PEOPLES BANCORP OF NORTH CAROLINA INC
Form 10-Q
November 05, 2013

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, 2013

OR

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

For the transition period from __________ to __________

PEOPLES BANCORP OF NORTH CAROLINA, INC.
(Exact name of registrant as specified in its charter)

North Carolina
(State or other jurisdiction of incorporation or organization)

000-27205	56-2132396
(Commission File No.)	(IRS Employer Identification No.)
518 West C Street, Newton, North Carolina	28658
(Address of principal executive offices)	(Zip Code)

(828) 464-5620
(Registrant's telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes X No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes X No

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

Large Accelerate Filer	Accelerated Filer	Non-Accelerated Filer

Smaller Reporting Company	X

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

Yes No X

Indicate the number of shares outstanding of each of the registrant's classes of common stock, as of the latest practicable date.
5,613,495 shares of common stock, outstanding at October 31, 2013.

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Statements made in this Form 10-Q, other than those concerning historical information, should be considered forward-looking statements pursuant to the safe harbor provisions of the Securities Exchange Act of 1934 and the Private Securities Litigation Act of 1995. These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management and on the information available to management at the time that this Form 10-Q was prepared. These statements can be identified by the use of words like "expect," "anticipate," "estimate," and "believe," variations of these words and other similar expressions. Readers should not place undue reliance on forward-looking statements as a number of important factors could cause actual results to differ materially from those in the forward-looking statements. Factors that could cause actual results to differ materially include, but are not limited to, (1) competition in the markets served by Peoples Bank, (2) changes in the interest rate environment, (3) general national, regional or local economic conditions may be less favorable than expected, resulting in, among other things, a deterioration in credit quality and the possible impairment of collectibility of loans, (4) legislative or regulatory changes, including changes in accounting standards, (5) significant changes in the federal and state legal and regulatory environments and tax laws, (6) the impact of changes in monetary and fiscal policies, laws, rules and regulations and (7) other risks and factors identified in other filings with the Securities and Exchange Commission, including but not limited to those described in Peoples Bancorp of North Carolina, Inc.'s Annual Report on Form 10-K for the year ended December 31, 2012

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

September 30, 2013 and December 31, 2012

(Dollars in thousands)

Assets		September 30, 2013 (Unaudited)	December 31, 2012 (Audited)
Cash and due from banks, including reserve requirements	$	53,977	32,617
of $10,342 and $9,625			
Interest-bearing deposits		26,973	16,226
Cash and cash equivalents		80,950	48,843
Investment securities available for sale		301,788	297,823
Other investments		5,215	5,599
Total securities		307,003	303,422
Mortgage loans held for sale		2,201	6,922
Loans		617,061	619,974
Less allowance for loan losses		(13,854)	(14,423)
Net loans		603,207	605,551
Premises and equipment, net		16,543	15,874
Cash surrender value of life insurance		13,597	13,273
Other real estate		2,751	6,254
Accrued interest receivable and other assets		16,489	13,377
Total assets	$	1,042,741	1,013,516
Liabilities and Shareholders' Equity			
Deposits:			
Non-interest bearing demand	$	188,860	161,582
NOW, MMDA & savings		384,429	371,719
Time, $100,000 or more		120,153	134,733
Other time		104,849	113,491
Total deposits		798,291	781,525
Securities sold under agreements to repurchase		48,174	34,578
FHLB borrowings		70,000	70,000

Junior subordinated debentures		20,619	20,619
Accrued interest payable and other liabilities		9,985	9,047
Total liabilities		947,069	915,769
Commitments			
Shareholders' equity:			
Series A preferred stock, $1,000 stated value; authorized			
5,000,000 shares; issued and outstanding			
12,524 shares in 2013 and 2012		12,524	12,524
Common stock, no par value; authorized			
20,000,000 shares; issued and outstanding			
5,613,495 shares in 2013 and 2012		48,133	48,133
Retained earnings		35,810	31,478
Accumulated other comprehensive (loss) income		(795)	5,612
Total shareholders' equity		95,672	97,747
Total liabilities and shareholders' equity	$	1,042,741	1,013,516

See accompanying Notes to Consolidated Financial Statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Earnings

Three and Nine Months Ended September 30, 2013 and 2012

(Dollars in thousands, except per share amounts)

	Three months ended September 30,			Nine months ended September 30,	
		2013 (Unaudited)	2012 (Unaudited)	2013 (Unaudited)	2012 (Unaudited)
Interest income:					
Interest and fees on loans	$	7,592	8,170	22,671	24,822
Interest on due from banks		22	15	62	34
Interest on investment securities:					
U.S. Government sponsored enterprises		307	519	970	2,327
States and political subdivisions		1,179	877	3,233	2,463
Other		88	74	264	206
Total interest income		9,188	9,655	27,200	29,852
Interest expense:					
NOW, MMDA & savings deposits		160	274	578	913
Time deposits		396	737	1,285	2,632
FHLB borrowings		618	689	1,914	2,064
Junior subordinated debentures		100	110	299	332
Other		11	32	43	105
Total interest expense		1,285	1,842	4,119	6,046
Net interest income		7,903	7,813	23,081	23,806
Provision for loan losses		337	761	2,164	4,413
Net interest income after provision for loan losses		7,566	7,052	20,917	19,393
Non-interest income:					
Service charges		1,189	1,222	3,333	3,601
Other service charges and fees		258	228	900	828
Gain on sale of securities		-	12	614	1,203
Mortgage banking income		301	296	1,000	793
Insurance and brokerage commissions		161	150	478	404
Loss on sale and write-down of					

other real estate		(111)	(326)	(284)	(710)
Miscellaneous		1,313	1,304	3,806	3,739
Total non-interest income		3,111	2,886	9,847	9,858
Non-interest expense:					
Salaries and employee benefits		4,183	4,187	12,614	11,960
Occupancy		1,357	1,291	3,988	3,891
Other		2,349	2,678	7,004	7,420
Total non-interest expense		7,889	8,156	23,606	23,271
Earnings before income taxes		2,788	1,782	7,158	5,980
Income tax expense		870	369	1,848	1,400
Net earnings		1,918	1,413	5,310	4,580
Dividends and accretion on preferred stock		156	157	470	853
Net earnings available to common shareholders	$	1,762	1,256	4,840	3,727
Basic net earnings per common share	$	0.31	0.23	0.86	0.67
Diluted net earnings per common share	$	0.31	0.23	0.86	0.67
Cash dividends declared per common share	$	0.03	0.02	0.09	0.11

See accompanying Notes to Consolidated Financial Statements.

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PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income (Loss)

Three and Nine Months Ended September 30, 2013 and 2012

(Dollars in thousands)

	Three months ended September 30,		Nine months ended September 30,	
	2013 (Unaudited)	2012 (Unaudited)	2013 (Unaudited)	2012 (Unaudited)
Net earnings	$ 1,918	1,413	5,310	4,580
Other comprehensive (loss) income:				
Unrealized holding (losses) gains on securities available for sale	(2,084)	1,427	(9,881)	5,156
Reclassification adjustment for gains on securities available for sale included in net earnings	-	(12)	(614)	(1,203)
Total other comprehensive (loss) income, before income taxes	(2,084)	1,415	(10,495)	3,953
Income tax (benefit) expense related to other comprehensive (loss) income:				
Unrealized holding (losses) gains on securities available for sale	(812)	555	(3,849)	2,008
Reclassification adjustment for gains on securities available for sale included in net earnings	-	(4)	(239)	(470)
Total income tax (benefit) expense related to other comprehensive (loss) income	(812)	551	(4,088)	1,538
Total other comprehensive (loss) income,				

net of tax		(1,272)	864	(6,407)	2,415
Total comprehensive income (loss)	$	646	2,277	(1,097)	6,995

See accompanying Notes to Consolidated Financial Statements.

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PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Nine Months Ended September 30, 2013 and 2012

(Dollars in thousands)

		2013 (Unaudited)		2012 (Unaudited)	
Cash flows from operating activities:					
Net earnings	$	5,310		4,580	
Adjustments to reconcile net earnings to net cash provided by operating activities:					
Depreciation, amortization and accretion		6,099		6,651	
Provision for loan losses		2,164		4,413	
Gain on sale of investment securities		(614	)	(1,203	)
(Gain)/Loss on sale of other real estate		(86	)	21	
Write-down of other real estate		370		689	
Restricted stock expense		104		17	
Change in:					
Mortgage loans held for sale		4,721		(838	)
Cash surrender value of life insurance		(324	)	(307	)
Other assets		897		565	
Other liabilities		938		826	
Net cash provided by operating activities		19,579		15,414	
Cash flows from investing activities:					
Purchases of investment securities available for sale		(89,169	)	(55,617	)
Proceeds from calls, maturities and paydowns of investment securities available for sale		52,666		48,123	
Proceeds from sales of investment securities available for sale		17,463		47,062	
Purchases of FHLB stock		-		(493	)
FHLB stock redemption		384		606	
Net change in loans		(1,448	)	35,910	
Purchases of premises and equipment		(1,575	)	(657	)
Proceeds from sales of other real estate and repossessions		4,823		4,611	
Net cash (used) provided by investing activities		(16,856	)	79,545	
Cash flows from financing activities:					
Net change in deposits		16,766		(58,641	)
		13,596		3,536	

Net change in securities sold under agreements to repurchase			
Proceeds from FHLB borrowings		15,000	25,400
Repayments of FHLB borrowings		(15,000)	(25,400)
Warrant repurchase		-	(425)
Stock options exercised		-	410
Preferred stock repurchased		-	(11,695)
Cash dividends paid on preferred stock		(470)	(866)
Cash dividends paid on common stock		(508)	(610)
Net cash provided (used) by financing activities		29,384	(68,291)
Net change in cash and cash equivalents		32,107	26,668
Cash and cash equivalents at beginning of period		48,843	29,236
Cash and cash equivalents at end of period	$	80,950	55,904

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows, continued

Nine Months Ended September 30, 2013 and 2012

(Dollars in thousands)

	2013 (Unaudited)	2012 (Unaudited)
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 4,179	6,609
Income taxes	$ 1,937	1,190
Noncash investing and financing activities:		
Change in unrealized (loss) gain on investment securities		
available for sale, net	$ (6,407)	2,414
Transfers of loans to other real estate and repossessions	$ 2,153	4,669
Financed portion of sales of other real estate	$ 525	330
Accretion of Series A preferred stock	$ -	70
Discount on preferred stock	$ -	835

See accompanying Notes to Consolidated Financial Statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(1) Summary of Significant Accounting Policies

The consolidated financial statements include the financial statements of Peoples Bancorp of North Carolina, Inc. and its wholly-owned subsidiaries, Peoples Bank (the "Bank") and Community Bank Real Estate Solutions, LLC, along with the Bank's wholly-owned subsidiaries, Peoples Investment Services, Inc. and Real Estate Advisory Services, Inc. ("REAS") (collectively called the "Company"). All significant intercompany balances and transactions have been eliminated in consolidation.

The consolidated financial statements in this report (other than the Consolidated Balance Sheet at December 31, 2012) are unaudited. In the opinion of management, all adjustments (none of which were other than normal accruals) necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. Management of the Company has made a number of estimates and assumptions relating to reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare these consolidated financial statements in conformity with generally accepted accounting principles in the United States ("GAAP"). Actual results could differ from those estimates.

The Company's accounting policies are fundamental to understanding management's discussion and analysis of results of operations and financial condition. Many of the Company's accounting policies require significant judgment regarding valuation of assets and liabilities and/or significant interpretation of the specific accounting guidance. A description of the Company's significant accounting policies can be found in Note 1 of the Notes to Consolidated Financial Statements in the Company's 2012 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 2, 2013 Annual Meeting of Shareholders.

Recently Issued Accounting Pronouncements
In January 2013, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2013-01, Balance Sheet (Topic 210): Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities. ASU No. 2013-01 provides additional guidance to clarify the intended scope of ASU No. 2011-11, Balance Sheet (Topic 210): Disclosures about Offsetting Assets and Liabilities. ASU No. 2013-01 is effective for fiscal years beginning on or after January 1, 2013, and interim periods within those annual periods. The adoption of this guidance did not have a material impact on the Company's results of operations, financial position or disclosures.

In February 2013, FASB issued ASU No. 2013-02, Comprehensive Income (Topic 220): Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income. The objective of ASU No. 2013-02 is to improve the reporting of significant reclassifications out of accumulated other comprehensive income. For public entities, ASU No. 2013-02 is effective for reporting periods beginning after December 15, 2012. The adoption of this guidance did not have a material impact on the Company's results of operations, financial position or disclosures.

Other accounting standards that have been issued or proposed by FASB or other standards-setting bodies are not expected to have a material impact on the Company's results of operations, financial position or disclosures.

Reclassification
Certain amounts in the 2012 consolidated financial statements have been reclassified to conform to the 2013 presentation.

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(2) Investment Securities

Investment securities available for sale at September 30, 2013 and December 31, 2012 are as follows:

(Dollars in thousands)

	September 30, 2013			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Mortgage-backed securities	$ 127,153	1,017	697	127,473
U.S. Government sponsored enterprises	22,557	186	9	22,734
State and political subdivisions	147,847	2,313	5,032	145,128
Corporate bonds	3,535	15	63	3,487
Trust preferred securities	1,250	-	-	1,250
Equity securities	748	968	-	1,716
Total	$ 303,090	4,499	5,801	301,788

(Dollars in thousands)

	December 31, 2012			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Mortgage-backed securities	$ 146,755	1,875	606	148,024
U.S. Government sponsored enterprises	18,714	203	80	18,837
State and political subdivisions	118,591	7,171	104	125,658
Corporate bonds	2,571	19	4	2,586
Trust preferred securities	1,250	-	-	1,250
Equity securities	748	720	-	1,468
Total	$ 288,629	9,988	794	297,823

The current fair value and associated unrealized losses on investments in securities with unrealized losses at September 30, 2013 and December 31, 2012 are summarized in the tables below, with the length of time the individual securities have been in a continuous loss position.

(Dollars in thousands)

	September 30, 2013					
	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mortgage-backed securities	$ 45,774	596	10,173	101	55,947	697
U.S. Government sponsored enterprises	1,078	9	-	-	1,078	9
State and political subdivisions	76,195	5,032	-	-	76,195	5,032
Corporate bonds	1,507	63	-	-	1,507	63
Total	$ 124,554	5,700	10,173	101	134,727	5,801

(Dollars in thousands)

	December 31, 2012					
	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mortgage-backed securities	$ 48,126	468	12,913	138	61,039	606
U.S. Government sponsored enterprises	3,402	80	-	-	3,402	80
State and political subdivisions	9,490	104	-	-	9,490	104
Corporate bonds	1,035	4	-	-	1,035	4
Total	$ 62,053	656	12,913	138	74,966	794

At September 30, 2013, unrealized losses in the investment securities portfolio relating to debt securities totaled $5.8 million. The unrealized losses on these debt securities arose due to changing interest rates and are considered to be temporary. From the September 30, 2013 tables above, 78 out of 180 securities issued by state and political subdivisions contained unrealized losses, 27 out of 95 securities issued by U.S. Government sponsored enterprises, including mortgage-backed securities, contained unrealized losses, and two out of five securities issued by corporations contained unrealized losses. These unrealized losses are considered temporary because of acceptable financial condition and results of operations on each security and the repayment sources of principal and interest on U.S. Government sponsored enterprises, including mortgage-backed securities, are government backed.

The amortized cost and estimated fair value of investment securities available for sale at September 30, 2013, by contractual maturity, are shown below. Expected maturities of mortgage-backed securities will differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

September 30, 2013
(Dollars in thousands)

		Amortized Cost	Estimated Fair Value
Due within one year	$	2,637	2,670
Due from one to five years		27,480	27,789
Due from five to ten years		118,720	116,014
Due after ten years		26,352	26,126
Mortgage-backed securities		127,153	127,473
Equity securities		748	1,716
Total	$	303,090	301,788

Proceeds from sales of securities available for sale during the nine months ended September 30, 2013 were $17.5 million and resulted in gross gains of $738,000 and gross losses of $124,000. Proceeds from sales of securities available for sale during the nine months ended September 30, 2012 were $47.0 million and resulted in gross gains of $1.3 million and gross losses of $103,000.

Securities with a fair value of approximately $82.7 million and $73.9 million at September 30, 2013 and December 31, 2012, respectively, were pledged to secure public deposits and for other purposes as required by law.

(3) Loans

Major classifications of loans at September 30, 2013 and December 31, 2012 are summarized as follows:

(Dollars in thousands)

		September 30, 2013	December 31, 2012
Real estate loans			
Construction and land development	$	67,870	73,176
Single-family residential		191,338	195,003
Single-family residential -			
Banco de la Gente stated income		50,035	52,019
Commercial		205,911	200,633
Multifamily and farmland		11,541	8,951

Total real estate loans		526,695	529,782
Loans not secured by real estate			
Commercial loans		64,957	64,295
Farm loans		22	11
Consumer loans		9,754	10,148
All other loans		15,633	15,738
Total loans		617,061	619,974
Less allowance for loan losses		13,854	14,423
Net loans	$	603,207	605,551

The Bank grants loans and extensions of credit primarily within the Catawba Valley region of North Carolina, which encompasses Catawba, Alexander, Iredell and Lincoln counties and also in Mecklenburg, Union and Wake counties of North Carolina. Although the Bank has a diversified loan portfolio, a substantial portion of the loan portfolio is collateralized by improved and unimproved real estate, the value of which is dependent upon the real estate market. Risk characteristics of the major components of the Bank's loan portfolio are discussed below:

- Construction and land development loans – The risk of loss is largely dependent on the initial estimate of whether the property's value at completion equals or exceeds the cost of property construction and the availability of take-out financing. During the construction phase, a number of factors can result in delays or cost overruns. If the estimate is inaccurate or if actual construction costs exceed estimates, the value of the property securing the loan may be insufficient to ensure full repayment when completed through a permanent loan, sale of the property, or by seizure of collateral. As of September 30, 2013, construction and land development loans comprised approximately 11% of the Bank's total loan portfolio.

- Single-family residential loans – Declining home sales volumes, decreased real estate values and higher than normal levels of unemployment could contribute to losses on these loans. As of September 30, 2013, single-family residential loans comprised approximately 39% of the Bank's total loan portfolio, and include Banco de la Gente single-family residential stated income loans which were approximately 8% of the Bank's total loan portfolio.

- Commercial real estate loans – Repayment is dependent on income being generated in amounts sufficient to cover operating expenses and debt service. These loans also involve greater risk because they are generally not fully amortizing over a loan period, but rather have a balloon payment due at maturity. A borrower's ability to make a balloon payment typically will depend on being able to either refinance the loan or timely sell the underlying property. As of September 30, 2013, commercial real estate loans comprised approximately 33% of the Bank's total loan portfolio.

- Commercial loans – Repayment is generally dependent upon the successful operation of the borrower's business. In addition, the collateral securing the loans may depreciate over time, be difficult to appraise, be illiquid, or fluctuate in value based on the success of the business. As of September 30, 2013, commercial loans comprised approximately 11% of the Bank's total loan portfolio.

Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on non-accrual status when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. Loans may be placed on non-accrual status regardless of whether or not such loans are considered past due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

The following tables present an age analysis of past due loans, by loan type, as of September 30, 2013 and December 31, 2012:

September 30, 2013
(Dollars in thousands)

		Loans 30-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Total Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Real estate loans							
Construction and land development	$	229	5,752	5,981	61,889	67,870	-
Single-family residential		4,242	1,773	6,015	185,323	191,338	-
Single-family residential - Banco de la Gente stated income		4,388	2,764	7,152	42,883	50,035	1,987
Commercial		2,437	153	2,590	203,321	205,911	-
Multifamily and farmland		137	185	322	11,219	11,541	185
Total real estate loans		11,433	10,627	22,060	504,635	526,695	2,172
Loans not secured by real estate							
Commercial loans		902	62	964	63,993	64,957	-
Farm loans		-	-	-	22	22	-
Consumer loans		180	25	205	9,549	9,754	1
All other loans		-	-	-	15,633	15,633	-
Total loans	$	12,515	10,714	23,229	593,832	617,061	2,173

December 31, 2012
(Dollars in thousands)

		Loans 30-89 Days Past Due	Loans 90 or More Days Past Due	Total Past Due Loans	Total Current Loans	Total Loans	Accruing Loans 90 or More Days Past Due
Real estate loans							
Construction and land development	$	1,280	6,858	8,138	65,038	73,176	-
Single-family residential		4,316	1,548	5,864	189,139	195,003	-
Single-family residential - Banco de la Gente stated income		11,077	3,659	14,736	37,283	52,019	2,378
Commercial		1,720	1,170	2,890	197,743	200,633	-
Multifamily and farmland		7	-	7	8,944	8,951	-
Total real estate loans		18,400	13,235	31,635	498,147	529,782	2,378

Loans not secured by real estate							
Commercial loans		888	66	954	63,341	64,295	23
Farm loans		-	-	-	11	11	-
Consumer loans		250	10	260	9,888	10,148	2
All other loans		-	-	-	15,738	15,738	-
Total loans	$	19,538	13,311	32,849	587,125	619,974	2,403

The following table presents the Company’s non-accrual loans as of September 30, 2013 and December 31, 2012:

(Dollars in thousands)

		September 30, 2013	December 31, 2012
Real estate loans			
Construction and land development	$	6,993	9,253
Single-family residential		3,284	2,491
Single-family residential -			
Banco de la Gente stated income		1,748	2,232
Commercial		1,969	3,263
Total real estate loans		13,994	17,239
Loans not secured by real estate			
Commercial loans		112	344
Consumer loans		38	47
Total	$	14,144	17,630

At each reporting period, the Bank determines which loans are impaired. Accordingly, the Bank's impaired loans are reported at their estimated fair value on a non-recurring basis. An allowance for each impaired loan that is collateral-dependent is calculated based on the fair value of its collateral. The fair value of the collateral is based on appraisals performed by REAS, a subsidiary of the Bank. REAS is staffed by certified appraisers that also perform appraisals for other companies. Factors including the assumptions and techniques utilized by the appraiser are considered by management. If the recorded investment in the impaired loan exceeds the measure of fair value of the collateral, a valuation allowance is recorded as a component of the allowance for loan losses. An allowance for each impaired loan that is non-collateral dependent is calculated based on the present value of projected cash flows. If the recorded investment in the impaired loan exceeds the present value of projected cash flows, a valuation allowance is recorded as a component of the allowance for loan losses. Impaired loans under $250,000 are not individually evaluated for impairment, with the exception of the Bank's troubled debt restructured ("TDR") loans in the residential mortgage loan portfolio, which are individually evaluated for impairment. Accruing impaired loans were $27.1 million, $30.6 million and $38.7 million at September 30, 2013, December 31, 2012 and September 30, 2012, respectively. Interest income recognized on accruing impaired loans was $916,000, $1.4 million and $1.5 million for the nine months ended September 30, 2013, the nine months ended September 30, 2012 and the year ended December 31, 2012, respectively. Interest income recognized on accruing impaired loans was $337,000 and $543,000 for the three months ended September 30, 2013 and 2012, respectively. No interest income is recognized on non-accrual impaired loans subsequent to their classification as non-accrual.

The following tables present the Company's impaired loans as of September 30, 2013 and December 31, 2012:

September 30, 2013
(Dollars in thousands)

						Average Outstanding Impaired Loans			
	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Recorded Investment in Impaired Loans	Related Allowance	Three Months Ended September 30, 2012	Three Months Ended September 30, 2013	Nine Months Ended September 30, 2012	Nine Months Ended September 30, 2013
Real estate loans									
Construction and land development	$10,399	6,705	923	7,628	61	12,318	7,902	13,806	8,954
Single-family residential	8,705	1,228	6,828	8,056	161	7,320	7,965	7,868	8,404
Single-family residential - Banco de la Gente stated income	21,651	-	20,775	20,775	1,259	21,038	20,780	20,752	20,904
Commercial	4,063	3,100	556	3,656	8	6,317	3,753	5,565	4,297
Multifamily and farmland	185	-	185	185	3	200	185	201	188
Total impaired real estate loans	45,003	11,033	29,267	40,300	1,492	47,193	40,585	48,192	42,747

Loans not secured by real estate									
Commercial loans	643	-	628	628	11	1,186	701	1,187	816
Consumer loans	317	272	43	315	1	23	316	38	185
Total impaired loans	$45,963	11,305	29,938	41,243	1,504	48,402	41,602	49,417	43,748

December 31, 2012
(Dollars in thousands)

	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Recorded Investment in Impaired Loans	Related Allowance	Average Outstanding Impaired Loans
Real estate loans						
Construction and land development	$ 17,738	11,795	680	12,475	61	12,810
Single-family residential	9,099	766	7,799	8,565	177	7,590
Single-family residential - Banco de la Gente stated income	21,806	-	21,000	21,000	1,278	21,158
Commercial	5,830	4,569	467	5,036	6	5,433
Multifamily and farmland	193	-	193	193	1	200
Total impaired real estate loans	54,666	17,130	30,139	47,269	1,523	47,191
Loans not secured by real estate						
Commercial loans	983	347	592	939	12	1,125
Consumer loans	68	-	66	66	1	41
Total impaired loans	$ 55,717	17,477	30,797	48,274	1,536	48,357

Changes in the allowance for loan losses for the three and nine months ended September 30, 2013 and 2012 were as follows:

(Dollars in thousands)

	Real Estate Loans									
	Construction and Land Development	Single-Family Residential	Single-Family Residential - Banco de la Gente Stated Income	Commercial	Multifamily and Farmland	Commercial	Farm	Consumer and All Other	Unallocated	Total
Nine months ended September 30, 2013										
Allowance for loan losses:										
Beginning balance	$4,399	3,231	1,998	2,049	28	1,088	-	245	1,385	14,423
Charge-offs	(732)	(1,204)	(252)	(327)	-	(483)	-	(485)	-	(3,483)
Recoveries	374	75	101	50	-	39	-	111	-	750
Provision	99	864	67	240	8	140	-	379	367	2,164
Ending balance	$4,140	2,966	1,914	2,012	36	784	-	250	1,752	13,854
Three months ended September 30, 2013										
Allowance for loan losses:										
Beginning balance	$4,725	3,304	1,924	1,858	34	822	-	229	1,133	14,029
Charge-offs	(17)	(569)	(28)	(51)	-	(101)	-	(204)	-	(970)
Recoveries	348	31	31	-	-	14	-	34	-	458
Provision	(916)	200	(13)	205	2	49	-	191	619	337
Ending balance	$4,140	2,966	1,914	2,012	36	784	-	250	1,752	13,854
Allowance for loan losses September 30, 2013:										
Ending balance: individually evaluated for impairment	$1	60	1,233	-	-	-	-	-	-	1,294
Ending balance: collectively evaluated for impairment	4,139	2,906	681	2,012	36	784	-	250	1,752	12,560

	Construction and Land Development	Single-Family Residential	Single-Family Residential - Banco de la Gente Stated Income	Commercial	Multifamily and Farmland	Commercial	Farm	Consumer and All Other	Unallocated	Total
Ending balance	$4,140	2,966	1,914	2,012	36	784	-	250	1,752	13,854
Loans September 30, 2013:										
Ending balance	$67,870	191,338	50,035	205,911	11,541	64,957	22	25,387	-	617,061
Ending balance: individually evaluated for impairment	$6,790	3,079	19,803	3,100	-	-	-	272	-	33,044
Ending balance: collectively evaluated for impairment	$61,080	188,259	30,232	202,811	11,541	64,957	22	25,115	-	584,017

(Dollars in thousands)

	Real Estate Loans									
	Construction and Land Development	Single-Family Residential	Single-Family Residential - Banco de la Gente Stated Income	Commercial	Multifamily and Farmland	Commercial	Farm	Consumer and All Other	Unallocated	Total
Nine months ended September 30, 2012										
Allowance for loan losses:										
Beginning balance	$7,182	3,253	2,104	1,731	13	1,029	-	255	1,037	16,604
Charge-offs	(3,045)	(666)	(483)	(547)	-	(498)	-	(403)	-	(5,642)
Recoveries	522	71	-	374	-	95	-	115	-	1,177
Provision	1,733	367	450	(21)	-	(18)	-	222	1,679	4,412
Ending balance	$6,392	3,025	2,071	1,537	13	608	-	189	2,716	16,551
Three months ended September 30, 2012										
Allowance for loan losses:										
Beginning balance	$7,645	2,902	2,224	1,516	13	629	-	191	1,520	16,640
Charge-offs	(663)	(176)	(112)	(24)	-	(156)	-	(135)	-	(1,266)
Recoveries	304	2	-	-	-	84	-	26	-	416
Provision	(894)	297	(41)	45	-	51	-	107	1,196	761

Ending balance	$6,392	3,025	2,071	1,537	13	608	-	189	2,716	16,551
Allowance for loan losses September 30, 2012:										
Ending balance: individually evaluated for impairment	$1,527	376	1,261	114	-	-	-	-	-	3,278
Ending balance: collectively evaluated for impairment	4,865	2,649	810	1,423	13	608	-	189	2,716	13,273
Ending balance	$6,392	3,025	2,071	1,537	13	608	-	189	2,716	16,551
Loans September 30, 2012:										
Ending balance	$80,733	197,043	52,124	203,603	4,964	60,358	12	26,945	-	625,782
Ending balance: individually evaluated for impairment	$19,734	3,716	20,054	6,798	-	346	-	-	-	50,648
Ending balance: collectively evaluated for impairment	$60,999	193,327	32,070	196,805	4,964	60,012	12	26,945	-	575,134

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The Company utilizes an internal risk grading matrix to assign a risk grade to each of its loans. Loans are graded on a scale of 1 to 8. These risk grades are evaluated on an ongoing basis. The Low Substandard risk grade was removed from the Company's internal risk grading matrix during the first quarter of 2013. No loans were classified Low Substandard at December 31, 2012. A description of the general characteristics of the eight risk grades is as follows:

- Risk Grade 1 – Excellent Quality: Loans are well above average quality and a minimal amount of credit risk exists. CD or cash secured loans or properly margined actively traded stock or bond secured loans would fall in this grade.
- Risk Grade 2 – High Quality: Loans are of good quality with risk levels well within the Company's range of acceptability. The organization or individual is established with a history of successful performance though somewhat susceptible to economic changes.
- Risk Grade 3 – Good Quality: Loans of average quality with risk levels within the Company's range of acceptability but higher than normal. This may be a new organization or an existing organization in a transitional phase (e.g. expansion, acquisition, market change).
- Risk Grade 4 – Management Attention: These loans have higher risk and servicing needs but still are acceptable. Evidence of marginal performance or deteriorating trends is observed. These are not problem credits presently, but may be in the future if the borrower is unable to change its present course.
- Risk Grade 5 – Watch: These loans are currently performing satisfactorily, but there has been some recent past due history on repayment and there are potential weaknesses that may, if not corrected, weaken the asset or inadequately protect the Company's position at some future date.
- Risk Grade 6 – Substandard: A Substandard loan is inadequately protected by the current sound net worth and paying capacity of the obligor or the collateral pledged (if there is any). There is a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. There is a distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.
- Risk Grade 7 – Doubtful: Loans classified as Doubtful have all the weaknesses inherent in loans classified Substandard, plus the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values highly questionable and improbable. Doubtful is a temporary grade where a loss is expected but is presently not quantified with any degree of accuracy. Once the loss position is determined, the amount is charged off.
- Risk Grade 8 – Loss: Loans classified as Loss are considered uncollectable and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this worthless loan even though partial recovery may be realized in the future. Loss is a temporary grade until the appropriate authority is obtained to charge the loan off.

The following tables present the credit risk profile of each loan type based on internally assigned risk grades as of September 30, 2013 and December 31, 2012:

September 30, 2013
(Dollars in thousands)

	Real Estate Loans									
	Construction and Land Development	Single-Family Residential	Single-Family Residential - Banco de la Gente Stated Income	Commercial	Multifamily and Farmland	Commercial	Farm	Consumer	All Other	Total

1- Excellent Quality	$8	18,693	-	-	-	361	-	1,171	-	20,233
2- High Quality	5,868	57,682	-	37,940	286	6,755	-	3,725	2,147	114,403
3- Good Quality	26,814	69,013	23,193	119,080	8,019	44,285	22	4,041	11,125	305,592
4- Management Attention	14,666	32,766	9,528	39,925	506	12,408	-	431	2,361	112,591
5- Watch	9,629	7,652	7,384	4,564	2,545	401	-	32	-	32,207
6- Substandard	10,885	5,532	9,930	4,402	185	747	-	351	-	32,032
7- Doubtful	-	-	-	-	-	-	-	-	-	-
8- Loss	-	-	-	-	-	-	-	3	-	3
Total	$67,870	191,338	50,035	205,911	11,541	64,957	22	9,754	15,633	617,061

December 31, 2012
(Dollars in thousands)

	Real Estate Loans									
	Construction and Land Development	Single-Family Residential	Single-Family Residential - Banco de la Gente Stated Income	Commercial	Multifamily and Farmland	Commercial	Farm	Consumer	All Other	Total
1- Excellent Quality	$11	24,662	-	-	-	672	-	1,239	-	26,584
2- High Quality	4,947	56,829	-	27,511	32	9,260	-	4,122	2,317	105,018
3- Good Quality	24,952	62,018	24,724	114,001	4,975	40,814	11	4,186	13,416	289,097
4- Management Attention	18,891	35,727	11,366	47,603	3,039	11,844	-	392	5	128,867
5- Watch	9,580	9,504	3,597	6,911	712	976	-	134	-	31,414
6- Substandard	14,795	6,263	12,332	4,607	193	729	-	70	-	38,989
7- Low Substandard	-	-	-	-	-	-	-	-	-	-
8- Doubtful	-	-	-	-	-	-	-	-	-	-
9- Loss	-	-	-	-	-	-	-	5	-	5
Total	$73,176	195,003	52,019	200,633	8,951	64,295	11	10,148	15,738	619,974

At September 30, 2013, TDR loans amounted to $17.1 million, including $251,000 in performing TDR loans. Performing TDR balances reflect current year TDR loans only, in accordance with GAAP. At December 31, 2012, TDR loans were $23.9 million, including $2.0 million in performing TDR loans. The terms of these loans have been renegotiated to provide a reduction in principal or interest as a result of the deteriorating financial position of the borrower.

The following table presents an analysis of TDR loans by loan type as of September 30, 2013:

September 30, 2013
(Dollars in thousands)

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Real estate loans			
Construction and land development	14	$ 10,098	6,750
Single-family residential	22	1,367	1,978
Single-family residential - Banco de la Gente stated income	68	7,630	6,263

Commercial	6		2,236	1,816
Multifamily and farmland	1		322	185
Total real estate TDR loans	111		21,653	16,992
Loans not secured by real estate				
Commercial loans	8		242	120
Consumer loans	1		2	-
Total TDR loans	120	$	21,897	17,112

The Bank did not enter into any new TDR loan modifications during the three months ended September 30, 2013. The following table presents an analysis of loan modifications during the nine months ended September 30, 2013:

Nine months ended September 30, 2013
(Dollars in thousands)

	Number of Contracts		Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Real estate loans				
Construction and land development	2	$	841	825
Single-family residential -				
Banco de la Gente stated income	4	$	471	466
Total real estate TDR loans	6		1,312	1,291
Total TDR loans	6	$	1,312	1,291

The following tables present an analysis of loan modifications during the three and nine months ended September 30, 2012:

Three months ended September 30, 2012
(Dollars in thousands)

	Number of Contracts		Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Real estate loans				
Single-family residential	2	$	177	176
Single-family residential -				
Banco de la Gente stated income	3	$	276	275
Total real estate TDR loans	5		453	451
Total TDR loans	5	$	453	451

Nine months ended September 30, 2012
(Dollars in thousands)

	Number of Contracts		Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Real estate loans				
Single-family residential	3	$	302	301
Single-family residential -				
Banco de la Gente stated income	18	$	1,862	1,847
Total real estate TDR loans	21		2,164	2,148
Loans not secured by real estate				
Commercial loans	1		14	14
Total TDR loans	22	$	2,178	2,162

The following table presents an analysis of TDR loans by loan type as of December 31, 2012:

December 31, 2012
(Dollars in thousands)

	Number of Contracts		Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Real estate loans				
Construction and land development	11	$	10,465	6,633
Single-family residential	33		3,014	4,084
Single-family residential -				
Banco de la Gente stated income	122		13,459	12,170
Commercial	4		1,457	682
Multifamily and farmland	-		-	-

Total real estate TDR loans	170		28,395	23,569
Loans not secured by real estate				
Commercial loans	9		511	368
Consumer loans	1		2	-
Total TDR loans	180	$	28,908	23,937

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(4) Net Earnings Per Common Share

Net earnings per common share is based on the weighted average number of common shares outstanding during the period while the effects of potential common shares outstanding during the period are included in diluted earnings per common share. The average market price during the year is used to compute equivalent shares.

The reconciliation of the amounts used in the computation of both "basic earnings per common share" and "diluted earnings per common share" for the three and nine months ended September 30, 2013 and 2012 is as follows:

For the three months ended September 30, 2013

	Net Earnings Available to Common Shareholders (Dollars in thousands)	Common Shares	Per Share Amount
Basic earnings per common share	$ 1,762	5,613,495	$ 0.31
Effect of dilutive securities:			
Stock options	-	15,180	
Diluted earnings per common share	$ 1,762	5,628,675	$ 0.31

For the nine months ended September 30, 2013

	Net Earnings Available to Common Shareholders (Dollars in thousands)	Common Shares	Per Share Amount
Basic earnings per common share	$ 4,840	5,613,495	$ 0.86
Effect of dilutive securities:			
Stock options	-	8,554	
Diluted earnings per common share	$ 4,840	5,622,049	$ 0.86

For the three months ended September 30, 2012

	Net Earnings Available to Common Shareholders (Dollars in thousands)	Common Shares	Per Share Amount
Basic earnings per common share	$ 1,256	5,559,016	$ 0.23
Effect of dilutive securities:			
Stock options	-	2,570	
Diluted earnings per common share	$ 1,256	5,561,586	$ 0.23

For the nine months ended September 30, 2012

	Net Earnings Available to	Common Shares	Per Share Amount

	Common Shareholders (Dollars in thousands)		
Basic earnings per common share	$ 3,727	5,549,148	$ 0.67
Effect of dilutive securities:			
Stock options	-	2,168	
Diluted earnings per common share	$ 3,727	5,551,316	$ 0.67

(5) Stock-Based Compensation

The Company has an Omnibus Stock Ownership and Long Term Incentive Plan (the “1999 Plan”) whereby certain stock-based rights, such as stock options, restricted stock and restricted stock units were granted to eligible directors and employees. The 1999 Plan expired on May 13, 2009 but still governs the rights and obligations of the parties for grants made thereunder.
Under the 1999 Plan, the Company granted incentive stock options to certain eligible employees in order that they may purchase Company stock at a price equal to the fair market value on the date of the grant. The options granted in 1999 vested over a five-year period. Options granted subsequent to 1999 vested over a three-year period. All options expire ten years after issuance.

In addition, under the 1999 Plan, the Company granted 3,000 restricted stock units in 2007 at a grant date fair value of $17.40 per share. The Company granted 1,750 restricted stock units at a grant date fair value of $12.80 per share during the third quarter of 2008 and 2,000 restricted stock units at a grant date fair value of $11.37 per share during the fourth quarter of 2008. The Company recognizes compensation expense on the restricted stock units over the period of time the restrictions are in place (three years from the grant date for the grants of restricted stock units to date under the 1999 Plan). The amount of expense recorded each period reflects the changes in the Company’s stock price during the period. As of September 30, 2013, there was no unrecognized compensation cost related to the 2007 and 2008 restricted stock unit grants.

The Company also has an Omnibus Stock Ownership and Long Term Incentive Plan that was approved by shareholders on May 7, 2009 (the “2009 Plan”) whereby certain stock-based rights, such as stock options, restricted stock, restricted stock units, performance units, stock appreciation rights or book value shares, may be granted to eligible directors and employees. A total of 303,691 shares are currently reserved for possible issuance under the 2009 Plan. All rights must be granted or awarded within ten years from the May 7, 2009 effective date of the 2009 Plan.

The Company granted 29,514 restricted stock units under the 2009 Plan at a grant date fair value of $7.90 per share during the first quarter of 2012. 5,355 restricted stock units were forfeited by the executive officers of the Company as required by the agreement with the U.S. Department of the Treasury (“UST”) in conjunction with the Company’s participation in the Capital Purchase Program (“CPP”) under the Troubled Asset Relief Program (“TARP”). In July 2012, the Company granted 5,355 restricted stock units at a grant date fair value of $8.25 per share. The Company granted 26,795 restricted stock units under the 2009 Plan at a grant date fair value of $11.90 per share during the second quarter of 2013. The Company recognizes compensation expense on the restricted stock units over the period of time the restrictions are in place (five years from the grant date for the 2012 grants and four years from the grant date for the 2013 grants). The amount of expense recorded each period reflects the changes in the Company’s stock price during the period. As of September 30, 2013, the total unrecognized compensation cost related to the restricted stock unit grants under the 2009 Plan was $550,000.

The Company recognized compensation expense for restricted stock unit awards of $104,000 and $31,000 for the nine months ended September 30, 2013 and 2012, respectively.

(6) Fair Value

The Company is required to disclose fair value information about financial instruments, whether or not recognized on the face of the balance sheet, for which it is practicable to estimate that value. The assumptions used in the estimation of the fair value of the Company’s financial instruments are detailed below. Where quoted prices are not available, fair values are based on estimates using discounted cash flows and other valuation techniques. The use of discounted cash

flows can be significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. The following disclosures should not be considered a surrogate of the liquidation value of the Company, but rather a good faith estimate of the increase or decrease in the value of financial instruments held by the Company since purchase, origination, or issuance.

The Company groups assets and liabilities 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. These levels are:

- Level 1 – Valuation is based upon quoted prices for identical instruments traded in active markets.
- Level 2 – Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
- Level 3 – Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

Cash and Cash Equivalents

For cash, due from banks and interest-bearing deposits, the carrying amount is a reasonable estimate of fair value. Cash and cash equivalents are reported in the Level 1 fair value category.

Investment Securities Available for Sale
Fair values of investment securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges when available. If quoted prices are not available, fair value is determined using matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities. Fair values for investment securities with quoted market prices are reported in the Level 1 fair value category. Fair value measurements obtained from independent pricing services are reported in the Level 2 fair value category. All other fair value measurements are reported in the Level 3 fair value category.

Other Investments
For other investments, the carrying value is a reasonable estimate of fair value. Other investments are reported in the Level 3 fair value category.

Mortgage Loans Held for Sale
Mortgage loans held for sale are carried at lower of aggregate cost or market value. The cost of mortgage loans held for sale approximates the market value. Mortgage loans held for sale are reported in the Level 3 fair value category.

Loans
The fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings. For variable rate loans, the carrying amount is a reasonable estimate of fair value. Loans are reported in the Level 3 fair value category, as the pricing of loans is more subjective than the pricing of other financial instruments.

Cash Surrender Value of Life Insurance
For cash surrender value of life insurance, the carrying value is a reasonable estimate of fair value. Cash surrender value of life insurance is reported in the Level 2 fair value category.

Other Real Estate
The fair value of other real estate is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. Other real estate is reported in the Level 3 fair value category.

Deposits
The fair value of demand deposits, interest-bearing demand deposits and savings is the amount payable on demand at the reporting date. The fair value of certificates of deposit is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities. Deposits are reported in the Level 2 fair value category.

Securities Sold Under Agreements to Repurchase
For securities sold under agreements to repurchase, the carrying value is a reasonable estimate of fair value. Securities sold under agreements to repurchase are reported in the Level 2 fair value category.

Federal Home Loan Bank ("FHLB") Borrowings
The fair value of FHLB borrowings is estimated based upon discounted future cash flows using a discount rate comparable to the current market rate for such borrowings. FHLB borrowings are reported in the Level 2 fair value category.

Junior Subordinated Debentures
Because the Company's junior subordinated debentures were issued at a floating rate, the carrying amount is a reasonable estimate of fair value. Junior subordinated debentures are reported in the Level 2 fair value category.

Commitments to Extend Credit and Standby Letters of Credit

Commitments to extend credit and standby letters of credit are generally short-term and at variable interest rates. Therefore, both the carrying value and estimated fair value associated with these instruments are immaterial.

Limitations

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on many judgments. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial instruments include deferred income taxes and premises and equipment. In addition, the tax ramifications related to the realization of unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

The table below presents the balance of securities available for sale, which are measured at fair value on a recurring basis by level within the fair value hierarchy, as of September 30, 2013 and December 31, 2012.

(Dollars in thousands)

		September 30, 2013			
		Fair Value Measurements	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	$	127,473	-	127,473	-
U.S. Government					
sponsored enterprises	$	22,734	-	22,734	-
State and political subdivisions	$	145,128	-	145,128	-
Corporate bonds	$	3,487	-	3,487	-
Trust preferred securities	$	1,250	-	-	1,250
Equity securities	$	1,716	1,716	-	-

(Dollars in thousands)

		December 31, 2012			
		Fair Value Measurements	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	$	148,024	-	148,024	-
U.S. Government					
sponsored enterprises	$	18,837	-	18,837	-
State and political subdivisions	$	125,658	-	125,658	-
Corporate bonds	$	2,586	-	2,586	-
Trust preferred securities	$	1,250	-	-	1,250
Equity securities	$	1,468	1,468	-	-

The following is an analysis of fair value measurements of investment securities available for sale using Level 3, significant unobservable inputs, for the nine months ended September 30, 2013.

(Dollars in thousands)

	Investment Securities Available for Sale Level 3 Valuation

Balance, beginning of period	$	1,250
Change in book value		-
Change in gain/(loss) realized and unrealized		-
Purchases/(sales)		-
Transfers in and/or (out) of Level 3		-
Balance, end of period	$	1,250
Change in unrealized gain/(loss) for assets still held in Level 3	$	-

The fair value measurements for impaired loans and other real estate on a non-recurring basis at September 30, 2013 and December 31, 2012 are presented below. The fair value measurement process uses certified appraisals and other market-based information; however, in many cases, it also requires significant input based on management's knowledge of and judgment about current market conditions, specific issues relating to the collateral, and other matters. As a result, all fair value measurements for impaired loans and other real estate are considered Level 3.

(Dollars in thousands)

		Fair Value Measurements September 30, 2013	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for the Nine Months Ended September 30, 2013
Impaired loans	$	39,739	-	-	39,739	(2,521)
Other real estate	$	2,751	-	-	2,751	(284)

(Dollars in thousands)

		Fair Value Measurements December 31, 2012	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for the Year Ended December 31, 2012
Impaired loans	$	46,738	-	-	46,738	(6,875)
Other real estate	$	6,254	-	-	6,254	(1,136)

The carrying amount and estimated fair value of financial instruments at September 30, 2013 and December 31, 2012 are as follows:

(Dollars in thousands)

			Fair Value Measurements at September 30, 2013			
		Carrying Amount	Level 1	Level 2	Level 3	Total
Assets:						
Cash and cash equivalents	$	80,950	80,950	-	-	80,950
Investment securities available for sale		301,788	1,716	298,822	1,250	301,788
Other investments		5,215	-	-	5,215	5,215
Mortgage loans held for sale		2,201	-	-	2,201	2,201
Loans, net		603,207	-	-	594,017	594,017
Cash surrender value of life insurance		13,597	-	13,597	-	13,597
Liabilities:						
Deposits	$	798,291	-	797,400	-	797,400
Securities sold under agreements to repurchase		48,174	-	48,174	-	48,174
FHLB borrowings		70,000	-	71,197	-	71,197
Junior subordinated debentures		20,619	-	20,619	-	20,619

(Dollars in thousands)

	Carrying Amount	Fair Value Measurements at December 31, 2012 Level 1	Level 2	Level 3	Total
Assets:					
Cash and cash equivalents	$ 48,843	48,843	-	-	48,843
Investment securities available for sale	297,823	1,468	295,105	1,250	297,823
Other investments	5,599	-	-	5,599	5,599
Mortgage loans held for sale	6,922	-	-	6,922	6,922
Loans, net	605,551	-	-	599,996	599,996
Cash surrender value of life insurance	13,273	-	13,273	-	13,273
Liabilities:					
Deposits	$ 781,525	-	780,662	-	780,662
Securities sold under agreements to repurchase	34,578	-	34,578	-	34,578
FHLB borrowings	70,000	-	76,375	-	76,375
Junior subordinated debentures	20,619	-	20,619	-	20,619

(7) Derivative Instruments and Hedging Activities

Accounting Policy for Derivative Instruments and Hedging Activities

The disclosure requirements for derivatives and hedging activities have the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The disclosure requirements include qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

The Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts that are intended to economically hedge certain of its risks, even though hedge accounting does not apply or the Company elects not to apply hedge accounting.

Risk Management Objective of Using Derivatives

The Company has an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. By using

derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair value gain in the derivative. The Company minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties that are reviewed periodically by the Company. The Company did not have any interest rate derivatives outstanding as of September 30, 2013 or December 31, 2012.

Cash Flow Hedges of Interest Rate Risk

The Company's objectives in using interest rate derivatives are to add stability to interest income and expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps and floors as part of its interest rate risk management strategy. For hedges of the Company's variable-rate loan assets, interest rate swaps designated as cash flow hedges involve the receipt of fixed-rate amounts from a counterparty in exchange for the Company making variable-rate payments over the life of the agreements without exchange of the underlying notional amount. For hedges of the Company's variable-rate loan assets, the interest rate floors designated as a cash flow hedge involves the receipt of variable-rate amounts from a counterparty if interest rates fall below the strike rate on the contract in exchange for an up front premium. The Company had an interest rate swap contract that expired in June 2011. The Company did not have any interest rate derivatives outstanding as of September 30, 2013 or December 31, 2012.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in "Accumulated Other Comprehensive Income" and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings.

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

The following is a discussion of our financial position and results of operations and should be read in conjunction with the information set forth under Item 1A Risk Factors and the Company's Consolidated Financial Statements and Notes thereto on pages A-28 through A-64 of the Company's 2012 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 2, 2013 Annual Meeting of Shareholders.

Introduction

Management's discussion and analysis of earnings and related data are presented to assist in understanding the consolidated financial condition and results of operations of the Company. The Company is the parent company of the Bank and a registered bank holding company operating under the supervision of the Board of Governors of the Federal Reserve System (the "Federal Reserve"). The Bank is a North Carolina-chartered bank, with offices in Catawba, Lincoln, Alexander, Mecklenburg, Iredell, Union and Wake counties, operating under the banking laws of North Carolina and the rules and regulations of the Federal Deposit Insurance Corporation (the "FDIC").

Overview

Our business consists principally of attracting deposits from the general public and investing these funds in commercial loans, real estate mortgage loans, real estate construction loans and consumer loans. Our profitability depends primarily on our net interest income, which is the difference between the income we receive on our loan and investment securities portfolios and our cost of funds, which consists of interest paid on deposits and borrowed funds. Net interest income also is affected by the relative amounts of our interest-earning assets and interest-bearing liabilities. When interest-earning assets approximate or exceed interest-bearing liabilities, a positive interest rate spread will generate net interest income. Our profitability is also affected by the level of other income and operating expenses. Other income consists primarily of miscellaneous fees related to our loans and deposits, mortgage banking income and commissions from sales of annuities and mutual funds. Operating expenses consist of compensation and benefits, occupancy related expenses, federal deposit and other insurance premiums, data processing, advertising and other expenses.

Our operations are influenced significantly by local economic conditions and by policies of financial institution regulatory authorities. The earnings on our assets are influenced by the effects of, and changes in, trade, monetary and fiscal policies and laws, including interest rate policies of the Federal Reserve, inflation, interest rates, market and monetary fluctuations. Lending activities are affected by the demand for commercial and other types of loans, which in turn is affected by the interest rates at which such financing may be offered. Our cost of funds is influenced by interest rates on competing investments and by rates offered on similar investments by competing financial institutions in our market area, as well as general market interest rates. These factors can cause fluctuations in our net interest income and other income. In addition, local economic conditions can impact the credit risk of our loan portfolio, in that (1) local employers may be required to eliminate employment positions of individual borrowers, and (2) small businesses and commercial borrowers may experience a downturn in their operating performance and become unable to make timely payments on their loans. Management evaluates these factors in estimating its allowance for loan losses and changes in these economic factors could result in increases or decreases to the provision for loan losses.

Economic conditions in 2013, while demonstrating some sign of improvement, continue to have a negative impact on our financial condition and results of operations. Unfavorable economic indicators, such as high unemployment, depressed real estate prices and higher than normal levels of loan defaults, demonstrate the difficult business conditions that are affecting the general economy and therefore our operating results. The unemployment rates in our primary market area continue to be higher than state and national averages.

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") into law. This legislation made extensive changes to the laws regulating financial products and

services as well as firms and companies offering financial products and services. The Dodd-Frank Act also altered certain corporate governance matters affecting public companies. The legislation requires substantial rulemaking and mandates numerous additional studies, the results of which could impact future legislative and regulatory action. We continue to evaluate this legislation including its related rules and regulations, and we continue to assess the extent to which it will impact our current and future operations.

While we are unable to determine all ramifications of the Dodd-Frank Act at this time, we expect that many of the requirements called for in the Dodd-Frank Act will be implemented over time, and most will be subject to implementing regulations over the course of several years. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank Act will be implemented by the various regulatory agencies, the full extent of the impact of such requirements will have on financial institutions' operations is unclear. The changes resulting from the Dodd-Frank Act may impact the profitability of our business activities, require changes to certain of our business practices, impose upon us more stringent capital, liquidity and leverage ratio requirements or otherwise adversely affect our business. These changes may also require us to invest significant management attention and resources to evaluate and make necessary changes in order to comply with new statutory and regulatory requirements.

Although we are unable to control the external factors that influence our business, by maintaining high levels of balance sheet liquidity, managing our interest rate exposures and by actively monitoring asset quality, we seek to minimize the potentially adverse risks of unforeseen and unfavorable economic trends.

Our business emphasis has been to operate as a well-capitalized, profitable and independent community-oriented financial institution dedicated to providing quality customer service. We are committed to meeting the financial needs of the communities in which we operate. We believe that we can be more effective in servicing our customers than many of our non-local competitors because of our ability to quickly and effectively provide senior management responses to customer needs and inquiries. While we continue to focus our resources in and around our current footprint, we do consider other avenues of growth that would add shareholder value. While we were an unsuccessful bidder in an FDIC assisted transaction, we will consider other opportunities as they become available.

The Federal Reserve has maintained the Federal Funds Rate at 0.25% since December 2008. This historically low rate has had a negative impact on earnings and will continue to have a negative impact on our net interest income in future periods. The negative impact of low interest rates has been partially offset by earnings realized on interest rate contracts utilized by the Bank. Additional information regarding the Bank's interest rate contacts is provided below in the section entitled "Asset Liability and Interest Rate Risk Management."

On December 23, 2008, the Company entered into a Securities Purchase Agreement ("Purchase Agreement") with the UST pursuant to the CPP under the TARP. Under the Purchase Agreement, the Company agreed to issue and sell 25,054 shares of Series A preferred stock and a Warrant to purchase 357,234 shares of the Company's common stock. Proceeds from this issuance of Series A preferred shares were allocated between preferred stock and the Warrant based on their relative fair values at the time of the sale. Of the $25.1 million in proceeds, $24.4 million was allocated to the Series A preferred stock and $704,000 was allocated to the Warrant. The discount recorded on the Series A preferred stock that resulted from allocating a portion of the proceeds to the Warrant was being accreted directly to retained earnings over a five-year period applying a level yield.

The Series A preferred stock qualifies as Tier 1 capital and will pay cumulative dividends at a rate of 5% per annum for the first five years (i.e., through December 23, 2013) and 9% per annum thereafter. The Series A preferred stock may be redeemed at the stated amount of $1,000 per share plus any accrued and unpaid dividends. Under the terms of the original Purchase Agreement, the Company could not redeem the Series A preferred shares until December 23, 2011 unless the total amount of the issuance, $25.1 million, was replaced with the same amount of other forms of capital that would qualify as Tier 1 capital. However, with the enactment of the American Recovery and Reinvestment Act of 2009 ("ARRA"), the Company can now redeem the Series A preferred shares at any time, if approved by the Company's primary regulator. The Series A preferred stock is non-voting except for class voting rights on matters that would adversely affect the rights of the holders of the Series A preferred stock.

The UST sold all of its Series A preferred stock in a public auction in June 2012, and, as a result, the Company is no longer subject to the executive compensation and corporate governance standards imposed by TARP. The Company purchased 12,530 shares of the 25,054 outstanding shares of Series A preferred stock from the UST. The shares were purchased for $933.36 per share, for a total purchase price of $11,778,576, including $83,575 accrued and unpaid dividends on the Series A preferred stock. The Company retired the 12,530 shares purchased. The $834,999 difference between the $12,530,000 face value of the Series A preferred stock retired and the $11,695,001 purchase price of the Series A preferred stock retired was credited to retained earnings effective June 30, 2012. Remaining Series A preferred shares are redeemable at any time at par. The Company expects to be able to repurchase the shares from future earnings; however, there are no immediate plans to repurchase these shares.

During the third quarter of 2012, the Company completed its repurchase of the Warrant to purchase 357,234 shares of the Company's common stock. The Company repurchased the Warrant for a total price of $425,000. The exercise

price of the Warrant was $10.52 per common share and was exercisable at anytime on or before December 18, 2018. The Company is no longer accreting the discount associated with the Warrant, as the discount remaining at the time of repurchase was included in the cost of the Warrant. As of September 30, 2013, the Company had accreted a total of $478,000 of the discount related to the Series A preferred stock.

Summary of Significant Accounting Policies

The Company's accounting policies are fundamental to understanding management's discussion and analysis of results of operations and financial condition. Many of the Company's accounting policies require significant judgment regarding valuation of assets and liabilities and/or significant interpretation of specific accounting guidance. A more complete description of the Company's significant accounting policies can be found in Note 1 of the Notes to Consolidated Financial Statements in the Company's 2012 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 2, 2013 Annual Meeting of Shareholders.

Many of the Company's assets and liabilities are recorded using various techniques that require significant judgment as to recoverability. The collectibility of loans is reflected through the Company's estimate of the allowance for loan losses. The Company performs periodic and systematic detailed reviews of its lending portfolio to assess overall collectibility. In addition, certain assets and liabilities are reflected at their estimated fair value in the consolidated financial statements. Such amounts are based on either quoted market prices or estimated values derived from dealer quotes used by the Company, market comparisons or internally generated modeling techniques. The Company's internal models generally involve present value of cash flow techniques. The various techniques are discussed in greater detail elsewhere in this management's discussion and analysis and the Notes to the Consolidated Financial Statements.

There are other complex accounting standards that require the Company to employ significant judgment in interpreting and applying certain of the principles prescribed by those standards. These judgments include, but are not limited to, the determination of whether a financial instrument or other contract meets the definition of a derivative in accordance with GAAP.

The disclosure requirements for derivatives and hedging activities have the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The disclosure requirements include qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

The Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts that are intended to economically hedge certain of its risks, even though hedge accounting does not apply or the Company elects not to apply hedge accounting.

The Company has an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. By using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair-value gain in the derivative. The Company minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties that are reviewed periodically by the Company. The Company had an interest rate swap contract that expired in June 2011. The Company did not have any interest rate derivatives outstanding as of September 30, 2013.

The Company's objectives in using interest rate derivatives are to add stability to interest income and expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps and floors as part of its interest rate risk management strategy. For hedges of the Company's variable-rate loan assets, interest rate swaps designated as cash flow hedges involve the receipt of fixed-rate amounts from a counterparty in exchange for the Company making variable-rate payments over the life of the agreements without

exchange of the underlying notional amount. For hedges of the Company's variable-rate loan assets, the interest rate floor designated as a cash flow hedge involves the receipt of variable-rate amounts from a counterparty if interest rates fall below the strike rate on the contract in exchange for an up front premium.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in "Accumulated Other Comprehensive Income" and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings.

GAAP establishes a framework for measuring fair value and expands disclosures about fair value measurements. There is a three-level fair value hierarchy for fair value measurements. Level 1 inputs are quoted prices in active markets for identical assets or liabilities that a company has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. The table below presents the balance of securities available for sale, which are measured at fair value on a recurring basis by level within the fair value hierarchy as of September 30, 2013 and December 31, 2012.

(Dollars in thousands)

	September 30, 2013			
	Fair Value Measurements	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	$ 127,473	-	127,473	-
U.S. Government sponsored enterprises	$ 22,734	-	22,734	-
State and political subdivisions	$ 145,128	-	145,128	-
Corporate bonds	$ 3,487	-	3,487	-
Trust preferred securities	$ 1,250	-	-	1,250
Equity securities	$ 1,716	1,716	-	-

(Dollars in thousands)

	December 31, 2012			
	Fair Value Measurements	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	$ 148,024	-	148,024	-
U.S. Government sponsored enterprises	$ 18,837	-	18,837	-
State and political subdivisions	$ 125,658	-	125,658	-
Corporate bonds	$ 2,586	-	2,586	-
Trust preferred securities	$ 1,250	-	-	1,250
Equity securities	$ 1,468	1,468	-	-

Fair values of investment securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges when available. If quoted prices are not available, fair value is determined using matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities.

The following is an analysis of fair value measurements of investment securities available for sale using Level 3, significant unobservable inputs, for the nine months ended September 30, 2013:

(Dollars in thousands)

	Investment Securities Available for Sale Level 3 Valuation
Balance, beginning of period	$ 1,250
Change in book value	-
Change in gain/(loss) realized and unrealized	-

Purchases/(sales)		-
Transfers in and/or (out) of Level 3		-
Balance, end of period	$	1,250
Change in unrealized gain/(loss) for assets still held in Level 3	$	-

The Bank's September 30, 2013 and December 31, 2012 fair value measurements for impaired loans and other real estate on a non-recurring basis are presented below. The fair value measurement process uses certified appraisals and other market-based information; however, in many cases, it also requires significant input based on management's knowledge of and judgment about current market conditions, specific issues relating to the collateral, and other matters. As a result, all fair value measurements for impaired loans and other real estate are considered Level 3.

(Dollars in thousands)

		Fair Value Measurements September 30, 2013	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for the Nine Months Ended September 30, 2013
Impaired loans	$	39,739	-	-	39,739	(2,521)
Other real estate	$	2,751	-	-	2,751	(284)

(Dollars in thousands)

		Fair Value Measurements December 31, 2012	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for the Year Ended December 31, 2012
Impaired loans	$	46,738	-	-	46,738	(6,875)
Other real estate	$	6,254	-	-	6,254	(1,136)

At each reporting period, the Bank determines which loans are impaired. Accordingly, the Bank's impaired loans are reported at their estimated fair value on a non-recurring basis. An allowance for each impaired loan that is collateral-dependent is calculated based on the fair value of its collateral. The fair value of the collateral is based on appraisals performed by REAS, a subsidiary of the Bank. REAS is staffed by certified appraisers that also perform appraisals for other companies. Factors, including the assumptions and techniques utilized by the appraiser, are considered by management. If the recorded investment in the impaired loan exceeds the measure of fair value of the collateral, a valuation allowance is recorded as a component of the allowance for loan losses. An allowance for each impaired loan that is non-collateral dependent is calculated based on the present value of projected cash flows. If the recorded investment in the impaired loan exceeds the present value of projected cash flows, a valuation allowance is recorded as a component of the allowance for loan losses. Impaired loans under $250,000 are not individually evaluated for impairment, with the exception of the Bank's TDR loans in the residential mortgage loan portfolio, which are individually evaluated for impairment. Accruing impaired loans were $27.1 million, $30.6 million and $38.7 million at September 30, 2013, December 31, 2012 and September 30, 2012, respectively. Interest income recognized on accruing impaired loans was $916,000, $1.4 million and $1.5 million for the nine months ended September 30, 2013, the nine months ended September 30, 2012 and the year ended December 31, 2012, respectively. Interest income recognized on accruing impaired loans was $337,000 and $543,000 for the three months ended September 30, 2013 and 2012, respectively. No interest income is recognized on non-accrual impaired loans subsequent to their classification as non-accrual.

Results of Operations

Summary. Net earnings for the third quarter of 2013 were $1.9 million or $0.34 basic and diluted net earnings per share for the three months ended September 30, 2013, before adjustment for preferred stock dividends and accretion, as compared to $1.4 million or $0.25 basic and diluted net earnings per share, before adjustment for preferred stock dividends and accretion, for the same period one year ago. After adjusting for dividends and accretion on preferred stock, net earnings available to common shareholders were $1.8 million or $0.31 basic and diluted net earnings per common share for the three months ended September 30, 2013, as compared to $1.3 million or $0.23 basic and diluted net earnings per common share, for the same period one year ago. The increase in third quarter earnings is attributable to a decrease in the provision for loan losses, a decrease in non-interest expense, an increase in non-interest income and an increase in net interest income.

The annualized return on average assets was 0.74% for the three months ended September 30, 2013 compared to 0.55% for the same period one year ago, and annualized return on average shareholders' equity was 8.02% for the three months ended September 30, 2013 compared to 5.80% for the same period one year ago.

Year-to-date net earnings as of September 30, 2013 were $5.3 million, or $0.95 basic net earnings per share and $0.94 diluted net earnings per share, before adjustment for preferred stock dividends and accretion, as compared to $4.6 million, or $0.83 basic and diluted net earnings per share, before adjustment for preferred stock dividends and accretion, for the same period one year ago. After adjusting for dividends and accretion on preferred stock, net earnings available to common shareholders for the nine months ended September 30, 2013 were $4.8 million, or $0.86 basic and diluted net earnings per common share, as compared to $3.7 million, or $0.67 basic and diluted net earnings per common share, for the same period one year ago. The increase in year-to-date earnings is primarily attributable to a decrease in the provision for loan losses, which was partially offset by an aggregate decrease in net interest income and an aggregate increase in non-interest expense, as discussed below.

The annualized return on average assets was 0.70% for the nine months ended September 30, 2013 compared to 0.59% for the same period one year ago, and annualized return on average shareholders' equity was 7.11% for the nine months ended September 30, 2013 compared to 5.86% for the same period one year ago.

Net Interest Income. Net interest income, the major component of the Company's net earnings, was $7.9 million for the three months ended September 30, 2013 compared to $7.8 million for the same period one year ago. This increase was primarily due to a decrease in interest expense due to a reduction in the cost of funds and a reduction in interest-bearing liabilities, which were partially offset by a decrease in interest income resulting from a decrease in loans and a decrease in the yield on earning assets.

Interest income decreased $467,000 or 5% for the three months ended September 30, 2013 compared to the same period one year ago. The decrease was due to a reduction in average loans and a decrease in the yield on earning assets. The average yield on earning assets for the quarters ended September 30, 2013 and 2012 was 4.08% and 4.22%, respectively. During the quarter ended September 30, 2013, average loans decreased $26.7 million to $612.7 million from $639.4 million for the three months ended September 30, 2012.

Interest expense decreased $557,000 or 30% for the three months ended September 30, 2013 compared with the same period one year ago due to lower cost of funds and a reduction in certificates of deposit. The average rate paid on interest-bearing checking and savings accounts was 0.17% for the three months ended September 30, 2013 as compared to 0.31% for the same period one year ago. The average rate paid on certificates of deposits was 0.69% for the three months ended September 30, 2013 compared to 1.09% for the same period one year ago. During the quarter ended September 30, 2013, average certificates of deposit decreased $42.1 million to $227.3 million from $269.4 million for the three months ended September 30, 2012.

The following table sets forth for each category of interest-earning assets and interest-bearing liabilities, the average amounts outstanding, the interest incurred on such amounts and the average rate earned or incurred for the three months ended September 30, 2013 and 2012. The table also sets forth the average rate earned on total interest-earning assets, the average rate paid on total interest-bearing liabilities, and the net yield on total average interest-earning assets for the same periods. Yield information does not give effect to changes in fair value that are reflected as a component of shareholders' equity. Yields and interest income on tax-exempt investments have been adjusted to tax equivalent basis using an effective tax rate of 38.55% for securities that are both federal and state tax exempt, an effective tax rate of 31.65% for federal tax exempt securities and an effective tax rate of 6.90% for state tax exempt securities. Non-accrual loans and the interest income that was recorded on these loans, if any, are included in the yield calculations for loans in all periods reported.

	Three months ended September 30, 2013			Three months ended September 30, 2012		
(Dollars in thousands)	Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate
Interest-earning assets:						
Loans receivable	$ 612,716	7,592	4.92%	639,402	8,170	5.08%
Investments - taxable	134,447	296	0.87%	175,697	575	1.30%
Investments - nontaxable*	168,324	1,863	4.39%	109,459	1,320	4.80%
Other	35,641	22	0.24%	25,978	15	0.23%
Total interest-earning assets	951,128	9,773	4.08%	950,536	10,080	4.22%
Cash and due from banks	43,281			25,485		
Other assets	47,582			55,224		
Allowance for loan losses	(13,868)			(16,911)		
Total assets	$ 1,028,123			1,014,334		
Interest-bearing liabilities:						
NOW, MMDA & savings deposits	$ 380,564	160	0.17%	348,680	274	0.31%
Time deposits	227,276	396	0.69%	269,369	737	1.09%
FHLB borrowings	70,000	618	3.50%	70,000	689	3.92%
Trust preferred securities	20,619	100	1.93%	20,619	110	2.12%
Other	46,270	11	0.09%	49,320	32	0.26%
Total interest-bearing liabilities	744,729	1,285	0.68%	757,988	1,842	0.97%
Demand deposits	184,151			154,434		
Other liabilities	5,234			5,427		
Shareholders' equity	94,902			96,940		
Total liabilities and shareholder's equity	$ 1,029,016					