FIDELITY D & D BANCORP INC
Form 10-Q
November 09, 2012

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2012

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: 333-90273

FIDELITY D & D BANCORP, INC.

STATE OF INCORPORATION: IRS EMPLOYER IDENTIFICATION NO:

PENNSYLVANIA 23-3017653

Address of principal executive offices:

BLAKELY & DRINKER ST.

DUNMORE, PENNSYLVANIA 18512

TELEPHONE:

570-342-8281

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See 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 ¨ (Do not check if a smaller reporting company)	Smaller reporting company x

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

¨ YES x NO

The number of outstanding shares of Common Stock of Fidelity D & D Bancorp, Inc. on October 31, 2012, the latest practicable date, was 2,307,606 shares.

FIDELITY D & D BANCORP, INC.

Form 10-Q September 30, 2012

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PART I – Financial Information

Item 1: Financial Statements

Fidelity D & D Bancorp, Inc. and Subsidiary
Consolidated Balance Sheets

(Unaudited)

(dollars in thousands)	September 30, 2012	December 31, 2011
Assets:		
Cash and due from banks	$ 11,685	$ 15,158
Interest-bearing deposits with financial institutions	33,937	37,007
Total cash and cash equivalents	45,622	52,165
Available-for-sale securities	102,833	108,154
Held-to-maturity securities	302	389
Federal Home Loan Bank stock	3,019	3,699
Loans, net (allowance for loan losses of $8,142 in 2012; $8,108 in 2011)	420,928	398,186
Loans held-for-sale (fair value $1,890 in 2012, $4,661 in 2011)	1,844	4,537
Foreclosed assets held-for-sale	1,610	1,169
Bank premises and equipment, net	14,270	13,575
Cash surrender value of bank owned life insurance	9,984	9,740
Accrued interest receivable	1,991	2,082
Other assets	13,044	13,046
Total assets	$ 615,447	$ 606,742
Liabilities:		
Deposits:		
Interest-bearing	$ 409,467	$ 419,647
Non-interest-bearing	114,653	96,155
Total deposits	524,120	515,802
Accrued interest payable and other liabilities	2,705	6,809
Short-term borrowings	14,069	9,507
Long-term debt	16,000	21,000
Total liabilities	556,894	553,118
Shareholders' equity:		

Preferred stock authorized 5,000,000 shares with no par value; none issued	-	-
Capital stock, no par value (10,000,000 shares authorized; shares issued and outstanding; 2,307,606 in 2012; and 2,254,542 in 2011)	23,416	22,354
Retained earnings	34,647	32,380
Accumulated other comprehensive income/ (loss)	490	(1,110)
Total shareholders' equity	58,553	53,624
Total liabilities and shareholders' equity	$ 615,447	$ 606,742

See notes to unaudited consolidated financial statements

Fidelity D & D Bancorp, Inc. and Subsidiary
Consolidated Statements of Income
(Unaudited)

(dollars in thousands except per share data)	Three months ended September 30, 2012	Three months ended September 30, 2011	Nine months ended September 30, 2012	Nine months ended September 30, 2011
Interest income:				
Loans:				
Taxable	$ 5,313	$ 5,551	$ 15,885	$ 17,119
Nontaxable	107	122	359	382
Interest-bearing deposits with financial institutions	12	34	55	73
Investment securities:				
U.S. government agency and corporations	226	355	747	1,020
States and political subdivisions (nontaxable)	298	305	917	893
Other securities	18	9	54	37
Total interest income	5,974	6,376	18,017	19,524
Interest expense:				
Deposits	585	852	1,886	2,909
Securities sold under repurchase agreements	4	14	27	40
Long-term debt	215	261	667	775
Total interest expense	804	1,127	2,580	3,724
Net interest income	5,170	5,249	15,437	15,800
Provision for loan losses	700	500	2,000	1,350
Net interest income after provision for loan losses	4,470	4,749	13,437	14,450
Other income:				
Service charges on deposit accounts	470	458	1,313	1,319
Interchange fees	276	247	798	713
Fees from trust fiduciary activities	140	97	447	298
Fees from financial services	155	140	441	439
Service charges on loans	195	155	846	488
Fees and other revenue	94	100	269	289
Earnings on bank-owned life insurance	83	80	244	235
Gain (loss) on sale, recovery, or disposal of:				
Loans	500	161	1,329	499
Investment securities	3	13	264	29
Premises and equipment	(16)	(2)	(17)	(2)
Foreclosed assets held-for-sale	(32)	28	(47)	46
Write-down of foreclosed assets held-for-sale	-	-	(60)	(66)
Impairment losses on investment securities:				
Other-than-temporary impairment on investment securities	(1)	(46)	(242)	(351)
	1	40	106	271

Non-credit-related losses on investment securities not expected to be sold (recognized in other comprehensive income/(loss))				
Net impairment losses on investment securities recognized in earnings	-	(6)	(136)	(80)
Total other income	1,868	1,471	5,691	4,207
Other expenses:				
Salaries and employee benefits	2,116	2,164	6,767	6,583
Premises and equipment	889	852	2,593	2,747
Advertising and marketing	552	464	947	814
Professional services	292	314	963	927
FDIC assessment	130	79	379	508
Loan collection	197	286	498	426
Other real estate owned	41	40	131	95
Office supplies and postage	103	98	315	334
Other	133	147	1,251	1,120
Total other expenses	4,453	4,444	13,844	13,554
Income before income taxes	1,885	1,776	5,284	5,103
Provision for income taxes	486	449	1,311	1,260
Net income	$ 1,399	$ 1,327	$ 3,973	$ 3,843
Per share data:				
Net income - basic	$ 0.61	$ 0.59	$ 1.74	$ 1.74
Net income - diluted	$ 0.61	$ 0.59	$ 1.74	$ 1.74
Dividends	$ 0.25	$ 0.25	$ 0.75	$ 0.75

See notes to unaudited consolidated financial statements

Fidelity D & D Bancorp, Inc. and Subsidiary

Consolidated Statements of Comprehensive Income	Three months ended		Nine months ended	
(Unaudited)	September 30,		September 30,	
(dollars in thousands)	2012	2011	2012	2011
Net income	$ 1,399	$ 1,327	$ 3,973	$ 3,843
Other comprehensive income, before tax:				
Unrealized holding gains on available-for-sale securities	1,182	974	2,331	3,257
Reclassification adjustment for gains realized in income	(3)	(13)	(264)	(29)
Net unrealized gains	1,179	961	2,067	3,228
Tax effect	(401)	(327)	(703)	(1,098)
Unrealized gains, net of tax	778	634	1,364	2,130
Non-credit-related impairment gains (losses) on investment securities not expected to be sold	76	7	358	(46)
Tax effect	(26)	(2)	(122)	16
Net non-credit-related impairment gains (losses) on investment securities	50	5	236	(30)
Other comprehensive income, net of tax	828	639	1,600	2,100
Total comprehensive income, net of tax	$ 2,227	$ 1,966	$ 5,573	$ 5,943

See notes to unaudited consolidated financial statements

Fidelity D & D Bancorp, Inc. and Subsidiary
Consolidated Statements of Changes in Shareholders' Equity
For the nine months ended September 30, 2012 and 2011
(Unaudited)

(dollars in thousands)	Capital stock Shares	Amount	Retained earnings	Accumulated other comprehensive income/ (loss)	Total
Balance, December 31, 2010	2,178,028	$21,047	$29,545	$ (3,817)	$46,775
Comprehensive income			3,843	2,100	5,943
Issuance of common stock through Employee Stock Purchase Plan	4,801	67			67
Issuance of common stock through Dividend Reinvestment Plan	55,844	924			924
Stock-based compensation expense		24			24
Cash dividends declared			(1,650)		(1,650)
Balance, September 30, 2011	2,238,673	$22,062	$31,738	$ (1,717)	$52,083
Balance, December 31, 2011	2,254,542	$22,354	$32,380	$ (1,110)	$53,624
Comprehensive income			3,973	1,600	5,573
Issuance of common stock through Employee Stock Purchase Plan	3,874	67			67
Issuance of common stock through Dividend Reinvestment Plan	49,190	980			980
Stock-based compensation expense		15			15
Cash dividends declared			(1,706)		(1,706)
Balance, September 30, 2012	2,307,606	$23,416	$34,647	$ 490	$58,553

See notes to unaudited consolidated financial statements

Fidelity D & D Bancorp, Inc. and Subsidiary
Consolidated Statements of Cash Flows

(Unaudited)	Nine months ended September 30,	
(dollars in thousands)	2012	2011
Cash flows from operating activities:		
Net income	$3,973	$3,843
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	2,612	2,213
Provision for loan losses	2,000	1,350
Deferred income tax (benefit) expense	(253)	177
Stock-based compensation expense	15	24
Proceeds from sale of loans held-for-sale	64,605	24,752
Originations of loans held-for-sale	(58,395)	(21,896)
Write-down of foreclosed assets held-for-sale	60	66
Earnings on bank-owned life insurance	(244)	(235)
Net gain from sales of loans	(1,329)	(499)
Net gain from sales and recoveries of investment securities	(264)	(29)
Net loss (gain) from sales of foreclosed assets held-for-sale	47	(46)
Loss on disposal of equipment	17	2
Other-than-temporary impairment on securities	136	80
Change in:		
Accrued interest receivable	90	(343)
Other assets	(249)	331
Accrued interest payable and other liabilities	(4,086)	92
Net cash provided by operating activities	8,735	9,882
Cash flows from investing activities:		
Held-to-maturity securities:		
Proceeds from maturities, calls and principal pay-downs	88	76
Available-for-sale securities:		
Proceeds from sales	3,584	841
Proceeds from maturities, calls and principal pay-downs	24,029	18,017
Purchases	(20,891)	(39,348)
Decrease in FHLB stock	680	648
Net (increase) decrease in loans	(28,898)	10,466
Acquisition of bank premises and equipment	(1,809)	(262)
Proceeds from sale of foreclosed assets held-for-sale	719	891
Net cash used by investing activities	(22,498)	(8,671)
Cash flows from financing activities:		
Net increase in deposits	8,318	43,150
Net increase in short-term borrowings	4,561	9,456
Repayments of long-term debt	(5,000)	-
Proceeds from employee stock purchase plan participants	67	67

Dividends paid, net of dividends reinvested	(1,124)	(1,104)
Proceeds from dividend reinvestment plan participants	398	379
Net cash provided by financing activities	7,220	51,948
Net (decrease) increase in cash and cash equivalents	(6,543)	53,159
Cash and cash equivalents, beginning	52,165	22,967
Cash and cash equivalents, ending	$45,622	$76,126

See notes to unaudited consolidated financial statements

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FIDELITY D & D BANCORP, INC.

Notes to Consolidated Financial Statements

(Unaudited)

1. Nature of operations and critical accounting policies

Nature of operations

Fidelity Deposit and Discount Bank (the Bank) is a commercial bank chartered in the Commonwealth of Pennsylvania and a wholly-owned subsidiary of Fidelity D & D Bancorp, Inc. (the Company or collectively, the Company). Having commenced operations in 1903, the Bank is committed to provide superior customer service, while offering a full range of banking products and financial and trust services to both our consumer and commercial customers from our main office located in Dunmore and other branches located throughout Lackawanna and Luzerne counties.

Principles of consolidation

The accompanying unaudited consolidated financial statements of the Company and the Bank have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to this Form 10-Q and Rule 8-03 of Regulation S-X. Accordingly, they do not include all of the information and footnote disclosures required by GAAP for complete financial statements. In the opinion of management, all normal recurring adjustments necessary for a fair presentation of the financial condition and results of operations for the periods have been included. All significant inter-company balances and transactions have been eliminated in consolidation.

The preparation of financial statements in conformity with GAAP 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 financial statements and the reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates. For additional information and disclosures required under GAAP, refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

Management is responsible for the fairness, integrity and objectivity of the unaudited financial statements included in this report. Management prepared the unaudited financial statements in accordance with GAAP. In meeting its responsibility for the financial statements, management depends on the Company's accounting systems and related internal controls. These systems and controls are designed to provide reasonable but not absolute assurance that the financial records accurately reflect the transactions of the Company, the Company's assets are safeguarded and that the financial statements present fairly the financial condition and results of operations of the Company.

In the opinion of management, the consolidated balance sheets as of September 30, 2012 and December 31, 2011 and the related consolidated statements of income and consolidated statements of comprehensive income for the three- and nine-month periods ended September 30, 2012 and 2011, and consolidated statements of changes in shareholders' equity and consolidated statements of cash flows for the nine months ended September 30, 2012 and 2011 present fairly the financial condition and results of operations of the Company. All material adjustments required for a fair presentation have been made. These adjustments are of a normal recurring nature. Certain reclassifications have been made to the 2011 financial statements to conform to the 2012 presentation.

This Quarterly Report on Form 10-Q should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2011, and the notes included therein, included within the Company's Annual Report filed on Form 10-K.

Critical accounting policies

The presentation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect many of the reported amounts and disclosures. Actual results could differ from these estimates.

A material estimate that is particularly susceptible to significant change relates to the determination of the allowance for loan losses. Management believes that the allowance for loan losses at September 30, 2012 is adequate and reasonable. Given the subjective nature of identifying and valuing loan losses, it is likely that well-informed individuals could make different assumptions and could, therefore, calculate a materially different allowance value. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in the future. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize adjustments to the allowance based on their judgment of information available to them at the time of their examination.

Another material estimate is the calculation of fair values of the Company's investment securities. Except for the Company's investment in corporate bonds, consisting of pooled trust preferred securities, fair values of the other investment securities are determined by prices provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions. For the pooled trust preferred securities, management is unable to obtain readily attainable and realistic pricing from market traders due to a lack of active market participants and therefore management has determined the market for these securities to be inactive. In order to determine the fair value of the pooled trust preferred securities, management relied on the use of an income valuation approach (present value technique) that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs, the results of which are more representative of fair value than the market approach valuation technique used for the other investment securities.

Based on experience, management is aware that estimated fair values of investment securities tend to vary among valuation services. Accordingly, when selling investment securities, price quotes may be obtained from more than one source. The majority of the Company's investment securities are classified as available-for-sale (AFS). AFS securities are carried at fair value on the consolidated balance sheets, with unrealized gains and losses, net of income tax, reported separately within shareholders' equity as a component of accumulated other comprehensive income (loss) (OCI).

The fair value of residential mortgage loans, classified as held-for-sale (HFS), is obtained from the Federal National Mortgage Association (FNMA) or the Federal Home Loan Bank (FHLB). Generally, the market to which the Company sells mortgages it originates for sale is restricted and price quotes from other sources are not typically obtained. On occasion, the Company may transfer loans from the loan portfolio to loans HFS. Under these rare circumstances, pricing may be obtained from other entities and the loans are transferred at the lower of cost or market value and simultaneously sold. As of September 30, 2012 and December 31, 2011, loans classified as HFS consisted of residential mortgages.

For purposes of the consolidated statements of cash flows, cash and cash equivalents includes cash on hand, amounts due from banks and interest-bearing deposits with financial institutions. For the nine months ended September 30, 2012 and 2011, the Company paid interest of $2.6 million and $3.8 million, respectively. The Company was required to pay income taxes of $1.8 million and $1.2 million during the first nine months of 2012 and 2011, respectively. Transfers from loans to foreclosed assets held-for-sale amounted to $1.4 million and $0.8 million during the nine months ended September 30, 2012 and 2011. During the same respective periods, transfers from loans to loans HFS amounted to $2.8 million and $4.8 million. Expenditures for construction in process, a component of other assets in the consolidated balance sheets, are included in acquisition of bank premises and equipment.

2. New Accounting Pronouncements

In 2011, the Financial Accounting Standards Board (FASB) issued, and in 2012 the Company adopted, an accounting update related to Fair Value Measurement: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRSs. This update amends existing Fair Value Measurements, to bring U.S. GAAP for fair value measurements in line with International Accounting Standards. The update clarifies existing guidance for items such as: the application of the highest and best use concept to non-financial assets and liabilities; the application of fair value measurement to financial instruments classified in a reporting entity's stockholder's equity; and disclosure requirements regarding quantitative information about unobservable inputs used in the fair value measurements of level 3 assets. The guidance also creates an exception to existing guidance for entities which carry financial instruments within a portfolio or group, under which the entity is now permitted to base the price used for fair valuation upon a price that would be received to sell the net asset position or transfer a net liability position in an orderly transaction. The guidance also allows for the application of premiums and discounts in a fair value measurement if the financial instrument is categorized in level 2 or 3 of the fair value hierarchy. It also contains new disclosure requirements regarding fair value amounts categorized as level 3 in the fair value hierarchy such as: disclosure of the valuation process used; effects of and relationships between unobservable inputs; usage of non-financial assets for purposes other than their highest and best use when that is the basis of the disclosed fair value; and categorization by level of items disclosed at fair value, but not measured at fair value for financial statement purposes. For public entities, this update is effective for interim and annual periods beginning after December 15, 2011. The adoption of the new accounting guidance did not have an impact on the Company's consolidated financial statements.

In June, 2011, the FASB issued an accounting update related to, Presentation of Comprehensive Income. The provisions of this update amend the accounting topic to facilitate the continued alignment of U.S. GAAP with International Accounting Standards. The update prohibits the presentation of the components of comprehensive income in the statement of stockholder's equity. Reporting entities are allowed to present either: a statement of comprehensive income, which reports both net income and other comprehensive income; or separate, but consecutive, statements of net income and other comprehensive income. Under previous GAAP, all three presentations were acceptable. Regardless of the presentation selected, the reporting entity is required to present all reclassifications between other comprehensive and net income on the face of the new statement or statements. For public entities, the provisions of this update are effective for fiscal years and interim periods beginning after December 31, 2011. The Company has elected to present a separate statement of comprehensive income.

3. Investment securities

The amortized cost and fair value of investment securities at September 30, 2012 and December 31, 2011 are summarized as follows:

(dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
September 30, 2012				
Held-to-maturity securities:				
MBS - GSE residential	$ 302	$ 35	$ -	$ 337
Available-for-sale securities:				
Agency - GSE	$ 21,696	$ 114	$ 6	$ 21,804
Obligations of states and political subdivisions	26,829	3,071	-	29,900
Corporate bonds:				
Pooled trust preferred securities	6,366	142	4,845	1,663
MBS - GSE residential	46,906	2,101	-	49,007
Total debt securities	101,797	5,428	4,851	102,374
Equity securities - financial services	295	165	1	459
Total available-for-sale securities	$ 102,092	$ 5,593	$ 4,852	$ 102,833

(dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
December 31, 2011				
Held-to-maturity securities:				
MBS - GSE residential	$ 389	$ 42	$ -	$ 431
Available-for-sale securities:				
Agency - GSE	$ 25,773	$ 108	$ 8	$ 25,873
Obligations of states and political subdivisions	28,402	1,937	180	30,159
Corporate bonds:				
Pooled trust preferred securities	6,574	123	5,231	1,466
MBS - GSE residential	48,792	1,482	57	50,217
Total debt securities	109,541	3,650	5,476	107,715
Equity securities - financial services	295	144	-	439

Total available-for-sale securities	$ 109,836	$ 3,794	$ 5,476	$ 108,154

The amortized cost and fair value of debt securities at September 30, 2012 by contractual maturity are summarized below:

(dollars in thousands)	Amortized cost	Fair value
Held-to-maturity securities:		
MBS - GSE residential	$ 302	$ 337
Available-for-sale securities:		
Debt securities:		
Due in one year or less	$ 2,806	$ 2,809
Due after one year through five years	17,113	17,220
Due after five years through ten years	3,253	3,451
Due after ten years	31,719	29,887
Total debt securities	54,891	53,367
MBS - GSE residential	46,906	49,007
Total available-for-sale debt securities	$ 101,797	$ 102,374

Expected maturities will differ from contractual maturities because issuers and borrowers may have the right to call or repay obligations with or without call or prepayment penalty. Federal agency and municipal securities are included based on their original stated maturity. Mortgage-backed securities, which are based on weighted-average lives and subject to monthly principal pay-downs, are listed in total.

The following tables present the fair value and gross unrealized losses of investment securities aggregated by investment type, the length of time and the number of securities that have been in a continuous unrealized loss position as of September 30, 2012 and December 31, 2011:

	Less than 12 months		More than 12 months		Total	
(dollars in thousands)	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
September 30, 2012						
Agency – GSE	$ 1,025	$ 6	$ -	$ -	$ 1,025	$ 6
Obligations of states and political subdivisions	-	-	-	-	-	-
Corporate bonds:						
Pooled trust preferred securities	-	-	1,109	4,845	1,109	4,845
MBS - GSE residential	-	-	-	-	-	-
Subtotal, debt securities	1,025	6	1,109	4,845	2,134	4,851

Equity securities - financial services	123	1	-	-	123	1
Total temporarily impaired securities	$ 1,148	$ 7	$ 1,109	$ 4,845	$2,257	$ 4,852
Number of securities	2		7		9	
December 31, 2011						
Agency – GSE	$ 4,011	$ 8	$ -	$ -	$4,011	$ 8
Obligations of states and political subdivisions	-	-	941	180	941	180
Corporate bonds:						
Pooled trust preferred securities	-	-	1,343	5,231	1,343	5,231
MBS - GSE residential	6,126	57	-	-	6,126	57
Total securities Total temporarily impaired securities	$ 10,137	$ 65	$ 2,284	$ 5,411	$12,421	$ 5,476
Number of securities	7		9		16	

Most of the securities in the investment portfolio have fixed rates or have predetermined scheduled rate changes, and many have call features that allow the issuer to call the security at par before its stated maturity, without penalty. Management believes the cause of the unrealized losses is related to changes in interest rates, instability in the capital markets or the limited trading activity due to illiquid conditions in the debt market and is not directly related to credit quality.

Management conducts a formal review of investment securities on a quarterly basis for the presence of other-than-temporary impairment (OTTI). The accounting guidance related to OTTI requires the Company to assess whether OTTI is present when the fair value of a debt security is less than its amortized cost at the balance sheet date. Under these circumstances, OTTI is considered to have occurred if: (1) the entity has intent to sell the security; (2) more likely than not the entity will be required to sell the security before recovery of its amortized cost basis; or (3) the present value of expected cash flows is not sufficient to recover the entire amortized cost.

The accounting guidance requires that credit-related OTTI be recognized in earnings while non-credit-related OTTI on securities not expected to be sold be recognized in other comprehensive income (loss) (OCI). Non-credit-related OTTI is based on other factors affecting market conditions, including illiquidity. Presentation of OTTI is made in the consolidated statements of income on a gross basis with an offset for the amount of non-credit-related OTTI recognized in OCI.

The Company’s OTTI evaluation process also follows the guidance set forth in topics related to debt and equity securities. The guidance set forth in these pronouncements require the Company to take into consideration current market conditions, fair value in relationship to cost, extent and nature of changes in fair value, issuer rating changes and trends, volatility of earnings, current analysts’ evaluations, all available information relevant to the collectability of debt securities, the ability and intent to hold investments until a recovery of fair value which may be maturity and other factors when evaluating for the existence of OTTI. The guidance requires that OTTI be recognized as a realized loss through earnings when there has been an adverse change in the holder’s expected cash flows such that the full amount (principal and interest) will probably not be received. This requirement is consistent with the impairment model in the guidance for accounting for debt and equity securities.

For all security types discussed below, as of September 30, 2012, the Company applied the criteria provided in the recognition and presentation guidance related to OTTI. That is, management has no intent to sell the securities and no conditions were identified by management that more likely than not would require the Company to sell the securities before recovery of their amortized cost basis. The results indicated there was no presence of OTTI for the Company’s portfolios of Agency – Government Sponsored Enterprise (GSE), Mortgage-backed securities (MBS) – GSE residential and Obligations of states and political subdivisions.

Agency - GSE and MBS - GSE residential

Agency – GSE and MBS – GSE residential securities consist of short- and medium-term notes issued by Federal Home Loan Mortgage Corporation (FHLMC), Federal National Mortgage Association (FNMA), Federal Home Loan Bank (FHLB), Federal Farm Credit Bank (FFCB) and Government National Mortgage Association (GNMA). These securities have interest rates that are largely fixed-rate issues, have varying short- to mid-term maturity dates and have contractual cash flows guaranteed by the U.S. government or agencies of the U.S. government.

Obligations of states and political subdivisions

The municipal securities are bank qualified or bank eligible, general obligation and revenue bonds rated as investment grade by various credit rating agencies and have fixed rates of interest with mid- to long-term maturities. Fair values of these securities are highly driven by interest rates. Management performs ongoing credit quality reviews on these issues.

In the above security types, the change in fair value is attributable to changes in interest rates and those instruments with unrealized losses were not caused by deterioration of credit quality. Accordingly, as of September 30, 2012, recognition of OTTI on these securities was unnecessary.

Pooled trust preferred securities

A Pooled Trust Preferred Collateralized Debt Obligation (CDO) is a type of investment security collateralized by trust preferred securities (TPS) issued by banks, insurance companies and real estate investment trusts. The primary collateral type is a TPS issued by a bank. A TPS is a hybrid security that consists of both debt and equity characteristics which includes the ability of the issuer to voluntarily defer interest payments for up to 20 consecutive quarters. A TPS is considered a junior security in the capital structure of the issuer.

There are various investment classes or tranches issued by the CDO. The most senior tranche has the lowest yield but the most protection from credit losses. Conversely, the most junior tranche has the highest yield and the most risk of credit loss. Junior tranches are subordinate to senior tranches and losses are generally allocated from the lowest tranche with the equity component holding the most risk of credit loss and then subordinate tranches in reverse order up to the most senior tranche. The allocation of losses is defined in the indenture when the CDO was formed.

Unrealized losses in the pooled trust preferred securities (PreTSLs) are caused mainly by the following factors: (1) collateral deterioration due to bank failures and credit concerns across the banking sector; (2) widening of credit spreads and (3) illiquidity in the market. The Company's review of its portfolio of pooled trust preferred securities determined that in 2012, credit-related OTTI be recorded on two holdings, both of which are contained in the Company's AFS securities portfolio, from credit quality downgrades on the underlying collateral, including the collateral of four banks deferring interest payments within these two securities and one bank fully redeeming which removes all future earnings cash flow.

The following table summarizes the amount of OTTI recognized in earnings, by security during the periods indicated:

	Three months ended September 30,		Nine months ended, September 30,	
(dollars in thousands)	2012	2011	2012	2011
Pooled trust preferred securities:				
PreTSL IV, Mezzanine	$ -	$ 5	$ -	$ 5
PreTSL IX, B1, B3	-	-	18	-
PreTSL XVIII, C	-	-	118	-
PreTSL XXIV, B1	-	-	-	75
Total	$ -	$ 5	$ 136	$ 80

The following is a tabular roll-forward of the cumulative amount of credit-related OTTI recognized in earnings:

	Nine months ended September 30, 2012		
(dollars in thousands)	HTM	AFS	Total
Beginning balance of credit-related OTTI	$-	$(15,280)	$(15,280)
Additions for credit-related OTTI not previously recognized	-	-	-
Additional credit-related OTTI previously recognized when there is no intent to sell before recovery of amortized cost basis	-	(136)	(136)
Ending balance of credit-related OTTI	$-	$(15,416)	$(15,416)

To determine credit-related OTTI, the Company analyzes the collateral of each individual tranche within each of the 13 individual pools in the Company's portfolio of pooled trust preferred securities (PreTSLs). The Company engaged a third party structured finance firm to: review the underlying collateral of each PreTSL; research trustee reports to update relevant data and credit ratings of the underlying collateral; project default rates and cash flows of the collateral and simulate 10,000 Monte Carlo time-to-default scenarios, performed quarterly to arrive at the single best estimate of future cash flow for each tranche.

The sub-topics of the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 320 provide the scope, steps and accounting guidance for impairment: 1) determine whether an investment is impaired; 2) evaluate whether impairment is other-than-temporary; then 3) recognition of OTTI. The guidance in ASC 320 retains and emphasizes the objective of OTTI assessment and the related disclosure requirements by aligning the OTTI methodology for certain securitizations. ASC 325 provides a scope exception for investments that were considered of high credit quality (i.e. rated "AA" or higher) at the time of acquisition. The application of the guidance contained in ASC 320 is used for two investments considered of high credit quality and ASC 325 is used for the remaining eleven securities. In summary, for the first two quarters of 2012, the quarterly evaluations indicated there was a significant adverse change in cash flows in two of the thirteen securities, thereby signifying the likelihood of the Company not being able to recover its principal. As a result, $0.1 million of credit related OTTI was recorded during the nine

months ended September 30, 2012 all of which pertained to the first half of 2012. There was no credit related OTTI required to be recorded in the third quarter of 2012.

The guidance prescribed in ASC 320 is used for investments that, upon purchase, were rated of high credit quality, “AA” or higher, by a nationally recognized statistical rating organization. The Company has two PreTSLs (XXIV and XXVII) that were of high credit quality, “AA” rated, upon acquisition. The PreTSL XXVII evaluation proved a high probability that the Company will be able to collect all amounts due, both principal and interest, by maturity and thus, determined the impairment is temporary. PreTSL XXIV was evaluated under ASC 320 to determine if the Company expects to recover the remaining amortized cost basis and whether OTTI is deemed to have occurred. An adverse change or short-fall in the expected cash flows compared to the amortized cost would be recorded as credit-related OTTI. To assess the likelihood of recoverability, the present value of the best estimate of future cash flows is compared to the amortized cost. In this situation, the discount rate used was the interest rate implicit in the security at the date of acquisition. The application of the guidance on this security did not result in an adverse change in cash flows when compared to the last measurements and therefore, no credit related OTTI was recorded during the first nine months of 2012.

The remaining eleven PreTSLs were rated “A” by a nationally recognized statistical rating organization at the date of acquisition and as such are considered beneficial interests of securitized financial assets. For these securities, the Company applies the guidance of ASC 325. Under this and other relevant guidance, if the fair value is below amortized cost and the present value of the best estimate of future cash flows declines significantly, evidencing a probable material adverse change in cash flows since the last measurement date, credit-related OTTI is deemed to exist and written down to the determined present value through a charge to current earnings. The discount rate used under ASC 325 is the yield to accrete beneficial interest, which is representative of the resulting interest from the total gross estimated future cash flows less the current amortized cost. In applying this guidance to the remaining securities, PreTSLs IX and XVIII measured an adverse change in cash flows and credit related OTTI of $18 thousand and $0.1 million, respectively, was recorded in the nine months of 2012 all of which, as noted above, pertained to cash flow analyses performed during the two quarters in the first half of 2012. There was no credit related OTTI required to be recorded in the third quarter of 2012.

The following table is the composition of the Company’s non-accrual PreTSL securities as of the period indicated:

(dollars in thousands)		September 30, 2012		December 31, 2011	
		Book	Fair	Book	Fair
Deal	Class	value	value	value	value
Pre TSL V	Mezzanine	$ -	$ 26	$ -	$ 25
Pre TSL VII	Mezzanine	-	76	-	79
Pre TSL IX	B-1,B-3	1,527	506	1,605	529
Pre TSL XI	B-3	1,083	313	1,119	357
Pre TSL XV	B-1	-	30	-	20
Pre TSL XVIII	C	167	-	285	5
Pre TSL XIX	C	316	-	316	8
Pre TSL XXIV	B-1	407	14	407	15
		$ 3,500	$ 965	$ 3,732	$ 1,038

The securities included in the above table, have experienced impairment of principal, and interest was “paid-in-kind”. When these two conditions exist, the security is placed on non-accrual status. Quarterly, each of the other PreTSL issues is evaluated for the presence of these two conditions and if necessary placed on non-accrual status.

The following table provides additional information with respect to the Company’s pooled trust preferred securities as of September 30, 2012:

(dollars in thousands)				
	Current number	Actual deferrals	Excess subordination (2)	Effective subordination (3)

Deal	Class	Book value	Fair value	Unrealized gain (loss)	Moody's / Fitch ratings [1]	of banks / insurance companies	Actual deferrals and defaults	and defaults as a % of current collateral	Excess subordination	as a % of current performing collateral	as a % of current performing collateral
Pre TSL IV	Mezzanine	$412	$422	$10	Caa2 / CCC	6 /-	$18,000	27.1	$10,263	19.8	36.6
Pre TSL V	Mezzanine	-	26	26	C / D	3 /-	28,950	100.0	None	N/A	N/A
Pre TSL VII	Mezzanine	-	76	76	Ca / C	16 /-	96,000	51.6	None	N/A	N/A
Pre TSL IX	B-1,B-3	1,527	506	(1,021)	Ca / C	46 /-	109,310	27.5	None	N/A	3.9
Pre TSL XI	B-3	1,083	313	(770)	Ca / C	62 /-	185,280	32.3	None	N/A	N/A
Pre TSL XV	B-1	-	30	30	C / C	63 / 8	195,200	33.8	None	N/A	N/A
Pre TSL XVI	C	-	-	-	C / C	49 / 7	273,478	47.7	None	N/A	N/A
Pre TSL XVII	C	-	-	-	C / C	50 / 6	179,270	37.9	None	N/A	N/A
Pre TSL XVIII	C	167	-	(167)	Ca / C	66 / 13	205,340	31.1	None	N/A	N/A
Pre TSL XIX	C	316	-	(316)	C / C	50 / 14	182,150	28.2	None	N/A	N/A
Pre TSL XXIV	B-1	407	14	(393)	Ca / CC	77 / 12	349,300	34.6	None	N/A	14.9
Pre TSL XXV	C-1	-	-	-	C / C	56 / 8	272,000	34.3	None	N/A	1.9
Pre TSL XXVII	B	2,454	276	(2,178)	Ca / CC	42 / 7	86,800	26.7	296	0.1	26.3
		$6,366	$1,663	$(4,703)							

(1) All ratings have been updated through September 30, 2012.

(2) Excess subordination represents the excess (if any) of the amount of performing collateral over the given class of bonds.

(3) Effective subordination represents the estimated percentage of the performing collateral that would need to defer or default at the next payment in order to trigger a loss of principal or interest. This differs from excess subordination in that it considers the effect of excess interest earned on the performing collateral.

For a further discussion on the fair value determination of the Company's investment in PreTSLs and other financial instruments, see Note 7, "Fair value measurements".

4. Loans

The classifications of loans at September 30, 2012 and December 31, 2011 are summarized as follows:

(dollars in thousands)	September 30, 2012	December 31, 2011
Commercial and industrial	$ 68,731	$ 68,372
Commercial real estate:		
Non-owner occupied	83,296	79,475
Owner occupied	74,190	76,611
Construction	11,519	9,387
Consumer:		
Home equity installment	32,965	36,390
Home equity line of credit	33,045	32,486
Auto	17,469	13,539
Other	5,964	5,833
Residential:		
Real estate	96,522	80,091
Construction	5,369	4,110
Total	429,070	406,294
Less:		
Allowance for loan losses	(8,142)	(8,108)
Loans, net	$ 420,928	$ 398,186

Net deferred loan costs of $0.9 million and $0.8 million have been added to the carrying values of loans at September 30, 2012 and December 31, 2011, respectively.

The Company services real estate loans for investors in the secondary mortgage market which are not included in the accompanying consolidated balance sheets. The approximate amount of mortgages serviced amounted to $208.9 million as of September 30, 2012 and $193.5 million as of December 31, 2011.

The Company utilizes an external independent loan review firm that reviews and validates the credit risk program on at least an annual basis. Results of these reviews are presented to management and the Board of Directors. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Company’s policies and procedures.

Non-accrual loans

The decision to place loans on non-accrual status is made on an individual basis after considering factors pertaining to each specific loan. Commercial and industrial and commercial real estate loans are placed on non-accrual status when management has determined that payment of all contractual principal and interest is in doubt or the loan is past due 90 days or more as to principal and interest, unless well-secured and in the process of collection. Consumer loans secured by real estate and residential mortgage loans are placed on non-accrual status at 120 days past due as to principal and interest and unsecured consumer loans are charged off when the loan is 90 days or more past due as to principal and interest.

Non-accrual loans, segregated by class, at September 30, 2012 and December 31, 2011, were as follows:

(dollars in thousands)	September 30, 2012	December 31, 2011
Commercial and industrial	$ 60	$ 458
Commercial real estate:		
Non-owner occupied	2,240	2,406
Owner occupied	5,202	6,288
Construction	1,130	656
Consumer:		
Home equity installment	904	1,017
Home equity line of credit	381	730
Auto	4	-
Other	91	-
Residential:		
Real estate	2,454	2,329
Construction	-	78
Total	$ 12,466	$ 13,962

Troubled Debt Restructuring

A modification of a loan constitutes a troubled debt restructuring (TDR) when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Company offers various types of concessions when modifying a loan, however, forgiveness of principal is rarely granted. Commercial and industrial loans modified in a TDR often involve temporary interest-only payments, term extensions, and converting revolving credit lines to term loans. Additional collateral, a co-borrower, or a guarantor is often requested. Commercial real estate and construction loans modified in a TDR often involve reducing the interest rate for the remaining term of the loan, extending the maturity date at an interest rate lower than the current market rate for new debt with similar risk, or substituting or adding a new borrower or guarantor. Construction loans modified in a TDR may also involve extending the interest-only payment period. Residential mortgage loans modified in a TDR are primarily comprised of loans where monthly payments are lowered to accommodate the borrowers' financial needs for an extended period of time. After the lowered monthly payment period ends, the borrower would revert back to paying principal and interest per the original terms with the maturity date adjusted accordingly. Home equity modifications and automobile loan modifications are typically not made and therefore standard terms do not exist for loans of this type.

Loans modified in a TDR may or may not be placed in non-accrual status. As of September 30, 2012, total TDRs amounted to $2.2 million of which $1.1 million were on non-accrual status. As of December 31, 2011, total TDRs amounted to $6.7 million of which $1.4 million were on non-accrual status. The reduction of $4.5 million in TDRs is the result of a loan of $1.8 million which was repaid upon the sale of the underlying collateral by the borrower. The proceeds of which were used to repay the loan. A second loan of $2.4 million to a related borrower which had been a TDR was repaid with the proceeds of a new loan by the Bank on conventional loan terms and conditions. Partial charge-offs may be taken against the outstanding loan balance of TDRs, but, only in rare instances. As a result, loans modified in a TDR for the Company may have the financial effect of increasing the specific allowance for loan losses associated with the loan. The Company considers all TDRs to be impaired loans. An allowance for impaired loans that have been modified in a TDR is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or the loan's observable market price. If the loan is collateral dependent, the estimated fair value of the collateral, less any selling costs, is used to establish the allowance. Management exercises significant judgment in developing these estimates.

There were no loans modified in a TDR during the three- and nine-months ended September 30, 2012. The following presents by class, loans modified as TDRs during the twelve months ended September 30, 2012 that subsequently defaulted (i.e., 90 days or more past due following a modification) during the three- and nine-months ended September 30, 2012:

Loans modified as a TDR within the previous twelve months that subsequently defaulted during the:

(dollars in thousands)	Three months ended September 30, 2012		Nine months ended September 30, 2012	
	Number of contracts	Recorded investment	Number of contracts	Recorded investment
Commercial real estate - owner occupied	-	$ -	1	$ 1,078

In the above table, the period end balance is inclusive of all partial pay downs and charge-offs since the modification date.

The $1.1 million commercial real estate loan TDR that subsequently defaulted had been modified to lower payments. The Company has been applying all payments during this time to principal. An updated appraisal was obtained on the collateral during the first quarter of 2012 which necessitated an increase in the reserve for loan losses on this loan. The borrower has resumed making payments under a new agreement.

Loans modified in a TDR are closely monitored for delinquency as an early indicator of possible future default. If loans modified in a TDR subsequently default, the Company evaluates the loan for possible further impairment. The allowance may be increased, adjustments may be made in the allocation of the allowance or partial charge offs may be taken to further write-down the carrying value of the loan.

Past due loans

Loans are considered past due when the contractual principal and/or interest is not received by the due date. An aging analysis of past due loans, segregated by class of loans, as of the period indicated is as follows (dollars in thousands):

September 30, 2012	30 - 59 Days past due	60 - 89 Days past due	Past due 90 days or more *	Total past due	Current	Total loans receivables	Recorded investment past due ≥ 90 days and accruing
Commercial and industrial	$ 105	$ 360	$ 257	$ 722	$ 68,009	$ 68,731	$ 197
Commercial real estate:							
Non-owner occupied	358	1,361	2,300	4,019	79,277	83,296	60
Owner occupied	572	751	5,384	6,707	67,483	74,190	182
Construction	-	-	1,130	1,130	10,389	11,519	-
Consumer:							
Home equity installment	925	30	932	1,887	31,078	32,965	28
Home equity line of credit	-	-	433	433	32,612	33,045	52
Auto	655	58	5	718	16,751	17,469	1
Other	23	12	91	126	5,838	5,964	-
Residential:							
Real estate	206	1,135	2,538	3,879	92,643	96,522	84
Construction	-	-	-	-	5,369	5,369	-
Total	$ 2,844	$ 3,707	$ 13,070	$ 19,621	$ 409,449	$ 429,070	$ 604

* Includes $12.5 million of non-accrual loans.

December 31, 2011	30 - 59 Days past due	60 - 89 Days past due	Past due 90 days or more *	Total past due	Current	Total loans receivables	Recorded investment past due ≥ 90 days and accruing
Commercial and industrial	$ 61	$ 20	$ 458	$ 539	$ 67,833	$ 68,372	$ -
Commercial real estate:							
Non-owner occupied	1,802	386	2,406	4,594	74,881	79,475	-
Owner occupied	134	71	6,288	6,493	70,118	76,611	-
Construction	-	-	656	656	8,731	9,387	-
Consumer:							
Home equity installment	450	161	1,017	1,628	34,762	36,390	-
Home equity line of credit	11	-	730	741	31,745	32,486	-
Auto	437	181	-	618	12,921	13,539	-
Other	19	11	-	30	5,803	5,833	-
Residential:							
Real estate	297	317	2,594	3,208	76,883	80,091	265
Construction	-	-	78	78	4,032	4,110	-
Total	$ 3,211	$ 1,147	$ 14,227	$ 18,585	$ 387,709	$ 406,294	$ 265

* Includes $14.0 million of non-accrual loans.

Impaired loans

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 in accordance with the contractual terms of the loan. Factors considered in determining impairment include payment status, collateral value and the probability of collecting payments when due. The significance of payment delays and/or shortfalls is determined on a case-by-case basis. All circumstances surrounding the loan are taken into account. Such factors include the length of the delinquency, the underlying reasons and the borrower's prior payment record. Impairment is measured on these loans on a loan-by-loan basis. Impaired loans include non-accrual loans and other loans deemed to be impaired based on the aforementioned factors. At September 30, 2012, impaired loans consisted of accruing TDRs totaling $1.1 million and $12.5 million of non-accrual loans. The non-accrual total, as of September 30, 2012, includes $1.1 million of non-accruing TDRs. At December 31, 2011, impaired loans consisted of accruing TDRs totaling $5.3 million in addition to the $14.0 million of non-accrual loans. The non-accrual total, as of December 31, 2011, includes $1.4 million of non-accruing TDRs. Payments received on non-accrual loans are recognized on a cash basis. Payments are first applied against the outstanding principal balance, then to the recovery of any charged-off amounts. Any excess is treated as a recovery of interest income.

Impaired loans, segregated by class, as of the period indicated are detailed below:

(dollars in thousands)	Unpaid principal balance	Recorded investment with allowance	Recorded investment with no allowance	Total recorded investment	Related allowance	Average recorded investment	Interest income recognized	Cash basis interest income recognized
September 30, 2012								
Commercial & industrial	$ 133	$ 50	$ 53	$ 103	$ 25	$ 339	$ 2	$ -
Commercial real estate:								
Non-owner occupied	2,793	1,007	1,725	2,732	268	4,509	150	-
Owner occupied	6,330	4,633	1,142	5,775	456	7,044	100	-
Construction	1,130	662	468	1,130	194	848	-	-
Consumer:								
Home equity installment	1,045	128	776	904	47	898	-	-
Home equity line of credit	435	144	237	381	31	477	-	-
Auto	4	4	-	4	1	1	-	-
Other	91	70	21	91	35	26	-	-
Residential:								
Real Estate	2,190	1,141	1,313	2,454	97	2,249	10	-
Construction	-	-	-	-	-	63	-	-
Total	$ 14,151	$ 7,839	$ 5,735	$ 13,574	$ 1,154	$ 16,454	$ 262	$ -

(dollars in thousands)	Unpaid principal balance	Recorded investment with allowance	Recorded investment with no allowance	Total recorded investment	Related allowance	Average recorded investment	Interest income recognized	Cash basis interest income recognized
December 31, 2011								
Commercial & industrial	$ 549	$ 322	$ 179	$ 501	$ 63	$ 355	$ 2	$ -
Commercial real estate:								
Non-owner occupied	5,434	3,144	2,176	5,320	301	3,026	53	-
Owner occupied	8,538	5,730	2,915	8,645	792	4,953	108	14
Construction	656	656	-	656	152	375	-	-
Consumer:								
Home equity installment	1,050	395	622	1,017	88	751	6	3
Home equity line of credit	730	229	501	730	55	488	2	1
Auto	-	-	-	-	-	3	-	-
Other	-	-	-	-	-	12	-	-
Residential:								
Real Estate	2,619	1,083	1,246	2,329	84	2,867	155	59

Construction	94	78	-	78	-	91	-	-
Total	$ 19,670	$ 11,637	$ 7,639	$ 19,276	$ 1,535	$ 12,921	$ 326	$ 77

Credit Quality Indicators

Commercial and industrial and commercial real estate

The Company utilizes a loan grading system and assigns a credit risk grade to its loans in the commercial and industrial and commercial real estate portfolios. The grading system provides a means to measure portfolio quality and aids in the monitoring of the credit quality of the overall loan portfolio. The credit risk grades are arrived at using a risk rating matrix to assign a grade to each of the loans in the commercial and industrial and commercial real estate portfolios.

The following is a description of each risk rating category the Company uses to classify each of its commercial and industrial and commercial real estate loans:

Pass

Loans in this category have an acceptable level of risk and are graded in range of one to five. Secured loans generally have good collateral coverage. Current financial statements reflect acceptable balance sheet ratios, sales and earnings trends. Management is considered to be good, and there is some depth existing. Payment experience on the loans has been good with minor or no delinquency experience. Loans with a grade of one are of the highest quality in the range. Those graded five are of marginally acceptable quality.

Special Mention

Loans in this category are graded a six and may be protected but are potentially weak. They constitute a credit risk to the Company, but have not yet reached the point of adverse classification. Some of the following conditions may exist: little or no collateral coverage; lack of current financial information; delinquency problems; highly leveraged; available financial information reflects poor balance sheet ratios and profit and loss statements reflect uncertain trends; and document exceptions. Loans in this category should not remain on the list for an inordinate period of time (no more than one year) and then the loan should be passed or classified appropriately. Cash flow may not be sufficient to support total debt service requirements.

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Substandard

Loans in this category are graded a seven and have a well-defined weakness which may jeopardize the ultimate collectability of the debt. The collateral pledged may be lacking in quality or quantity. Financial statements may indicate insufficient cash flow to service the debt; and/or do not reflect a sound net worth. The payment history indicates chronic delinquency problems. Management is considered to be weak. There is a distinct possibility that the Company may sustain a loss. All loans on non-accrual are rated substandard. Loans 90+ days past due unless otherwise fully supported should be classified substandard. Also, borrowers that are bankrupt are substandard.

Doubtful

Loans in this category are graded an eight and have a better than 50% possibility of the Company sustaining a loss, but the loss cannot be determined because of specific reasonable factors which may strengthen credit in the near-term. Many of the weaknesses present in a substandard loan exist. Liquidation of collateral, if any, is likely. Any loan graded lower than an eight is considered to be uncollectible and charged-off.

Consumer and Residential

The consumer and residential loan segments are regarded as homogeneous loan pools and as such are not risk rated. For these portfolios, the Company utilizes payment activity, history and recency of payment. Non-performing loans are considered to be loans past due 90 days or more and accruing and non-accrual loans. All loans not classified as non-performing are considered performing.

The following table presents loans, segregated by class, categorized into the appropriate credit quality indicator category as of the period indicated:

Commercial credit exposure

Credit risk profile by creditworthiness category

	Commercial real estate -	Commercial real estate -	Commercial real estate -

	Commercial and industrial		non-owner occupied		owner occupied		construction	
(dollars in thousands)	9/30/2012	12/31/2011	9/30/2012	12/31/2011	9/30/2012	12/31/2011	9/30/2012	12/31/2011
Pass	$ 65,428	$ 64,064	$ 72,577	$ 65,819	$ 66,637	$ 66,298	$ 8,883	$ 6,911
Special mention	2,201	2,953	4,176	5,681	1,553	1,627	1,473	1,246
Substandard	1,102	1,355	6,543	7,975	6,000	8,686	1,163	1,230
Doubtful	-	-	-	-	-	-	-	-
Total	$ 68,731	$ 68,372	$ 83,296	$ 79,475	$ 74,190	$ 76,611	$ 11,519	$ 9,387

Consumer credit exposure

Credit risk profile based on payment activity

	Home equity installment		Home equity line of credit		Auto		Other	
(dollars in thousands)	9/30/2012	12/31/2011	9/30/2012	12/31/2011	9/30/2012	12/31/2011	9/30/2012	12/31/2011
Performing	$ 32,033	$ 35,373	$ 32,612	$ 31,756	$ 17,464	$ 13,539	$ 5,873	$ 5,833
Non-performing	932	1,017	433	730	5	-	91	-
Total	$ 32,965	$ 36,390	$ 33,045	$ 32,486	$ 17,469	$ 13,539	$ 5,964	$ 5,833

Mortgage lending credit exposure

Credit risk profile based on payment activity

	Residential real estate		Residential construction	
(dollars in thousands)	9/30/2012	12/31/2011	9/30/2012	12/31/2011
Performing	$ 93,984	$ 77,497	$ 5,369	$ 4,032
Non-performing	2,538	2,594	-	78
Total	$ 96,522	$ 80,091	$ 5,369	$ 4,110

<u>Allowance for loan losses</u>

Management continually evaluates the credit quality of the Company's loan portfolio and performs a formal review of the adequacy of the allowance for loan losses (the allowance) on a quarterly basis. The allowance reflects management's best estimate of the amount of credit losses in the loan portfolio. Management's judgment is based on the evaluation of individual loans, past experience, the assessment of current economic conditions and other relevant factors including the amounts and timing of cash flows expected to be received on impaired loans. Those estimates may be susceptible to significant change. Loan losses are charged directly against the allowance when loans are deemed to be uncollectible. Recoveries from previously charged-off loans are added to the allowance when received.

Management applies two primary components during the loan review process to determine proper allowance levels. The two components are a specific loan loss allocation for loans that are deemed impaired and a general loan loss allocation for those loans not specifically allocated. The methodology to analyze the adequacy of the allowance for loan losses is as follows:

- § identification of specific impaired loans by loan category;
- § specific loans that are not impaired, but have an identified potential for loss;
- § calculation of specific allowances where required for the impaired loans based on collateral and other objective and quantifiable evidence;
- § determination of loans with similar credit characteristics within each class of the loan portfolio segment and eliminating the impaired loans;
- § application of historical loss percentages (two-year average) to pools to determine the allowance allocation;
- § application of qualitative factor adjustment percentages to historical losses for trends or changes in the loan portfolio. Qualitative factor adjustments include:
  - o levels of and trends in delinquencies and non-accrual loans;
  - o levels of and trends in charge-offs and recoveries;
  - o trends in volume and terms of loans;
  - o changes in risk selection and underwriting standards;
  - o changes in lending policies, procedures and practices;
  - o experience, ability and depth of lending management;
  - o national and local economic trends and conditions; and
  - o changes in credit concentrations.

Allocation of the allowance for different categories of loans is based on the methodology as explained above. A key element of the methodology to determine the allowance is the Company's credit risk evaluation process, which includes credit risk grading of individual commercial and industrial and commercial real estate loans. Commercial and industrial and commercial real estate loans are assigned credit risk grades based on the Company's assessment of conditions that affect the borrower's ability to meet its contractual obligations under the loan agreement. That process includes reviewing borrowers' current financial information, historical payment experience, credit documentation, public information and other information specific to each individual borrower. Upon review, the commercial loan credit risk grade is revised or reaffirmed as the case may be. The credit risk grades may be changed at any time management feels an upgrade or downgrade may be warranted. The credit risk grades for the commercial and industrial and commercial real estate loan portfolios are taken into account in the reserve methodology and loss factors are applied based upon the credit risk grades. The loss factors applied are based upon the Company's historical experience as well as what we believe to be best practices and common industry standards. Historical experience reveals there is a direct correlation between the credit risk grades and loan charge-offs. The changes in allocations in the commercial and industrial and commercial real estate loan portfolio from period to period are based upon the

credit risk grading system and from periodic reviews of the loan portfolio.

Each quarter, management performs an assessment of the allowance for loan losses. The Company's Special Assets Committee meets quarterly and the applicable lenders discuss each relationship under review and reach a consensus on the appropriate estimated loss amount based on current accounting guidance. The Special Assets Committee's focus is on ensuring the pertinent facts are considered and the reserve amounts pursuant to the accounting principles are reasonable. The assessment process includes the review of all loans on a non-accruing basis as well as a review of certain loans to which the lenders or the Company's Credit Administration function have assigned a criticized or classified risk rating. In 2012, the Company did not change its policy or methodology in calculating the allowance for loan losses from the policy or methodology used in 2011.

The Company's policy is to charge off unsecured consumer loans when they become 90 days or more past due as to principal and interest. In the other portfolio segments, amounts are charged off at the point in time when the Company deems the balance to be uncollectible.

Information related to the change in the allowance for loan losses and the Company's recorded investment in loans by portfolio segment as of the period indicated is as follows:

As of and for the nine months ended September 30, 2012

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	$ 1,221	$ 3,979	$ 1,435	$ 1,051	$ 422	$ 8,108
Charge-offs	135	1,258	491	121	-	2,005
Recoveries	23	-	16	-	-	39
Provision	55	1,083	457	579	(174)	2,000
Ending balance	$ 1,164	$ 3,804	$ 1,417	$ 1,509	$ 248	$ 8,142
Ending balance: individually evaluated for impairment	$ 25	$ 918	$ 114	$ 97		$ 1,154
Ending balance: collectively evaluated for impairment	$ 1,139	$ 2,886	$ 1,303	$ 1,412		$ 6,740
Loans Receivables: Ending balance	$ 68,731	$ 169,005	$ 89,443	$ 101,891		$ 429,070
Ending balance: individually evaluated for impairment	$ 103	$ 9,637	$ 1,380	$ 2,454		$ 13,574
Ending balance: collectively evaluated for impairment	$ 68,628	$ 159,368	$ 88,063	$ 99,437		$ 415,496

As of and for the three months ended September 30, 2012

(dollars in thousands)	Commercial & industrial	Commercial real estate	Consumer	Residential real estate	Unallocated	Total
Allowance for Loan Losses:						
Beginning balance	$ 1,195					