an 8% risk-based capital ratio. The prompt corrective action standards discussed below, in effect, establish a minimum 2% tangible capital standard.

The risk-based capital standard for savings banks requires the maintenance of Tier 1 (core) and total capital (which is defined as core capital and supplementary capital) to risk-weighted assets of at least 4% and 8%, respectively. In determining the amount of risk-weighted assets, all assets, including certain off-balance sheet assets, are multiplied by a risk-weight factor of 0% to 100%, assigned by the Office of Thrift Supervision capital regulation based on the risks inherent in the type of asset. Core capital is defined as common stockholders' equity (including retained earnings), certain noncumulative perpetual preferred stock and related surplus and minority interests in equity accounts of consolidated subsidiaries, less intangibles other than certain mortgage servicing rights and credit card relationships. The components of supplementary

capital currently include cumulative preferred stock, long-term perpetual preferred stock, mandatory convertible securities, subordinated debt and intermediate preferred stock, allowance for loan and lease losses up to a maximum of 1.25% of risk-weighted assets, and up to 45% of net unrealized gains on available-for-sale equity securities with readily determinable fair market values. Overall, the amount of supplementary capital included as part of total capital cannot exceed 100% of core capital.

At December 31, 2008, Monadnock Community Bank's capital exceeded all applicable requirements.

**Loans to One Borrower.** A federal savings bank generally may not make a loan or extend credit to a single or related group of borrowers in excess of 15% of unimpaired capital and surplus on an unsecured basis. An additional amount may be loaned, equal to 10% of unimpaired capital and surplus, if the loan is secured by readily marketable collateral, which generally does not include real estate. As of December 31, 2008, Monadnock Community Bank was in compliance with the loans-to-one-borrower limitations.

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

"Qualified thrift investments" include various types of loans made for residential and housing purposes, investments related to such purposes, including certain mortgage-backed and related securities, and loans for personal, family, household and certain other purposes up to a limit of 20% of portfolio assets. "Qualified thrift investments" also include 100% of an institution's credit card loans, education loans and small business loans. Monadnock Community Bank also may satisfy the QTL test by qualifying as a "domestic building and loan association" as defined in the Internal Revenue Code of 1986.

A savings bank that fails the QTL test must either convert to a bank charter or operate under specified restrictions. At December 31, 2008, Monadnock Community Bank maintained approximately 98.62% of its portfolio assets in qualified thrift investments, and therefore satisfied the QTL test.

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

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

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

The Office of Thrift Supervision may disapprove a notice or application if:

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

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

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

**Transactions with Related Parties.** A federal savings bank's authority to engage in transactions with its "affiliates" is limited by Office of Thrift Supervision regulations and Regulation W of the Federal Reserve Board, which implements Sections 23A and 23B of the Federal Reserve Act. The term "affiliates" for these purposes generally means any company that controls or is under common control with an institution. Monadnock Bancorp, Inc. and its non-savings institution subsidiaries would be affiliates of Monadnock Community Bank. In general, transactions with affiliates must be on terms that are as favorable to the savings bank as comparable transactions with non-affiliates. In addition, certain types of these transactions are restricted to an aggregate percentage of the savings bank's capital. Collateral in specified amounts must usually be provided by affiliates in order to receive loans from the savings bank. In addition, Office of Thrift Supervision regulations prohibit a savings bank from lending to any of its affiliates that are engaged in activities that are not permissible for bank holding companies and from purchasing the securities of any affiliate, other than a subsidiary.

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

**Enforcement.** The Office of Thrift Supervision has primary enforcement responsibility over federal savings banks and has the authority to bring enforcement action against all "institution-affiliated parties," including controlling stockholders, attorneys, appraisers and accountants who knowingly or recklessly participate in wrongful action likely to have an adverse effect on an institution. Formal enforcement action may range from the issuance of a capital directive or cease and desist order to removal of officers and/or directors of the savings bank, receivership, conservatorship, the termination of deposit insurance or the imposition of civil money penalties. The Federal Deposit Insurance Corporation also has the authority to recommend to the Director of the Office of Thrift Supervision that enforcement action be taken with respect to a particular savings bank. If action is not taken by the Director, the Federal Deposit Insurance Corporation has authority to take action under specified circumstances.

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

agency an acceptable plan to achieve compliance with the standard. If an institution fails to meet these standards, the appropriate federal banking agency may require the institution to submit a compliance plan.

**Prompt Corrective Action Regulations.** Under the prompt corrective action regulations, the Office of Thrift Supervision is authorized and, under certain circumstances, required to take supervisory actions against undercapitalized savings banks. For this purpose, a savings bank is placed in one of the following five categories based on the savings bank's capital:

- well-capitalized (at least 5% leverage capital, 6% tier 1 risk-based capital and 10% total risk-based capital);
- adequately capitalized (at least 4% leverage capital, 4% tier 1 risk-based capital and 8% total risk-based capital);
- undercapitalized (less than 3% leverage capital, 4% tier 1 risk-based capital or 8% total risk-based capital);
- significantly undercapitalized (less than 3% leverage capital, 3% tier 1 risk-based capital or 6% total risk-based capital); or
- critically undercapitalized (less than 2% tangible capital).

Generally, the Office of Thrift Supervision is required to appoint a receiver or conservator for a savings bank that is "critically undercapitalized." The regulation also provides that a capital restoration plan must be filed with the Office of Thrift Supervision within 45 days of the date a savings bank receives notice that it is "undercapitalized," "significantly undercapitalized" or "critically undercapitalized." In addition, numerous mandatory supervisory restrictions become immediately applicable to the savings bank, including, but not limited to, restrictions on growth, investment activities, capital distributions and affiliate transactions. The Office of Thrift Supervision may also take any one of a number of discretionary supervisory actions against undercapitalized savings banks, including the issuance of a capital directive and the replacement of senior executive officers and directors.

At December 31, 2008, Monadnock Community Bank met the criteria for being considered "well-capitalized."

**Insurance of Deposit Accounts.** Deposit accounts in Monadnock Community Bank are insured by the Federal Deposit Insurance Corporation up to a maximum of \$100,000 per separately insured depositor and up to a maximum of \$250,000 for self-directed retirement accounts. Monadnock Community Bank's deposits, therefore, are subject to Federal Deposit Insurance Corporation deposit insurance assessments. The Federal Deposit Insurance Corporation has adopted a risk-based system for determining deposit insurance assessments.

On October 3, 2008, President George W. Bush signed the Emergency Economic Stabilization Act of 2008, which temporarily raises the basic limit on federal deposit insurance coverage from \$100,000 to \$250,000 per depositor. The temporary increase in deposit insurance coverage became effective upon the President's signature. The legislation provides that the basic deposit insurance limit will return to \$100,000 after December 31, 2009. During the fourth quarter of 2008, the Bank elected the unlimited deposit insurance coverage through December 31, 2009 for non-interest bearing transaction accounts through the FDIC's Temporary Liquidity Guarantee Program.

The Federal Deposit Insurance Corporation regulations assess insurance premiums based on an institution's risk. Under this assessment system, the Federal Deposit Insurance Corporation evaluates the risk of each financial institution based on its supervisory rating, financial ratios and long-term debt issuer rating. The rates for nearly all of the financial institution industry vary between five and seven cents for every \$100 of domestic deposits. Federal law requires the Federal Deposit Insurance Corporation to establish a deposit reserve ratio for the deposit insurance fund of between 1.15% and 1.50% of estimated deposits.

On December 16, 2008, the Board of Directors of the FDIC approved a restoration plan for the Deposit Insurance Fund which raised the assessment rate schedule uniformly by seven basis points (annualized), beginning January 1, 2009, from a minimum of five basis points to twelve basis points. On February 26, 2009, the FDIC approved an amended restoration plan for the Deposit Insurance Fund. Beginning in the second quarter of 2009, the FDIC will adjust the base

assessment based on an institution's level of unsecured debt, secured liabilities and brokered deposits. As a result, the Bank will be subject to additional assessments beginning April 1, 2009 since the Bank's FHLB advances exceeded 25% of domestic deposits. In addition, the FDIC has proposed 1) imposing an emergency special assessment of 20 basis points on all insured depository institutions on June 30, 2009 and 2) after June 30, 2009, permitting the FDIC Board of Directors to impose an emergency special assessment of up to 10 basis points at the end of any calendar quarter whenever the FDIC estimates that the Deposit Insurance Fund reserve ratio will fall to a level that the Board believes would adversely affect public confidence or to a level close to zero or negative. The increase in FDIC assessments and any special assessments may have a negative effect on the Bank's earnings for 2009.

Effective March 31, 2006, the Federal Deposit Insurance Corporation merged the Bank Insurance Fund and the Savings Association Insurance Fund into a single fund called the Deposit Insurance Fund. In addition to the Federal Deposit Insurance Corporation assessments, the Financing Corporation ("FICO") is authorized to impose and collect, with the approval of the Federal Deposit Insurance Corporation, assessments for anticipated payments, issuance costs and custodial fees on bonds issued by the FICO in the 1980s to recapitalize the Federal Savings and Loan Insurance Corporation. The bonds issued by the FICO are due to mature in 2017 through 2019. For the quarter ended December 31, 2008, the annualized FICO assessment was equal to 1.10 basis points for each \$100 in domestic deposits maintained at an institution.

**Temporary Liquidity Guarantee Program.** On October 14, 2008, the Federal Deposit Insurance Corporation announced a new program – the Temporary Liquidity Guarantee Program. This program has two components. One guarantees newly issued senior unsecured debt of a participating organization, up to certain limits established for each institution, issued between October 14, 2008 and June 30, 2009. The Federal Deposit Insurance Corporation will pay the unpaid principal and interest on a Federal Deposit Insurance Corporation-guaranteed debt instrument upon the uncured failure of the participating entity to make a timely payment of principal or interest in accordance with the terms of the instrument. The guarantee will remain in effect until June 30, 2012. In return for the Federal Deposit Insurance Corporation's guarantee, participating institutions will pay the Federal Deposit Insurance Corporation a fee based on the amount and maturity of the debt. The Bank opted to participate in this component of the Temporary Liquidity Guarantee Program.

The other component of the program provides full federal deposit insurance coverage for non-interest bearing transaction deposit accounts, regardless of dollar amount, until December 31, 2009. An annualized 10 basis point assessment on balances in noninterest-bearing transaction accounts that exceed the existing deposit insurance limit of \$250,000 will be assessed on a quarterly basis to insured depository institutions that have not opted out of this component of the Temporary Liquidity Guarantee Program. The Bank opted to participate in this component of the Temporary Liquidity Guarantee Program.

**U.S. Treasury's Troubled Asset Relief Program Capital Purchase Program.** The Emergency Economic Stabilization Act of 2008 was enacted in October 2008 and provides the U.S. Secretary of the Treasury with broad authority to implement certain actions to help restore stability and liquidity to U.S. markets. One of the provisions resulting from the legislation is the Troubled Asset Relief Program, Capital Purchase Program ("CPP"), which provides direct equity investment in perpetual preferred stock by the U.S. Treasury Department in qualified financial institutions. The program is voluntary and requires an institution to comply with a number of restrictions and provisions, including limits on executive compensation, stock redemptions and declaration of dividends. The CPP provides for a minimum investment of one percent of total risk-weighted assets and a maximum investment equal to the lesser of three percent of total risk-weighted assets or \$25 billion. Participation in the program is not automatic and is subject to approval by the U.S. Treasury Department. Monadnock Bancorp, Inc. received \$1.834 million under the CPP program in December 2008.

In addition, the current economic crisis has generated new federal legislation, including the American Recovery and Reinvestment Act of 2009 ("ARRA"), which has created new corporate governance reporting obligations, as well as compensation and financial restrictions, on banks and financial services companies receiving federal assistance pursuant to this statute and the TARP Capital Purchase Program. There can be no assurance that some of these restrictions may be applied more broadly in the future to financial institutions that are not receiving federal assistance. Moreover, it is likely that additional legislation will be enacted in the future affecting the regulation of financial institutions and their holding companies.

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

***Federal Home Loan Bank System.*** Monadnock Community Bank is a member of the Federal Home Loan Bank System, which consists of 12 regional Federal Home Loan Banks. The Federal Home Loan Bank System provides a central credit facility primarily for member institutions. As a member of the Federal Home Loan Bank of Boston, Monadnock Community Bank is required to acquire and hold shares of capital stock in the Federal Home Loan Bank. As of December 31, 2008, Monadnock Community Bank was in compliance with this requirement.

On December 8, 2008, the Federal Home Loan Bank of Boston announced a moratorium on the repurchase of excess stock held by its members. The moratorium will remain in effect indefinitely. On February 26, 2009, the Federal Home Loan Bank of Boston announced that dividend payments for the first quarter of 2009 were suspended and that it is unlikely that dividends will be paid in 2009. Dividend payments totaling approximately \$73,000 were received for the year ended December 31, 2008.

### **Federal Reserve System**

Federal Reserve Board regulations require savings banks to maintain non-interest-earning reserves against their transaction accounts, such as negotiable order of withdrawal and regular checking accounts. At December 31, 2008, Monadnock Community Bank was in compliance with these reserve requirements. The balances maintained to meet the reserve requirements imposed by the Federal Reserve Board may be used to satisfy liquidity requirements imposed by the Office of Thrift Supervision.

### **The USA PATRIOT Act**

The USA PATRIOT Act gives the federal government new powers to address terrorist threats through enhanced domestic security measures, expanded surveillance powers, increased information sharing and broadened anti-money laundering requirements. Certain provisions of the Act impose affirmative obligations on a broad range of financial institutions, including federal savings banks, like Monadnock Community Bank. These obligations include enhanced anti-money laundering programs, customer identification programs and regulations relating to private banking accounts or correspondence accounts in the United States for non-United States persons or their representatives (including foreign individuals visiting the United States).

Monadnock Community Bank has established policies and procedures to ensure compliance with the USA PATRIOT Act's provisions, and the impact of the USA PATRIOT Act on our operations has not been material.

### **Privacy Requirements of the Gramm-Leach-Bliley Act**

The Gramm-Leach-Bliley Act of 1999 provided for sweeping financial modernization for commercial banks, savings banks, securities firms, insurance companies, and other financial institutions operating in the United States. Among other provisions, the Gramm-Leach-Bliley Act places limitations on the sharing of consumer financial information with unaffiliated third parties. Specifically, the Gramm-Leach-Bliley Act requires all financial institutions offering financial products or services to retail customers to provide such customers with the financial institution's privacy policy and provide such customers the opportunity to "opt out" of the sharing of personal financial information with unaffiliated third parties.

### **Holding Company Regulation**

Monadnock Bancorp, Inc. is a unitary savings and loan holding company, subject to regulation and supervision by the Office of Thrift Supervision. The Office of Thrift Supervision has enforcement authority over Monadnock Bancorp, Inc. and its non-savings institution subsidiaries. Among other things, this authority permits the Office of Thrift Supervision to restrict or prohibit activities that are determined to be a risk to Monadnock Community Bank. Monadnock Bancorp, Inc.'s activities are generally limited to those permissible for financial holding companies. A financial holding company may

engage in activities that are financial in nature, including underwriting equity securities and insurance, incidental to financial activities or complementary to a financial activity.

Federal law prohibits a savings and loan holding company, directly or indirectly, or through one or more subsidiaries, from acquiring control of another savings institution or holding company thereof, without prior written approval of the Office of Thrift Supervision. It also prohibits the acquisition or retention of, with specified exceptions, more than 5% of the equity securities of a company engaged in activities that are not closely related to banking or financial in nature or acquiring or retaining control of an institution that is not federally insured. In evaluating applications by holding companies to acquire savings institutions, the Office of Thrift Supervision must consider the financial and managerial resources and future prospects of the savings institution involved, the effect of the acquisition on the risk to the insurance fund, the convenience and needs of the community and competitive factors.

### **Sarbanes-Oxley Act of 2002**

The Sarbanes-Oxley Act of 2002 is a law that addresses, among other issues, corporate governance, auditing and accounting, executive compensation, and enhanced and timely disclosure of corporate information. As directed by Section 302(a) of Sarbanes-Oxley Act of 2002, Monadnock Bancorp, Inc.'s Chief Executive Officer and Chief Financial Officer each are required to certify that its quarterly and annual reports do not contain any untrue statement of a material fact. The rules have several requirements, including having these officers certify that: they are responsible for establishing, maintaining and regularly evaluating the effectiveness of our internal controls; they have made certain disclosures to our auditors and the audit committee of the Board of Directors about our internal controls; and they have included information in our quarterly and annual reports about their evaluation and whether there have been significant changes in our internal controls or in other factors that could significantly affect internal controls. Monadnock Bancorp, Inc. will be subject to further reporting and audit requirements beginning with the year ending December 31, 2009 under the requirements of the Sarbanes-Oxley Act. Monadnock Bancorp, Inc. has been developing policies, procedures and systems designed to comply with these regulations.

### **Federal Securities Laws**

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

The registration under the Securities Act of 1933 of shares of Monadnock Bancorp, Inc. common stock that were issued in the 2006 stock offering does not cover the resale of the shares. Shares of common stock purchased by persons who are not affiliates of Monadnock Bancorp, Inc. may be resold without registration. Shares purchased by an affiliate of Monadnock Bancorp, Inc. will be subject to the resale restrictions of Rule 144 under the Securities Act of 1933. If Monadnock Bancorp, Inc. meets the current public information reporting requirements of Rule 144 under the Securities Act of 1933, each affiliate of Monadnock Bancorp, Inc. that complies with the other conditions of Rule 144, including those that require the affiliate's sale to be aggregated with those of other persons, would be able to sell in the public market, without registration, a number of shares not to exceed, in any three-month period, the greater of 1% of the outstanding shares of Monadnock Bancorp, Inc., or the average weekly volume of trading in the shares during the preceding four calendar weeks. In the future, Monadnock Bancorp, Inc. may permit affiliates to have their shares registered for sale under the Securities Act of 1933.

### **ITEM 1A. Risk Factors**

Not applicable for a smaller reporting company.

### **ITEM 1B. Unresolved Staff Comments**

Not applicable for a smaller reporting company.

**ITEM 2. Properties**

As of December 31, 2008, Monadnock Community Bank leased its main office and owned its branch office. The following is a list of our locations:

<u>Location</u>	<u>Owned or Leased</u>	<u>Year Acquired or Leased</u>	<u>Net Book Value of Real Property</u>
Main Office			
One Jaffrey Road Peterborough, New Hampshire 03458	Leased	1998	\$ --
Branch Office			
172 Central Street Winchendon, Massachusetts 01475	Owned	2004	\$360,000

The net book value of our premises, land and equipment was \$744,000 at December 31, 2008, which includes undeveloped property located in Rindge, New Hampshire as a potential new office site.

**ITEM 3. Legal Proceedings**

We are involved, from time to time, as plaintiff or defendant in various legal actions arising in the normal course of business. At December 31, 2008, we were not involved in any legal proceedings, the outcome of which would be material to our financial condition, results of operations, or cash flows.

**ITEM 4. Submission of Matters to a Vote of Security Holders**

No matters were submitted to a vote of stockholders during the fourth quarter of the year under report.

**PART II****ITEM 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

Our common stock is traded on the OTC Electronic Bulletin Board under the symbol "MNKB.OB". The approximate number of holders of record of Monadnock Bancorp, Inc.'s common stock as of December 31, 2008 was 321. Certain shares of Monadnock Bancorp, Inc. are held in "nominee" or "street" name and accordingly, the number of beneficial owners of such shares is not known or included in the foregoing number. The following table sets forth the range of the high and low bid prices of Monadnock Bancorp, Inc. common stock since January 1, 2007 and is based upon information provided through finance.Yahoo.com. Monadnock Bancorp, Inc. has never paid dividends. As part of the CPP transaction with the U.S. Treasury, Monadnock Bancorp, Inc. has agreed that it may pay dividends on its common stock only with the prior approval of the U.S. Treasury. The quotations reflect inter-dealer prices, without retail markup, markdown or commission, and may not represent actual transactions.

<u>Quarter</u>	<u>High</u>	<u>Low</u>	<u>Dividends</u>
Quarter ended December 31, 2008	\$ 6.45	\$ 3.40	\$ 0.00
Quarter ended September 30, 2008	6.10	5.25	0.00
Quarter ended June 30, 2008	6.50	5.80	0.00
Quarter ended March 31, 2008	6.50	5.80	0.00
Quarter ended December 31, 2007	6.75	6.05	0.00
Quarter ended September 30, 2007	6.75	6.30	0.00
Quarter ended June 30, 2007	6.85	6.36	0.00
Quarter ended March 31, 2007	7.30	6.35	0.00

Dividend payments by Monadnock Bancorp, Inc. are dependent primarily on dividends it receives from Monadnock Community Bank, because Monadnock Bancorp, Inc. has no source of income other than dividends from Monadnock Community Bank and interest payments with respect to Monadnock Bancorp, Inc.'s loan to the employee stock ownership plan prior to the refinancing of the loan with a third party. See Item 1 – Business - Borrowings. A regulation of the Office of Thrift Supervision imposes restrictions on the ability of Monadnock Community Bank to pay dividends to Monadnock Bancorp, Inc. See “Regulation – Capital Distributions.” Also, see Item 11, “Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters” for the Equity Compensation Plan table.

**ITEM 6. Selected Financial Data**

Not applicable for a smaller reporting company.

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

The “Management’s Discussion and Analysis of Financial Condition and Results of Operations” section of Monadnock Bancorp, Inc.’s 2008 Annual Report to Stockholders is incorporated herein by reference.

**ITEM 7A. Quantitative and Qualitative Disclosures about Market Risk**

The “Management of Interest Rate Risk” section of Monadnock Bancorp, Inc.’s 2008 Annual Report to Stockholders is incorporated herein by reference.

**ITEM 8. Financial Statements and Supplementary Data**

The consolidated financial statements included in Monadnock Bancorp, Inc.’s 2008 Annual Report to Stockholders are incorporated herein by reference.

**ITEM 9. Changes In and Disagreements With Accountants on Accounting and Financial Disclosure**

None.

**ITEM 9A(T). Controls and Procedures**

- a) Under the supervision and with the participation of our management, including our Chief Executive Officer and Chief Financial Officer, we evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report. Based upon that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that, as of the end of the period covered by this report, our disclosure controls and procedures were effective to ensure that information required to be disclosed in the reports that the Company files or submits under the Securities Exchange Act of 1934, is recorded, processed, summarized and reported, within the time periods specified in the SEC’s rules and forms.
- b) The “Report of Management on Internal Control over Financial Reporting” section of Monadnock Bancorp, Inc.’s 2008 Annual Report to Stockholders is incorporated herein by reference.
- c) There has been no change in Monadnock Bancorp, Inc.’s internal control over financial reporting during Monadnock Bancorp, Inc.’s fourth quarter of fiscal year 2008 that has materially affected, or is reasonably likely to materially affect, Monadnock Bancorp, Inc.’s internal control over financial reporting. The “Report of Management on Internal Control over Financial Reporting” section of Monadnock Bancorp, Inc.’s 2008 Annual Report to Stockholders is incorporated herein by reference.

**ITEM 9B. Other Information**

None.

### PART III

#### **ITEM 10. Directors, Executive Officers and Corporate Governance**

The Company has adopted a Code of Ethics that applies to the Company's principal executive officer, principal accounting officer or controller or persons performing similar functions. The Code of Ethics is available for free by writing to: Corporate Secretary: Monadnock Bancorp, Inc., 1 Jaffrey Road, Peterborough, NH 03458 and is also available through Monadnock Bancorp Inc.'s website at [www.monadnockbank.com](http://www.monadnockbank.com).

Information concerning Directors, Executive Officers and corporate governance of the Company is incorporated herein by reference from our definitive Proxy Statement (the "Proxy Statement"), specifically the section captioned "Proposal I - Election of Directors."

The information concerning compliance with the reporting requirements of Section 16(a) of the Securities Exchange Act of 1934 by directors, officers and ten percent stockholders of the Company required by this item is incorporated by reference herein from the Company's definitive proxy statement for its 2009 Annual Meeting of Stockholders.

#### **ITEM 11. Executive Compensation**

Information concerning executive compensation is incorporated herein by reference from our Proxy Statement, specifically the section captioned "Executive Compensation."

#### **ITEM 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

Information concerning security ownership of certain owners and management and related stockholder matters is incorporated herein by reference from our Proxy Statement, specifically the sections captioned "Voting Securities and Principal Holders Thereof" and the "Equity Compensation Plan" table.

#### **ITEM 13. Certain Relationships and Related Transactions, and Director Independence**

Information concerning relationships and transactions is incorporated herein by reference from our Proxy Statement, specifically the section captioned "Transactions with Certain Related Persons."

#### **ITEM 14. Principal Accountant Fees and Services**

Information concerning principal accountant fees and services is incorporated herein by reference from our Proxy Statement, specifically the section captioned "Proposal II - Ratification of Appointment of Independent Registered Public Accounting Firm."

### PART IV

#### **ITEM 15. Exhibits and Financial Statement Schedules**

- 3.1 Articles of Incorporation of Monadnock Bancorp, Inc.\*
- 3.2 Bylaws of Monadnock Bancorp, Inc.\*
- 4.1 Form of Common Stock Certificate of Monadnock Bancorp, Inc.\*
- 4.2 Articles Supplementary for the Fixed Rate Cumulative Perpetual Preferred Stock, Series A\*\*
- 4.3 Articles Supplementary for the Fixed Rate Cumulative Perpetual Preferred Stock, Series B\*\*
- 4.4 Warrant to Purchase Fixed Rate Cumulative Perpetual Preferred Stock, Series B\*\*
- 10.1 Employee Stock Ownership Plan\*
- 10.2 Monadnock Community Bancorp, Inc. 2005 Stock Option Plan\*\*\*
- 10.3 Monadnock Community Bancorp, Inc. 2005 Recognition and Retention Plan\*\*\*
- 10.4 Monadnock Bancorp, Inc. 2007 Equity Incentive Plan\*\*\*\*

- 10.5 Letter Agreement, dated December 19, 2008, between Monadnock Bancorp, Inc. and the United States Department of the Treasury, which includes the Securities Purchase Agreement-Standard Terms attached thereto, with respect to the issuance and sale of the Series A Preferred Stock and the Warrant\*\*
- 10.6 Waiver of Senior Executive Officers, dated December 12, 2008\*\*
- 10.7 Amendment to Benefit Plans and Related Consent of Senior Executive Officers\*\*
- 13 Annual Report to Stockholders
- 21 Subsidiaries of Registrant\*
- 23.1 Consent of Shatswell, MacLeod & Company, P.C.
- 31.1 Certification of Chief Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 31.2 Certification of Chief Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended, as adopted pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
- 32 Certification of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

---

\* Incorporated by reference to the Registration Statement on Form SB-2 (Registration Number 333-132548) as filed on March 17, 2006, as amended.

\*\* Incorporated by reference to the Form 8-K (Commission File No. 000-50810) filed on December 24, 2008.

\*\*\* Incorporated by reference to Appendix B and Appendix C to the Proxy Statement for Monadnock Community Bancorp, Inc.'s 2005 Annual Meeting of Stockholders (Commission File No. 000-50810) filed on March 24, 2005.

\*\*\*\* Incorporated by reference to Appendix A to the Proxy Statement for Monadnock Bancorp, Inc.'s 2007 Annual Meeting of Stockholders (Commission File No. 000-50810) filed on March 23, 2007.

**SIGNATURES**

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

**Monadnock Bancorp, Inc.**

Date: March 23, 2009

By: /s/ William M. Pierce, Jr.  
William M. Pierce, Jr.  
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

By: /s/ William M. Pierce, Jr.  
William M. Pierce, Jr.  
President, Chief Executive Officer and Director  
(Principal Executive Officer)

By: /s/ Karl F. Betz  
Karl F. Betz  
Senior Vice President and Chief Financial Officer  
(Principal Accounting Officer)

Date: March 23, 2009

Date: March 23, 2009

By: /s/ Kenneth A. Christian  
Kenneth A. Christian  
Director

By: /s/ Samuel J. Hackler  
Samuel J. Hackler  
Director

Date: March 23, 2009

Date: March 23, 2009

By: /s/ Jack Goldstein  
Jack Goldstein  
Director

By: /s/ Thomas C. LaFortune  
Thomas C. LaFortune  
Director

Date: March 23, 2009

Date: March 23, 2009

By: /s/ Kenneth R. Simonetta  
Kenneth R. Simonetta  
Director

By: /s/ Edward J. Shea  
Edward J. Shea  
Director

Date: March 23, 2009

Date: March 23, 2009

By: /s/ Nancy L. Carlson  
Nancy L. Carlson  
Director

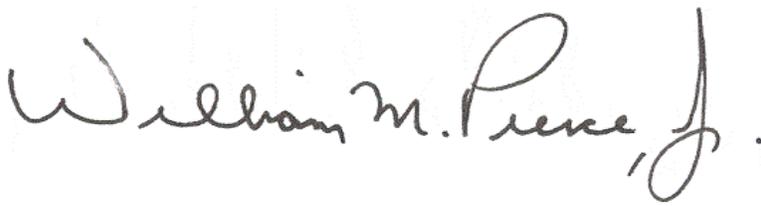
Date: March 23, 2009



**Annual Report  
2008**

## TABLE OF CONTENTS

	Page
Message to Our Stockholders	1
Selected Consolidated Financial and Other Data	2
Selected Financial Ratios and Other Data	3
Management's Discussion and Analysis of Financial Condition and Results of Operations	4
Independent Auditor's Report	21
Consolidated Balance Sheets	22
Consolidated Statements of Income	23
Consolidated Statements of Changes in Stockholders' Equity	24 to 25
Consolidated Statements of Cash Flows	26 to 27
Notes to Consolidated Financial Statements	28



Dear Stockholder:

Although the last eighteen months have been quite challenging due to illiquidity in the markets, financial turmoil in the credit markets and the Federal Reserve having to reduce the federal funds target rate by 5.25% since September 2007, we were able to record net income of \$72,000 for the year compared with net income of \$83,000 for 2007. Our book value per share and tangible book value per share were \$7.76 and \$7.61, respectively, at December 31, 2008.

During the fourth quarter of 2008, we completed a \$1.834 million Capital Purchase Program (CPP) transaction with the U.S. Treasury. The CPP is part of the U. S. Treasury's Troubled Asset Relief Program authorized under the Emergency Economic Stabilization Act of 2008 to stabilize the U. S. financial system. The Company sold Preferred stock to the U. S. Treasury in exchange for the capital injection. We are pleased to be a part of the CPP program which will allow us to continue our growth strategy and further support individuals and businesses in our local market areas. We believe that the CPP will allow us to improve our franchise and shareholder value over the long term.

In the lending area, we continue to be a diversified lender with a wide array of product offerings that suit the needs of small business owners and commercial customers as well as retail customers. Our net loan portfolio increased \$6.7 million, or 10.5%, from \$64.0 million at the end of 2007 to \$70.7 million at the end of 2008.

The introduction of a new product, Rewards Checking, in the fourth quarter of 2007 has been successful in capturing new checking accounts. Rewards Checking accounts increased \$7.2 million during the year ended December 31, 2008 and totaled \$10.6 million at December 31, 2008. In 2009, we will look to add new products such as gathering deposits online from new customers not in our local market area with Checkingfinder.com.

The Board of Directors and management team remains committed to the communities we serve and our shareholders.

Very truly yours,  
Monadnock Bancorp, Inc.



William M. Pierce, Jr.  
President and Chief Executive Officer

---

One Jaffrey Road · P.O. Box 888 · Peterborough, New Hampshire 03458 · Tel: 603-924-9654 · Fax: 603-924-9379

172 Central Street · Winchendon, Massachusetts 01475 · Tel: 978-297-9654 · Fax: 978-297-9657

[www.monadnockbank.com](http://www.monadnockbank.com)

**SELECTED CONSOLIDATED FINANCIAL AND OTHER DATA  
OF  
MONADNOCK BANCORP, INC. AND SUBSIDIARY**

The summary information presented below under "Selected Financial Condition Data" and "Selected Operating Data" at and for the years ended December 31, 2008, 2007 and 2006 is derived from our audited consolidated financial statements. On June 28, 2006, Monadnock Bancorp, Inc. succeeded Monadnock Community Bancorp, Inc. as the holding company of Monadnock Community Bank. The following information is only a summary and should be read in conjunction with our consolidated financial statements and notes beginning on page 22.

	At December 31,		
	2008	2007	2006
	(In Thousands)		
<b>Selected Financial Condition Data:</b>			
Total assets	\$ 127,593	\$ 105,176	\$ 96,185
Cash and cash equivalents	700	1,181	1,098
Loans, net	70,702	64,031	53,709
Securities available-for-sale	51,171	36,596	38,320
Other investments (interest-bearing time deposit)	200	100	100
FHLB stock	2,568	1,608	1,328
Deposits	61,772	64,818	61,362
Total borrowings	54,526	30,538	24,965
Total stockholders' equity	10,867	9,437	9,676

	Year Ended December 31,		
	2008	2007	2006
	(In Thousands)		
<b>Selected Operating Data:</b>			
Total interest and dividend income	\$ 6,365	\$ 6,030	\$ 4,626
Total interest expense	3,481	3,449	2,464
Net interest and dividend income	2,884	2,581	2,162
Provision for loan losses	156	112	37
Net interest and dividend income after provision for loan losses	2,728	2,469	2,125
Customer service charges	201	199	201
Other non-interest income	227	154	73
Total non-interest income	428	353	274
Total non-interest expense	3,024	2,666	2,273
Income before income taxes	132	156	126
Income tax provision	60	73	51
Net income	<u>\$ 72</u>	<u>\$ 83</u>	<u>\$ 75</u>

**Selected Financial Ratios and Other Data:**

	At or For the Year Ended		
	December 31,		
	2008	2007	2006
<b>Performance Ratios:</b>			
Return on assets (ratio of net income to average total assets)	0.06%	0.08%	0.09%
Return on equity (ratio of net income to average equity)	0.78%	0.87%	1.02%
Ratio of non-interest expense to average total assets	2.67%	2.66%	2.74%
Efficiency ratio(1)	91.29%	90.87%	93.32%
Ratio of average interest-earning assets to average interest-bearing liabilities	112.70%	115.88%	115.67%
Average interest rate spread (2)	2.21%	2.07%	2.19%
Net interest margin(3)	2.60%	2.63%	2.67%
<b>Asset Quality Ratios:</b>			
Non-performing assets to total assets	0.81%	0.26%	0.06%
Allowance for loan losses to non-performing loans(4)	81.14%	144.44%	558.33%
Allowance for loan losses to total loans(4)	0.58%	0.61%	0.62%
Net charge-offs to average outstanding loans(4)	0.20%	0.10%	0.03%
Non-performing loans to total loans(4)	0.72%	0.42%	0.11%
<b>Capital Ratios:</b>			
Equity to total assets at end of period	8.52%	8.97%	10.06%
Average equity to average assets	8.17%	9.58%	8.82%
Tier 1 leverage(5)	8.19%	8.14%	8.67%
Tier 1 risk-based(5)	16.10%	15.30%	18.16%
Total risk-based(5)	16.73%	15.99%	18.89%
<b>Other Data:</b>			
Number of full-service offices	2	2	2
Number of average full-time equivalent employees	26	24	24
Number of loans	979	935	823
Number of deposit accounts	5,142	5,341	5,345

(1) Efficiency ratio represents non-interest expense as a percentage of net interest income plus non-interest income.

(2) Spread represents the difference between the weighted average yield on interest-earning assets and weighted average cost on interest-bearing liabilities.

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

(4) The allowance for loan losses at December 31, 2008, 2007 and 2006 was \$413,000, \$390,000 and \$335,000, respectively.

(5) Capital ratios are for Monadnock Community Bank only.

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

This discussion and analysis reflects our consolidated financial statements and other relevant statistical data. The information in this section has been derived from the audited consolidated financial statements, which appear beginning on page 22 of this annual report.

### Forward-Looking Statements

These financial statements and management discussion and analysis contains forward-looking statements, which are based on assumptions and describe future plans, strategies and expectations of Monadnock Bancorp, Inc. (or the "Company") and its wholly owned subsidiary, Monadnock Community Bank (or the "Bank"). These forward-looking statements are generally identified by use of the words "believe," "expect," "intend," "anticipate," "estimate," "project," or similar words. Our ability to predict results or the actual effect of future plans or strategies is uncertain. Factors which could have a material adverse effect on our operations include, but are not limited to, changes in interest rates, general economic conditions, the impact of the U.S. Government's economic stimulus program and its various financial institution rescue plans including the Troubled Asset Relief Program ("TARP"), economic conditions in the states of New Hampshire or Massachusetts, legislative and regulatory changes, monetary and fiscal policies of the U.S. Government, including policies of the U.S. Treasury and the Federal Reserve Board, fiscal policies of the New Hampshire or Massachusetts State Government, the quality or composition of our loan or investment portfolios, demand for loan products, competition for and the availability of loans that we purchase for our portfolio, deposit flows, competition, demand for financial services in our market areas and accounting principles and guidelines, acquisitions and the integration of acquired businesses, asset-liability management, the financial and securities markets and the availability of and costs associated with sources of liquidity.

We wish to caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. We wish to advise readers that the factors listed above could affect our financial performance and could cause our actual results for future periods to differ materially from any opinions or statements expressed with respect to future periods in any current statements. We do not undertake and specifically decline any obligation to publicly release the result of any revisions, which may be made to any forward-looking statements to reflect events or circumstances after the date of such statements or to reflect the occurrence of anticipated or unanticipated events.

### General

The following discussion is intended to assist in understanding the financial condition and results of operations of Monadnock Bancorp, Inc. and Monadnock Community Bank. On June 28, 2006, Monadnock Bancorp, Inc. succeeded Monadnock Community Bancorp, Inc. as the holding company of Monadnock Community Bank. The information contained in this section should be read in conjunction with other sections of this annual report, including the financial statements.

As a community based financial institution, our principal business has historically consisted of attracting deposits from the general public and the business community and making loans secured by various types of collateral, including residential and commercial real estate and general business assets. Deposit flows are influenced by a number of factors, including interest rates paid on competing investments, account maturities, fee structures, and level of personal income and savings. Lending activities are influenced by the demand for funds, interest rate levels, the number and quality of lenders, and regional economic cycles. Our sources of funds for lending activities include deposits, borrowings, payments on loans, maturation or sales of securities and income provided from operations.

Our earnings are primarily dependent upon our net interest income, which is the difference between interest income on interest-earning assets, which principally consists of loans and investment securities, and interest expense on interest-bearing liabilities, which principally consists of deposits and borrowings. Our results of operations also are affected by the level of our provision for loan losses, non-interest income and non-interest expense. Non-interest income consists primarily of service charges on deposit accounts, point of sale income from debit and credit card transactions, ATM fees and any gain on sale of loans and investments. Non-interest expense consists primarily of salaries and employee benefits, occupancy, equipment, data processing, ATM expense, professional fees and marketing. Our results of operations may also be affected significantly by general and local economic and competitive conditions, changes in market interest rates, governmental policies, Federal Home Loan Bank ("FHLB") dividend policies, Federal Deposit Insurance Corporation ("FDIC") assessment rates, costs associated with becoming compliant with Section 404 of the Sarbanes-Oxley Act of 2002 by December 31, 2009 as a Smaller Reporting Company as well as actions of regulatory authorities.

### **Critical Accounting Policies and Estimates**

In reviewing and understanding our financial information, you are encouraged to read and understand the significant accounting policies used in preparing our consolidated financial statements.

These policies are described in Note 3 to our consolidated financial statements. The accounting and financial reporting policies of Monadnock Bancorp, Inc. conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. Accordingly, the consolidated financial statements require certain estimates, judgments, and assumptions, which are believed to be reasonable, based upon the information available. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the financial statements and the reported amounts of income and expenses during the periods presented. The following accounting policies comprise those that management believes are the most critical to aid in fully understanding and evaluating our reported financial results.

**Allowance for Loan Losses.** The allowance for loan losses is established through a provision for loan losses charged to expense. Loans are charged against the allowance for loan losses when management believes that the collectibility of the principal is unlikely. Subsequent recoveries are added to the allowance. The allowance is an amount that management believes will cover known and inherent losses in the loan portfolio, based on evaluations of the collectibility of loans. The evaluations take into consideration such factors as changes in the types and amount of loans in the loan portfolio, historical loss experience, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, estimated losses relating to specifically identified loans, and current economic conditions. Our methodology for analyzing the allowance for loan losses consists of specific and general components. The specific component relates to loans that are classified as doubtful, substandard or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience and quantitative and qualitative factors unique to the Bank for consumer, residential and commercial loans.

While management uses the best information available to make loan loss allowance evaluations, adjustments to the allowance may be necessary based on changes in economic and other conditions or changes in accounting guidance. In addition, the Office of Thrift Supervision, as an integral part of its examination process, periodically reviews our allowance for loan losses. The Office of Thrift Supervision may require the recognition of adjustments to the allowance for loan losses based on its judgment of information available to it at the time of their examination.

**Loans.** Loans are stated at the amount of unpaid principal, reduced by an allowance for loan losses and deferred net loan origination fees, and increased by premiums on purchased loans. Loan fees and certain direct loan origination costs are deferred, and the net fee or cost is recognized as an adjustment to interest income using the effective interest method over the remaining lives of the associated loans. Loan premiums on purchased loans are amortized into interest income as a yield adjustment over the estimated lives of the loan pools using the effective interest method.

**Investments.** Investments and mortgage-backed securities that the Bank has both the positive intent and ability to hold to maturity are classified as held-to-maturity and carried at cost. All mortgage-backed securities are currently available-for-sale and carried at fair value. Purchase premiums and discounts on mortgage-backed securities are amortized and accreted to interest income using the effective interest method, taking into consideration assumed prepayment patterns.

## **Management Strategy**

Our strategy is to operate as an independent financial institution dedicated to serving the needs of customers in our market area, which consists of western Hillsborough and eastern Cheshire counties in New Hampshire and northern Worcester county in Massachusetts. We intend to continue to increase our loan portfolio and to attract retail deposits, with the goal of expanding our deposit base. This growth may include the establishment of a new office, either by acquisition or by exploring opportunities in our market area although we currently have no arrangements or understandings regarding any specific transaction.

During the fourth quarter of 2008, the Company completed a \$1.834 million Capital Purchase Program ("CPP") transaction with the U.S. Treasury Department. The CPP is part of the U. S. Treasury's Troubled Asset Relief Program authorized under the Emergency Economic Stabilization Act of 2008 to stabilize the U. S. financial system. The Company sold to the Treasury Department in exchange for the capital infusion: (i) 1,834 shares of the Company's Fixed Rate Cumulative Perpetual Preferred Stock, Series A, par value \$0.01 per share (the "Series A Preferred Stock"), having a liquidation amount per share of \$1,000, for a total purchase price of \$1,834,000, and (ii) a warrant (the "Warrant") to purchase 92.00092 shares of the Company's Fixed Rate Cumulative Perpetual Preferred Stock, Series B, par value \$0.01 per share (the "Series B Preferred Stock"), with a liquidation amount of \$1,000 per share, at an exercise price per share of \$.01. The Warrant had a ten year term and was immediately exercisable. Immediately following the issuance of the Series A Preferred Stock and the Warrant, the Treasury Department exercised its rights under the Warrant to acquire 92 shares of the Series B Preferred Stock through a cashless exercise. The Company contributed 90% of the proceeds, or \$1,650,600, to the Bank which allowed Monadnock Community Bank to purchase net mortgage-backed securities of \$16.0 million during the fourth quarter of 2008 while funding this leverage primarily with FHLB advances and Federal Reserve borrowings, which totaled \$11.8 million in order to take advantage of positive interest rate spreads. The mortgage-backed securities were purchased as an interim measure while the Company uses this new capital to increase its lending opportunities.

The Series A Preferred Stock pays cumulative dividends at a rate of 5% per 360 day year for the first five years and thereafter at a rate of 9% per 360 day year. As a result of The American Recovery and Reinvestment Act of 2009, the Company may redeem the Series A Preferred Stock at any time at the liquidation amount plus accrued and unpaid dividends. The Series A Preferred Stock is generally non-voting. The Series B Preferred Stock pays cumulative dividends at a rate of 9% per 360 day year. The Series B Preferred Stock generally has the same rights and privileges as the Series A Preferred Stock. The Securities Purchase Agreement with the U. S. Treasury provides for certain restrictions on dividend payments and stock repurchases by the Company while the securities are outstanding including: (1) the payment of dividends on its common stock without approval of the U.S. Treasury and (2) repurchase of its common stock without approval of the U.S. Treasury during the 10-year period following its issuance (unless the securities have been transferred to a third party). We do not believe the compensation restrictions imposed under the CPP will have a material effect on the Company. The CPP program will allow us to continue our growth strategy and further support individuals and businesses in our local market areas. We believe that the CPP will allow us to improve our franchise and stockholder value over the long term. See Note 2 – Preferred Stock in our consolidated financial statements for additional information.

Our commitment is to provide a reasonable range of products and services to meet the needs of our customers. Our goal is to grow Monadnock Bancorp, Inc. while providing cost effective services to our market area and leveraging our infrastructure.

Financial highlights of our strategy include:

**Operating as a Community Savings Bank and Offering Personalized Customer Service.** We are committed to meeting the financial needs of the communities in which we operate. We provide a broad range of individualized consumer and business financial services. We believe that we can be more effective in servicing our customers than many of our non-local competitors because our employees and senior management are able to respond promptly to customer needs and inquiries. Our ability to provide these services is enhanced by the experience of our senior management, which has an average of nearly 30 years' experience in the financial services industry.

**Increasing Loan Production.** Our strategy of increasing net income includes increasing our loan production. Our business plan anticipates that we may emphasize originating commercial real estate, both permanent and construction, commercial business loans and to a lesser extent one- to four-family residential real estate loans. Commercial real estate and commercial business loans provide higher returns and involve a greater degree of credit risk than one- to four-family residential mortgage loans. Because payments on commercial real estate and commercial business loans are often dependent on the successful operation or management of the properties or business, repayment of such loans may be subject to adverse conditions in the real estate market or the economy. Our net loan portfolio increased from \$64.0 million at December 31, 2007 to \$70.7 million at December 31, 2008, or a 10.5% increase. We plan to continue to grow our loan portfolio with the additional capital that was received from the Preferred Stock issuance to the U.S. Treasury through the Troubled Asset Relief Program.

**Building Core Deposits.** We offer checking accounts, NOW accounts and savings accounts, which generally are lower cost sources of funds than certificates of deposit and are less sensitive to withdrawal when interest rates fluctuate. In order to build our core deposit base, we intend to continue to offer a broad range of deposit products and to increase our core deposits through possible branch acquisitions, or the establishment of a new office although we currently have no arrangements or understandings regarding any specific transaction. In an effort to increase core deposits and become more competitive, the Bank implemented a high interest, Rewards Checking account in October 2007. At December 31, 2008, this product totaled \$10.6 million in deposits.

**Maintaining Asset Quality.** Our asset quality is reflected in our ratio of non-performing assets to total assets, which was 0.81% and 0.26% at December 31, 2008 and December 31, 2007, respectively. The increase in nonperforming assets was primarily attributable to the following: 1) a commercial loan relationship secured by an inn for \$474,000 which was transferred to other real estate owned at the end of the second quarter of 2008 and 2) a commercial loan relationship for \$380,000 secured by a convenience store and gas station being placed on nonperforming status at the end of the third quarter of 2008. Management is striving to continue to maintain good asset quality. We have introduced new loan products only when we were confident that our staff had the necessary expertise and sound underwriting and collection procedures were in place. In addition to these lending practices, we invest in high grade securities.

**Improving Non-Interest Income.** Non-interest income consists primarily of fees, service charges and net gains from securities sales. We plan to target programs to increase non-interest income such as the overdraft checking program we instituted in December 2005.

**Improving Our Efficiency Ratio.** Our infrastructure and fixed operating costs can support a larger asset base. We believe the proceeds from our recently completed preferred stock issuance described above will allow us to continue to increase our asset base through greater loan production which should help improve our efficiency ratio (non-interest expense divided by net-interest income and non-interest income) by generating additional income. Our efficiency ratio was 91.29% for the year ended December 31, 2008 compared with 90.87% for the year ended December 31, 2007.

All of these initiatives are designed to improve our profitability in future years.

## Comparison of Financial Condition at December 31, 2008 and December 31, 2007.

**Recent Events.** During the fourth quarter of 2008, the Company completed a \$1.834 million CPP transaction with the U.S. Treasury Department. The CPP is part of the U. S. Treasury's Troubled Asset Relief Program authorized under the Emergency Economic Stabilization Act of 2008 to stabilize the U. S. financial system. The Company sold preferred stock to the U. S. Treasury in exchange for the capital injection. The additional capital from this preferred stock issuance allowed the Company to increase total assets by \$16.8 million, or 15.2%, to \$127.6 million at December 31, 2008 from \$110.8 million at September 30, 2008. The Company purchased \$16.0 million of net mortgage-backed securities during the fourth quarter of 2008 while funding this leverage primarily with FHLB advances and Federal Reserve Bank ("FRB") borrowings, which totaled \$11.8 million in order to take advantage of positive interest rate spreads. The Company anticipates that the leverage transaction should have a positive impact on earnings for 2009.

**Loans.** Our net loan portfolio grew by \$6.7 million, or 10.5%, to \$70.7 million at December 31, 2008 from \$64.0 million at December 31, 2007. Loan growth during the year ended December 31, 2008 was primarily concentrated in commercial and commercial real estate loans which grew \$3.4 million and \$2.5 million, respectively. Other significant loan increases for the year ended December 31, 2008 were in consumer loans which increased by \$766,000, home equity loans which increased by \$623,000 and one- to four-family residential loans which increased by \$562,000 which was partially offset by a decrease in construction and land development loans of \$571,000 and multifamily real estate loans of \$597,000. Our business plan anticipates that we may continue to emphasize originating commercial real estate, both permanent and construction, commercial business loans and one- to four-family residential real estate loans. Given the current interest rate environment, we have decided to originate and sell future production of 30 year fixed rate one- to four-family residential mortgages beginning in 2009. We plan to continue to grow our loan portfolio with the additional capital that was received through the U.S. Treasury's Troubled Asset Relief Program as noted above.

**Investments.** We classify our investments in debt securities as securities held-to-maturity, securities available-for-sale or trading securities. Securities held-to-maturity are carried at amortized cost, securities available-for-sale are carried at market value with unrealized gains and losses shown in accumulated other comprehensive income (loss) as a separate component of stockholders' equity, net of related tax effects, and trading securities are carried at market value with unrealized gains and losses reflected in earnings. We had no securities classified as held-to-maturity or trading securities during 2008 or 2007.

Our investment portfolio increased \$14.6 million, or 39.9%, to \$51.2 million at December 31, 2008 from \$36.6 million at December 31, 2007. The increase was primarily due to the purchase of \$45.7 million in mortgage-backed securities guaranteed by Fannie Mae, Ginnie Mae and Freddie Mac, partially offset by \$19.9 million in sales of mortgage-backed securities and \$10.9 million in principal paydowns of mortgage-backed securities. The increase in the investment portfolio was primarily funded with FHLB advances.

At December 31, 2008, the net unrealized losses on securities available-for-sale, net of related tax effects were \$89,000 compared with net unrealized gains on securities available-for-sale, net of related tax effects of \$91,000 at December 31, 2007. These net unrealized gains and losses are shown in accumulated other comprehensive income or loss as a separate component of stockholders' equity.

At December 31, 2008, the weighted average maturity of mortgage-backed securities available-for-sale was 316 months, based upon their final maturities. However, normal principal repayments and prepayments of mortgage-backed securities are received regularly, substantially reducing their weighted average maturities. All of our mortgage-backed securities are adjustable with a weighted average term to next repricing adjustment of 27 months on average.

**Deposits.** Our total deposits decreased \$3.0 million to \$61.8 million at December 31, 2008 from \$64.8 million at December 31, 2007. Interest-bearing deposits decreased \$2.3 million to \$57.2 million at December 31, 2008 from \$59.5 million at December 31, 2007, while noninterest-bearing deposits decreased \$760,000 during the year ended December 31, 2008. The decrease in interest-bearing deposits was primarily due to a decrease in time certificates of

\$8.1 million, partially offset by an increase in NOW accounts of \$6.2 million. The decrease in time certificates was due to a \$2.7 million decrease in time certificates over \$100,000 as the result of customers transferring these deposits to other deposit products and interest rate sensitive customers withdrawing deposits due to competitive rates being offered elsewhere. The increase in NOW accounts during the year ended December 31, 2008 was due to the implementation of our Rewards Checking account product in the fourth quarter of 2007. Rewards Checking accounts increased \$7.2 million during the year ended December 31, 2008 and totaled \$10.6 million at December 31, 2008.

**Borrowings.** FHLB advances and FRB borrowings increased \$23.6 million, or 77.4%, to \$54.1 million at December 31, 2008 from \$30.5 million at December 31, 2007. The increase in FHLB advances and FRB borrowings was used primarily to purchase net mortgage-backed securities and FHLB stock totaling \$15.5 million during 2008 as well as to fund net loan growth.

Principal payments due on FHLB advances and FRB borrowings after December 31, 2008 are \$15.1 million in 2009, \$9.3 million in 2010, \$10.6 million in 2011, \$5.3 million in 2012, \$5.8 million in 2013 and \$8.0 million in years thereafter. The FHLB will require the repayment of \$4.0 million of borrowings during 2009 if the three-month LIBOR exceeds specified rates; \$3.0 million of which is at a weighted average interest rate of 3.04% maturing in 2009 if the three-month LIBOR exceeds 6.50%. Additionally, the FHLB will require the repayment of \$1.0 million of borrowings during 2009 if the three-month LIBOR exceeds 6.50% of which borrowings is at an interest rate of 3.99% maturing in 2014. As of December 31, 2008, the three month LIBOR was at 1.425%. During the year ended December 31, 2008, the Bank borrowed an additional \$6.0 million in callable advances from the FHLB. These advances are callable at the discretion of the FHLB on the call date noted and most are callable continuously on a quarterly basis thereafter. The FHLB has the right to call \$9.0 million in borrowings during 2009, of which borrowings have a weighted average interest rate of 3.86% and a weighted average maturity of 77 months. The FHLB has the right to call \$3.0 million in borrowings during 2010, of which borrowings have a weighted average interest rate of 2.90% and a weighted average maturity of 49 months. In addition, the FHLB has the right to call \$2.0 million in borrowings during 2011, of which borrowings are at a weighted average interest rate of 3.17% and maturity of 82 months.

**Stockholders' Equity.** Total stockholders' equity increased \$1.4 million, or 14.9%, to \$10.9 million at December 31, 2008 from \$9.4 million at December 31, 2007. The increase in stockholders' equity was primarily attributable to the capital injection of \$1.834 million received from the U.S. Treasury Department. The Company sold 1,834 shares of fixed rate, non-voting, cumulative perpetual, Series A Preferred Stock, with an initial dividend rate of 5% per annum. The U. S. Treasury Department also received warrants, which were immediately exercised, for 92 shares of fixed rate, non-voting, cumulative perpetual, Series B Preferred Stock, with an annual dividend rate of 9%. Other increases in stockholders' equity were attributable to an \$81,000 increase related to the recognition of stock option expense as well as restricted stock award amortization and \$72,000 in net income for the year ended December 31, 2008. These increases were partially offset by a \$411,000 decrease related to the repurchase of 65,000 shares of common stock for treasury and a decrease in accumulated other comprehensive income of \$180,000. Our equity to assets ratio was 8.52% at December 31, 2008 compared to 8.97% at December 31, 2007.

## Average Balances, Net Interest Income, Yields Earned and Rates Paid

The following table sets forth certain information for the years ended December 31, 2008 and 2007 and at December 31, 2008. The average yields and costs are derived by dividing income or expense by the average balance of assets or liabilities, respectively, for the periods presented. Average balances are derived from daily balances.

	At December 31,		For the Year ended December 31,					
	2008		2008			2007		
	Ending Balance	Weighted Average Yield/Cost	Average Balance	Interest	Average Yield/Cost	Average Balance	Interest	Average Yield/Cost
(Dollars in Thousands)								
<b>INTEREST-EARNING ASSETS</b>								
Loans (1)	\$ 71,096	6.20 %	\$ 67,843	\$4,338	6.39 %	\$ 58,377	\$3,993	6.84 %
Mortgage-backed securities(2)	51,318	4.97	39,487	1,933	4.90	34,177	1,769	5.18
Agency securities	--	--	--	--	--	2,304	93	4.04
Federal Home Loan Bank stock	2,568	2.50	2,135	73	3.42	1,432	88	6.15
Other interest-earning assets	200	1.86	1,262	22	1.74	1,716	87	5.07
Total interest-earning assets	125,182	5.61	110,727	6,366	5.75	98,006	6,030	6.15
Non-interest earning assets	2,411		2,310			2,039		
Total assets	<u>\$127,593</u>		<u>\$113,037</u>			<u>\$100,045</u>		
<b>INTEREST-BEARING LIABILITIES</b>								
NOW and money market	\$ 21,907	2.21	\$ 19,941	\$ 472	2.37	\$ 13,553	\$ 250	1.84
Savings deposits	2,292	0.25	2,490	12	0.48	2,353	12	0.51
Time certificates	33,047	3.43	34,164	1,326	3.88	42,303	2,028	4.79
FHLB advances and other borrowings	54,526	3.30	41,654	1,672	4.01	26,370	1,159	4.40
Total interest-bearing liabilities	111,772	3.06	98,249	3,482	3.54	84,579	3,449	4.08
Non-interest bearing liabilities	4,953		5,556			5,881		
Total liabilities	116,725		103,805			90,460		
Stockholders' equity	10,868		9,232			9,585		
Total liabilities and stockholders' equity	<u>\$127,593</u>		<u>\$113,037</u>			<u>\$100,045</u>		
Net interest/spread		<u>2.55 %</u>		<u>\$2,884</u>	<u>2.21 %</u>		<u>\$2,581</u>	<u>2.07 %</u>
Net interest margin(3)		<u>2.88 %</u>			<u>2.60 %</u>			<u>2.63 %</u>
Ratio of interest-earning assets to interest-bearing liabilities	<u>112.00 %</u>		<u>112.70 %</u>			<u>115.88 %</u>		

(1) Calculated net of deferred costs and includes non-performing loans.

(2) Calculated based on amortized cost.

(3) Net interest income divided by interest-earning assets.

## Rate/Volume Analysis

The following table presents the dollar amount of changes in interest income and interest expense for major components of our interest-earning assets and interest-bearing liabilities. For each category of interest-earning assets and interest-bearing liabilities, information is provided on changes attributable to: (1) changes in volume, which are changes in volume multiplied by the old rate; (2) changes in rate, which are changes in rate multiplied by the old volume; and (3) changes in rate/volume, which are the changes in rate times the changes in volume.

	For the Year Ended December 31, 2008 vs. 2007 Increase (Decrease) Due to			
	Volume	Rate	Rate/ Volume	Net
	(In Thousands)			
<b>INTEREST-EARNING ASSETS</b>				
Loans (1)	\$ 648	\$ (261)	\$ (42)	\$345
Mortgage-backed and U.S. Government agency securities (2)	153	(76)	(6)	71
Federal Home Loan Bank stock	43	(39)	(19)	(15)
Other interest-earning assets	(23)	(57)	15	(65)
Total interest-earning assets	<u>\$ 821</u>	<u>\$ (433)</u>	<u>\$ (52)</u>	<u>\$336</u>
<b>INTEREST-BEARING LIABILITIES</b>				
NOW and money market accounts	\$ 118	\$ 71	\$ 33	\$222
Savings deposits	1	0	0	1
Time certificates	(391)	(387)	75	(703)
Federal Home Loan Bank advances	672	(101)	(58)	513
Total interest-bearing liabilities	<u>\$ 400</u>	<u>\$ (417)</u>	<u>\$ 50</u>	<u>\$ 33</u>
Net interest/spread	<u>\$ 421</u>	<u>\$ (16)</u>	<u>\$ (102)</u>	<u>\$303</u>

(1) Calculated net of deferred costs and includes non-performing loans.

(2) Calculated based on amortized cost.

## Comparison of Results of Operations for the Years Ended December 31, 2008 and 2007.

**General.** We recorded net income of \$72,000 for the year ended December 31, 2008 compared with net income of \$83,000 for the year ended December 31, 2007. The decrease in earnings for the year ended December 31, 2008 compared with a year earlier was primarily attributable to an increase in noninterest expense of \$357,000, an increase in the provision for loan losses of \$44,000, partially offset by an increase in net interest and dividend income of \$303,000, an increase in noninterest income of \$75,000 and a decrease in income tax expense of \$13,000.

Our profitability has been marginal during the last few years primarily due to our high fixed operating costs in relation to the amount of net interest and dividend income and noninterest income we generated and our comparatively low net interest margin (net interest and dividend income divided by average interest earning assets). Noninterest expense (consisting primarily of salaries and employee benefits) divided by net interest and dividend income plus noninterest income, commonly referred to as our efficiency ratio was 91.3% for the year ended December 31, 2008 compared with 90.9% for the year ended December 31, 2007. The existing operating platform we have in place relative to the size of our customer base and asset base has tended to negatively impact our profitability in the past. Our net interest margin for the year ended December 31, 2008 was 2.60% as compared to 2.63% for the year ended December 31, 2007.

**Net Interest and Dividend Income.** Net interest and dividend income increased \$303,000, or 11.7%, to \$2.9 million for the year ended December 31, 2008 compared to \$2.6 million for the year ended December 31, 2007. The increase reflected a \$335,000, or 5.6% increase in interest and dividend income, offset by a \$33,000, or 1.0%, increase in interest expense. The increase in net interest and dividend income of \$303,000 was primarily due to an increase in

the average balance of interest-earning assets by \$12.7 million, or 13.0%, from \$98.0 million for the year ended December 31, 2007 to \$110.7 million for the year ended December 31, 2008. This was partially offset by an increase in the average balance of interest-bearing liabilities of \$13.6 million, or 16.1%, from \$84.6 million for the year ended December 31, 2007 to \$98.2 million for the year ended December 31, 2008. The interest rate spread was 2.21% and 2.07% for the year ended December 31, 2008 and 2007, respectively. The increase in the interest rate spread for the year ended December 31, 2008 compared with a year ago was primarily due to a decrease in the average cost of our interest-bearing liabilities by 54 basis points to 3.54% for the year ended December 31, 2008 from 4.08% for the year ended December 31, 2007, partially offset by a decrease of 40 basis points in the average yield of our interest-earning assets to 5.75% for the year ended December 31, 2008 from 6.15% for the year ended December 31, 2007. The decrease in our average cost on interest-bearing liabilities as well as the decrease in the average yield on our interest-earning assets was primarily due to the Federal Reserve's decision to lower the Federal funds rate by 400 basis points since December 2007.

**Interest and Dividend Income.** Total interest and dividend income increased by \$335,000, or 5.6%, to \$6.4 million for the year ended December 31, 2008 from \$6.0 million for the year ended December 31, 2007. The increase of \$335,000 related to an increase in the balance of average interest-earning assets of \$12.7 million, or 13.0%, from \$98.0 million for the year ended December 31, 2007 to \$110.7 million for the year ended December 31, 2008, partially offset by a decrease in the average yields on interest-earning assets from 6.15% for the year ended December 31, 2007 to 5.75% for the year ended December 31, 2008. Interest income on loans increased \$345,000 from \$4.0 million for the year ended December 31, 2007 to \$4.3 million for the year ended December 31, 2008. The increase was primarily the result of an increase in the average loan balance of \$9.4 million, or 16.3%, from \$58.4 million for the year ended December 31, 2007 to \$67.8 million for the year ended December 31, 2008, partially offset by a decrease in the average loan yield from 6.84% for the year ended December 31, 2007 to 6.39% for the year ended December 31, 2008. The increase in the average balance of loans was attributable to a \$4.1 million increase in the average balance of commercial real estate loans, a \$2.9 million increase in the average balance of one- to four-family residential loans, a \$1.4 million increase in the average balance of commercial loans as well as a \$773,000 increase in the average balance of consumer loans. The decrease in average loan yields was primarily due to a decrease in the Prime Rate of 400 basis points since December 2007 as well as the addition of new loans at lower rates during 2008.

Interest and dividend income on investment securities, FHLB stock and interest-bearing deposits with other financial institutions decreased by \$9,000 to \$2.0 million for the year ended December 31, 2008. The decrease was due to a decrease in the average yields on investments from 5.14% for the year ended December 31, 2007 to 4.69% for the year ended December 31, 2008, which was offset by an increase in the average balance of the investment portfolio by \$3.6 million from \$39.6 million for the year ended December 31, 2007 to \$43.2 million for the year ended December 31, 2008. The increase in the average balance of the investment portfolio was the direct result of our leveraging the Bank with FHLB advances and purchasing primarily mortgage-backed securities. The decrease in the average yield was due to the downward repricing of adjustable rate mortgage-backed securities due to the lower interest rate environment, lower dividends received from the FHLB of Boston during 2008 compared with 2007 as well as the purchase of slightly lower yielding investment securities during 2008. The FHLB of Boston has indicated that little or no dividend payments may be made on FHLB stock for the foreseeable future.

**Interest Expense.** Total interest expense increased by \$33,000, or 1.0% from \$3.45 million for the year ended December 31, 2007 to \$3.5 million for the year ended December 31, 2008. The increase of \$33,000 related primarily to an increase in the average balance of interest-bearing liabilities of \$13.6 million, or 16.1% from \$84.6 million for the year ended December 31, 2007 to \$98.2 million for the year ended December 31, 2008, which was offset by a decrease in the average overall cost of interest-bearing liabilities from 4.08% for the year ended December 31, 2007 to 3.54% for the year ended December 31, 2008. Interest expense on deposits decreased \$480,000 from \$2.3 million for the year ended December 31, 2007 to \$1.8 million for the year ended December 31, 2008. The decrease was primarily due to a decrease in the average balance of time certificates of \$8.1 million from \$42.3 million for the year ended December 31, 2007 to \$34.2 million for the year ended December 31, 2008, coupled with a decrease in the average cost of time certificates of 91 basis points from 4.79% for the year ended December 31, 2007 to 3.88% for the year ended December 31, 2008. The average balance of time certificates comprised 72.7% of interest-bearing deposits for the year ended December 31, 2007 compared with 60.4% for the year ended December 31, 2008. The decrease in the average balance of time certificates was due to customers transferring these deposits to other deposit products such as

Rewards Checking as well as interest rate sensitive customers leaving the Bank due to competitive rates being offered elsewhere. Interest expense on NOW accounts increased by \$282,000 while interest expense on money market accounts decreased by \$60,000. The increase in interest expense on NOW accounts was attributable to an increase in the average balance of NOW accounts by \$7.1 million to \$11.4 million for the year ended December 31, 2008 from \$4.3 million for the year ended December 31, 2007, coupled with an increase in the average cost of NOW accounts by 157 basis points to 3.01% for the year ended December 31, 2008 from 1.44% for the year ended December 31, 2007. The increase in the average balance and average cost of NOW accounts was primarily due to the implementation of our Rewards Checking account product during the fourth quarter of 2007. The decrease in interest expense on money market accounts was attributable to a \$747,000 decrease in the average balance of money market accounts to \$8.6 million for the year ended December 31, 2008 from \$9.3 million for the year ended December 31, 2007, coupled with a 52 basis point decrease in the average overall cost of money market accounts to 1.51% for the year ended December 31, 2008 from 2.03% for the year ended December 31, 2007. The decrease in the average balance of money market accounts was attributable to customers transferring balances from this account to other deposit products with higher interest rates. The decrease in the overall cost of money market accounts was the result of interest rate cuts from the Federal Reserve which lowered the Federal Funds rate by 400 basis points since December 2007.

Interest expense on FHLB advances and other borrowings increased \$513,000 from \$1.2 million for the year ended December 31, 2007 to \$1.7 million for the year ended December 31, 2008. The increase was primarily due to an increase in the average balance of FHLB advances and other borrowings of \$15.3 million, or 58.0%, from \$26.4 million for the year ended December 31, 2007 to \$41.7 million for the year ended December 31, 2008, partially offset by a decrease in the average borrowing cost on FHLB advances and other borrowings from 4.40% for the year ended December 31, 2007 to 4.01% for the year ended December 31, 2008. The increase in average FHLB advances and other borrowings was used to purchase net investment securities, FHLB stock as well as to fund net loan growth. The decrease in the overall cost of FHLB advances and other borrowings was directly the result of interest rate cuts from the Federal Reserve which lowered the Federal Funds rate by 400 basis points since December 2007. FHLB advances and other borrowings recorded during 2008 and still outstanding at the end of the year totaled \$27.1 million at a weighted average cost of 2.22% and original weighted average maturity of 34 months.

**Provision for Loan Losses.** We recorded a provision for loan losses of \$156,000 for the year ended December 31, 2008 compared with a provision for loan losses of \$112,000 for the year ended December 31, 2007. The increase in the provision for loan losses was primarily due to an increase in the level of net charge-offs of \$133,000 for the year ended December 31, 2008 compared with \$61,000 for the year ended December 31, 2007. In addition, the increase in the provision was necessary due to additional weakness we identified in a commercial loan for a retail sporting goods establishment for the year ended December 31, 2008. The increase in the provision for loan losses was partially offset by the classification of certain loans into more favorable risk ratings during 2008 due to the seasoning of real estate owner-occupied first mortgage loans. The allowance for loan losses as of December 31, 2008 was maintained at a level that represents management's best estimate of losses inherent in the loan portfolio. Although we believe that we have established the allowance for loan losses at levels to absorb probable and estimable losses, future additions or deductions may be necessary if economic or other conditions in the future differ from the current environment. Provisions to the allowance may be necessary if the market in which we operate further deteriorates, or the composition of our loan portfolio changes. Additionally, regulatory agencies review our allowance for loan losses as part of their examination process. Such agencies may require us to recognize additions to the allowance based on judgments which may be different from those of management.

**Total Noninterest Income.** Noninterest income increased \$75,000, or 21.2%, to \$428,000 for the year ended December 31, 2008 from \$353,000 for the year ended December 31, 2007. The increase was primarily attributable to net gains on sales of available-for-sale securities of \$125,000 for the year ended December 31, 2008 compared with \$76,000 of such sales for the year ended December 31, 2007, an increase in income related to debit, credit and ATM transactions as well as an increase in net servicing income for the year ended December 31, 2008 compared with the same period in 2007.

**Total Noninterest Expense.** Noninterest expense increased \$357,000, or 13.4% to \$3.0 million for the year ended December 31, 2008 compared with \$2.7 million for the year ended December 31, 2007. Salaries and employee benefits expense increased \$154,000 from \$1.4 million for the year ended December 31, 2007 to \$1.5 million for the

year ended December 31, 2008. The increase in salaries and employee benefits expense related to an increase in staffing for the commercial lending area, salary increases, an increase in benefit costs for medical coverage, increases related to stock benefit plans for executives and employees, partially offset by an increase in the deferrals of loan origination costs. Other increases in noninterest expense related to an increase of \$80,000 in other expenses, a \$50,000 increase in data processing costs and a \$41,000 increase in other real estate owned and collection expense. The increase in other expenses related to higher Federal Deposit Insurance Corporation assessment premiums in 2008 compared with 2007, additional ongoing expenses related to the Rewards Checking product as well as increased expenses for directors related to fees and stock benefit plans. The increase in data processing costs related to increased service bureau costs as well as computer related costs due to internal controls compliance under Sarbanes-Oxley and other technical support costs. On December 16, 2008, the Board of Directors of the FDIC approved a restoration plan for the Deposit Insurance Fund which will raise the assessment rate schedule uniformly by seven basis points (annualized), beginning January 1, 2009, from five basis points to twelve basis points. Beginning in the second quarter of 2009, the FDIC has also proposed a new rule that may also adjust the base assessment based on an institution's level of unsecured debt, secured liabilities and brokered deposits. As a result, the Bank may also be subject to additional assessments beginning April 1, 2009 since the Bank's FHLB advances exceed 15% of domestic deposits. There can be no assurance that the proposed rule for the second quarter of 2009 will be implemented by the FDIC in its proposed form. The increase in FDIC assessments may have a negative effect on the Bank's earnings for 2009.

**Income Taxes.** Income tax expense decreased \$13,000, or 17.8%, to \$60,000 for the year ended December 31, 2008 from \$73,000 for the year ended December 31, 2007. The effective tax rate was 45.2% for the year ended December 31, 2008 compared to 46.8% for the year ended December 31, 2007.

## **Management of Interest Rate Risk**

**Our Risk When Interest Rates Change.** The rates of interest we earn on assets and pay on liabilities generally are established contractually for a period of time. Market interest rates change over time. Our loans generally have longer maturities than our deposits. Accordingly, our results of operations, like those of other financial institutions, are impacted by changes in interest rates and the interest rate sensitivity of our assets and liabilities. The risk associated with changes in interest rates and our ability to adapt to these changes is known as interest rate risk and is a significant market risk.

**How We Measure Our Risk of Interest Rate Changes.** As part of our attempt to manage our exposure to changes in interest rates and comply with applicable regulations, we monitor our interest rate risk. In monitoring interest rate risk we continually analyze and manage assets and liabilities based on their payment streams and interest rates, the timing of their maturities, and their sensitivity to actual or potential changes in market interest rates.

In order to minimize the potential for adverse effects of material and prolonged increases in interest rates on our results of operations, we have adopted asset/liability and funds management policies to better match the maturities and repricing terms of our interest-earning assets and interest-bearing liabilities. The Board of Directors sets and recommends the asset and liability and funds management policies of Monadnock Community Bank, which are implemented by the asset/liability management committee.

The purpose of the asset/liability management committee is to communicate, coordinate and control asset/liability management consistent with our business plan and Board approved policies. The committee establishes and monitors the volume and mix of assets and funding sources taking into account relative costs and spreads, interest rate sensitivity and liquidity needs. Our objectives are to manage assets and funding sources to produce results that are consistent with our liquidity, capital adequacy, growth, risk and profitability goals.

The asset/liability management committee generally meets quarterly to review, among other things, economic conditions and interest rate outlook, current and projected liquidity needs and capital position, anticipated changes in the volume and mix of assets and liabilities and interest rate risk exposure limits versus current projections using a net present value of portfolio equity analysis and income simulations. The asset/liability management committee recommends appropriate strategy changes based on this review.

In order to manage our assets and liabilities and achieve the desired liquidity, credit quality, interest rate risk, profitability and capital targets, we have focused our strategies on:

- Using FHLB advances and pricing on fixed-term non-core deposits to align maturities and repricing terms;
- Purchasing adjustable rate securities;
- Originating and purchasing adjustable rate loans;
- Originating and purchasing a reasonable volume of fixed rate mortgages; and
- Managing our deposits to establish stable deposit relationships.

Depending on the level of general market interest rates, the relationship between long-term and short-term interest rates, market conditions and competitive factors, the asset/liability management committee may determine to increase our interest rate risk position in order to maintain and improve our net interest margin.

The asset/liability management committee regularly reviews interest rate risk by forecasting the impact of alternative interest rate environments on net interest income and market value of portfolio equity, which is defined as the net present value of an institution's existing assets, liabilities and off-balance sheet instruments, and evaluating such impacts against the maximum potential changes in net interest income and market value of portfolio equity that are authorized by the Board of Directors of Monadnock Community Bank.

The Office of Thrift Supervision provides us with the information presented in the following table, which is based on information provided to the Office of Thrift Supervision by Monadnock Community Bank. It presents the change in Monadnock Community Bank's net portfolio value at December 31, 2008 (the latest data available), that would occur upon an immediate change in interest rates based on Office of Thrift Supervision assumptions, but without giving effect to any steps that management might take to counteract such change.

The following table illustrates the change in net interest income at December 31, 2008 that would occur in the event of an immediate change in interest rates, with no effect given to any steps that management might take, within the parameters established by our asset/liability management committee, to counter the effect of such interest movement. Due to the low interest rate environment at December 31, 2008, the down 200 basis point scenario is not applicable.

**At December 31, 2008**

<b>Change in Interest Rates in Basis Points ("bp") (Rate Shock in Rates)</b>	<b>Net Portfolio Value</b>				
	<b>as % of PV of Assets</b>				
	<b>\$ Amount</b>	<b>\$ Change</b>	<b>% Change</b>	<b>NPV Ratio</b>	<b>\$ Change</b>
<b>(Dollars in Thousands)</b>					
+300 bp	9,889	(442)	(4)%	7.84%	(4)bp
+200 bp	10,621	289	3 %	8.28%	40bp
+100 bp	10,657	326	3 %	8.21%	33bp
0 bp	10,331	--	-- %	7.88%	--
-100 bp	9,382	(949)	(9)%	7.11%	(77)bp

The Office of Thrift Supervision uses certain assumptions in assessing the interest rate risk of savings associations. These assumptions relate to interest rates, loan prepayment rates, deposit decay rates, and the market values of certain assets under differing interest rate scenarios, among others.

As with any method of measuring interest rate risk, shortcomings are inherent in the method of analysis presented in the foregoing table. For example, although assets and liabilities may have similar maturities or periods to repricing, they may react in different degrees to changes in the market interest rates. Also, the interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while interest rates on other types may lag behind changes in market rates. Additionally, certain assets, such as adjustable rate mortgage loans, have features that restrict changes in interest rates on a short-term basis and over the life of the asset. Further, if interest rates change, expected rates of prepayments on loans and early withdrawals from certificates of deposit could deviate significantly from those assumed in calculating the table.

### **Liquidity and Commitments**

Historically, we have maintained liquid assets at levels believed to be adequate to meet the requirements of normal operations, including potential deposit outflows. We regularly review cash flow projections and update them to assure that adequate liquidity is maintained. Liquidity may increase or decrease depending upon the availability of funds and comparative yields on investments in relation to the return on loans.

Our liquidity, represented by cash and cash equivalents and mortgage-backed and related securities, is a product of our operating, investing and financing activities. Our primary sources of funds are deposits; amortization, prepayments and maturities of outstanding loans and mortgage-backed securities; and other short-term investments and funds provided from operations. While scheduled payments from the amortization of loans and mortgage-backed related securities and maturing investment securities and short-term investments are relatively predictable sources of funds, deposit flows and loan prepayments are greatly influenced by general interest rates, economic conditions and competition. In addition, we invest excess funds in short-term interest-earning assets, which provide liquidity to meet lending requirements. We also generate cash through borrowings. We utilize FHLB advances and Federal Reserve borrowings to leverage our capital base and provide funds for our lending and investment activities, and enhance our interest rate risk management.

Liquidity management is both a daily and long-term function of business management. Excess liquidity is generally invested in short-term investments such as overnight deposits and federal funds sold. On a longer-term basis, we maintain a strategy of investing in various lending products such as residential, commercial and consumer loans. We use our sources of funds primarily to meet ongoing commitments, to pay maturing time deposits and savings withdrawals, to fund loan commitments and to maintain our portfolio of mortgage-backed and related securities. At December 31, 2008, the total approved and unfunded loan commitments amounted to \$7.5 million, which includes the unadvanced portion of loans of \$7.2 million. Certificates of deposit, advances from the FHLB of Boston and borrowings from the Federal Reserve scheduled to mature in one year or less at December 31, 2008, totaled \$24.4 million, \$14.1 million and \$1.0 million, respectively. Based on historical experience, we believe that a significant portion of maturing deposits will remain with Monadnock Community Bank. We anticipate that we will continue to have sufficient funds, through deposits and borrowings, to meet our current commitments.

During 2008, the Bank took certain actions to improve our contingency liquidity in the event additional liquidity was needed. We secured a repurchase line of credit with a brokerage firm for \$5.0 million. We secured a liquidity line with a correspondent bank for \$1.0 million. At December 31, 2008, we had approximately \$2.7 million in investment securities as collateral to support discount window borrowings from the FRB. At December 31, 2008, we had approximately \$1.7 million in discount window borrowings available to us from the FRB.

At December 31, 2008, we had an additional borrowing capacity with the FHLB of Boston of \$9.8 million based on our collateral with the FHLB of Boston as well as our internal policy which limits FHLB advances to 50% of total assets.

### **Stockholders' Equity**

Total stockholders' equity increased \$1.4 million, or 14.9%, to \$10.87 million at December 31, 2008 from \$9.44 million at December 31, 2007. The increase in stockholders' equity was primarily attributable to the capital injection of \$1.834 million received from the U.S. Treasury Department. The Company sold 1,834 shares of fixed rate, non-voting, cumulative perpetual, Series A Preferred Stock, with an initial dividend rate of 5%. The U. S.

Treasury Department also received warrants, which were immediately exercised, for 92 shares of fixed rate, non-voting, cumulative perpetual, Series B Preferred Stock, with an annual dividend rate of 9%. Other increases in stockholders' equity were attributable to an \$81,000 increase related to the recognition of stock option expense as well as restricted stock award amortization and \$72,000 in net income for the year ended December 31, 2008. These increases were partially offset by a \$411,000 decrease related to the repurchase of 65,000 shares of common stock for treasury and a decrease in accumulated other comprehensive income of \$180,000. Our equity to assets ratio was 8.52% at December 31, 2008 compared to 8.97% at December 31, 2007. See Note 2 – Preferred Stock and Management's Discussion and Analysis of Financial Condition and Results of Operations under the section "Management Strategy" for additional information.

Consistent with our goal to operate a sound and profitable financial institution, we actively seek to maintain a "well-capitalized" institution in accordance with regulatory standards. As of December 31, 2008, the most recent notification from the Office of Thrift Supervision categorized Monadnock Community Bank as "well-capitalized" under the regulatory framework for prompt corrective action. To be categorized as well-capitalized, the bank must maintain Tier I leverage, Tier I risk-based and total risk-based capital ratios of 5%, 6% and 10%, respectively. There have been no conditions or events since that notification that management believes would cause a change in Monadnock Community Bank's categorization.

### **Impact of Inflation**

The financial statements presented in this annual report have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). These principles require the measurement of financial position and operating results in terms of historical dollars, without considering changes in the relative purchasing power of money over time due to inflation.

Our primary assets and liabilities are monetary in nature. As a result, interest rates have a more significant impact on our performance than the effects of general levels of inflation. Interest rates, however, do not necessarily move in the same direction or with the same magnitude as the price of goods and services, since such prices are affected by inflation. In a period of rapidly rising interest rates, the liquidity and maturity structure of our assets and liabilities are critical to the maintenance of acceptable performance levels.

The principal effect of inflation, as distinct from levels of interest rates, on earnings is in the area of non-interest expense. Such expense items as employee compensation, employee benefits and occupancy and equipment costs may be subject to increases as a result of inflation. An additional effect of inflation is the possible increase in the dollar value of the collateral securing loans that we have made. We are unable to determine the extent, if any, to which properties securing our loans have appreciated in dollar value due to inflation.

### **Recent Accounting Pronouncements**

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement 109" (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken, or expected to be taken, in a tax return and provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2007. The Company's adoption of FIN 48 did not have a material impact on its financial statements.

In September 2006, the FASB ratified the consensus reached by the Emerging Issues Task Force ("EITF") on Issue No. 06-4 "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements," (EITF Issue 06-4). EITF 06-4 requires companies with an endorsement split-dollar life insurance arrangement to recognize a liability for future postretirement benefits. The effective date is for fiscal years beginning after December 15, 2007, with earlier application permitted. The Company should recognize the effects of applying this issue through either (a) a change in accounting principle through a cumulative effect adjustment to retained earnings or (b) a change in accounting principle through retrospective application to all periods.

The adoption of the new issue did not have a material impact on the Company's financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" (SFAS 157). SFAS No. 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles (GAAP) and expands disclosures about fair value measurements. The FASB's FSP FAS 157-2, "Effective Date of FASB Statement No. 157", defers until January 1, 2009, the application of SFAS 157 to nonfinancial assets and nonfinancial liabilities not recognized or disclosed at least annually at fair value. This includes nonfinancial assets and nonfinancial liabilities initially measured at fair value in a business combination or other new basis event, but not measured at fair value in subsequent periods. The Company adopted this statement on January 1, 2008. See Note 15- Fair Value Measurements for additional information.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115" (SFAS 159). SFAS 159 permits entities, at specified election dates, to choose to measure certain financial instruments at fair value that are not currently required to be measured at fair value. The fair value option is applied on an instrument-by-instrument basis, is irrevocable and can only be applied to an entire instrument and not to specified risks, specific cash flows, or portions of that instrument. Unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings at each subsequent reporting date and upfront fees and costs related to those items will be recognized in earnings as incurred and not deferred. SFAS No. 159 is effective in fiscal years beginning after November 15, 2007 and may not be applied retrospectively. The adoption of the new standard did not have a material impact on the Company's financial position, results of operations or cash flows. See Note 15 - Fair Value Measurements for additional information.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements and Amendment of ARB No. 51 ("SFAS No. 160"). The new pronouncement requires all entities to report noncontrolling (minority) interests in subsidiaries as a component of stockholders' equity. SFAS No. 160 will be effective for fiscal years beginning after December 15, 2008. Early adoption is prohibited. Management does not anticipate that this statement will have a material impact on the Company's financial condition and results of operations.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), "Business Combinations" (SFAS 141(R)). SFAS 141(R) will significantly change the accounting for business combinations. Under SFAS 141(R), an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. It also amends the accounting treatment for certain specific items including acquisition costs and non controlling minority interests and includes a substantial number of new disclosure requirements. SFAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after January 1, 2009. The Company does not expect the adoption of this statement to have a material impact on its financial condition and results of operations.

In February 2008, the FASB issued FSP FAS 140-3, "Accounting for Transfers of Financial Assets and Repurchase Financing Transactions." This FSP provides guidance on how the transferor and transferee should separately account for a transfer of a financial asset and a related repurchase financing if certain criteria are met. This guidance will be effective January 1, 2009. The adoption of this new FSP is not expected to have a material effect on the Company's results of operations or financial position.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities-an amendment of FASB Statement No. 133" (SFAS 161). SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (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 guidance in SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. This statement encourages, but does not require, comparative disclosures for earlier periods at

initial adoption. The Company does not expect the adoption of this statement to have a material impact on its financial condition and results of operations.

In April 2008, the FASB issued FSP FAS 142-3, "Determination of the Useful Life of Intangible Assets." This FSP provides guidance as to factors considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS 142, "Goodwill and Other Intangible Assets." This guidance will be effective January 1, 2009. The adoption is not expected to have a material effect on the Company's results of operations or financial position.

In May 2008, the FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles." This standard formalizes minor changes in prioritizing accounting principles used in the preparation of financial statements that are presented in conformity with GAAP. This standard became effective November 18, 2008.



# Shatswell, MacLeod & Company, P.C.

The Board of Directors  
Monadnock Bancorp, Inc.  
Peterborough, New Hampshire

## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We have audited the accompanying consolidated balance sheets of Monadnock Bancorp, Inc. and Subsidiary as of December 31, 2008 and 2007 and the related consolidated statements of income, changes in stockholders' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Monadnock Bancorp, Inc. and Subsidiary as of December 31, 2008 and 2007, and the results of their operations and their cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

83 PINE STREET • WEST PEABODY, MASSACHUSETTS 01960-3035 • TELEPHONE (978) 535-0206 • FACSIMILE (978) 535-9908  
smc@shatswell.com www.shatswell.com

SHATSWELL, MacLEOD & COMPANY, P.C.

West Peabody, Massachusetts  
February 24, 2009

CONSOLIDATED BALANCE SHEETS

December 31, 2008 and 2007

<u>ASSETS</u>	2008	2007
Cash and due from banks	\$ 699,761	\$ 1,181,206
Total cash and cash equivalents	699,761	1,181,206
Interest-bearing time deposit in other bank	200,000	100,000
Investments in available-for-sale securities (at fair value)	51,171,392	36,595,813
Federal Home Loan Bank stock, at cost	2,568,300	1,607,700
Loans, net of allowance for loan losses of \$413,337 as of December 31, 2008 and \$389,770 as of December 31, 2007	70,702,121	64,030,781
Premises and equipment	743,883	809,493
Other real estate owned	521,349	
Goodwill	132,293	132,293
Core deposit intangible	43,875	61,250
Accrued interest receivable	582,314	442,749
Other assets	227,359	214,674
Total assets	<u>\$127,592,647</u>	<u>\$105,175,959</u>
 <u>LIABILITIES AND STOCKHOLDERS' EQUITY</u>		
Deposits:		
Noninterest-bearing	\$ 4,525,816	\$ 5,286,039
Interest-bearing	57,246,233	59,531,823
Total deposits	61,772,049	64,817,862
Federal Home Loan Bank advances	53,125,924	30,537,976
Federal Reserve Bank borrowings	1,000,000	
Other borrowings – ESOP loan	400,000	
Other liabilities	427,185	383,533
Total liabilities	<u>116,725,158</u>	<u>95,739,371</u>
Stockholders' equity:		
Preferred stock, par value \$.01 per share; authorized 2,000,000 shares;		
Preferred stock, fixed rate cumulative perpetual, Series A, par value		
\$.01 per share; 1,834 shares issued at December 31, 2008;		
liquidation value \$1,000 per share	18	
Preferred stock, fixed rate cumulative perpetual, Series B, par value		
\$.01 per share; 92 shares issued at December 31, 2008;		
liquidation value \$1,000 per share	1	
Common stock, par value \$.01 per share; authorized 10,000,000 shares;		
1,293,608 shares issued at December 31, 2008 and 2007; 1,163,958 and		
1,228,958 outstanding at December 31, 2008 and December 31, 2007,		
respectively	12,936	12,936
Paid-in capital	9,629,945	7,755,439
Retained earnings	2,782,651	2,710,788
Unearned compensation - ESOP	(360,916)	(402,683)
Unearned compensation – Restricted stock awards	(266,228)	(298,799)
Treasury stock, at cost (129,650 shares at December 31, 2008 and		
64,650 shares at December 31, 2007)	(842,238)	(431,687)
Accumulated other comprehensive (loss) income	(88,680)	90,594
Total stockholders' equity	<u>10,867,489</u>	<u>9,436,588</u>
Total liabilities and stockholders' equity	<u>\$127,592,647</u>	<u>\$105,175,959</u>

The accompanying notes are an integral part of these consolidated financial statements.

## CONSOLIDATED STATEMENTS OF INCOME

Years Ended December 31, 2008 and 2007

	2008	2007
Interest and dividend income:		
Interest and fees on loans	\$4,338,000	\$3,993,166
Interest on investments-taxable	1,933,132	1,862,320
Other interest income	94,276	174,497
Total interest and dividend income	<u>6,365,408</u>	<u>6,029,983</u>
Interest expense:		
Interest on deposits	1,809,929	2,289,822
Interest on Federal Home Loan Bank advances and other borrowings	1,671,701	1,159,016
Total interest expense	<u>3,481,630</u>	<u>3,448,838</u>
Net interest and dividend income	2,883,778	2,581,145
Provision for loan losses	156,249	111,709
Net interest and dividend income after provision for loan losses	<u>2,727,529</u>	<u>2,469,436</u>
Noninterest income:		
Service charges on deposits	201,215	199,018
Net gain on sales of available-for-sale securities	124,890	75,759
Loan commissions		2,246
Other income	102,061	75,779
Total noninterest income	<u>428,166</u>	<u>352,802</u>
Noninterest expense:		
Salaries and employee benefits	1,522,471	1,368,648
Occupancy expense	161,429	156,310
Equipment expense	88,525	87,651
Data processing	268,539	218,978
Blanket bond insurance	15,835	16,250
Professional fees	211,338	196,499
Supplies and printing	34,396	43,957
Telephone expense	57,210	50,885
Marketing expense	129,000	110,597
Postage expense	38,253	40,916
Other real estate owned and collection expense	45,275	4,149
Other expense	451,091	371,230
Total noninterest expense	<u>3,023,362</u>	<u>2,666,070</u>
Income before income tax expense	132,333	156,168
Income tax expense	59,857	73,132
Net income	<u>\$ 72,476</u>	<u>\$ 83,036</u>
Shares used in computing net income per share:		
Basic	1,094,525	1,177,299
Diluted	1,127,614	1,218,087
Net income available per common share – basic	\$ 0.06	\$ 0.07
Net income available per common share – diluted	0.06	0.07

The accompanying notes are an integral part of these consolidated financial statements.

MONADNOCK BANCORP, INC. AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
Years Ended December 31, 2008 and 2007

	Preferred Stock Series A	Preferred Stock Series B	Common Stock	Paid-In Capital	Retained Earnings	Unearned Compensation ESOP	Unearned Restricted Stock Awards	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total
Balance, December 31, 2006	\$	\$	\$12,936	\$7,725,786	\$2,627,752	\$(431,445)	\$(139,104)	\$	\$(120,125)	\$ 9,675,800
Comprehensive loss:										
Net income					83,036					
Net change in unrealized holding loss on available for-sale securities, net of tax effect									210,719	
Comprehensive income										293,755
Employee Stock Ownership Plan Distribution				(2,482)		28,762				26,280
Purchase of common stock for Equity Incentive Plan (26,538 shares)				(5,307)			(175,151)			(180,458)
Purchase of common stock for Treasury (64,650 shares)								(431,687)		(431,687)
Recognition of stock option expense				37,442						37,442
Restricted stock award amortization							15,456			15,456
Balance, December 31, 2007			12,936	7,755,439	2,710,788	(402,683)	(298,799)	(431,687)	90,594	9,436,588
Comprehensive income:										
Net income					72,476					
Net change in unrealized holding loss on available for sale securities, net of tax effect									(179,274)	
Comprehensive income										(106,798)
Employee Stock Ownership Plan Distribution				(8,205)		41,767				33,562
Purchase of common stock for Treasury (65,000 shares)								(410,551)		(410,551)
Recognition of stock option expense				48,117						48,117
Restricted stock award amortization							32,571			32,571
Preferred stock issuance	18	1		1,833,981						1,834,000
Preferred stock accretion (amortization)				613	(613)					-
Balance, December 31, 2008	\$ 18	\$ 1	\$12,936	\$9,629,945	\$2,782,651	\$(360,916)	\$(266,228)	\$(842,238)	\$( 88,680)	\$10,867,489

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

Years Ended December 31, 2008 and 2007

(Continued)

Reclassification disclosure for the years ended December 31:

	<u>2008</u>	<u>2007</u>
Net unrealized holding (losses) gains on available-for-sale securities	\$(171,971)	\$424,690
Reclassification adjustment for net realized gains in net income	<u>(124,890)</u>	<u>(75,759)</u>
Other comprehensive(loss) income before income tax effect	(296,861)	348,931
Income tax expense	<u>117,587</u>	<u>(138,212)</u>
Other comprehensive (loss) income, net of tax	<u><u>\$(179,274)</u></u>	<u><u>\$210,719</u></u>

Accumulated other comprehensive loss as of December 31, 2008 consists of net unrealized holding losses on available-for-sale securities, net of taxes. Accumulated other comprehensive income as of December 31, 2007 consists of net unrealized holding gains on available-for-sale securities, net of taxes.

The accompanying notes are an integral part of these consolidated financial statements.

## CONSOLIDATED STATEMENTS OF CASH FLOWS

Years Ended December 31, 2008 and 2007

	2008	2007
Cash flows from operating activities:		
Net income	\$ 72,476	\$ 83,036
Adjustments to reconcile net income to net cash provided by operating activities:		
Net gain on sales of available-for-sale securities	(124,890)	(75,759)
Net amortization of securities	174,467	82,750
Change in deferred loan origination costs, net	18,460	(31,619)
Provision for loan losses	156,249	111,709
Amortization of unearned compensation – restricted stock award plans	32,571	15,456
Recognition of stock option expense	48,117	37,442
Depreciation and amortization	108,516	107,495
Increase in accrued interest receivable	(139,565)	(15,070)
Amortization of core deposit intangible	17,375	20,375
Decrease (increase) in other assets	23,428	(41,235)
Decrease in loan servicing rights and interest-only strips, net	1,740	13,851
Decrease (increase) in prepaid expenses	15,786	(16,800)
Deferred income tax expense	9,521	68,736
Increase in taxes receivable	(53,639)	(21,913)
(Decrease) increase in restricted stock award plans accrued expense	(6)	10,355
Increase in accrued expenses	59,704	20,487
Increase in accrued interest payable	54,886	24,835
Increase in other liabilities	70,696	17,375
Net cash provided by operating activities	<u>545,892</u>	<u>411,506</u>
Cash flows from investing activities:		
Purchase of interest-bearing time deposits in other bank	(100,000)	
Purchases of available-for-sale securities	(45,676,094)	(22,855,000)
Proceeds from sales of available-for-sale securities	19,858,430	12,233,726
Principal payments received on available-for-sale securities	10,895,647	12,687,247
Purchases of Federal Home Loan Bank stock, net	(960,600)	(279,400)
Loan originations and principal collections, net	(6,473,528)	(9,508,786)
Loans purchased	(898,981)	(896,793)
Recoveries of previously charged off loans	5,111	4,025
Capital expenditures - premises and equipment	(42,906)	(130,173)
Net cash used in investing activities	<u>(23,392,921)</u>	<u>(8,745,154)</u>

CONSOLIDATED STATEMENTS OF CASH FLOWS

Years Ended December 31, 2008 and 2007

(continued)

	<u>2008</u>	<u>2007</u>
Cash flows from financing activities:		
Net increase in demand deposits, savings and NOW deposits	5,032,618	3,086,495
Net (decrease) increase in time deposits	(8,078,431)	369,458
Net change on short-term advances from Federal Home Loan Bank	4,144,000	(976,000)
Long-term advances from Federal Home Loan Bank	27,099,081	13,240,857
Payments on long-term advances from Federal Home Loan Bank	(8,655,133)	(6,692,000)
Refinance ESOP loan with another financial institution	400,000	
Net change in short-term borrowing from Federal Reserve	1,000,000	
Purchase of common stock for treasury	(410,551)	(431,687)
Purchase of 26,538 shares for Equity Incentive Plan		(180,458)
Proceeds from issuance of preferred stock	1,834,000	
	<u>22,365,584</u>	<u>8,416,665</u>
Net cash provided by financing activities		
	(481,445)	83,017
Net (decrease) increase in cash and cash equivalents		
Cash and cash equivalents at beginning of period	1,181,206	1,098,189
Cash and cash equivalents at end of period	<u>\$ 699,761</u>	<u>\$ 1,181,206</u>
Supplemental disclosures:		
Interest paid	\$ 3,426,744	\$ 3,424,003
Income taxes paid	100,000	24,405
Allocation of common stock by the ESOP	33,562	26,280
Transfer of loans to other real estate owned	521,349	

The accompanying notes are an integral part of these consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Years Ended December 31, 2008 and 2007

NOTE 1 - NATURE OF OPERATIONS

Monadnock Community Bank (the "Bank") provides a variety of financial services to corporations and individuals from its offices in Peterborough, New Hampshire and Winchendon, Massachusetts. The Bank is engaged principally in the business of attracting deposits from the general public and investing those deposits in residential and commercial real estate loans, and in consumer and small business loans. On June 28, 2004, in accordance with a Plan of Mutual Holding Company Reorganization and Stock Issuance, the Bank became a federally chartered stock bank and wholly-owned subsidiary of Monadnock Community Bancorp, Inc., a federally chartered stock holding company. Monadnock Community Bancorp, Inc. became a majority owned subsidiary of Monadnock Mutual Holding Company, a federally chartered mutual holding company. On June 28, 2006, in accordance with a Plan of Conversion and Reorganization, the Bank became the wholly-owned subsidiary of Monadnock Bancorp, Inc. (the "Company"), a Maryland chartered stock holding company. Further, Monadnock Mutual Holding Company sold its ownership interest in Monadnock Community Bancorp, Inc. to the public in a "second step" offering and ceased to exist. The Company sold 707,681 shares, par value of \$.01 per share or the maximum of the offering range, to the public raising \$4.8 million in net proceeds. As part of the conversion, existing public stockholders of Monadnock Community Bancorp, Inc. received 1,3699 shares of Company common stock in exchange for each of their existing shares of Monadnock Community Bancorp, Inc. common stock.

NOTE 2 – PREFERRED STOCK

On December 19, 2008, the Company entered into a Letter Agreement, which includes a Securities Purchase Agreement (together, the "Purchase Agreement"), with the United States Department of the Treasury ("Treasury Department") pursuant to which the Company has issued and sold to the Treasury Department: (i) 1,834 shares of the Company's Fixed Rate Cumulative Perpetual Preferred Stock, Series A, par value \$0.01 per share (the "Series A Preferred Stock"), having a liquidation amount per share of \$1,000, for a total purchase price of \$1,834,000, and (ii) a warrant (the "Warrant") to purchase 92.00092 shares of the Company's Fixed Rate Cumulative Perpetual Preferred Stock, Series B, par value \$0.01 per share (the "Series B Preferred Stock"), with a liquidation amount of \$1,000 per share, at an exercise price per share of \$.01. The Warrant had a ten year term and was immediately exercisable. Immediately following the issuance of the Series A Preferred Stock and the Warrant, the Treasury Department exercised its rights under the Warrant to acquire 92 shares of the Series B Preferred Stock through a cashless exercise.

The Series A Preferred Stock pays cumulative dividends at a rate of 5% per 360 day year for the first five years and thereafter at a rate of 9% per 360 day year. The Purchase Agreement provided that (1) the Company may not redeem the Series A Preferred Stock during the first three years except with the proceeds from a "qualified equity offering" and (2) after three years, the Company may, at its option, redeem the Series A Preferred Stock at the liquidation amount plus accrued and unpaid dividends (the "Redemption Amount"). As a result of the enactment of The American Recovery and Reinvestment Act of 2009 on February 17, 2009, the Series A Preferred Stock and the Series B Preferred Stock may be redeemed by the Company upon payment of the Redemption Amount. The Series A Preferred Stock is generally non-voting. The Series B Preferred Stock pays cumulative dividends at a rate of 9% per 360 day year. The Series B Preferred Stock generally has the same rights and privileges as the Series A Preferred Stock.

The Series A Preferred Stock and the Warrant were issued in a private placement exempt from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended. The Company has agreed to register for resale the Series A Preferred Stock and the Series B Preferred Stock upon the request of the Treasury Department. The Purchase Agreement provides that neither the Series A Preferred Stock nor the Series B Preferred Stock will be subject to any contractual restrictions on transfer, except that the Treasury Department and its transferees may not effect any transfer of the Series A Preferred Stock or the Series B Preferred Stock that would cause the Company to otherwise become subject to the periodic reporting requirements of the Securities Exchange Act of 1934. The Purchase Agreement also provides for certain restrictions on dividend payments and stock repurchases by the Company.

The Company has allocated the \$1.834 million in proceeds received from the U. S. Treasury Department between Series A Preferred Stock and Series B Preferred Stock assuming that the Preferred Stock would be replaced with a qualifying equity offering and the Preferred Stock would therefore be redeemed at the end of 5 years. The allocation has been recorded assuming a discount rate of 15% on the cash flows of each instrument.

The allocation of the proceeds is as follows:

Series A Preferred Stock	\$1,728,809
Series B Preferred Stock	105,191
Proceeds received from the Treasury Department	<u>\$1,834,000</u>

The Preferred Stock Series A is being accreted over a 5 year period, so that at the end of 5 years, the balance in Preferred Stock would equal \$1,834,000.

Estimated accretion from retained earnings for each of the five years succeeding 2008 is as follows:

2009	\$ 21,038
2010	21,038
2011	21,038
2012	21,038
2013	20,338
	<u>\$104,490</u>

The Preferred Stock Series B is being amortized over a 5 year period, so that at the end of 5 years, the balance in Preferred Stock would equal \$92,001.

Estimated amortization to retained earnings for each of the five years succeeding 2008 is as follows:

2009	\$ 2,638
2010	2,638
2011	2,638
2012	2,638
2013	2,550
	<u>\$13,102</u>

### NOTE 3 - ACCOUNTING POLICIES

The accounting and reporting policies of the Company and its subsidiary conform to accounting principles generally accepted in the United States of America and predominant practices within the savings institution industry. The consolidated financial statements were prepared using the accrual method of accounting. The significant accounting policies are summarized below to assist the reader in better understanding the consolidated financial statements and other data contained herein.

#### USE OF ESTIMATES:

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

#### BASIS OF CONSOLIDATION:

The consolidated financial statements include the accounts of Monadnock Bancorp, Inc. and its wholly-owned subsidiary, the Bank for 2008 and 2007. All significant intercompany accounts and transactions have been eliminated.

#### CASH AND CASH EQUIVALENTS:

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, cash items and due from banks.

Cash and due from banks as of December 31, 2008 and 2007 includes \$298,000 and \$75,000, respectively, which is subject to withdrawals and usage restrictions to satisfy the reserve requirements of the Federal Reserve Bank. In addition, as of December 31, 2008 and 2007 a total of \$50,000 is required to be maintained at another correspondent bank.

## SECURITIES:

Investments in debt securities are adjusted for amortization of premiums and accretion of discounts computed so as to approximate the interest method. Gains or losses on sales of investment securities are computed on a specific identification basis.

The Company classifies debt and equity securities into one of three categories: held-to-maturity, available-for-sale, or trading. These security classifications may be modified after acquisition only under certain specified conditions. In general, securities may be classified as held-to-maturity only if the Company has the positive intent and ability to hold them to maturity. Trading securities are defined as those bought and held principally for the purpose of selling them in the near term. All other securities must be classified as available-for-sale.

- Held-to-maturity securities are measured at amortized cost in the consolidated balance sheets. Unrealized holding gains and losses are not included in earnings or in a separate component of capital. They are merely disclosed in the notes to the consolidated financial statements.
- Available-for-sale securities are carried at fair value on the consolidated balance sheets. Unrealized holding gains and losses are not included in earnings, but are reported as a net amount (less expected tax) in a separate component of capital until realized.
- Trading securities are carried at fair value on the consolidated balance sheets. Unrealized holding gains and losses for trading securities are included in earnings.

Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses.

On December 8, 2008, the Federal Home Loan Bank of Boston announced a moratorium on the repurchase of excess stock held by its members. The moratorium will remain in effect indefinitely.

## LOANS:

Loans receivable that management has the intent and ability to hold until maturity or payoff, are reported at their outstanding principal balances adjusted for amounts due to borrowers on unadvanced loans, any charge-offs, the allowance for loan losses and any deferred fees, costs on originated loans or unamortized premiums or discounts on purchased loans.

Interest on loans is recognized on a simple interest basis.

Loan origination, commitment fees and certain direct origination costs are deferred and the net amount amortized as an adjustment of the related loan's yield. The Company is amortizing these amounts over the contractual life of the related loans.

Residential real estate loans are generally placed on nonaccrual when reaching 90 days past due or in process of foreclosure. All closed-end consumer loans 90 days or more past due and any equity line in the process of foreclosure are placed on nonaccrual status. Secured consumer loans are written down to realizable value and unsecured consumer loans are charged-off upon reaching 120 or 180 days past due depending on the type of loan. Commercial real estate loans and commercial business loans and leases which are 90 days or more past due are generally placed on nonaccrual status, unless secured by sufficient cash or other assets immediately convertible to cash. When a loan has been placed on nonaccrual status, previously accrued and uncollected interest is reversed against interest on loans. A loan can be returned to accrual status when collectibility of principal is reasonably assured and the loan has performed for a period of time, generally six months.

Cash receipts of interest income on impaired loans are credited to principal to the extent necessary to eliminate doubt as to the collectibility of the net carrying amount of the loan. Some or all of the cash receipts of interest income on impaired loans is recognized as interest income if the remaining net carrying amount of the loan is deemed to be fully collectible. When recognition of interest income on an impaired loan on a cash basis is appropriate, the amount of income that is recognized is limited to that which would have been accrued on the net carrying amount of the loan at the contractual interest rate. Any cash interest payments received in excess of the limit and not applied to reduce the net carrying amount of the loan are recorded as recoveries of charge-offs until the charge-offs are fully recovered.

#### ALLOWANCE FOR LOAN LOSSES:

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential loans for impairment disclosures.

Servicing assets are recognized as separate assets when rights are acquired through purchase or through sale of financial assets. Capitalized servicing rights are reported in other assets and are amortized into noninterest income in proportion to, and over the period of, the estimated future net servicing income of the underlying financial assets. Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to amortized cost. Impairment is determined by stratifying rights by predominant characteristics, such as interest rates and terms. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. Impairment is recognized through a valuation allowance for an individual stratum, to the extent that fair value is less than the capitalized amount for the stratum.

#### PREMISES AND EQUIPMENT:

Premises and equipment are stated at cost, less accumulated depreciation and amortization. Cost and related allowances for depreciation and amortization of premises and equipment retired or otherwise disposed of are removed from the respective accounts with any gain or loss included in income or expense. Depreciation and amortization are calculated principally on the straight-line method over the estimated useful lives of the assets. Useful lives are 40 years for bank buildings and 3 - 10 years for furniture and equipment. Leasehold improvements are amortized over the lesser of the life of the lease or the estimated life of the related improvement. Maintenance and repairs are charged to expense as incurred, and improvements are capitalized.

#### OTHER REAL ESTATE OWNED AND IN-SUBSTANCE FORECLOSURES:

Other real estate owned includes properties acquired through foreclosure and properties classified as in-substance foreclosures in accordance with Statement of Financial Accounting Standards ("SFAS") No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructuring." These properties are carried at the lower of cost or estimated fair value less estimated costs to sell. Any write-down from cost to estimated fair value, required at the time of foreclosure or classification as in-substance foreclosure, is charged to the allowance for loan losses. Expenses incurred in connection with maintaining these assets, subsequent write-downs and gains or losses recognized upon sale are included in other expense.

In accordance with SFAS No. 114, "Accounting by Creditors for Impairment of a Loan," the Company classifies loans as in-substance repossessed or foreclosed if the Company receives physical possession of the debtor's assets regardless of whether formal foreclosure proceedings take place.

#### ADVERTISING:

The Company directly expenses costs associated with advertising as they are incurred.

#### IDENTIFIED INTANGIBLE ASSETS AND GOODWILL:

Intangible assets include the excess of the purchase price over the fair value of net assets acquired (goodwill) in the acquisition of the branch purchase with Fitchburg Savings Bank effective October 15, 2004 as well as a core deposit intangible (CDI) related to the branch purchase noted above. The core deposit intangible is amortized using the sum of the year's digits method over 9.3 years. The Company periodically evaluates intangible assets for impairment on the basis of whether any events and circumstances might have diminished the fair value of such assets below their carrying value. The Company has determined that the carrying values of identified intangible assets and goodwill are not impaired as of December 31, 2008.

A summary of acquired amortized intangible assets is as follows:

	As of December 31, 2008		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Core deposit intangible-branch purchase	<u>\$135,000</u>	<u>\$91,125</u>	<u>\$43,875</u>

	As of December 31, 2007		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Core deposit intangible-branch purchase	<u>\$135,000</u>	<u>\$73,750</u>	<u>\$61,250</u>

Aggregate amortization expense was \$17,375 and \$20,375 in 2008 and 2007, respectively.

Estimated amortization expense for each of the five years succeeding 2008, and thereafter, is as follows:

2009	\$14,375
2010	11,375
2011	8,375
2012	5,583
2013	4,000
Thereafter	<u>167</u>
	<u>\$43,875</u>

#### INCOME TAXES:

The Company recognizes income taxes under the asset and liability method. Under this method, deferred tax assets and liabilities are established for the temporary differences between the accounting basis and the tax basis of the Company's assets and liabilities at enacted tax rates expected to be in effect when the amounts related to such temporary differences are realized or settled.

#### RETIREMENT AND BENEFIT PLANS:

The Company has an Employee Stock Ownership Plan ("ESOP"), covering eligible employees with one year of service as defined by the ESOP. The Company records compensation expense in an amount equal to the fair value of shares committed to be released from the ESOP to employees, plus discretionary contributions.

#### EARNINGS PER SHARE:

Basic earnings per share is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding for the period. Diluted earnings per share reflects additional common shares that would have

been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance.

Reconciliation of the numerators and the denominators of the basic and diluted per share computations for net income are as follows:

	<u>Income (Numerator)</u>	<u>Shares (Denominator)</u>	<u>Per-Share Amount</u>
Year ended December 31, 2008			
Basic EPS			
Net income as reported	\$ 72,476		
Preferred stock net accretion	(613)		
Cumulative preferred stock dividend earned	<u>(3,333)</u>		
Net income available to common shareholders	\$ 68,530	1,094,525	\$ 0.06
Effect of dilutive securities options		<u>33,089</u>	
Diluted EPS			
Net income available to common stockholders	<u>\$ 68,530</u>	<u>1,127,614</u>	\$ 0.06
Year ended December 31, 2007			
Basic EPS			
Net income	\$ 83,036	1,177,299	\$ 0.07
Effect of dilutive securities options		<u>40,788</u>	
Diluted EPS			
Net income	<u>\$ 83,036</u>	<u>1,218,087</u>	\$ 0.07

#### STOCK-BASED COMPENSATION:

At December 31, 2008, the Company has two stock-based incentive plans which are described more fully in Note 12. Beginning in 2006, the Company accounts for the plans under the recognition and measurement principles of SFAS 123 (revised 2004), "Share-Based Payment." During the years ended December 31, 2008 and 2007, \$48,117 and \$37,442, respectively, in stock-based employee compensation was recognized. The compensation cost that has been charged against income for the granting of stock awards under the Monadnock Community Bancorp, Inc. 2005 Recognition and Retention Plan and Monadnock Bancorp, Inc. Equity Incentive Plan was \$32,565 and \$25,811 for the years ended December 31, 2008 and 2007, respectively.

#### FAIR VALUES OF FINANCIAL INSTRUMENTS:

SFAS No. 107, "Disclosures about Fair Value of Financial Instruments," requires that the Company disclose estimated fair value for its financial instruments. Fair value methods and assumptions used by the Company in estimating its fair value disclosures are as follows:

Cash and cash equivalents: The carrying amounts reported in the consolidated balance sheets for cash and cash equivalents approximate those assets' fair values.

Interest-bearing time deposits in other banks: Fair values of interest-bearing time deposits in other banks are estimated using discounted cash flow analyses based on current rates for similar types of time deposits.

Securities (including mortgage-backed securities): Fair values for securities are based on quoted market prices, where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable instruments.

Loans receivable: For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. The fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality.

Accrued interest receivable: The carrying amount of accrued interest receivable approximates its fair value.

Deposit liabilities: The fair values disclosed for interest and non-interest checking, passbook savings and money market accounts are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits.

Federal Home Loan Bank advances: Fair values for Federal Home Loan Bank advances are estimated using a discounted cash flow technique that applies interest rates currently being offered on advances to a schedule of aggregated expected monthly maturities on Federal Home Loan Bank advances.

Off-balance sheet instruments: The fair value of commitments to originate loans is estimated using the fees currently charged to enter similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments and the unadvanced portion of loans, fair value also considers the difference between current levels of interest rates and the committed rates.

Effective January 1, 2008, the Company adopted Statement of Financial Accounting Standards No. 157 ("SFAS 157"), Fair Value Measurements, which provides a framework for measuring fair value under generally accepted accounting principles. See Note 15.

The Company also adopted SFAS No. 159, The Fair Value Option for Financial Assets and Financial Liabilities, including an amendment of FASB Statement No. 115. SFAS No. 159 allows an entity the irrevocable option to elect fair value for the initial and subsequent measurement for certain financial assets and liabilities on a contract-by-contract basis. The Company did not elect fair value treatment for any financial assets or liabilities upon adoption.

#### RECENT ACCOUNTING PRONOUNCEMENTS:

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48, "Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement 109" (FIN 48). FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken, or expected to be taken, in a tax return and provides guidance on derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. FIN 48 is effective for fiscal years beginning after December 15, 2007. The Company's adoption of FIN 48 did not have a material impact on its financial statements.

In September 2006, the FASB ratified the consensus reached by the Emerging Issues Task Force ("EITF") on Issue No. 06-4 "Accounting for Deferred Compensation and Postretirement Benefit Aspects of Endorsement Split-Dollar Life Insurance Arrangements," (EITF Issue 06-4). EITF 06-4 requires companies with an endorsement split-dollar life insurance arrangement to recognize a liability for future postretirement benefits. The effective date is for fiscal years beginning after December 15, 2007, with earlier application permitted. The Company should recognize the effects of applying this issue through either (a) a change in accounting principle through a cumulative effect adjustment to retained earnings or (b) a change in accounting principle through retrospective application to all periods. The adoption of the new issue did not have a material impact on the Company's financial position, results of operations or cash flows.

In September 2006, the FASB issued SFAS No. 157, "Fair Value Measurements" (SFAS 157). SFAS No. 157 defines fair value, establishes a framework for measuring fair value under generally accepted accounting principles (GAAP) and expands disclosures about fair value measurements. The FASB's FSP FAS 157-2, "Effective Date of FASB Statement No. 157", defers until January 1, 2009, the application of SFAS 157 to nonfinancial assets and nonfinancial liabilities not recognized or disclosed at least annually at fair value. This includes nonfinancial assets and nonfinancial liabilities initially measured at fair value in a business combination or other new basis event, but not measured at fair value in subsequent periods. The Company adopted this statement on January 1, 2008. See Note 15- Fair Value Measurements for additional information.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities - Including an amendment of FASB Statement No. 115" (SFAS 159). SFAS 159 permits entities, at specified election dates, to choose to measure certain financial instruments at fair value that are not currently required to be measured at fair value. The fair value option is applied on an instrument-by-instrument basis, is irrevocable and can only be applied to an entire instrument and not to specified risks, specific cash flows, or portions of that instrument. Unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings at each subsequent reporting date and upfront fees and costs related to those items will be recognized in earnings as incurred and not deferred. SFAS No. 159 is effective in fiscal years beginning after November 15, 2007 and may not be applied retrospectively. The adoption of the new standard did not have a material impact on the Company's financial position, results of operations or cash flows. See Note 15 - Fair Value Measurements for additional information.

In December 2007, the FASB issued SFAS No. 160, "Noncontrolling Interests in Consolidated Financial Statements and Amendment of ARB No. 51 ("SFAS No. 160"). The new pronouncement requires all entities to report noncontrolling (minority) interests in subsidiaries as a component of stockholders' equity. SFAS No. 160 will be effective for fiscal years

beginning after December 15, 2008. Early adoption is prohibited. Management does not anticipate that this statement will have a material impact on the Company's financial condition and results of operations.

In December 2007, the FASB issued SFAS No. 141 (Revised 2007), "Business Combinations" (SFAS 141(R)). SFAS 141(R) will significantly change the accounting for business combinations. Under SFAS 141(R), an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. It also amends the accounting treatment for certain specific items including acquisition costs and non controlling minority interests and includes a substantial number of new disclosure requirements. SFAS 141(R) applies prospectively to business combinations for which the acquisition date is on or after January 1, 2009. The Company does not expect the adoption of this statement to have a material impact on its financial condition and results of operations.

In February 2008, the FASB issued FSP FAS 140-3, "Accounting for Transfers of Financial Assets and Repurchase Financing Transactions." This FSP provides guidance on how the transferor and transferee should separately account for a transfer of a financial asset and a related repurchase financing if certain criteria are met. This guidance will be effective January 1, 2009. The adoption of this new FSP is not expected to have a material effect on the Company's results of operations or financial position.

In March 2008, the FASB issued SFAS No. 161, "Disclosures about Derivative Instruments and Hedging Activities-an amendment of FASB Statement No. 133" (SFAS 161). SFAS 161 changes the disclosure requirements for derivative instruments and hedging activities. Entities are required to provide enhanced disclosures about (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 guidance in SFAS 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008, with early application encouraged. This statement encourages, but does not require, comparative disclosures for earlier periods at initial adoption. The Company does not expect the adoption of this statement to have a material impact on its financial condition and results of operations.

In April 2008, the FASB issued FSP FAS 142-3, "Determination of the Useful Life of Intangible Assets." This FSP provides guidance as to factors considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS 142, "Goodwill and Other Intangible Assets." This guidance will be effective January 1, 2009. The adoption is not expected to have a material effect on the Company's results of operations or financial position.

In May 2008, the FASB issued SFAS No. 162, "The Hierarchy of Generally Accepted Accounting Principles." This standard formalizes minor changes in prioritizing accounting principles used in the preparation of financial statements that are presented in conformity with GAAP. This standard became effective November 18, 2008.

#### NOTE 3 - INVESTMENTS IN AVAILABLE-FOR-SALE SECURITIES

Debt securities have been classified in the consolidated balance sheets according to management's intent. The amortized cost of securities and their approximate fair values are as follows:

	Amortized Cost Basis	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2008:				
Mortgage-backed securities:				
FNMA	\$26,175,930	\$110,894	\$(146,516)	\$26,140,308
FHLMC	16,182,334	47,719	(30,704)	16,199,349
GNMA	8,959,973	24,222	(152,460)	8,831,735
Total mortgage-backed securities	<u>51,318,237</u>	<u>182,835</u>	<u>(329,680)</u>	<u>51,171,392</u>
Total investments in available-for sale securities	<u>\$51,318,237</u>	<u>\$182,835</u>	<u>\$(329,680)</u>	<u>\$51,171,392</u>

	Amortized Cost Basis	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2007:				
Mortgage-backed securities:				
FNMA	\$13,639,059	\$113,755	\$	\$13,752,814
FHLMC	8,370,811	31,490	(4,330)	8,397,971
GNMA	14,435,927	36,087	(26,986)	14,445,028
Total mortgage-backed securities	<u>36,445,797</u>	<u>181,332</u>	<u>(31,316)</u>	<u>36,595,813</u>
Total investments in available-for-sale securities	<u>\$36,445,797</u>	<u>\$181,332</u>	<u>\$(31,316)</u>	<u>\$36,595,813</u>

There were no securities of issuers whose aggregate carrying amount exceeded 10% of stockholders' equity as of December 31, 2008.

As of December 31, 2008 and 2007, securities with carrying amounts totaling \$51,028,783 and \$20,998,650, respectively, were pledged to secure Federal Home Loan Bank advances and Federal Reserve borrowings.

The fair value of available-for-sale securities by contractual maturity at December 31, 2008 are shown below. Actual maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Fair Value
Due after ten years	<u>\$51,171,392</u>
	<u>\$51,171,392</u>

Proceeds from sales of available-for-sale securities were \$19,858,430 during the year ended December 31, 2008. Gross realized gains and gross realized losses on those sales were \$133,492 and \$8,602, respectively. Proceeds from sales of available-for-sale securities were \$12,233,726 during the year ended December 31, 2007. Gross realized gains and gross realized losses on those sales were \$78,259 and \$2,500, respectively. The tax provision applicable to these net gains amounted to \$49,469 during 2008 and \$30,008 during 2007.

The aggregate fair value and unrealized losses of securities that have been in a continuous unrealized-loss position for less than twelve months and for twelve months or more, and are not other than temporarily impaired, are as follows:

December 31, 2008	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mortgage-backed securities:						
FNMA	\$13,022,039	\$146,516	\$	\$	\$13,022,039	\$146,516
FHLMC	6,764,048	30,704			6,764,048	30,704
GNMA	6,393,921	120,782	729,440	31,678	7,123,361	152,460
Total temporarily impaired securities	<u>\$26,180,008</u>	<u>\$298,002</u>	<u>\$729,440</u>	<u>\$31,678</u>	<u>\$26,909,448</u>	<u>\$329,680</u>

December 31, 2007	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mortgage-backed securities:						
FHLMC	\$2,675,334	\$ 4,330	\$	\$	\$2,675,334	\$ 4,330
GNMA	4,651,556	8,880	2,424,148	18,106	7,075,704	26,986
Total temporarily impaired securities	<u>\$7,326,890</u>	<u>\$13,210</u>	<u>\$2,424,148</u>	<u>\$18,106</u>	<u>\$9,751,038</u>	<u>\$31,316</u>

The investments in the Company's investment portfolio that are temporarily impaired as of December 31, 2008 and 2007 consist of debt securities issued by U.S. government agencies and a U.S. government sponsored enterprise with strong credit ratings. The unrealized losses in the above table are attributable to changes in market interest rates. Company management does not intend to sell these securities in the near term future, and due to the securities relative short duration, anticipates that the unrealized losses that currently exist will be dramatically reduced going forward. As Company management has the ability to hold debt securities for the foreseeable future, no declines are deemed to be other than temporary.

**NOTE 4 - LOANS**

Loans consisted of the following as of December 31:

	2008	2007
One-to-four family residential	\$32,088,239	\$31,526,555
Home equity	5,973,034	5,350,078
Commercial real estate	17,153,289	14,693,410
Multifamily	1,107,824	1,704,787
Construction and land development loans	570,051	1,141,352
Commercial loans	10,536,855	7,065,867
Consumer loans	3,373,273	2,607,149
	<u>70,802,565</u>	<u>64,089,198</u>
Allowance for loan losses	(413,337)	(389,770)
Deferred costs, net	312,893	331,353
Net loans	<u>\$70,702,121</u>	<u>\$64,030,781</u>

Certain directors and executive officers of the Company and companies in which they have a significant ownership interest were customers of the Bank during 2008. The aggregate amount of loans granted to directors, executive officers and their companies was \$1,390,196 and \$984,239 at December 31, 2008 and 2007, respectively. During 2008, \$484,859 of new loans were granted and principal repayments totaled \$78,902.

Changes in the allowance for loan losses were as follows for the years ended December 31:

	2008	2007
Balance at beginning of period	\$389,770	\$334,917
Recoveries of loans previously charged off	5,111	4,025
Provision for loan losses	156,249	111,709
Charge offs	(137,793)	(60,881)
Balance at end of period	<u>\$413,337</u>	<u>\$389,770</u>

The following table sets forth information regarding nonaccrual loans and accruing loans 90 days or more overdue as of December 31:

	2008	2007
Total nonaccrual loans	<u>\$509,166</u>	<u>\$269,725</u>
Accruing loans which are 90 days or more overdue	<u>\$ 0</u>	<u>\$ 0</u>

Information about loans that meet the definition of an impaired loan in SFAS No. 114 is as follows as of December 31:

	2008		2007	
	Recorded Investment In Impaired Loans	Related Allowance For Credit Losses	Recorded Investment In Impaired Loans	Related Allowance For Credit Losses
Loans for which there is a related allowance for credit losses	\$508,820	\$73,693	\$242,804	\$37,448
Loans for which there is no related allowance for credit losses			26,921	
Totals	<u>\$508,820</u>	<u>\$73,693</u>	<u>\$269,725</u>	<u>\$37,448</u>
Average recorded investment in impaired loans during the year ended December 31	<u>\$490,261</u>		<u>\$241,720</u>	
Related amount of interest income recognized during the time, in the year ended December 31, that the loans were impaired				
Total recognized	<u>\$ 0</u>		<u>\$ 0</u>	
Amount recognized using a cash-basis method of accounting	<u>\$ 0</u>		<u>\$ 0</u>	

Amortization of servicing rights was \$468 in 2008 and \$7,056 in 2007. The balance of capitalized loan servicing rights included in other assets as of December 31, 2008 and 2007 was \$418 and \$886, respectively. The fair value of these rights approximated their carrying amount.

NOTE 5 - PREMISES AND EQUIPMENT

The following is a summary of premises and equipment as of December 31:

	<u>2008</u>	<u>2007</u>
Land	\$ 215,800	\$ 215,800
Buildings	350,360	350,360
Leasehold improvements	171,483	147,847
Furniture and equipment	<u>604,359</u>	<u>614,925</u>
	1,342,002	1,328,932
Accumulated depreciation and amortization	<u>(598,119)</u>	<u>(519,439)</u>
	<u><u>\$ 743,883</u></u>	<u><u>\$ 809,493</u></u>

NOTE 6 - DEPOSITS

Deposits consisted of the following as of December 31:

	<u>2008</u>	<u>2007</u>
Demand accounts	<u>\$ 4,525,816</u>	<u>\$ 5,286,039</u>
Non-interest bearing deposits	<u>4,525,816</u>	<u>5,286,039</u>
NOW accounts	13,771,881	7,613,526
Savings accounts	2,292,348	2,448,071
Money market deposit accounts	8,134,807	8,344,598
Time certificates	<u>33,047,197</u>	<u>41,125,628</u>
Interest-bearing deposits	<u>57,246,233</u>	<u>59,531,823</u>
Total deposits	<u><u>\$61,772,049</u></u>	<u><u>\$64,817,862</u></u>

The aggregate amount of time deposit accounts in denominations of \$100,000 or more as of December 31, 2008 and 2007 was \$9,184,114 and \$11,851,684, respectively.

For time deposits as of December 31, 2008, the scheduled maturities for each of the following five years ended December 31, and thereafter, are:

2009	\$24,446,863
2010	3,875,727
2011	1,858,799
2012	730,606
2013	2,008,943
Thereafter	<u>126,259</u>
	<u><u>\$33,047,197</u></u>

Deposits from related parties held by the Company as of December 31, 2008 and 2007 amounted to \$309,788 and \$355,342, respectively.

NOTE 7 - FEDERAL HOME LOAN BANK ADVANCES

Advances consist of funds borrowed from the Federal Home Loan Bank of Boston (FHLB).

Maturities of advances from the FHLB for the years ending after December 31, 2008 and December 31, 2007 are summarized as follows:

<u>Year of Maturity</u>	<u>2008</u>	<u>Year of Maturity</u>	<u>2007</u>
2009	\$14,078,638	2008	\$ 448,515
2010	9,278,422	2009	5,048,114
2011	10,626,773	2010	6,903,771
2012	5,324,107	2011	3,612,501
2013	5,817,984	2012	4,569,568
Thereafter	8,000,000	Thereafter	9,955,507
	<u>\$53,125,924</u>		<u>\$30,537,976</u>

Borrowings from the FHLB are secured by a blanket lien on qualified collateral, consisting primarily of loans with first mortgages secured by one to four family properties, certain unencumbered investment securities and other qualified assets.

At December 31, 2008, the interest rates on FHLB advances ranged from 0.42% to 5.38% and at December 31, 2007, the interest rates on FHLB advances ranged from 2.77% to 5.38%. At December 31, 2008 and 2007, the weighted average interest rates on FHLB advances were 3.34% and 4.34%, respectively.

As of December 31, 2008, the Bank had \$4.0 million in putable advances (Knock-out Advances) from the FHLB. The FHLB will require that these borrowings become due immediately upon their Strike Date, as defined in the contract, if the three month LIBOR rate equals or exceeds the Strike Rate. As of December 31, 2008, the three month LIBOR was at 1.425%.

Knock-out Advances outstanding as of December 31, 2008 are as follows:

<u>Next Strike Date</u>	<u>Amount</u>	<u>Current Rate</u>	<u>Strike Rate</u>	<u>Maturity Date</u>
January 2, 2009	\$2,000,000	2.77%	6.50%	April 1, 2009
January 2, 2009	1,000,000	3.99	6.50	July 2, 2014
February 24, 2009	1,000,000	3.58	6.50	May 26, 2009

During 2006, 2007 and 2008, the Bank borrowed \$14.0 million in callable advances from the FHLB. These advances are callable at the discretion of the FHLB on the call date noted and are callable continuously on a quarterly basis thereafter.

Callable advances outstanding as of December 31, 2008 are as follows:

<u>Next Call Date</u>	<u>Amount</u>	<u>Current Rate</u>	<u>Maturity Date</u>
January 20, 2009	\$1,000,000	2.55%	January 18, 2013
February 24, 2009	1,000,000	4.05	August 24, 2012
February 24, 2009	3,000,000	4.19	November 25, 2016
March 2, 2009	1,000,000	4.25	May 30, 2017
March 12, 2009	1,000,000	3.99	December 12, 2016
March 12, 2009	1,000,000	3.69	September 12, 2014
December 21, 2009	1,000,000	3.60	December 20, 2012
January 8, 2010	2,000,000	3.15	January 8, 2013
March 10, 2010	1,000,000	2.39	March 11, 2013
February 25, 2011	1,000,000	3.09	February 25, 2013
July 14, 2011	1,000,000	3.25	July 16, 2018

NOTE 8 - FEDERAL RESERVE BANK BORROWINGS

Borrowings from the Federal Reserve Bank discount window are typically for a term of less than one month and are being secured by certain unencumbered investment securities with a total carrying value of \$2.9 million at December 31, 2008.

At December 31, 2008, the interest rate on Federal Reserve Bank borrowings was 0.50%. During 2008, the weighted average interest rate on Federal Reserve Bank borrowings was 0.79%.

NOTE 9 - INCOME TAX EXPENSE

The components of income tax expense are as follows for the years ended December 31:

	<u>2008</u>	<u>2007</u>
Current		
Federal	\$ 68,431	\$ 79,265
State	8,987	7,698
Benefit of operating loss carryforward	<u>(27,082)</u>	<u>(82,567)</u>
	50,336	4,396
Deferred:		
Federal	6,820	59,942
State	<u>2,701</u>	<u>8,794</u>
	9,521	68,736
 Total income tax expense	 <u>\$ 59,857</u>	 <u>\$ 73,132</u>

The reasons for the differences between the tax at the statutory federal income tax rate and the effective tax rates are summarized as follows for the years ended December 31:

	<u>2008</u>	<u>2007</u>
	% of	% of
	Income	Income
Federal income tax at statutory rate	34.0%	34.0%
Increase in tax resulting from:		
Unallowable expenses and other items	8.4	7.4
State tax expense, net of federal tax benefit	2.8	5.4
Effective tax rates	<u>45.2%</u>	<u>46.8%</u>

The Company had gross deferred tax assets and gross deferred tax liabilities as follows as of December 31:

	<u>2008</u>	<u>2007</u>
Deferred tax assets:		
Allowance for loan losses	\$ 145,409	\$ 148,042
Other temporary differences	4,633	478
Operating loss carryover	9,755	36,837
Depreciation	8,399	8,212
Core deposit intangible	20,944	17,627
Stock option – nonqualified	13,042	7,034
Net unrealized holding loss on available-for-sale securities	58,165	
Gross deferred tax assets	<u>260,347</u>	<u>218,230</u>
Deferred tax liabilities:		
Loan origination costs net of fees	(124,256)	(132,332)
Accrual to cash adjustment	(165,708)	(166,834)
Goodwill	(16,798)	(13,434)
Net unrealized holding gain on available-for-sale securities		(59,422)
Loan income	(372)	(1,061)
Gross deferred tax liabilities	<u>(307,134)</u>	<u>(373,083)</u>
Net deferred tax liability	<u>\$ (46,787)</u>	<u>\$(154,853)</u>

As of December 31, 2008, for state income tax purposes, the Company has operating loss carryovers of approximately \$174,000 which will expire in the years 2015 through 2016.

The Company adopted FASB interpretation No. 48, "Accounting for Uncertainty in Income Taxes – an interpretation of FASB Statement 109" (FIN 48) as of December 31, 2008. It is the Company's policy to provide for uncertain tax positions and the related interest and penalties based upon management's assessment of whether a tax benefit is more likely than not to be sustained upon examination by tax authorities. There was no effect on the Company's balance sheet or income statement from adoption of FIN 48.

NOTE 10 – EMPLOYEE STOCK OWNERSHIP PLAN (ESOP)

All Bank employees meeting certain age and service requirements are eligible to participate in the ESOP. On June 28, 2004, the Company's ESOP purchased 23,169 shares of common stock for \$135,304. Acquisitions of unearned ESOP shares by Monadnock Community Bank ESOP Trust were funded internally through a borrowing from Monadnock Community Bancorp, Inc., which was repayable annually with interest at a fixed rate of 4% for ten years. Shares are committed for release upon the repayment of the borrowing and are allocated to participants based on compensation. Participant's benefits become fully vested after six years of service. Company contributions are the primary source of funds for the ESOP's repayment of the loan.

Early in the third quarter of 2006, in accordance with a Plan of Conversion and Reorganization, the employee stock ownership plan completed its purchase of 42,460 shares of common stock for \$331,531, or \$7.81 per share. All employee stock ownership plan shares, comprising 6% of the total shares sold in the offering, were purchased in the open market through its newly designated trustee. In anticipation of the ESOP purchases, a new note was written to allow for borrowings totaling approximately \$454,000. The actual borrowings under this note agreement totaled \$435,171, of which borrowing had a fifteen year term and a floating rate of interest tied to the Prime rate at the beginning of each January 1st of each year. Principal and interest payments totaled \$51,526 for 2007.

On April 15, 2008, the Monadnock Community Bank ESOP Trust entered into a loan agreement with Rollstone Bank & Trust to refinance the ESOP loan which was previously held by Monadnock Bancorp, Inc. The newly refinanced loan has been guaranteed by Monadnock Bancorp, Inc. The amount of the refinanced ESOP loan was for \$400,000 at an interest rate of 5.25%, floating quarterly at a rate of interest tied to the Prime Rate. The interest rate on the loan as of December 31, 2008 was 5% and the loan has an interest rate floor of 5%. Interest only payments under this loan agreement were made beginning May 15, 2008 and continuing monthly thru December 15, 2008. Beginning January 15, 2009, principal and interest payments are scheduled to be made and continue through April 15, 2018. The outstanding term of the loan was reduced from thirteen years to ten years. Principal and interest payments totaled \$58,202 for 2008.

As of December 31, 2008, the remaining principal balance is payable as follows:

2009	\$ 34,402
2010	36,187
2011	38,064
2012	39,998
2013	42,115
Thereafter	209,234
Total	<u>\$400,000</u>

Compensation expense related to the ESOP amounted to \$33,562 and \$26,280 for the years ended December 31, 2008 and 2007, respectively.

The total shares that were allocated and are held by the ESOP at December 31, 2008 and 2007 are 14,954 and 9,882 shares, respectively. Unallocated shares are 49,951 and 55,731 at December 31, 2008 and 2007, respectively. The fair value of all ESOP shares was approximately \$228,000 and \$407,000 at December 31, 2008 and 2007, respectively.

NOTE 11 – 401(k) PLAN

The Bank established a 401(k) plan effective September 1, 2008 in which all Bank employees meeting certain age and service requirements are eligible to participate. Participants may contribute both pretax contributions (i.e. 401(k) contributions) as well as post tax (i.e. Roth 401(k) contributions) up to the annual dollar limits set by the IRS. Employee contributions are immediately 100 percent vested. The Bank may make discretionary contributions into the 401(k) plan and any contributions to the participants become fully vested after six years of service. During the year ended December 31, 2008, the Bank did not make any discretionary contributions to the 401(k) plan.

NOTE 12 – STOCK COMPENSATION PLANS

At the May 12, 2005 Annual Meeting of Stockholders, the Monadnock Community Bancorp, Inc. 2005 Stock Option Plan and the Monadnock Community Bancorp, Inc. 2005 Recognition and Retention Plan were approved by stockholders. Under the Company's 2005 Stock Option Plan, the Company may grant options to its directors, officers and employees for up to 63,072 shares of common stock. Both incentive stock options and non-statutory stock options may be granted under this plan. The exercise price of each option equals the market price of the Company's stock on the date of grant and an option's

maximum term is ten years. All options currently outstanding vest at 10% per year for the first eight (8) years and 20% in year nine (9) and upon a change in control, as defined in the plan, become fully vested and exercisable for one year following cessation of employment.

At the May 10, 2007 Annual Meeting of Stockholders, the Monadnock Bancorp, Inc. 2007 Equity Incentive Plan was approved by stockholders. Under the Company's 2007 Equity Incentive Plan, the Company may grant options to its directors, officers and employees for up to 70,768 shares of common stock. Both incentive stock options and non-statutory stock options may be granted under this plan. The exercise price of each option equals the market price of the Company's stock on the date of grant and an option's maximum term is ten years. All options granted during 2007 and currently outstanding vest at 10% per year for the first eight (8) years and 20% in year nine (9) and upon a change in control, as defined in the plan, become fully vested and exercisable for one year following cessation of employment. All options granted during 2008 and currently outstanding vest at 20% per year for five (5) years and upon a change in control, as defined in the plan, become fully vested and exercisable for one year following cessation of employment.

A summary of the status of the Company's stock options for the years ended December 31, 2008 and 2007 is presented below:

	2008		2007	
	Number of Options	Weighted Average Option Price	Number of Options	Weighted Average Option Price
Options at beginning of year	129,121	\$ 6.45	58,621	\$ 6.17
Granted	4,900	5.73	70,500	6.68
Canceled	(684)	6.12		
Options at end of year	<u>133,337</u>	\$ 6.42	<u>129,121</u>	\$ 6.45

The following table summarizes information about fixed stock options outstanding as of December 31, 2008:

Exercise Prices	Options Outstanding		Options Exercisable	
	Number Outstanding as of 12/31/08	Weighted-Average Remaining Contractual Life	Number Exercisable as of 12/31/08	Weighted-Average Exercise Price
\$ 5.73	4,900	9.7 years	--	--
6.12	55,335	6.9 years	16,598	\$ 6.12
6.68	70,500	8.4 years	7,050	6.68
7.23	2,602	7.5 years	520	7.23
\$ 6.42	<u>133,337</u>	7.8 years	<u>24,168</u>	\$ 6.31

The weighted average fair value of the options granted in 2008 and 2007 using the Black-Scholes option pricing model was \$2.01 per option share and \$3.73 per option share, respectively. The Company recorded compensation cost of \$48,117 and \$37,442 in 2008 and 2007, respectively, related to stock options. As of December 31, 2008, there was approximately \$380,000 of unrecognized compensation cost related to nonvested stock options. The cost is expected to be recognized over a weighted-average period of 7.8 years.

Assumptions used to determine the weighted average fair value of options granted:

	Year Ended December 31, 2008	Year Ended December 31, 2007
Dividend yield	N/A	N/A
Expected life in years	10 years	10 years
Expected volatility	13%	35%
Risk-free interest rate	3.88%	4.86%

Under the Company's 2005 Recognition and Retention Plan, the Company may grant stock awards to its directors, officers and employees for up to 25,228 shares of common stock. Under the Company's 2007 Equity Incentive Plan, the Company may grant stock awards to its directors, officers and employees for up to 26,538 shares of common stock. Shares are contingently awarded to recipients subject to restrictions based on the general rules of the plan. The Company applies SFAS No. 123(R), "Share-Based Payment," in accounting for stock awards. The stock allocations, based on the market price at the

date of grant, are recorded as unearned compensation. Unearned compensation is amortized over the vesting period to be benefited. All stock awards currently outstanding vest at 10% per year for the first eight (8) years and 20% in year nine (9) and become fully vested upon a change in control, as defined in the plan.

Stock awards for 25,197 shares, having a fair value of \$6.13 per share, were granted during 2005. Stock awards for 25,931 shares, having a fair value of \$6.60 per share, were granted during 2007. The Company recorded compensation cost of \$32,565 and \$25,811 in 2008 and 2007, respectively. As of December 31, 2008, there was approximately \$252,000 of unrecognized cost related to stock awards. The cost is expected to be recognized over a weighted-average period of 7.8 years.

#### NOTE 13 - REGULATORY MATTERS

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of its assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), of core capital (as defined) to adjusted total assets (as defined) and of Tangible capital (as defined) to tangible assets (as defined). Management believes, as of December 31, 2008 and 2007, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2008, the most recent notification from the Office of Thrift Supervision categorized the Bank as well-capitalized under the regulatory framework for prompt corrective action. To be categorized as well-capitalized the Bank must maintain minimum total risk-based, Tier 1 risk-based and core capital leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank's category.

	Actual		For Capital Adequacy Purposes		To Be Well-Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollar amounts in thousands)						
December 31, 2008:						
Total Capital (to Risk Weighted Assets)	\$10,846	16.73%	\$5,186	≥8.0%	\$6,483	≥10.0%
Core Capital (to Adjusted Total Assets)	10,438	8.19	5,097	≥4.0	6,371	≥ 5.0
Tangible Capital (to Tangible Assets)	10,438	8.19	1,911	≥1.5	N/A	N/A
Tier 1 Capital (to Risk Weighted Assets)	10,438	16.10	N/A	N/A	3,890	≥ 6.0
December 31, 2007:						
Total Capital (to Risk Weighted Assets)	8,915	15.99	4,461	≥8.0	5,576	≥10.0
Core Capital (to Adjusted Total Assets)	8,532	8.14	4,193	≥4.0	5,241	≥ 5.0
Tangible Capital (to Tangible Assets)	8,532	8.14	1,572	≥1.5	N/A	N/A
Tier 1 Capital (to Risk Weighted Assets)	8,532	15.30	N/A	N/A	3,346	≥ 6.0

On February 14, 2008, the Company's Board of Directors authorized its third stock repurchase program pursuant to which the Company intends to repurchase up to 65,000 shares, or 5.29% of its outstanding common stock. Any repurchased shares will be held as treasury stock and will be available for general corporate purposes. As of December 31, 2008, the Company had completed the Stock Repurchase Program, noted above, having purchased 65,000 shares of common stock for \$410,551, or a weighted average per share price of \$6.32.

#### NOTE 14 - COMMITMENTS AND CONTINGENT LIABILITIES

As of December 31, 2008, the Company is obligated under an operating lease for the Company's main office expiring July 31, 2013. The Company has the option to extend the lease for up to three additional five year periods.

The total minimum rental due in future periods under this existing agreement is as follows as of December 31, 2008:

2009	\$ 51,732
2010	51,732
2011	51,732
2012	51,732
2013	30,177
Total	<u>\$237,105</u>

The total rental expense amounted to \$49,588 for 2008 and \$47,444 for 2007.

#### NOTE 15 - FAIR VALUE MEASUREMENTS

In accordance with SFAS 157, the Company groups its financial assets and financial liabilities measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

Level 1 - Valuations for assets and liabilities traded in active exchange markets, such as the New York Stock Exchange. Level 1 also includes U.S. Treasury, other U.S. Government and agency mortgage-backed securities that are traded by dealers or brokers in active markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2 - Valuations for assets and liabilities traded in less active dealer or broker markets. Valuations are obtained from third party pricing services for identical or comparable assets or liabilities.

Level 3 - Valuations for assets and liabilities that are derived from other methodologies, including option pricing models, discounted cash flow models and similar techniques, are not based on market exchange, dealer, or broker traded transactions. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets and liabilities.

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.

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below. These valuation methodologies were applied to all of the Company's financial assets and financial liabilities carried at fair value as of December 31, 2008.

The Company's investment in mortgage-backed securities available-for-sale are generally classified within level 2 of the fair value hierarchy. For these securities, we obtain fair value measurements from independent pricing services. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. treasury yield curve, trading levels, market consensus prepayment speeds, credit information and the instrument's terms and conditions.

Level 3 is for positions that are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence. In the absence of such evidence, management's best estimate is used. Subsequent to inception, management only changes level 3 inputs and assumptions when corroborated by evidence such as transactions in similar instruments, completed or pending third-party transactions in the underlying investment or comparable entities, subsequent rounds of financing, recapitalization and other transactions across the capital structure, offerings in the equity or debt markets, and changes in financial ratios or cash flows.

The Company's impaired loans are reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using level 2 inputs based upon appraisals of similar properties obtained from a third party.

The following summarizes assets measured at fair value for the period ending December 31, 2008.

**ASSETS MEASURED AT FAIR VALUE ON A RECURRING BASIS**

	Fair Value Measurements at Reporting Date Using:			
	December 31, 2008	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3
Securities available-for-sale	\$51,171,392	\$	\$51,171,392	\$
Impaired loans	435,127		435,127	
Totals	\$51,606,519	\$	\$51,606,519	\$

The estimated fair values of the Company's financial instruments, all of which are held or issued for purposes other than trading, are as follows as of December 31:

	2008		2007	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Financial assets:</b>				
Cash and cash equivalents	\$ 699,761	\$ 699,761	\$ 1,181,206	\$ 1,181,206
Interest bearing time deposits in other bank	200,000	200,000	100,000	100,000
Available-for-sale securities	51,171,392	51,171,392	36,595,813	36,595,813
Federal Home Loan Bank stock	2,568,300	2,568,300	1,607,700	1,607,700
Loans, net	70,702,121	72,312,000	64,030,781	64,036,000
Accrued interest receivable	582,314	582,314	442,749	442,749
<b>Financial liabilities:</b>				
Deposits	61,772,049	62,184,000	64,817,862	65,074,000
FHLB advances	53,125,924	55,365,000	30,537,976	31,067,000
Federal Reserve borrowings	1,000,000	1,000,000		
ESOP loan	400,000	400,000		

The carrying amounts of financial instruments shown in the above table are included in the consolidated balance sheets under the indicated captions. Accounting policies related to financial instruments are described in Note 3.

**NOTE 16 - SIGNIFICANT GROUP CONCENTRATIONS OF CREDIT RISK**

Most of the Bank's business activity is with customers located within the state of New Hampshire. The majority of the Bank's loan portfolio is comprised of loans collateralized by real estate located in the state of New Hampshire.

**NOTE 17 - FINANCIAL INSTRUMENTS**

The Company is party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to originate loans and unadvanced funds on loans. The instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the consolidated balance sheets. The contract amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for loan commitments is represented by the contractual amounts of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

Commitments to originate loans are agreements to lend to a customer provided 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 commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the borrower. Collateral held varies, but may include secured interests in mortgages, accounts receivable, inventory, property, plant and equipment and income-producing properties.

The notional amounts of financial instrument liabilities with off-balance sheet credit risk are as follows as of December 31:

	<u>2008</u>	<u>2007</u>
Commitments to originate loans	\$ 314,263	\$ 516,000
Unadvanced portions of loans:		
Commercial lines of credit	1,909,140	1,452,348
Consumer lines of credit	5,083,995	5,287,331
Construction loans	234,185	92,555
	<u>\$7,541,583</u>	<u>\$7,348,234</u>

There is no material difference between the notional amounts and the estimated fair values of the off-balance sheet liabilities.

NOTE 18 - RECLASSIFICATION

Certain amounts in the prior year have been reclassified to be consistent with the current year's statement presentation.

## STOCKHOLDER INFORMATION

### EXECUTIVE OFFICES

One Jaffrey Road  
Peterborough, New Hampshire 03458

### REGISTRAR AND TRANSFER AGENT

Registrar and Transfer Company  
10 Commerce Drive  
Cranford, New Jersey 07016

### INDEPENDENT CERTIFIED PUBLIC ACCOUNTANTS

Shatswell, MacLeod & Company, P.C.  
83 Pine Street  
West Peabody, Massachusetts 01960

### COMMON STOCK LISTING

Monadnock Bancorp, Inc. stock is listed on the over-the-counter bulletin board under the symbol "MNKB.OB"

### SECURITIES COUNSEL

Luse Gorman Pomerenk & Schick, P.C.  
5335 Wisconsin Avenue, NW, Suite 400  
Washington, DC 20015

### FORM 10-K

A copy of Monadnock Bancorp, Inc. annual report on Form 10-K has been filed with the Securities and Exchange Commission and may be obtained without charge by written request to:

Karl F. Betz  
Senior Vice President & Chief Financial Officer  
Monadnock Bancorp, Inc.  
One Jaffrey Road  
Peterborough, New Hampshire 03458

### ANNUAL MEETING

The annual meeting of Monadnock Bancorp, Inc. will be held at 10:30 a.m., May 14, 2009 at:  
RiverMead Auditorium  
150 Rivermead Road  
Peterborough, New Hampshire 03458

### STOCKHOLDER RELATIONS

**Stockholders are encouraged to contact the Investor Relations Officer with any questions or comments about their investment.**

Direct inquiries to:  
Karl F. Betz  
Senior Vice President & Chief Financial Officer  
One Jaffrey Road  
Peterborough, New Hampshire 03458  
(800) 924-9654

## MONADNOCK BANCORP, INC.

### EXECUTIVE OFFICERS

William M. Pierce, Jr.  
President & Chief Executive Officer

Karl F. Betz  
Senior Vice President & Chief Financial Officer

William C. Gilson \*  
Senior Vice President & Senior Lending Officer

Donald R. Blanchette \*  
Senior Vice President

### OFFICERS \*

Wayne R. Gordon  
Vice President

Rachel O'Leary  
Assistant Vice President

R. Steven Venning  
Assistant Vice President

Julie Beaumont  
Compliance Officer

Donna G. Loucks  
Assistant Treasurer

Gail Murphy  
Branch Officer

### DIRECTORS

Kenneth A. Christian  
Chairman

Samuel Hackler  
Vice-Chairman

Thomas LaFortune  
Secretary

Kenneth R. Simonetta  
Assistant Secretary

Nancy L. Carlson

Jack Goldstein

William M. Pierce, Jr.  
President & Chief Executive Officer

Edward J. Shea

\* Officers of Monadnock Community Bank only.

**EXHIBIT 23.1**



CONSENT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

We consent to the incorporation in this Annual Report on Form 10-K of Monadnock Bancorp, Inc. and Subsidiary of our report dated February 24, 2009.

*Shatswell, MacLeod + Company, P.C.*

SHATSWELL, MacLEOD & COMPANY, P.C.

West Peabody, Massachusetts  
February 24, 2009

**Exhibit 31.1**

**Certification of Chief Executive Officer**  
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, William M. Pierce, Jr., certify that:

1. I have reviewed this Annual Report on Form 10-K of Monadnock Bancorp, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) designed such disclosure controls and procedures or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):

- a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
- b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting:

March 23, 2009

Date

/s/ William M. Pierce, Jr.

William M. Pierce, Jr.

President and Chief Executive Officer

**Certification of Chief Financial Officer**

Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Karl F. Betz, certify that:

1. I have reviewed this Annual Report on Form 10-K of Monadnock Bancorp, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this annual report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
  - a) designed such disclosure controls and procedures or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
  - b) designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
  - c) evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
  - d) disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting;

5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of the registrant's board of directors (or persons performing the equivalent functions):
- a) all significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting:

March 23, 2009

Date

/s/ Karl F. Betz

Karl F. Betz

Senior Vice President and Chief Financial Officer

**Certification pursuant to  
18 U.S.C. Section 1350,  
as adopted pursuant to  
Section 906 of the Sarbanes-Oxley Act of 2002**

William M. Pierce, Jr., President and Chief Executive Officer and Karl F. Betz, Senior Vice President and Chief Financial Officer of Monadnock Bancorp, Inc. (the “Company”) each certify in his capacity as an officer of the Company that he has reviewed the annual report of the Company on Form 10-K for the year ended December 31, 2008 and that to the best of his knowledge:

1. the report fully complies with the requirements of Sections 13(a) of the Securities Exchange Act of 1934; and
2. the information contained in the report fairly presents, in all material respects, the financial condition and results of operations of the Company.

The purpose of this statement is solely to comply with Title 18, Chapter 63, Section 1350 of the United States Code, as amended by Section 906 of the Sarbanes-Oxley Act of 2002.

A signed original of this written statement required by Section 906 has been provided to Monadnock Bancorp, Inc. and will be retained by Monadnock Bancorp, Inc. and furnished to the Securities and Exchange Commission or its staff upon request.

March 23, 2009

Date

/s/ William M. Pierce, Jr.

William M. Pierce, Jr.  
President and Chief Executive Officer

March 23, 2009

Date

/s/ Karl F. Betz

Karl F. Betz  
Senior Vice President and Chief Financial Officer