

AUBURN NATIONAL BANCORPORATION INC

Form 10-Q

May 16, 2011

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the quarterly period ended March 31, 2011

Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.
For the transition period _____ to _____

Commission File Number: 0-26486

Auburn National Bancorporation, Inc.

(Exact Name of Registrant as Specified in Its Charter)

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Delaware
(State or other jurisdiction of
incorporation or organization)

63-0885779
(I.R.S. Employer
Identification No.)

100 N. Gay Street
Auburn, Alabama 36830
(334) 821-9200

(Address and telephone number of principal executive offices)

(Former Name, Former Address and Former Fiscal Year, if Changed Since Last Report)

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 No

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

Yes No

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

Large Accelerated filer Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at April 30, 2011
Common Stock, \$0.01 par value per share	3,642,738 shares

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

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Table of Contents**PART 1. FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS****AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES****Condensed Consolidated Balance Sheets****(Unaudited)**

(Dollars in thousands, except share data)

	March 31, 2011	December 31, 2010
Assets:		
Cash and due from banks	\$ 14,690	\$ 11,432
Federal funds sold	21,250	7,500
Interest bearing bank deposits	3,403	2,492
Cash and cash equivalents	39,343	21,424
Securities available-for-sale	321,098	315,220
Loans held for sale	1,256	4,281
Loans, net of unearned income	368,909	374,215
Allowance for loan losses	(7,855)	(7,676)
Loans, net	361,054	366,539
Premises and equipment, net	8,032	8,105
Bank-owned life insurance	16,278	16,171
Other real estate	8,450	8,125
Other assets	26,046	23,964
Total assets	\$ 781,557	\$ 763,829
Liabilities:		
Deposits:		
Noninterest-bearing	\$ 94,849	\$ 87,660
Interest-bearing	536,545	519,467
Total deposits	631,394	607,127
Federal funds purchased and securities sold under agreements to repurchase	2,221	2,685
Long-term debt	85,327	93,331
Accrued expenses and other liabilities	4,814	4,318
Total liabilities	723,756	707,461
Stockholders equity:		
Preferred stock of \$.01 par value; authorized 200,000 shares; no issued shares		
Common stock of \$.01 par value; authorized 8,500,000 shares; issued 3,957,135 shares	39	39
Additional paid-in capital	3,753	3,752
Retained earnings	62,242	61,421

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Accumulated other comprehensive loss, net	(1,590)	(2,201)
Less treasury stock, at cost - 314,397 shares and 314,417 shares for March 31, 2011 and December 31, 2010, respectively	(6,643)	(6,643)
Total stockholders' equity	57,801	56,368
Total liabilities and stockholders' equity	\$ 781,557	\$ 763,829

See accompanying notes to condensed consolidated financial statements

Table of Contents**AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES****Condensed Consolidated Statements of Earnings****(Unaudited)**

	Quarter ended March 31,	
	2011	2010
<i>(Dollars in thousands, except share and per share data)</i>		
Interest income:		
Loans, including fees	\$ 5,287	\$ 5,433
Securities	2,538	3,219
Federal funds sold and interest bearing bank deposits	9	7
Total interest income	7,834	8,659
Interest expense:		
Deposits	2,170	2,640
Short-term borrowings	3	11
Long-term debt	847	1,177
Total interest expense	3,020	3,828
Net interest income	4,814	4,831
Provision for loan losses	600	1,450
Net interest income after provision for loan losses	4,214	3,381
Noninterest income:		
Service charges on deposit accounts	291	314
Mortgage lending	440	482
Bank-owned life insurance	107	126
Other	353	324
Securities (losses) gains, net:		
Realized gains, net	5	1,100
Total other-than-temporary-impairments	(261)	(240)
Non-credit portion of other-than-temporary impairments recognized in other comprehensive income	210	190
Total securities (losses) gains, net	(46)	1,050
Total noninterest income	1,145	2,296
Noninterest expense:		
Salaries and benefits	1,986	1,905
Net occupancy and equipment	346	384
Professional fees	171	176
FDIC and other regulatory assessments	282	276
Other real estate owned, net	(17)	61
Other	882	834
Total noninterest expense	3,650	3,636
Earnings before income taxes	1,709	2,041

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Income tax expense		160	424
Net earnings	\$	1,549	\$ 1,617
Net earnings per share:			
Basic and diluted	\$	0.43	\$ 0.44
Weighted average shares outstanding:			
Basic and diluted		3,642,728	3,643,116

See accompanying notes to condensed consolidated financial statements

Table of Contents**AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES****Condensed Consolidated Statements of Stockholders Equity and Comprehensive Income****(Unaudited)**

	Common Stock		Additional paid-in capital	Retained earnings	Accumulated other comprehensive income (loss)	Treasury stock	Total
	Shares	Amount					
<i>(Dollars in thousands, except share data)</i>							
Balance, December 31, 2009	3,957,135	\$ 39	\$ 3,751	\$ 58,917	\$ 111	\$ (6,635)	\$ 56,183
Comprehensive income:							
Net earnings				1,617			1,617
Other comprehensive loss due to change in other-than-temporary impairment losses related to factors other than credit on available-for- sale, net					(120)		(120)
Other comprehensive income due to change in all other unrealized gains (losses) on securities available-for- sale, net					809		809
Total comprehensive income				1,617	689		2,306
Cash dividends paid (\$0.195 per share)				(711)			(711)
Balance, March 31, 2010	3,957,135	\$ 39	\$ 3,751	\$ 59,823	\$ 800	\$ (6,635)	\$ 57,778
Balance, December 31, 2010	3,957,135	\$ 39	\$ 3,752	\$ 61,421	\$ (2,201)	\$ (6,643)	\$ 56,368
Comprehensive income:							
Net earnings				1,549			1,549
Other comprehensive loss due to change in other-than-temporary impairment losses related to factors other than credit on available-for- sale, net					(133)		(133)
Other comprehensive income due to change in all other unrealized gains (losses) on securities available-for- sale, net					744		744
Total comprehensive income				1,549	611		2,160
Cash dividends paid (\$0.20 per share)				(728)			(728)
Sale of treasury stock (20 shares)				1			1
Balance, March 31, 2011	3,957,135	\$ 39	\$ 3,753	\$ 62,242	\$ (1,590)	\$ (6,643)	\$ 57,801

See accompanying notes to condensed consolidated financial statements

Table of Contents**AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES****Condensed Consolidated Statements of Cash Flows****(Unaudited)**

<i>(In thousands)</i>	Quarter ended March 31,	
	2011	2010
Cash flows from operating activities:		
Net earnings	\$ 1,549	\$ 1,617
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Provision for loan losses	600	1,450
Depreciation and amortization	154	133
Premium amortization and discount accretion, net	636	442
Net loss (gain) on securities	46	(1,050)
Net gain on sale of loans held for sale	(344)	(392)
Net loss (gain) on other real estate	17	(37)
Loans originated for sale	(11,417)	(15,460)
Proceeds from sale of loans	14,748	16,707
Increase in cash surrender value of bank owned life insurance	(107)	(126)
Net increase in other assets	(2,475)	(1,064)
Net increase in accrued expenses and other liabilities	496	725
 Net cash provided by operating activities	 3,903	 2,945
Cash flows from investing activities:		
Proceeds from sales of securities available-for-sale	6,706	59,994
Proceeds from maturities of securities available-for-sale	11,777	47,840
Purchase of securities available-for-sale	(24,073)	(105,033)
Net decrease (increase) in loans	4,065	(6,102)
Net purchases of premises and equipment	(9)	(24)
Proceeds from sale of other real estate	478	435
 Net cash used in investing activities	 (1,056)	 (2,890)
Cash flows from financing activities:		
Net increase in noninterest-bearing deposits	7,189	5,952
Net increase in interest-bearing deposits	17,078	23,227
Net decrease in federal funds purchased and securities sold under agreements to repurchase	(464)	(13,553)
Repayments or retirement of long-term debt	(8,004)	(4)
Proceeds from sale of treasury stock	1	
Dividends paid	(728)	(711)
 Net cash provided by financing activities	 15,072	 14,911
 Net change in cash and cash equivalents	 17,919	 14,966
Cash and cash equivalents at beginning of period	21,424	12,395
 Cash and cash equivalents at end of period	 \$ 39,343	 \$ 27,361

Supplemental disclosures of cash flow information:

Cash paid during the period for:

Interest	\$ 3,188	\$ 4,048
Income taxes	332	120

Supplemental disclosure of non-cash transactions:

Real estate acquired through foreclosure	820	187
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See accompanying notes to condensed consolidated financial statements

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Notes to Condensed Consolidated Financial Statements

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

General

Auburn National Bancorporation, Inc. (the Company) provides a full range of banking services to individual and corporate customers in Lee County, Alabama and surrounding counties through its wholly owned subsidiary, AuburnBank (the Bank). The Company does not have any segments other than banking that are considered material.

Basis of Presentation and Use of Estimates

The unaudited condensed consolidated financial statements in this report have been prepared in accordance with U.S. generally accepted accounting principles for interim financial information. Accordingly, these financial statements do not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. The unaudited condensed consolidated financial statements include, in the opinion of management, all adjustments necessary to present a fair statement of the financial position and the results of operations for all periods presented. All such adjustments are of a normal recurring nature. The results of operations as of and for the quarter ended March 31, 2011 are not necessarily indicative of the results of operations that the Company and its subsidiaries may achieve for future interim periods or the entire year. For further information, refer to the consolidated financial statements and footnotes included in the Company's annual report on Form 10-K for the year ended December 31, 2010.

Subsequent Events

The Company has evaluated the effects of events or transactions through the date of this filing that have occurred subsequent to March 31, 2011. The Company does not believe there are any material subsequent events that would require further recognition or disclosure.

Accounting Developments

In the first quarter of 2011, the Company adopted new guidance related to the following Codification topic:

Accounting Standards Update (ASU) 2010-06, *Improving Disclosures about Fair Value Measurements*. Information about this pronouncement is described in more detail below.

ASU 2010-06, *Improving Disclosures about Fair Value Measurements*, amends the disclosure requirements for fair value measurements. Companies are required to disclose significant transfers in and out of Levels 1 and 2 of the fair value hierarchy. The ASU also clarifies that fair value measurement disclosures should be presented for each asset and liability class, which is generally a subset of a line item in the statement of financial position. In the rollforward of Level 3 activity, companies must present information on purchases, sales, issuances, and settlements on a gross basis rather than on a net basis. Companies should also provide information about the valuation techniques and inputs used to measure fair value for both recurring and nonrecurring instruments classified as either Level 2 or Level 3. In the first quarter of 2011, the Company adopted the requirement for gross presentation in the Level 3 rollforward with prospective application. The remaining provisions were effective for the Company in the first quarter of 2010. Adoption of the ASU did not have a significant impact on the consolidated financial statements of the Company since it amends only the disclosure requirements for fair value measurements.

Table of Contents**NOTE 2: BASIC AND DILUTED EARNINGS PER SHARE**

Basic net earnings per share is computed by dividing net earnings by the weighted average common shares outstanding for the quarters ended March 31, 2011 and 2010, respectively. Diluted net earnings per share reflect the potential dilution that could occur if the Company's potential common stock was issued. At March 31, 2011 and 2010, respectively, the Company had no options issued or outstanding, and therefore, no dilutive effect to consider for the diluted earnings per share calculation.

A reconciliation of the numerator and denominator of the basic and diluted earnings per share computation for the quarter ended March 31, 2011 and 2010 is presented below.

<i>(Dollars in thousands, except share and per share data)</i>	Quarter ended March 31,	
	2011	2010
Basic and diluted:		
Net earnings	\$ 1,549	\$ 1,617
Weighted average common shares outstanding	3,642,728	3,643,116
Earnings per share	\$ 0.43	\$ 0.44

NOTE 3: COMPREHENSIVE INCOME

Comprehensive income is defined as the change in equity from all transactions other than those with shareholders, and it includes net earnings and other comprehensive income (loss). Comprehensive income for the quarter ended March 31, 2011 and 2010 is presented below.

<i>(In thousands)</i>	Quarter ended March 31,	
	2011	2010
Comprehensive income:		
Net earnings	\$ 1,549	\$ 1,617
Other comprehensive income (loss):		
Due to change in other-than-temporary impairment losses related to factors other than credit on securities available-for-sale, net of tax	(133)	(120)
Due to change in all other unrealized gains (losses) on securities available-for-sale, net of tax	744	809
Total comprehensive income	\$ 2,160	\$ 2,306

NOTE 4: VARIABLE INTEREST ENTITIES

The Company is involved in various entities that are considered to be VIEs, as defined by authoritative accounting literature. Generally, a VIE is a corporation, partnership, trust or other legal structure that does not have equity investors with substantive or proportional voting rights or has equity investors that do not provide sufficient financial resources for the entity to support its activities.

At March 31, 2011, the Company did not have any consolidated VIEs to disclose but did have certain nonconsolidated VIEs, discussed below.

Trust Preferred Securities

The Company owns the common stock of a subsidiary business trust, Auburn National Bancorporation Capital Trust I, which issued mandatorily redeemable preferred capital securities (trust preferred securities) in the aggregate of approximately \$7.0 million at the time of issuance. This trust meets the definition of a VIE of which the Company is not the primary beneficiary; the trust's only assets are junior subordinated debentures issued by the Company, which were acquired by the trust using the proceeds from the issuance of the trust preferred securities and common stock. The junior subordinated debentures of approximately \$7.2 million are included in long-term debt and the Company's equity interest in the business trust is included in other assets. Interest expense on the junior subordinated debentures is reported in interest expense on long-term debt. For regulatory reporting and capital adequacy purposes, the Federal Reserve Board has indicated that such trust preferred securities will continue to constitute Tier 1 Capital until further notice.

Table of Contents**Affordable Housing Investments**

Periodically, the Company may invest in various limited partnerships that sponsor affordable housing projects in its primary markets and surrounding areas as a means of supporting local communities. These investments are designed to generate a return primarily through the realization of federal tax credits. These projects are funded through a combination of debt and equity and the partnerships meet the definition of a VIE. While the Company's investment as a limited partner in a single entity may at times exceed 50% of the outstanding equity interests, the Company does not consolidate the partnerships due to the nature of the management activities of the general partner and the performance guaranties provided by the project sponsors. The Company typically provides financing during the construction and development of the properties; however, permanent financing is generally obtained from independent parties upon completion of a project.

At March 31, 2011 and December 31, 2010, the Company had limited partnership investments of \$5.9 million and \$3.4 million, respectively, related to these projects, which are included in other assets on the Consolidated Balance Sheets. At March 31, 2011 and December 31, 2010, the Company had unfunded commitments related to affordable housing investments of \$2.5 million and \$1.9 million, respectively, included in accrued expenses and other liabilities on the Consolidated Balance Sheets.

Additionally, the Company had outstanding loan commitments with certain of the partnerships totaling \$11.4 million at March 31, 2011 and December 31, 2010, respectively. The funded portion of these loans was approximately \$7.6 and \$8.9 million at March 31, 2011 and December 31, 2010, respectively. The funded portions of these loans are included in loans, net of unearned income on the Consolidated Balance Sheets.

The following table summarizes VIEs that are not consolidated by the Company as of March 31, 2011.

<i>(Dollars in thousands)</i>	Maximum Loss Exposure	Liability Recognized	Classification
Type:			
Affordable housing investments (a)	\$ 5,877	2,507	Other assets
Trust preferred issuances	N/A	7,217	Long-term debt

- (a) Maximum loss exposure represents the Company's current investment of \$5.9 million included in other assets. The current investment of \$5.9 million includes \$2.5 million of unfunded commitments related to affordable housing investments included in accrued expenses and other liabilities.

Table of Contents**NOTE 5: SECURITIES**

At March 31, 2011 and December 31, 2010, respectively, all securities within the scope of FASB ASC 320, *Investments – Debt and Equity Securities* were classified as available-for-sale. The fair value and amortized cost for securities available-for-sale by contractual maturity at March 31, 2011 and December 31, 2010, respectively, are presented below.

	March 31, 2011							
	1 year or less	1 to 5 years	5 to 10 years	After 10 years	Fair Value	Gross Unrealized Gains	Unrealized Losses	Amortized Cost
<i>(Dollars in thousands)</i>								
Available-for-sale:								
Agency obligations (a)	\$		48,561	49,423	97,983	99	1,312	99,196
Agency RMBS (a)			9,128	129,283	138,411	1,382	1,750	138,779
State and political subdivisions	20	935	12,321	69,195	82,471	778	1,490	83,183
Trust preferred securities:								
Pooled				20	20		210	230
Individual issuer				2,213	2,213	129	146	2,230
Total available-for-sale	\$ 20	935	70,010	250,134	321,098	2,388	4,908	323,618

(a) Includes securities issued by U.S. government agencies or government sponsored entities.

	December 31, 2010							
	1 year or less	1 to 5 years	5 to 10 years	After 10 years	Fair Value	Gross Unrealized Gains	Unrealized Losses	Amortized Cost
<i>(Dollars in thousands)</i>								
Available-for-sale:								
Agency obligations (a)	\$		37,821	52,650	90,471	95	1,017	91,393
Agency RMBS (a)			9,976	133,168	143,144	1,566	1,441	143,019
State and political subdivisions	21	856	13,547	62,342	76,766	472	2,801	79,095
Trust preferred securities:								
Pooled				20	20		210	230
Individual issuer				2,129	2,129		153	2,282
Corporate debt		2,690			2,690			2,690
Total available-for-sale	\$ 21	3,546	61,344	250,309	315,220	2,133	5,622	318,709

(a) Includes securities issued by U.S. government agencies or government sponsored entities.

Securities with aggregate fair values of \$198.7 million and \$171.1 million at March 31, 2011 and December 31, 2010, respectively, were pledged to secure public deposits, securities sold under agreements to repurchase, Federal Home Loan Bank (FHLB) advances, and for other purposes required or permitted by law.

Included in other assets on the Consolidated Balance Sheets are cost-method investments. The carrying amounts of cost-method investments were \$5.8 million at March 31, 2011 and December 31, 2010, respectively. Cost-method investments primarily include non-marketable equity investments, such as FHLB of Atlanta stock and Federal Reserve Bank (FRB) stock.

Table of Contents**Gross Unrealized Losses and Fair Value**

The fair values and gross unrealized losses on securities at March 31, 2011 and December 31, 2010, respectively, segregated by those securities that have been in an unrealized loss position for less than twelve months and twelve months or more are presented below.

	Less than 12 Months		12 Months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
<i>(Dollars in thousands)</i>						
March 31, 2011						
Agency obligations	\$ 58,813	\$ 1,312	\$	\$	\$ 58,813	\$ 1,312
Agency RMBS	99,805	1,750			99,805	1,750
State and political subdivisions	35,201	1,151	3,815	339	39,016	1,490
Trust preferred securities:						
Pooled			20	210	20	210
Individual issuer			854	146	854	146
Total	\$ 193,819	\$ 4,213	\$ 4,689	\$ 695	\$ 198,508	\$ 4,908
December 31, 2010						
Agency obligations	\$ 45,351	\$ 1,017	\$	\$	\$ 45,351	1,017
Agency RMBS	89,840	1,441			89,840	1,441
State and political subdivisions	49,176	2,323	3,207	478	52,383	2,801
Trust preferred securities:						
Pooled			20	210	20	210
Individual issuer			847	153	847	153
Total	\$ 184,367	\$ 4,781	\$ 4,074	\$ 841	\$ 188,441	5,622

The applicable date for determining when securities are in an unrealized loss position is March 31, 2011. As such, it is possible that a security had a market value that exceeded its amortized cost on other days during the past twelve-month period.

For the securities in the previous table, the Company does not have the intent to sell and has determined it is not more likely than not that the Company will be required to sell the security before recovery of the amortized cost basis, which may be maturity. The Company has assessed each security for credit impairment. For debt securities, the Company evaluates, where necessary, whether credit impairment exists by comparing the present value of the expected cash flows to the securities' amortized cost basis. For cost-method investments, the Company evaluates whether an event or change in circumstances has occurred during the reporting period that may have a significant adverse effect on the fair value of the investment.

In determining whether a loss is temporary, the Company considers all relevant information including:

the length of time and the extent to which the fair value has been less than the amortized cost basis;

adverse conditions specifically related to the security, an industry, or a geographic area (for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, in the financial condition of the underlying loan obligors, including changes in technology or the discontinuance of a segment of the business that may affect the future earnings potential of the issuer or underlying loan obligors of the security or changes in the quality of the credit enhancement);

the historical and implied volatility of the fair value of the security;

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the payment structure of the debt security and the likelihood of the issuer being able to make payments that increase in the future;

failure of the issuer of the security to make scheduled interest or principal payments;

any changes to the rating of the security by a rating agency; and

recoveries or additional declines in fair value subsequent to the balance sheet date.

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To the extent the Company estimates future expected cash flows, the Company considered all available information in developing those expected cash flows. For asset-backed securities such as pooled trust preferred securities, such information generally included:

remaining payment terms of the security (including as applicable, terms that require underlying obligor payments to increase in the future);

current delinquencies and nonperforming assets of underlying collateral;

expected future default rates; and

subordination levels or other credit enhancements.

Agency obligations

The unrealized losses associated with agency obligations are primarily driven by changes in interest rates and not due to the credit quality of the securities. These securities are issued by U.S. government agencies or government-sponsored entities and do not have any credit losses given the explicit or implicit government guarantee.

Agency residential mortgage-backed securities (RMBS)

The unrealized losses associated with Agency RMBS are primarily driven by changes in interest rates and not due to the credit quality of the securities. These securities are issued by U.S. government agencies or government-sponsored entities and do not have any credit losses given the explicit or implicit government guarantee.

Securities of U.S. states and political subdivisions

The unrealized losses associated with securities of U.S. states and political subdivisions are primarily driven by changes in interest rates and are not due to the credit quality of the securities. These securities will continue to be monitored as part of the Company's quarterly impairment analysis, but are expected to perform even if the rating agencies reduce the credit rating of the bond insurers. As a result, the Company expects to recover the entire amortized cost basis of these securities.

Pooled trust preferred securities

The unrealized losses associated with pooled trust preferred securities are primarily driven by higher projected collateral losses and wider credit spreads. Pooled trust preferred securities primarily consist of securities issued by community banks and thrifts. The Company assesses impairment for these securities using a cash flow model. The key assumptions include default probabilities of the underlying collateral and recoveries on collateral defaults. Based upon the Company's assessment of the expected credit losses for these securities, and given the performance of the underlying collateral compared to the Company's credit enhancement, the Company expects to recover the remaining amortized cost basis of these securities.

Individual issuer trust preferred securities

The unrealized losses associated with individual issuer trust preferred securities are primarily related to securities backed by individual issuer community banks. For individual issuers, management evaluates the financial performance of the issuer on a quarterly basis to determine if it is probable that the issuer can make all contractual principal and interest payments. Based upon its evaluation, the Company expects to recover the remaining amortized cost basis of these securities.

Cost-method investments

At March 31, 2011, cost-method investments with an aggregate cost of \$5.8 million were not evaluated for impairment because the Company did not identify any events or changes in circumstances that may have a significant adverse effect on the fair value of these cost-method

investments.

The carrying values of the Company's investment securities could decline in the future if the underlying performance of the collateral for pooled trust preferred securities, the financial condition of individual issuers of trust preferred securities, or the credit quality of other securities deteriorate and the Company determines it is probable that it will not recover the entire amortized cost basis for the security. As a result, there is a risk that significant other-than-temporary impairment charges may occur in the future.

The following tables show the applicable credit ratings, fair values, gross unrealized losses, and life-to-date impairment charges for pooled and individual issuer trust preferred securities at March 31, 2011 and December 31, 2010, respectively, segregated by those securities that have been in an unrealized loss position for less than twelve months and twelve months or more.

Table of Contents**Trust Preferred Securities as of March 31, 2011**

	Credit Rating		Fair Value	Unrealized losses		Total	Life-to-date
				Less than 12 months	12 months or longer		Impairment
	Moody's	Fitch				Charges	
<i>(Dollars in thousands)</i>							
Pooled:							
ALESCO Preferred Funding XVII Ltd (a)	C	CC	\$ 20	\$	210	210	\$ 1,770
Individual issuers (b):							
Carolina Financial Capital Trust I	n/a	n/a	275				175
Main Street Bank Statutory Trust I (c)	n/a	n/a	440		60	60	
MNB Capital Trust I	n/a	n/a	138				362
PrimeSouth Capital Trust I	n/a	n/a	223				303
TCB Trust	n/a	n/a	414		86	86	
United Community Capital Trust	n/a	n/a	723				379
Total individual issuer			2,213		146	146	1,219
Total trust preferred securities			\$ 2,233	\$	356	356	\$ 2,989

n/a not applicable securities not rated.

- (a) Class B Deferrable Third Priority Secured Floating Rate Notes. The underlying collateral is primarily composed of trust preferred activities issued by community banks and thrifts.
- (b) 144A Floating Rate Capital Securities. Underlying issuer is a community bank holding company. Securities have no excess subordination or overcollateralization.
- (c) Now an obligation of BB&T Corporation.

Trust Preferred Securities as of December 31, 2010

	Credit Rating		Fair Value	Unrealized losses		Total	Life-to-date
				Less than 12 months	12 months or longer		Impairment
	Moody's	Fitch				Charges	
<i>(Dollars in thousands)</i>							
Pooled:							
ALESCO Preferred Funding XVII Ltd (a)	Ca	C	\$ 20	\$	210	210	\$ 1,770
Individual issuers (b):							
Carolina Financial Capital Trust I	n/a	n/a	312				138
Main Street Bank Statutory Trust I (c)	n/a	n/a	438		62	62	
MNB Capital Trust I	n/a	n/a	152				348
PrimeSouth Capital Trust I	n/a	n/a	197				303
TCB Trust	n/a	n/a	409		91	91	
United Community Capital Trust	n/a	n/a	621				379

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Total individual issuer	2,129	153	153	1,168
Total trust preferred securities	\$ 2,149	\$ 363	363	\$ 2,938

n/a - not applicable securities not rated.

- (a) Class B Deferrable Third Priority Secured Floating Rate Notes. The underlying collateral is primarily composed of trust preferred activities issued by community banks and thrifts.
- (b) 144A Floating Rate Capital Securities. Underlying issuer is a community bank holding company. Securities have no excess subordination or overcollateralization.

(c) Now an obligation of BB&T Corporation.

For pooled trust preferred securities, the Company estimated expected future cash flows of the security by estimating the expected future cash flows of the underlying collateral and applying those collateral cash flows, together with any credit enhancements such as subordination interests owned by third parties, to the security. The expected future cash flows of the underlying collateral are determined using the remaining contractual cash flows adjusted for future expected credit losses (which consider default probabilities derived from issuer credit ratings for the underlying collateral). The probability-weighted expected future cash flows of the security are then discounted at the interest rate used to recognize income on the security to arrive at a present value amount.

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Excess subordination is defined as the amount of performing collateral that is in excess of what is needed to pay-off a specified class of securities and all classes senior to the specified class. Performing collateral is defined as total collateral minus all collateral that is currently deferring or currently in default. This definition assumes that all collateral that is currently deferring will default with a zero recovery rate. The underlying issuers can cure the deferral, or some portion greater than zero could be recovered on default of an underlying issuer. Excess subordination, as defined previously, does not consider any excess interest spread that is built into the structure of the security, which provides another source of repayment for the bonds.

At March 31, 2011 and December 31, 2010, respectively, there was no excess subordination for the Class B notes of ALESCO Preferred Funding XVII, Ltd.

Other-Than-Temporarily Impaired Securities

On a quarterly basis, management makes an assessment to determine whether there have been events or economic circumstances to indicate that a security on which there is an unrealized loss is other-than-temporarily impaired. For equity securities with an unrealized loss, the Company considers many factors including the severity and duration of the impairment; the intent and ability of the Company to hold the security for a period of time sufficient for a recovery in value; and recent events specific to the issuer or industry. Equity securities on which there is an unrealized loss that is deemed to be other-than-temporary are written down to fair value with the write-down recorded as a realized loss in securities gains (losses), net.

For debt securities with an unrealized loss, an other-than-temporary impairment write-down is triggered when (1) the Company has the intent to sell a debt security, (2) it is more likely than not that the Company will be required to sell the debt security before recovery of its amortized cost basis, or (3) the Company does not expect to recover the entire amortized cost basis of the debt security. If the Company has the intent to sell a debt security or if it is more-likely-than-not that it will be required to sell the debt security before recovery, the other-than-temporary write-down is equal to the entire difference between the debt security's amortized cost and its fair value. If the Company does not intend to sell the security or it is not more likely than not that it will be required to sell the security before recovery, the other-than-temporary impairment write-down is separated into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings, as a realized loss in securities gains (losses), and is the difference between the security's amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security's fair value and the present value of future expected cash flows is due to factors that are not credit related and is recognized in other comprehensive income, net of applicable taxes.

The following table presents a roll-forward of the credit loss component of the amortized cost of debt securities that the Company has written down for other-than-temporary impairment and the credit component of the loss is recognized in earnings (referred to as credit-impaired debt securities). Other-than-temporary impairments recognized in earnings for the quarters ended March 31, 2011 and 2010 for credit-impaired debt securities are presented as additions in two components based upon whether the current year is the first time the debt security was credit-impaired (initial credit impairment) or is not the first time the debt security was credit-impaired (subsequent credit impairments). The credit loss component is reduced if the Company sells, intends to sell or believes it will be required to sell previously credit-impaired debt securities. Additionally, the credit loss component is reduced if the Company receives cash flows in excess of what it expected to receive over the remaining life of the credit-impaired debt security, the security matures or is fully written-down and deemed worthless. Changes in the credit loss component of credit-impaired debt securities were:

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<i>(Dollars in thousands)</i>	Quarter ended March 31,	
	2011	2010
Balance, beginning of period	\$ 2,938	\$ 4,570
Additions:		
Initial credit impairments		
Subsequent credit impairments	51	50
Reductions:		
Securities sold		
Due to change in intent or requirement to sell		
Securities fully written-down and deemed worthless		
Increases in expected cash flows		
Balance, end of period	\$ 2,989	\$ 4,620

Other-Than-Temporary-Impairment

The following table presents details of the other-than-temporary-impairment related to securities, including equity securities carried at cost, for the quarter ended March 31, 2011 and 2010.

<i>(Dollars in thousands)</i>	Quarter ended March 31,	
	2011	2010
Other-than-temporary impairment charges (included in earnings):		
Debt securities:		
Pooled trust preferred securities	\$	\$ 50
Individual issuer trust preferred securities	51	
Total debt securities	51	50
Total other-than-temporary impairment charges	\$ 51	\$ 50
Other-than-temporary impairment on debt securities:		
Recorded as part of gross realized losses:		
Credit-related	\$ 51	\$ 50
Recorded directly to other comprehensive income for non-credit related impairment	210	190
Total other-than-temporary impairment on debt securities	\$ 261	\$ 240

Realized Gains and Losses

The following table presents the gross realized gains and losses on securities, including cost-method investments. Realized losses include other-than-temporary impairment charges.

<i>(Dollars in thousands)</i>	Quarter ended March 31,	
	2011	2010
Gross realized gains	\$ 28	\$ 1,139
Gross realized losses	(74)	(89)
Realized losses (gains), net	\$ (46)	\$ 1,050

Table of Contents**NOTE 6: LOANS AND ALLOWANCE FOR LOAN LOSSES**

<i>(In thousands)</i>	March 31, 2011	December 31, 2010
Commercial and industrial	\$ 51,323	\$ 53,288
Construction and land development	48,814	47,850
Commercial real estate:		
Owner occupied	75,062	76,252
Other	86,820	89,989
Total commercial real estate	161,882	166,241
Residential real estate:		
Consumer mortgage	56,656	57,562
Investment property	39,341	38,679
Total residential real estate	95,997	96,241
Consumer installment	10,968	10,676
Total loans	368,984	374,296
Less: unearned income	(75)	(81)
Loans, net of unearned income	\$ 368,909	\$ 374,215

Loans secured by real estate were approximately 83.1% of the total loan portfolio at March 31, 2011. Due to declines in economic indicators and real estate values, loans secured by real estate may have a greater risk of non-collection than other loans. At March 31, 2011, the Company's geographic loan distribution was concentrated primarily in Lee County, Alabama and surrounding areas.

In accordance with ASC 310, a portfolio segment is defined as the level at which an entity develops and documents a systematic method for determining its allowance for loan losses. The Company's loan portfolio is disaggregated into the following portfolio segments: commercial and industrial, construction and land development, commercial real estate, residential real estate and consumer installment. The Company's loan portfolio segments were determined based on collateral type. Where appropriate, the Company's loan portfolio segments are further disaggregated into classes. A class is generally determined based on the initial measurement attribute, risk characteristics of the loan, and an entity's method for monitoring and determining credit risk.

The following describe the risk characteristics relevant to each of the portfolio segments.

Commercial and industrial (C&I) includes loans to finance business operations, equipment purchases, or other needs for small and medium-sized commercial customers. Also included in this category are loans to finance agricultural production. Generally the primary source of repayment is the cash flow from business operations and activities of the borrower.

Construction and land development (C&D) includes both loans and credit lines for the purpose of purchasing, carrying and developing land into commercial developments or residential subdivisions. Also included are loans and lines for construction of residential, multi-family and commercial buildings. Generally the primary source of repayment is dependent upon the sale or refinancing of the real estate collateral.

Commercial real estate (CRE) includes loans disaggregated into two classes: (1) owner occupied and (2) other.

Owner occupied includes loans secured by business facilities to finance business operations, equipment and owner-occupied facilities primarily for small and medium-sized commercial customers. Generally the primary source of repayment is the cash flow from business operations and activities of the borrower, who owns the property.

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Other primarily includes loans to finance income-producing commercial and multi-family properties. Loans in this class include loans for neighborhood retail centers, hotels, medical and professional offices, single retail stores, industrial buildings, warehouses and apartments leased generally to local businesses and residents. Generally the primary source of repayment is dependent upon income generated from the real estate collateral. The underwriting of these loans takes into consideration the occupancy and rental rates as well as the financial health of the borrower.

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Residential real estate (RRE) includes loans disaggregated into two classes: (1) consumer mortgage and (2) investment property.

Consumer mortgage primarily include first lien, or second lien mortgages and home equity lines to consumers that are secured by a primary residence or second home. These loans are underwritten in accordance with the Bank's general loan policies and procedures which require, among other things, proper documentation of each borrower's financial condition, satisfactory credit history and property value.

Investment property primarily includes loans to finance income-producing 1-4 family residential properties. Generally the primary source of repayment is dependent upon income generated from leasing the property securing the loan. The underwriting of these loans takes into consideration the rental rates as well as the financial health of the borrower.

Consumer installment includes loans to individuals both secured by personal property and unsecured. Loans include personal lines of credit, automobile loans, and other retail loans. These loans are underwritten in accordance with the Bank's general loan policies and procedures which require, among other things, proper documentation of each borrower's financial condition, satisfactory credit history, and if applicable, property value.

The following is a summary of current, accruing past due and nonaccrual loans by portfolio class as of March 31, 2011, and December 31, 2010.

	Accruing		Total	Total		Total
	Current	Past Due		Accruing	Non-	
(In thousands)			30-89 Days	Greater than	Loans	Loans
				90 days	Accrual	
March 31, 2011:						
Commercial and industrial	\$ 50,521	136	158		50,815	508
Construction and land development	44,279	492			44,771	4,043
Commercial real estate:						
Owner occupied	72,359	256			72,615	2,447
Other	85,150	163			85,313	1,507
Total commercial real estate	157,509	419			157,928	3,954
Residential real estate:						
Consumer mortgage	52,869	1,502			54,371	2,285
Investment property	38,617	499			39,116	225
Total residential real estate	91,486	2,001			93,487	2,510
Consumer installment	10,757	60			10,817	151
Total	\$ 354,552	3,108	158		357,818	11,166
December 31, 2010:						
Commercial and industrial	\$ 52,643	124			52,767	521
Construction and land development	43,547	201			43,748	4,102
Commercial real estate:						
Owner occupied	73,419				73,419	2,833
Other	88,087				88,087	1,902
Total commercial real estate	161,506				161,506	4,735
Residential real estate:						
Consumer mortgage	53,225	2,219			55,444	2,118
Investment property	37,556	767			38,323	356

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Total residential real estate	90,781	2,986	93,767	2,474	96,241
Consumer installment	10,646	29	10,675	1	10,676
Total	\$ 359,123	3,340	362,463	11,833	\$ 374,296

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At March 31, 2011 and December 31, 2010, nonaccrual loans amounted to \$11.2 million and \$11.8 million, respectively. At March 31, 2011, there were \$158,000 in loans 90 days past due and still accruing interest. At December 31, 2010, there were no loans 90 days past due and still accruing interest.

Allowance for Loan Losses

The Company assesses the adequacy of its allowance for loan losses prior to the end of each calendar quarter. The level of the allowance is based upon management's evaluation of the loan portfolios, past loan loss experience, current asset quality trends, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan quality indications and other pertinent factors, including regulatory recommendations. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. Loan losses are charged off when management believes that the full collectability of the loan is unlikely. A loan may be partially charged-off after a confirming event has occurred which serves to validate that full repayment pursuant to the terms of the loan is unlikely. Allocation of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, is deemed to be uncollectible.

The Company deems loans impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Collection of all amounts due according to the contractual terms means that both the interest and principal payments of a loan will be collected as scheduled in the loan agreement.

An impairment allowance is recognized if the fair value of the loan is less than the recorded investment in the loan (recorded investment in the loan is the principal balance plus any accrued interest, net of deferred loan fees or costs and unamortized premium or discount). The impairment is recognized through the allowance. Loans that are impaired are recorded at the present value of expected future cash flows discounted at the loan's effective interest rate, or if the loan is collateral dependent, impairment measurement is based on the fair value of the collateral, less estimated disposal costs. The Company believes it follows appropriate accounting and regulatory guidance in determining impairment and accrual status of impaired loans.

The level of allowance maintained is believed by management to be adequate to absorb probable losses inherent in the portfolio at the balance sheet date. The allowance is increased by provisions charged to expense and decreased by charge-offs, net of recoveries of amounts previously charged-off.

In assessing the adequacy of the allowance, the Company also considers the results of its ongoing independent loan review process. The Company's loan review process assists in determining whether there are loans in the portfolio whose credit quality has weakened over time and evaluating the risk characteristics of the entire loan portfolio. The Company's loan review process includes the judgment of management, the input from our independent loan reviewers, and reviews that may have been conducted by bank regulatory agencies as part of their examination process. The Company incorporates loan review results in the determination of whether or not it is probable that we will be able to collect all amounts due according to the contractual terms of a loan.

As part of the Company's quarterly assessment of the allowance, management divides the loan portfolio into five segments: commercial and industrial loans, construction and land development loans, commercial real estate, residential real estate, and consumer installment loans. The Company analyzes each segment and estimates an allowance allocation for each loan segment.

The allocation of the allowance for loan losses begins with a process of estimating the probable losses inherent for these types of loans. The estimates for these loans are established by category and based on the Company's internal system of credit risk ratings and historical loss data. The estimated loan loss allocation rate for the Company's internal system of credit risk grades is based on its experience with similarly graded loans. For loan segments where the Company believes it does not have sufficient historical loss data, the Company may make adjustments based, in part, on loss rates of peer bank groups. At March 31, 2011 and December 31, 2010, the Company adjusted its historical loss rates for the commercial real estate portfolio segment based, in part, on loss rates of peer bank groups. The related adjustments increased the allowance for loan losses for this portfolio segment at March 31, 2011 and December 31, 2010.

The estimated loan loss allocation for all five loan portfolio segments is then adjusted for management's estimate of probable losses for several qualitative and environmental factors. The allocation for qualitative and environmental factors is particularly subjective and does not lend itself to exact mathematical calculation. This amount represents estimated probable inherent credit losses which exist, but have not yet been identified, as of the balance sheet date, and are based upon quarterly trend assessments in delinquent and nonaccrual loans, credit concentration changes, prevailing economic

Table of Contents**Credit Quality Indicators**

The credit quality of the loan portfolio is summarized no less frequently than quarterly using categories similar to the standard asset classification system used by the federal banking agencies. The following table presents credit quality indicators for the loan portfolio segments and classes. These categories are utilized to develop the associated allowance for loan losses using historical losses adjusted for current economic conditions and are defined as follows:

Pass loans which are well protected by the current net worth and paying capacity of the obligor (or guarantors, if any) or by the fair value, less cost to acquire and sell, of any underlying collateral.

Special Mention loans with potential weakness that may, if not reversed or corrected, weaken the credit or inadequately protect the Company's position at some future date. These loans are not adversely classified and do not expose an institution to sufficient risk to warrant an adverse classification.

Accruing Substandard loans that exhibit a well-defined weakness which presently jeopardizes debt repayment, even though they are currently performing. These loans are characterized by the distinct possibility that the Company may incur a loss in the future if these weaknesses are not corrected;

Nonaccrual includes loans where management has determined that full payment of principal and interest is in doubt.

<i>(In thousands)</i>	March 31, 2011				Total loans
	Pass	Special Mention	Substandard Accruing	Nonaccrual	
Commercial and industrial	\$ 48,357	1,407	1,051	508	\$ 51,323
Construction and land development	39,142	602	5,027	4,043	48,814
Commercial real estate:					
Owner occupied	65,929	1,618	5,068	2,447	75,062
Other	84,781	47	485	1,507	86,820
Total commercial real estate	150,710	1,665	5,553	3,954	161,882
Residential real estate:					
Consumer mortgage	49,145	2,083	3,143	2,285	56,656
Investment property	34,926	1,676	2,514	225	39,341
Total residential real estate	84,071	3,759	5,657	2,510	95,997
Consumer installment	10,586	119	112	151	10,968
Total	\$ 332,866	7,552	17,400	11,166	\$ 368,984

<i>(In thousands)</i>	December 31, 2010				Total loans
	Pass	Special Mention	Substandard Accruing	Nonaccrual	
Commercial and industrial	\$ 51,632	722	413	521	\$ 53,288
Construction and land development	38,301	4,372	1,075	4,102	47,850
Commercial real estate:					
Owner occupied	67,702	716	5,001	2,833	76,252
Other	84,354	3,718	15	1,902	89,989
Total commercial real estate	152,056	4,434	5,016	4,735	166,241
Residential real estate:					
Consumer mortgage	48,620	2,700	4,124	2,118	57,562
Investment property	34,221	1,626	2,476	356	38,679

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Total residential real estate	82,841	4,326	6,600	2,474	96,241
Consumer installment	10,426	133	116	1	10,676
Total	\$ 335,256	13,987	13,220	11,833	\$ 374,296

Table of Contents**Impaired loans**

The following table presents details related to the Company's impaired loans. Loans which have been fully charged-off do not appear in the following table. The related allowance generally represents the following components which correspond to impaired loans:

Individually evaluated impaired loans equal to or greater than \$500,000 secured by real estate (nonaccrual construction and land development, commercial real estate, and residential real estate loans).

Individually evaluated impaired loans equal to or greater than \$250,000 not secured by real estate (nonaccrual commercial and industrial and consumer loans).

The following table sets forth certain information regarding the Company's impaired loans that were individually evaluated for impairment at March 31, 2011 and December 31, 2010.

	March 31, 2011			Quarter ended March 31, 2011		
	Unpaid principal balance (1)	Charge-offs and payments applied (2)	Recorded investment (3)	Related allowance	Average recorded investment	Interest income recognized (4)
<i>(In thousands)</i>						
With no allowance recorded:						
Commercial and industrial	\$				\$	\$
Construction and land development	2,499	(74)	2,425		2,455	
Commercial real estate:						
Owner occupied	700	(1)	699		730	3
Other	1,588	(81)	1,507		1,524	
Total commercial real estate	2,288	(82)	2,206		2,254	3
Residential real estate:						
Consumer mortgages	864	(34)	830		939	
Investment property					89	
Total residential real estate	864	(34)	830		1,028	
Consumer installment						
Total	\$ 5,651	(190)	5,461		\$ 5,737	\$ 3
With allowance recorded:						
Commercial and industrial	\$ 520	(13)	507	\$ 263	\$ 514	\$
Construction and land development	1,617		1,617	89	1,617	
Commercial real estate:						
Owner occupied	2,088		2,088	438	2,280	
Other						
Total commercial real estate	2,088		2,088	438	2,280	
Residential real estate:						
Consumer mortgages	1,064	(73)	991	165	1,004	
Investment property						
Total residential real estate	1,064	(73)	991	165	1,004	
Consumer installment						

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Total	\$ 5,289	(86)	5,203	\$ 955	\$ 5,415	\$
Total impaired loans	\$ 10,940	(276)	10,664	\$ 955	\$ 11,152	\$ 3

- (1) Unpaid principal balance represents the contractual obligation due from the customer.
- (2) Charge-offs and payments applied represents cumulative charge-offs taken, as well as interest payments that have been applied against the outstanding principal balance.
- (3) Recorded investment represents the unpaid principal balance less charge-offs and payments applied; it is shown before any related allowance for loan losses.
- (4) Represents interest income related to accruing TDRs, which are considered impaired.

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	December 31, 2010			
	Charge-offs			
<i>(In thousands)</i>	Unpaid principal balance (1)	and payments applied (2)	Recorded investment (3)	Related allowance
With no allowance recorded:				
Commercial and industrial	\$			
Construction and land development	2,538	(54)	2,484	
Commercial real estate:				
Owner occupied				
Other	1,592	(51)	1,541	
Total commercial real estate	1,592	(51)	1,541	
Residential real estate:				
Consumer mortgages	1,072	(27)	1,045	
Investment property	356		356	
Total residential real estate	1,428	(27)	1,401	
Consumer installment				
Total	\$ 5,558	(132)	5,426	
With allowance recorded:				
Commercial and industrial	\$ 528	(7)	521	\$ 277
Construction and land development	1,617		1,617	123
Commercial real estate:				
Owner occupied	3,124	(35)	3,089	765
Other				
Total commercial real estate	3,124	(35)	3,089	765
Residential real estate:				
Consumer mortgages	1,073	(56)	1,017	144
Investment property				
Total residential real estate	1,073	(56)	1,017	144
Consumer installment				
Total	\$ 6,342	(98)	6,244	\$ 1,309
Total impaired loans	\$ 11,900	(230)	11,670	\$ 1,309

(1) Unpaid principal balance represents the contractual obligation due from the customer.

(2) Charge-offs and payments applied represents cumulative charge-offs taken, as well as interest payments that have been applied against the outstanding principal balance.

(3) Recorded investment represents the unpaid principal balance less charge-offs and payments applied; it is shown before any related allowance for loan losses.

At March 31, 2011 and December 31, 2010, the Company had impaired loans classified as TDRs of \$7.2 million and \$7.6 million, respectively. At March 31, 2011 the Company had \$0.3 million in accruing TDRs. The Company had no accruing TDRs at December 31, 2010. For impaired loans classified as TDRs, the related allowance for loan losses was approximately \$0.7 million and \$1.0 million at March 31, 2011 and December 31, 2010, respectively. At March 31, 2011, there were no significant outstanding commitments to advance additional funds to customers whose loans had been restructured.

Table of Contents**NOTE 7: MORTGAGE SERVICING RIGHTS, NET**

Mortgage servicing rights (MSRs) are recognized based on the fair value of the servicing rights on the date the corresponding mortgage loans are sold. An estimate of the Company's MSRs is determined using assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rate, default rates, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, and late fees. Subsequent to the date of transfer, the Company has elected to measure its MSRs under the amortization method. Under the amortization method, MSRs are amortized in proportion to, and over the period of, estimated net servicing income.

The Company has recorded MSRs related to loans sold without recourse to Fannie Mae. The Company generally sells conforming, fixed-rate, closed-end, residential mortgages to Fannie Mae. MSRs are included in other assets on the accompanying Consolidated Balance Sheets.

The change in amortized MSRs and the related valuation allowance for the quarter ended March 31, 2011 and 2010 are presented below.

<i>(Dollars in thousands)</i>	Quarter ended March 31,	
	2011	2010
Beginning balance	\$ 1,189	834
Additions, net	87	49
Amortization expense	(50)	(32)
Ending balance	\$ 1,226	851
Fair value of amortized MSRs:		
Beginning of period	1,335	978
End of period	\$ 1,491	1,030

At March 31, 2011 and 2010 there was no valuation allowance recorded for MSRs. The Company periodically evaluates mortgage servicing rights for impairment. Impairment is determined by stratifying MSRs into groupings based on predominant risk characteristics, such as interest rate and loan type. If, by individual stratum, the carrying amount of the MSRs exceeds fair value, a valuation reserve is established. The valuation reserve is adjusted as the fair value changes.

NOTE 8: FAIR VALUE DISCLOSURES

Fair value is defined by FASB ASC 820, *Fair Value Measurements and Disclosures*, as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. FASB ASC 820 establishes a hierarchy for inputs used in measuring fair value that maximizes the use of observable inputs and minimizes the use of unobservable inputs by requiring that most observable inputs be used when available. Observable inputs are inputs that market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the Company. Unobservable inputs are inputs that reflect the Company's assumptions about the inputs market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. The hierarchy is broken down into three levels based on the reliability of inputs as follows:

Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets.

Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument.

Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement.

The Company's assets and liabilities recorded at fair value have been categorized based upon a fair value hierarchy in accordance with FASB ASC 820.

Securities Securities available-for-sale are recorded at fair value on a recurring basis. Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities would include highly liquid government securities such as U.S. Treasuries and exchange-traded equity securities.

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When instruments are traded in secondary markets and quoted market prices are not available, the Company generally relies on prices obtained from independent vendors. Vendors compile prices from various sources and often apply matrix pricing for similar securities when no price is observable. Securities measured with these valuation techniques are generally classified within Level 2 of the valuation hierarchy and often involve using quoted market prices for similar securities, pricing models or discounted cash flow analyses using inputs observable in the market where available. Examples include U.S. government agency securities and residential mortgage-backed securities.

Security fair value measurements using significant inputs that are unobservable in the market due to limited activity or a less liquid market are classified within Level 3 of the valuation hierarchy. Such measurements include securities valued using models or a combination of valuation techniques such as weighting of models and vendor or broker pricing, where the unobservable inputs are significant to the overall fair value measurement. Securities classified as Level 3 include pooled and individual issuer trust preferred securities.

Loans held for sale Loans held for sale are carried at the lower of cost or estimated fair value and are subjected to nonrecurring fair value adjustments. Estimated fair value is determined on the basis of the current market value of similar loans. All of the Company's loans held for sale are classified within Level 2 of the valuation hierarchy.

Loans, net Loans considered impaired under FASB ASC 310-10-35, *Receivables*, are loans for which, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired loans are subject to nonrecurring fair value adjustments to reflect (1) partial write-downs that are based on the observable market price or current appraised value of the collateral, or (2) the full charge-off of the loan carrying value. All of the Company's impaired loans are classified within Level 3 of the valuation hierarchy.

Other real estate Other real estate, consisting of properties obtained through foreclosure or in satisfaction of loans, are initially recorded at the lower of the loan's carrying amount or the fair value less costs to sell upon transfer of the loans to other real estate. Subsequently, other real estate is carried at the lower of carrying value or fair value less costs to sell. Fair value is generally determined on the basis of current appraisals, comparable sales, and other estimates of value obtained principally from independent sources, adjusted for estimated selling costs. All of the Company's other real estate is classified within Level 3 of the valuation hierarchy.

Other assets The Company has certain financial assets carried at fair value on a recurring basis, including interest rate swap agreements. The carrying amount of interest rate swap agreements is based on information obtained from a third party bank. The Company classified these derivative assets within Level 2 of the valuation hierarchy. These swaps qualify as derivatives, but are not designated as hedging instruments. The Company had no derivative contracts to assist in managing interest rate sensitivity at March 31, 2011 or December 31, 2010.

Mortgage servicing rights, net, included in other assets on the accompanying consolidated balance sheets, are carried at the lower of cost or estimated fair value and are subjected to nonrecurring fair value adjustments. MSRs do not trade in an active market with readily observable prices. To determine the fair value of MSRs, the Company engages an independent third party. The independent third party's valuation model calculates the present value of estimated future net servicing income using assumptions that market participants would use in estimating future net servicing income, including estimates of prepayment speeds, discount rate, default rates, cost to service, escrow account earnings, contractual servicing fee income, ancillary income, and late fees. Because the valuation of MSRs requires the use of significant unobservable inputs, all of the Company's MSRs are classified within Level 3 of the valuation hierarchy.

Other liabilities The Company has certain financial liabilities carried at fair value on a recurring basis, including interest rate swap agreements. The carrying amount of interest rate swap agreements is based on information obtained from a third party bank. The Company classified these derivative liabilities within Level 2 of the valuation hierarchy. These swaps qualify as derivatives, but are not designated as hedging instruments. The Company had no derivative contracts to assist in managing interest rate sensitivity at March 31, 2011 or December 31, 2010.

Table of Contents**Assets and liabilities measured at fair value on a recurring basis**

The following table presents the balances of the assets and liabilities measured at fair value on a recurring basis as of March 31, 2011 and December 31, 2010, respectively, by caption, on the consolidated balance sheets by FASB ASC 820 valuation hierarchy (as described above).

<i>(Dollars in thousands)</i>	Amount	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
March 31, 2011				
Securities available-for-sale:				
Agency obligations	\$ 97,983		97,983	
Agency RMBS	138,411		138,411	
State and political subdivisions	82,471		82,471	
Trust preferred securities:				
Pooled	20			20
Individual issuer	2,213			2,213
Total securities available-for-sale	321,098		318,865	2,233
Other assets ⁽¹⁾	995		995	
Total assets at fair value	\$ 322,093		319,860	2,233
Other liabilities ⁽¹⁾	995		995	
Total liabilities at fair value	\$ 995		995	
December 31, 2010				
Securities available-for-sale:				
Agency obligations	\$ 90,471			