

AUBURN NATIONAL BANCORPORATION, INC

Form 10-Q

November 14, 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 September 30, 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**  
Common Stock, \$0.01 par value per share

**Outstanding at October 31, 2011**  
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)**

|   | September 30,<br>2011 | December 31,<br>2010 |
|---|-----------------------|----------------------|
| <i>(Dollars in thousands, except share data)</i>                                      |                       |                      |
| <b>Assets:</b>  |                       |                      |
| Cash and due from banks   | \$ 13,165             | \$ 11,432            |
| Federal funds sold  | 40,664                | 7,500                |
| Interest bearing bank deposits  | 1,816                 | 2,492                |
| Cash and cash equivalents   | 55,645                | 21,424               |
| Securities available-for-sale   | 283,070               | 315,220              |
| Loans held for sale   | 2,906                 | 4,281                |
| Loans, net of unearned income   | 374,788               | 374,215              |
| Allowance for loan losses   | (6,340)               | (7,676)              |
| Loans, net  | 368,448               | 366,539              |
| Premises and equipment, net   | 8,672                 | 8,105                |
| Bank-owned life insurance   | 16,512                | 16,171               |
| Other real estate owned   | 7,770                 | 8,125                |
| Other assets  | 21,614                | 23,964               |
| Total assets  | \$ 764,637            | \$ 763,829           |
| <b>Liabilities:</b>   |                       |                      |
| <b>Deposits:</b>  |                       |                      |
| Noninterest-bearing   | \$ 99,148             | \$ 87,660            |
| Interest-bearing  | 509,922               | 519,467              |
| Total deposits  | 609,070               | 607,127              |
| Federal funds purchased and securities sold under agreements to repurchase            | 2,613                 | 2,685                |
| Long-term debt  | 85,317                | 93,331               |
| Accrued expenses and other liabilities  | 3,215                 | 4,318                |
| Total liabilities   | 700,215               | 707,461              |
| <b>Stockholders' equity:</b>  |                       |                      |
| 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                |

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|  |            |            |
|--|------------|------------|
| Retained earnings  | 63,608     | 61,421     |
| Accumulated other comprehensive income (loss), net   | 3,665      | (2,201)    |
| Less treasury stock, at cost - 314,397 shares and 314,417 shares at September 30, 2011 and December 31, 2010, respectively | (6,643)    | (6,643)    |
| Total stockholders' equity   | 64,422     | 56,368     |
| Total liabilities and stockholders' equity   | \$ 764,637 | \$ 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)**

|  | <b>Quarter ended September 30,</b> |              | <b>Nine months ended September 30,</b> |               |
|--|------------------------------------|--------------|--|---------------|
|  | <b>2011</b>                        | <b>2010</b>  | <b>2011</b>                            | <b>2010</b>   |
| <i>(Dollars in thousands, except share and per share data)</i>   |                                    |              |  |               |
| <b>Interest income:</b>  |                                    |              |  |               |
| Loans, including fees  | \$ 5,393                           | \$ 5,442     | \$ 16,051                              | \$ 16,367     |
| Securities   | 2,253                              | 2,922        | 7,404                                  | 9,100         |
| Federal funds sold and interest bearing bank deposits  | 14                                 | 6            | 37                                     | 23            |
| Total interest income  | 7,660                              | 8,370        | 23,492                                 | 25,490        |
| <b>Interest expense:</b>   |                                    |              |  |               |
| Deposits   | 1,958                              | 2,479        | 6,220                                  | 7,734         |
| Short-term borrowings  | 3                                  | 5            | 9                                      | 19            |
| Long-term debt   | 854                                | 1,148        | 2,547                                  | 3,480         |
| Total interest expense   | 2,815                              | 3,632        | 8,776                                  | 11,233        |
| <b>Net interest income</b>   | <b>4,845</b>                       | <b>4,738</b> | <b>14,716</b>                          | <b>14,257</b> |
| <b>Provision for loan losses</b>   | <b>600</b>                         | <b>730</b>   | <b>1,800</b>                           | <b>2,930</b>  |
| <b>Net interest income after provision for loan losses</b>   | <b>4,245</b>                       | <b>4,008</b> | <b>12,916</b>                          | <b>11,327</b> |
| <b>Noninterest income:</b>   |                                    |              |  |               |
| Service charges on deposit accounts  | 301                                | 328          | 882                                    | 976           |
| Mortgage lending   | 637                                | 1,007        | 1,516                                  | 2,114         |
| Bank-owned life insurance  | 127                                | 118          | 341                                    | 350           |
| Affordable housing investment losses   | (231)                              | (57)         | (461)                                  | (171)         |
| Other  | 349                                | 332          | 1,057                                  | 1,066         |
| Securities gains, net:   |                                    |              |  |               |
| Realized gains, net  | 451                                | 469          | 901                                    | 3,000         |
| Total other-than-temporary impairments   | (156)                              | (340)        | (468)                                  | (600)         |
| Non-credit portion of other-than-temporary impairments (transferred from) recognized in other comprehensive income | (80)                               |              | 130                                    | 210           |
| Total securities gains, net  | 215                                | 129          | 563                                    | 2,610         |
| Total noninterest income   | 1,398                              | 1,857        | 3,898                                  | 6,945         |
| <b>Noninterest expense:</b>  |                                    |              |  |               |
| Salaries and benefits  | 2,218                              | 2,051        | 6,272                                  | 5,895         |
| Net occupancy and equipment  | 364                                | 359          | 1,038                                  | 1,107         |
| Professional fees  | 190                                | 164          | 550                                    | 531           |
| FDIC and other regulatory assessments  | 178                                | 277          | 659                                    | 839           |
| Other real estate owned, net   | 506                                | 268          | 1,207                                  | 1,240         |
| Prepayment penalty on long-term debt   |                                    | 381          |  | 679           |
| Other  | 883                                | 866          | 2,626                                  | 2,520         |
| Total noninterest expense  | 4,339                              | 4,366        | 12,352                                 | 12,811        |

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|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| <b>Earnings before income taxes</b>         | 1,304     | 1,499     | 4,462     | 5,461     |
| <b>Income tax (benefit) expense</b>         | (63)      | 255       | 89        | 993       |
| <b>Net earnings</b>                         | \$ 1,367  | \$ 1,244  | \$ 4,373  | \$ 4,468  |
| <b>Net earnings per share:</b>              |           |           |           |           |
| Basic and diluted                           | \$ 0.38   | \$ 0.34   | \$ 1.20   | \$ 1.23   |
| <b>Weighted average shares outstanding:</b> |           |           |           |           |
| Basic and diluted                           | 3,642,738 | 3,642,701 | 3,642,735 | 3,642,896 |

*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         |                      | Accumulated<br>other<br>comprehensive<br>income<br>(loss) | Treasury<br>stock | Total     |
|---|--------------|--------|--------------------|----------------------|---|-------------------|-----------|
|   | Shares       | Amount | paid-in<br>capital | Retained<br>earnings |   |                   |           |
| <i>(Dollars in thousands, except share data)</i>  |              |        |                    |                      |   |                   |           |
| <b>Balance, December 31, 2009</b>   | 3,957,135    | \$ 39  | \$ 3,751           | \$ 58,917            | \$ 111  | \$ (6,635)        | \$ 56,183 |
| Comprehensive income:   |              |        |                    |                      |   |                   |           |
| Net earnings  |              |        |                    | 4,468                |   |                   | 4,468     |
| Other comprehensive loss due to change in<br>other-than-temporary impairment losses related to factors other<br>than credit on available-for- sale, net |              |        |                    |                      | (133)   |                   | (133)     |
| Other comprehensive income due to change in all other<br>unrealized gains (losses) on securities available-for- sale, net                               |              |        |                    |                      | 2,558   |                   | 2,558     |
| <b>Total comprehensive income</b>   |              |        |                    | 4,468                | 2,425   |                   | 6,893     |
| Cash dividends paid (\$0.585 per share)   |              |        |                    | (2,132)              |   |                   | (2,132)   |
| Stock repurchases (484 shares)  |              |        |                    |                      |   | (8)               | (8)       |
| Sale of treasury stock (85 shares)  |              |        | 1                  |                      |   |                   | 1         |
| <b>Balance, September 30, 2010</b>  | 3,957,135    | \$ 39  | \$ 3,752           | \$ 61,253            | \$ 2,536  | \$ (6,643)        | \$ 60,937 |
| <b>Balance, December 31, 2010</b>   | 3,957,135    | \$ 39  | \$ 3,752           | \$ 61,421            | \$ (2,201)  | \$ (6,643)        | \$ 56,368 |
| Comprehensive income:   |              |        |                    |                      |   |                   |           |
| Net earnings  |              |        |                    | 4,373                |   |                   | 4,373     |
| Other comprehensive loss due to change in<br>other-than-temporary impairment losses related to factors other<br>than credit on available-for- sale, net |              |        |                    |                      | (82)  |                   | (82)      |
| Other comprehensive income due to change in all other<br>unrealized gains (losses) on securities available-for- sale, net                               |              |        |                    |                      | 5,948   |                   | 5,948     |
| <b>Total comprehensive income</b>   |              |        |                    | 4,373                | 5,866   |                   | 10,239    |
| Cash dividends paid (\$0.60 per share)  |              |        |                    | (2,186)              |   |                   | (2,186)   |
| Sale of treasury stock (20 shares)  |              |        | 1                  |                      |   |                   | 1         |
| <b>Balance, September 30, 2011</b>  | 3,957,135    | \$ 39  | \$ 3,753           | \$ 63,608            | \$ 3,665  | \$ (6,643)        | \$ 64,422 |

See accompanying notes to condensed consolidated financial statements



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

|  | <b>Nine months ended September 30,</b> |             |
|--|--|-------------|
|  | <b>2011</b>                            | <b>2010</b> |
| <i>(In thousands)</i>  |  |             |
| <b>Cash flows from operating activities:</b>   |  |             |
| Net earnings   | \$ 4,373                               | \$ 4,468    |
| Adjustments to reconcile net earnings to net cash provided by operating activities:        |  |             |
| Provision for loan losses  | 1,800                                  | 2,930       |
| Depreciation and amortization  | 496                                    | 419         |
| Premium amortization and discount accretion, net   | 1,634                                  | 1,380       |
| Net gain on securities   | (563)                                  | (2,610)     |
| Net gain on sale of loans held for sale  | (1,253)                                | (1,847)     |
| Net loss on other real estate owned  | 1,233                                  | 1,118       |
| Loss on prepayment of long-term debt   |  | 679         |
| Loans originated for sale  | (44,028)                               | (73,521)    |
| Proceeds from sale of loans  | 46,425                                 | 74,068      |
| Increase in cash surrender value of bank owned life insurance                              | (341)                                  | (350)       |
| Loss on affordable housing partnership investments   | 461                                    | 171         |
| Net decrease in other assets   | 315                                    | 365         |
| Net increase (decrease) in accrued expenses and other liabilities                          | 458                                    | (104)       |
| Net cash provided by operating activities  | 11,010                                 | 7,166       |
| <b>Cash flows from investing activities:</b>   |  |             |
| Proceeds from sales of securities available-for-sale                                       | 113,841                                | 147,828     |
| Proceeds from maturities of securities available-for-sale                                  | 73,989                                 | 152,320     |
| Purchase of securities available-for-sale  | (147,455)                              | (282,433)   |
| Net increase in loans  | (6,364)                                | (3,824)     |
| Net purchases of premises and equipment  | (811)                                  | (75)        |
| Decrease in FHLB stock   | 631                                    |             |
| Capital contributions to affordable housing limited partnerships                           | (4,069)                                | (1,500)     |
| Proceeds from sale of other real estate owned  | 1,777                                  | 596         |
| Net cash provided by investing activities  | 31,539                                 | 12,912      |
| <b>Cash flows from financing activities:</b>   |  |             |
| Net increase in noninterest-bearing deposits   | 11,488                                 | 15,811      |
| Net (decrease) increase in interest-bearing deposits                                       | (9,545)                                | 7,288       |
| Net decrease in federal funds purchased and securities sold under agreements to repurchase | (72)                                   | (13,271)    |
| Repayments or retirement of long-term debt   | (8,014)                                | (10,693)    |
| Proceeds from sale of treasury stock   | 1                                      | 1           |
| Stock repurchases  |  | (8)         |
| Dividends paid   | (2,186)                                | (2,132)     |
| Net cash used in financing activities  | (8,328)                                | (3,004)     |
| Net change in cash and cash equivalents  | 34,221                                 | 17,074      |

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|   |                  |                  |
|---|------------------|------------------|
| Cash and cash equivalents at beginning of period  | 21,424           | 12,395           |
| <b>Cash and cash equivalents at end of period</b> | <b>\$ 55,645</b> | <b>\$ 29,469</b> |

**Supplemental disclosures of cash flow information:**

Cash paid during the period for:

|              |          |           |
|--------------|----------|-----------|
| Interest     | \$ 9,122 | \$ 11,698 |
| Income taxes | 347      | 1,490     |

**Supplemental disclosure of non-cash transactions:**

|  |       |       |
|--|-------|-------|
| Real estate acquired through foreclosure | 2,655 | 2,585 |
|--|-------|-------|

*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 in the interim statements 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.

The preparation of financial statements in conformity with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities as of the balance sheet date and the reported amounts or revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term include other-than-temporary impairment on investment securities, the determination of the allowance for loan losses, fair value of financial instruments, income taxes, and the valuation of deferred tax assets and other real estate owned.

##### **Reclassifications**

Certain amounts reported in prior periods have been reclassified to conform to the current-period presentation. These reclassifications had no effect on the Company's previously reported net earnings or total stockholders' equity.

##### **Subsequent Events**

The Company has evaluated the effects of events or transactions through the date of this filing that have occurred subsequent to September 30, 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*.

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

ASU 2011-02, *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*.

Information about these pronouncements is described in more detail below.

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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 roll-forward 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

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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 roll-forward 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.

ASU 2011-02, *A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*, provides guidance clarifying under what circumstances a creditor should classify a restructured loan as a troubled debt restructuring or TDR. A loan is a TDR if both of the following exist: (1) a creditor has granted a concession to the debtor, and (2) the debtor is experiencing financial difficulties. The ASU clarifies that a creditor should consider all aspects of a restructuring when evaluating whether it has granted a concession, which include determining whether a debtor can obtain funds from another source at market rates and assessing the value of additional collateral and guarantees obtained at the time of restructuring. The ASU provides factors a creditor should consider when determining if a debtor is experiencing financial difficulties, such as probability of payment default and bankruptcy declarations. The Company adopted the new guidance in the third quarter of 2011 with retrospective application to January 1, 2011. Adoption of the ASU required expansion of the Company's disclosures surrounding TDRs. See Note 6.

## 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 quarter and nine months ended September 30, 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 September 30, 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 and nine months ended September 30, 2011 and 2010 is presented below.

|  | Quarter ended September 30, |           | Nine months ended September 30, |           |
|--|-----------------------------|-----------|---------------------------------|-----------|
|  | 2011                        | 2010      | 2011                            | 2010      |
| <i>(Dollars in thousands, except share and per share data)</i> |                             |           |                                 |           |
| <b>Basic and diluted:</b>                                      |                             |           |                                 |           |
| Net earnings   | \$ 1,367                    | \$ 1,244  | \$ 4,373                        | \$ 4,468  |
| Weighted average common shares outstanding                     | 3,642,738                   | 3,642,701 | 3,642,735                       | 3,642,896 |
| Earnings per share   | \$ 0.38                     | \$ 0.34   | \$ 1.20                         | \$ 1.23   |

## 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 and nine months ended September 30, 2011 and 2010 is presented below.

|   | Quarter ended September 30, |          | Nine months ended September 30, |          |
|---|-----------------------------|----------|---------------------------------|----------|
|   | 2011                        | 2010     | 2011                            | 2010     |
| <i>(In thousands)</i>   |                             |          |                                 |          |
| <b>Comprehensive income:</b>  |                             |          |                                 |          |
| Net earnings  | \$ 1,367                    | \$ 1,244 | \$ 4,373                        | \$ 4,468 |
| <b>Other comprehensive income (loss):</b>   |                             |          |                                 |          |
| Due to change in other-than-temporary impairment losses related to factors other than credit on securities available-for-sale, net of tax | 51                          |          | (82)                            | (133)    |
| Due to change in all other unrealized gains on securities available-for-sale, net of tax  | 2,633                       | 1,361    | 5,948                           | 2,558    |
| Total comprehensive income  | \$ 4,051                    | \$ 2,605 | \$ 10,239                       | \$ 6,893 |

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The Company is involved in various entities that are considered to be variable interest entities ( 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 September 30, 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 included 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.

**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 September 30, 2011 and December 31, 2010, the Company had limited partnership investments of \$5.4 million and \$3.4 million, respectively, related to these projects, which are included in other assets. At September 30, 2011 and December 31, 2010, the Company had unfunded commitments related to affordable housing investments of \$0.3 million and \$1.9 million, respectively, included in accrued expenses and other liabilities.

Additionally, the Company had no outstanding loan commitments or funded loans outstanding with any of the partnerships at September 30, 2011. The Company had outstanding loan commitments with certain of the partnerships totaling \$11.4 million at December 31, 2010. The funded portion of these loans was approximately \$8.9 million at December 31, 2010. The funded portion of these loans is included in loans, net of unearned income.

The following table summarizes VIEs that are not consolidated by the Company as of September 30, 2011.

| <i>(Dollars in thousands)</i>      | <b>Maximum<br/>Loss<br/>Exposure</b> | <b>Liability<br/>Recognized</b> | <b>Classification</b>          |
|------------------------------------|--------------------------------------|---------------------------------|--------------------------------|
| <b>Type:</b>                       |                                      |                                 |                                |
| Affordable housing investments (a) | \$ 5,417                             | 308                             | Other assets/other liabilities |
| Trust preferred issuances          | N/A                                  | 7,217                           | Long-term debt                 |

- (a) Maximum loss exposure represents the Company's current net investment of \$5.4 million included in other assets. The net current investment of \$5.4 million includes \$0.3 million of unfunded commitments related to affordable housing investments included in accrued expenses and other liabilities.



**Table of Contents****NOTE 5: SECURITIES**

At September 30, 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 September 30, 2011 and December 31, 2010, respectively, are presented below.

|                                  | September 30, 2011 |                 |                  |                   |               |                           |                      |                   |
|----------------------------------|--------------------|-----------------|------------------|-------------------|---------------|---------------------------|----------------------|-------------------|
| (Dollars in thousands)           | 1 year<br>or less  | 1 to 5<br>years | 5 to 10<br>years | After 10<br>years | Fair<br>Value | Gross Unrealized<br>Gains | Unrealized<br>Losses | Amortized<br>Cost |
| Available-for-sale:              |                    |                 |                  |                   |               |                           |                      |                   |
| Agency obligations (a)           | \$                 |                 | 9,034            | 32,225            | 41,259        | 184                       | 5                    | \$ 41,080         |
| Agency RMBS (a)                  |                    |                 | 10,039           | 147,021           | 157,060       | 2,507                     | 38                   | 154,591           |
| State and political subdivisions | 20                 | 507             | 15,257           | 67,016            | 82,800        | 3,443                     | 61                   | 79,418            |
| Trust preferred securities:      |                    |                 |                  |                   |               |                           |                      |                   |
| Pooled                           |                    |                 |                  | 100               | 100           |                           | 130                  | 230               |
| Individual issuer                |                    |                 |                  | 1,851             | 1,851         | 162                       | 255                  | 1,944             |
| Total available-for-sale         | \$ 20              | 507             | 34,330           | 248,213           | 283,070       | 6,296                     | 489                  | \$ 277,263        |

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

|                                  | December 31, 2010 |                 |                  |                   |               |                           |                      |                   |
|----------------------------------|-------------------|-----------------|------------------|-------------------|---------------|---------------------------|----------------------|-------------------|
| (Dollars in thousands)           | 1 year<br>or less | 1 to 5<br>years | 5 to 10<br>years | After 10<br>years | Fair<br>Value | Gross Unrealized<br>Gains | Unrealized<br>Losses | Amortized<br>Cost |
| 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 \$172.0 million and \$171.1 million at September 30, 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 are cost-method investments. The carrying amounts of cost-method investments were \$5.2 and \$5.8 million at September 30, 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 September 30, 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>    |                     |                   |                     |                   |            |                   |
| <b>September 30, 2011:</b>       |                     |                   |                     |                   |            |                   |
| Agency obligations               | \$ 12,100           | 5                 |                     |                   | 12,100     | \$ 5              |
| Agency RMBS                      | 4,849               | 38                |                     |                   | 4,849      | 38                |
| State and political subdivisions | 1,415               | 21                | 714                 | 40                | 2,129      | 61                |
| Trust preferred securities:      |                     |                   |                     |                   |            |                   |
| Pooled                           |                     |                   | 100                 | 130               | 100        | 130               |
| Individual issuer                |                     |                   | 745                 | 255               | 745        | 255               |
| Total                            | \$ 18,364           | 64                | 1,559               | 425               | 19,923     | \$ 489            |
| <b>December 31, 2010:</b>        |                     |                   |                     |                   |            |                   |
| 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 September 30, 2011. As such, it is possible that a security in an unrealized loss position at September 30, 2011 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 assesses 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 considers all available information in developing those expected cash flows. For asset-backed securities such as pooled trust preferred securities, such information generally includes:

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 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 September 30, 2011, cost-method investments with an aggregate cost of \$5.2 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.

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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.

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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 September 30, 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.

**Trust Preferred Securities as of September 30, 2011**

|  | Credit Rating |       |            | Unrealized Losses   |                     |       | Life-to-date       |
|--|---------------|-------|------------|---------------------|---------------------|-------|--------------------|
|  |               |       |            | Less than 12 months | 12 months or Longer | Total | Impairment Charges |
| (Dollars in thousands)                 | Moody's       | Fitch | Fair Value | 12 months           | Longer              | Total |                    |
| <b>Pooled:</b>                         |               |       |            |                     |                     |       |                    |
| ALESCO Preferred Funding XVII Ltd (a)  | C             | CC    | \$ 100     |                     | 130                 | 130   | \$ 1,770           |
| <b>Individual issuer (b):</b>          |               |       |            |                     |                     |       |                    |
| Carolina Financial Capital Trust I     | n/a           | n/a   | 193        |                     |                     |       | 257                |
| Main Street Bank Statutory Trust I (c) | n/a           | n/a   | 383        |                     | 117                 | 117   |                    |
| MNB Capital Trust I                    | n/a           | n/a   | 55         |                     |                     |       | 445                |
| PrimeSouth Capital Trust I             | n/a           | n/a   | 75         |                     |                     |       | 425                |
| TCB Trust                              | n/a           | n/a   | 362        |                     | 138                 | 138   |                    |
| United Community Capital Trust         | n/a           | n/a   | 783        |                     |                     |       | 379                |
| Total individual issuer                |               |       | 1,851      |                     | 255                 | 255   | 1,506              |
| Total trust preferred securities       |               |       | \$ 1,951   |                     | 385                 | 385   | \$ 3,276           |

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 securities 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 |       |            | Unrealized Losses   |                     |       | Life-to-date       |
|--|---------------|-------|------------|---------------------|---------------------|-------|--------------------|
|  |               |       |            | Less than 12 months | 12 months or Longer | Total | Impairment Charges |
| (Dollars in thousands)                 | Moody's       | Fitch | Fair Value | 12 months           |                     |       |                    |
| Pooled:                                |               |       |            |                     |                     |       |                    |
| ALESCO Preferred Funding XVII Ltd (a)  | Ca            | C     | \$ 20      |                     | 210                 | 210   | \$ 1,770           |
| Individual issuer (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    |                    |

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|                                  |     |     |          |     |     |          |
|----------------------------------|-----|-----|----------|-----|-----|----------|
| United Community Capital Trust   | n/a | n/a | 621      |     |     | 379      |
| 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 securities 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.

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For pooled trust preferred securities, the Company estimates 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.

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 September 30, 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 and nine months ended September 30, 2011 and 2010 for credit-impaired debt securities are presented as additions in two components based upon whether the current period 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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|  | \$3,040<br>Quarter ended September 30,<br>2011 | \$3,040<br>September 30,<br>2010 | \$3,040<br>Nine months ended September 30,<br>2011 | \$3,040<br>September 30,<br>2010 |
|--|--|----------------------------------|--|----------------------------------|
| <i>(Dollars in thousands)</i>                      |  |                                  |  |                                  |
| Balance, beginning of period                       | \$ 3,040                                       | \$ 4,620                         | \$ 2,938   | \$ 4,570                         |
| Additions:   |  |                                  |  |                                  |
| Initial credit impairments                         |  | 340                              |  | 340                              |
| Subsequent credit impairments                      | 236  |                                  | 338  | 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                             | \$ 3,276                                       | \$ 4,960                         | \$ 3,276   | \$ 4,960                         |

**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 nine months ended September 30, 2011 and 2010.

|  | \$3,040<br>Quarter ended September 30,<br>2011 | \$3,040<br>September 30,<br>2010 | \$3,040<br>Nine months ended September 30,<br>2011 | \$3,040<br>September 30,<br>2010 |
|--|--|----------------------------------|--|----------------------------------|
| <i>(Dollars in thousands)</i>  |  |                                  |  |                                  |
| <b>Other-than-temporary impairment charges (included in earnings):</b> |  |                                  |  |                                  |
| Debt securities:   |  |                                  |  |                                  |
| Pooled trust preferred securities                                      | \$ 236   | \$ 340                           | \$ 338   | \$ 50                            |
| Individual issuer trust preferred securities                           | 236  | 340                              | 338  | 340                              |
| Total debt securities  | 236  | 340                              | 338  | 390                              |
| Cost-method investments  |  |                                  |  |                                  |
| Total other-than-temporary impairment charges                          | \$ 236   | \$ 340                           | \$ 338   | \$ 390                           |

**Other-than-temporary impairment on debt securities:**

|  |        |        |        |        |
|--|--------|--------|--------|--------|
| Recorded as part of gross realized losses:   |        |        |        |        |
| Credit-related   | \$ 236 | 340    | \$ 338 | \$ 340 |
| Securities with intent to sell   |        |        |        | 50     |
| (Transferred from) recorded directly to other comprehensive income for non-credit related impairment | (80)   |        | 130    | 210    |
| Total other-than-temporary impairment on debt securities   | \$ 156 | \$ 340 | \$ 468 | \$ 600 |

**Realized Gains and Losses**

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

|                               | \$3,040<br>Quarter ended September 30,<br>2011 | \$3,040<br>September 30,<br>2010 | \$3,040<br>Nine months ended September 30,<br>2011 | \$3,040<br>September 30,<br>2010 |
|-------------------------------|--|----------------------------------|--|----------------------------------|
| <i>(Dollars in thousands)</i> |  |                                  |  |                                  |
| Gross realized gains          | \$ 474   | \$ 475                           | \$ 1,379   | \$ 3,045                         |
| Gross realized losses         | (23)   | (6)                              | (478)  | (45)                             |



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|   |        |        |        |          |
|---|--------|--------|--------|----------|
| Other-than-temporary impairment charges | (236)  | (340)  | (338)  | (390)    |
| Realized gains, net                     | \$ 215 | \$ 129 | \$ 563 | \$ 2,610 |

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

| <i>(In thousands)</i>             | <b>September 30, 2011</b> | <b>December 31, 2010</b> |
|-----------------------------------|---------------------------|--------------------------|
| Commercial and industrial         | \$ 53,888                 | \$ 53,288                |
| Construction and land development | 40,781                    | 47,850                   |
| Commercial real estate:           |                           |                          |
| Owner occupied                    | 71,247                    | 76,252                   |
| Other                             | 94,812                    | 89,989                   |
| Total commercial real estate      | 166,059                   | 166,241                  |
| Residential real estate:          |                           |                          |
| Consumer mortgage                 | 58,935                    | 57,562                   |
| Investment property               | 43,095                    | 38,679                   |
| Total residential real estate     | 102,030                   | 96,241                   |
| Consumer installment              | 12,105                    | 10,676                   |
| Total loans                       | 374,863                   | 374,296                  |
| Less: unearned income             | (75)                      | (81)                     |
| Loans, net of unearned income     | \$ 374,788                | \$ 374,215               |

Loans secured by real estate were approximately 82.4% of the total loan portfolio at September 30, 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 September 30, 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 refinance 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 includes first 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 September 30, 2011, and December 31, 2010

| <i>(In thousands)</i>             | Current    | Accruing<br>30-89 Days<br>Past Due | Accruing<br>Greater than<br>90 days | Total<br>Accruing<br>Loans | Non-<br>Accrual | Total<br>Loans |
|-----------------------------------|------------|------------------------------------|-------------------------------------|----------------------------|-----------------|----------------|
| <b>September 30, 2011:</b>        |            |                                    |                                     |                            |                 |                |
| Commercial and industrial         | \$ 53,603  | 253                                |                                     | 53,856                     | 32              | \$ 53,888      |
| Construction and land development | 35,452     | 173                                |                                     | 35,625                     | 5,156           | 40,781         |
| Commercial real estate:           |            |                                    |                                     |                            |                 |                |
| Owner occupied                    | 69,652     |                                    |                                     | 69,652                     | 1,595           | 71,247         |
| Other                             | 92,791     |                                    |                                     | 92,791                     | 2,021           | 94,812         |
| Total commercial real estate      | 162,443    |                                    |                                     | 162,443                    | 3,616           | 166,059        |
| Residential real estate:          |            |                                    |                                     |                            |                 |                |
| Consumer mortgage                 | 57,532     | 471                                |                                     | 58,003                     | 932             | 58,935         |
| Investment property               | 41,845     | 623                                |                                     | 42,468                     | 627             | 43,095         |
| Total residential real estate     | 99,377     | 1,094                              |                                     | 100,471                    | 1,559           | 102,030        |
| Consumer installment              | 11,937     | 25                                 |                                     | 11,962                     | 143             | 12,105         |
| Total                             | \$ 362,812 | 1,545                              |                                     | 364,357                    | 10,506          | \$ 374,863     |
| <b>December 31, 2010:</b>         |            |                                    |                                     |                            |                 |                |
| Commercial and industrial         | \$ 52,643  | 124                                |                                     | 52,767                     | 521             | \$ 53,288      |
| Construction and land development | 43,547     | 201                                |                                     | 43,748                     | 4,102           | 47,850         |
| Commercial real estate:           |            |                                    |                                     |                            |                 |                |
| Owner occupied                    | 73,419     |                                    |                                     | 73,419                     | 2,833           | 76,252         |
| Other                             | 88,087     |                                    |                                     | 88,087                     | 1,902           | 89,989         |
| Total commercial real estate      | 161,506    |                                    |                                     | 161,506                    | 4,735           | 166,241        |
| Residential real estate:          |            |                                    |                                     |                            |                 |                |
| Consumer mortgage                 | 53,225     | 2,219                              |                                     | 55,444                     | 2,118           | 57,562         |
| Investment property               | 37,556     | 767                                |                                     | 38,323                     | 356             | 38,679         |
| Total residential real estate     | 90,781     | 2,986                              |                                     | 93,767                     | 2,474           | 96,241         |

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|                      |            |       |         |        |            |
|----------------------|------------|-------|---------|--------|------------|
| 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 September 30, 2011 and December 31, 2010, nonaccrual loans amounted to \$10.5 and \$11.8 million, respectively. At September 30, 2011 and 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 loss rates 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. 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 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. Consistent with prior periods, at September 30, 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 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 conditions, changes in lending personnel experience, changes in lending policies or procedures and other influencing factors. These qualitative and environmental factors are considered for each of the five loan segments and the allowance allocation, as determined by the processes noted above, is increased or decreased based on the incremental assessment of these factors.



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The Company maintains an unallocated amount for inherent factors that cannot be practically assigned to individual loan segments or categories that is needed due to the imprecision in the overall measurement process.

The following table details the changes in the allowance for loan losses by portfolio segment for the quarter and nine months ended September 30, 2011.

|                              | September 30, 2011              |   |                           |                            |                         |             |          |
|------------------------------|---------------------------------|---|---------------------------|----------------------------|-------------------------|-------------|----------|
| (In thousands)               | Commercial<br>and<br>industrial | Construction<br>and land<br>development | Commercial<br>real estate | Residential<br>real estate | Consumer<br>installment | Unallocated | Total    |
| <b>Quarter ended:</b>        |                                 |   |                           |                            |                         |             |          |
| Beginning balance            | \$ 767                          | 2,759                                   | 2,722                     | 1,104                      | 190                     | 204         | \$ 7,746 |
| Charge-offs                  | (298)                           | (1,572)                                 | (79)                      | (73)                       | (7)                     |             | (2,029)  |
| Recoveries                   | 5                               | 1                                       |                           | 14                         | 3                       |             | 23       |
| Net (charge-offs) recoveries | (293)                           | (1,571)                                 | (79)                      | (59)                       | (4)                     |             | (2,006)  |
| Provision                    | 288                             | (50)                                    |                           | 359                        | (8)                     | 11          | 600      |
| Ending balance               | \$ 762                          | 1,138                                   | 2,643                     | 1,404                      | 178                     | 215         | \$ 6,340 |
| <b>Nine months ended:</b>    |                                 |   |                           |                            |                         |             |          |
| Beginning balance            | \$ 972                          | 2,223                                   | 2,893                     | 1,336                      | 141                     | 111         | \$ 7,676 |
| Charge-offs                  | (659)                           | (1,717)                                 | (419)                     | (519)                      | (11)                    |             | (3,325)  |
| Recoveries                   | 28                              | 2                                       |                           | 149                        | 10                      |             | 189      |
| Net (charge-offs) recoveries | (631)                           | (1,715)                                 | (419)                     | (370)                      | (1)                     |             | (3,136)  |
| Provision                    | 421                             | 630                                     | 169                       | 438                        | 38                      | 104         | 1,800    |
| Ending balance               | \$ 762                          | 1,138                                   | 2,643                     | 1,404                      | 178                     | 215         | \$ 6,340 |

The following table presents an analysis of the allowance for loan losses and recorded investment in loans by portfolio segment and impairment methodology as of September 30, 2011 and December 31, 2010.

| (In thousands)                    | Collectively evaluated (1) |                              | Individually evaluated (2) |                              | Total Allowance |                              |
|-----------------------------------|----------------------------|------------------------------|----------------------------|------------------------------|-----------------|------------------------------|
|                                   | Allowance for loan losses  | Recorded investment in loans | Allowance for loan losses  | Recorded investment in loans | for loan losses | Recorded investment in loans |
| <b>September 30, 2011:</b>        |                            |                              |                            |                              |                 |                              |
| Commercial and industrial         | \$ 762                     | 53,661                       |                            | 227                          | 762             | 53,888                       |
| Construction and land development | 929                        | 35,625                       | 209                        | 5,156                        | 1,138           | 40,781                       |
| Commercial real estate            | 2,221                      | 162,374                      | 422                        | 3,685                        | 2,643           | 166,059                      |
| Residential real estate           | 1,163                      | 100,713                      | 241                        | 1,317                        | 1,404           | 102,030                      |
| Consumer installment              | 178                        | 12,105                       |                            |                              | 178             | 12,105                       |
| Unallocated                       | 215                        |                              |                            |                              | 215             |                              |
| Total                             | \$ 5,468                   | 364,478                      | 872                        | 10,385                       | 6,340           | 374,863                      |
| <b>December 31, 2010:</b>         |                            |                              |                            |                              |                 |                              |
| Commercial and industrial         | \$ 695                     | 52,767                       | 277                        | 521                          | 972             | 53,288                       |
| Construction and land development | 2,100                      | 43,748                       | 123                        | 4,102                        | 2,223           | 47,850                       |
| Commercial real estate            | 2,128                      | 161,611                      | 765                        | 4,630                        | 2,893           | 166,241                      |



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|                         |          |         |       |        |       |         |
|-------------------------|----------|---------|-------|--------|-------|---------|
| Residential real estate | 1,192    | 93,823  | 144   | 2,418  | 1,336 | 96,241  |
| Consumer installment    | 141      | 10,676  |       |        | 141   | 10,676  |
| Unallocated             | 111      |         |       |        | 111   |         |
| Total                   | \$ 6,367 | 362,625 | 1,309 | 11,671 | 7,676 | 374,296 |

- (1) Represents loans collectively evaluated for impairment in accordance with ASC 450-20, *Loss Contingencies* (formerly FAS 5), and pursuant to amendments by ASU 2010-20 regarding allowance for unimpaired loans.
- (2) Represents loans individually evaluated for impairment in accordance with ASC 310-30, *Receivables* (formerly FAS 114), and pursuant to amendments by ASU 2010-20 regarding allowance for impaired loans.

**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.

**Substandard Accruing** 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.

| (In thousands)                    | September 30, 2011 |                    |                         |            |                |
|-----------------------------------|--------------------|--------------------|-------------------------|------------|----------------|
|                                   | Pass               | Special<br>Mention | Substandard<br>Accruing | Nonaccrual | Total<br>loans |
| Commercial and industrial         | \$ 51,602          | 1,460              | 794                     | 32         | \$ 53,888      |
| Construction and land development | 34,233             | 279                | 1,113                   | 5,156      | 40,781         |
| Commercial real estate:           |                    |                    |                         |            |                |
| Owner occupied                    | 63,149             | 4,996              | 1,507                   | 1,595      | 71,247         |
| Other                             | 83,956             | 627                | 8,208                   | 2,021      | 94,812         |
| Total commercial real estate      | 147,105            | 5,623              | 9,715                   | 3,616      | 166,059        |
| Residential real estate:          |                    |                    |                         |            |                |
| Consumer mortgage                 | 50,977             | 2,335              | 4,691                   | 932        | 58,935         |
| Investment property               | 38,675             | 2,246              | 1,547                   | 627        | 43,095         |
| Total residential real estate     | 89,652             | 4,581              | 6,238                   | 1,559      | 102,030        |
| Consumer installment              | 11,741             | 115                | 106                     | 143        | 12,105         |
| Total                             | \$ 334,333         | 12,058             | 17,966                  | 10,506     | \$ 374,863     |

| (In thousands)                    | December 31, 2010 |                    |                         |            |                |
|-----------------------------------|-------------------|--------------------|-------------------------|------------|----------------|
|                                   | Pass              | Special<br>Mention | Substandard<br>Accruing | Nonaccrual | Total<br>loans |
| 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         |

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|                               |            |        |        |        |            |
|-------------------------------|------------|--------|--------|--------|------------|
| 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     |
| 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 tables present 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 tables set forth certain information regarding the Company's impaired loans that were individually evaluated for impairment at September 30, 2011 and December 31, 2010.

|                                    | September 30, 2011                 |  |                            |                      |
|------------------------------------|------------------------------------|--|----------------------------|----------------------|
|                                    | Unpaid<br>principal<br>balance (1) | Charge-offs<br>and payments<br>applied (2) | Recorded<br>investment (3) | Related<br>allowance |
| <i>(In thousands)</i>              |                                    |  |                            |                      |
| <b>With no allowance recorded:</b> |                                    |  |                            |                      |
| Commercial and industrial          | \$ 227                             |  | 227                        |                      |
| Construction and land development  | 3,958                              | (1,572)                                    | 2,386                      |                      |
| Commercial real estate:            |                                    |  |                            |                      |
| Owner occupied                     | 811                                | (11)                                       | 800                        |                      |
| Other                              | 655                                | (44)                                       | 611                        |                      |
| Total commercial real estate       | 1,466                              | (55)                                       | 1,411                      |                      |
| Residential real estate:           |                                    |  |                            |                      |
| Consumer mortgages                 |                                    |  |                            |                      |
| Investment property                |                                    |  |                            |                      |
| Total residential real estate      |                                    |  |                            |                      |
| Consumer installment               |                                    |  |                            |                      |
| Total                              | \$ 5,651                           | (1,627)                                    | 4,024                      |                      |
| <b>With allowance recorded:</b>    |                                    |  |                            |                      |
| Commercial and industrial          | \$                                 |  |                            | \$                   |
| Construction and land development  | 2,913                              | (143)                                      | 2,770                      | 209                  |
| Commercial real estate:            |                                    |  |                            |                      |
| Owner occupied                     | 1,104                              | (24)                                       | 1,080                      | 204                  |
| Other                              | 1,240                              | (46)                                       | 1,194                      | 218                  |
| Total commercial real estate       | 2,344                              | (70)                                       | 2,274                      | 422                  |
| Residential real estate:           |                                    |  |                            |                      |
| Consumer mortgages                 | 1,005                              | (79)                                       | 926                        | 71                   |
| Investment property                | 391                                |  | 391                        | 170                  |
| Total residential real estate      | 1,396                              | (79)                                       | 1,317                      | 241                  |
| Consumer installment               |                                    |  |                            |                      |

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|                             |                  |                |               |               |
|-----------------------------|------------------|----------------|---------------|---------------|
| Total                       | \$ 6,653         | (292)          | 6,361         | \$ 872        |
| <b>Total impaired loans</b> | <b>\$ 12,304</b> | <b>(1,919)</b> | <b>10,385</b> | <b>\$ 872</b> |

- (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.

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|                                    | December 31, 2010                  |  |                            |                      |
|------------------------------------|------------------------------------|--|----------------------------|----------------------|
|                                    | Unpaid<br>principal<br>balance (1) | Charge-offs<br>and payments<br>applied (2) | Recorded<br>investment (3) | Related<br>allowance |
| <i>(In thousands)</i>              |                                    |  |                            |                      |
| <b>With no allowance recorded:</b> |                                    |  |                            |                      |
| 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                      |                      |
| <b>With allowance recorded:</b>    |                                    |  |                            |                      |
| Commercial and industrial          | \$ 528                             | (7)  | 521                        | \$ 277               |
| Construction and land development  | 1,618                              |  | 1,618                      | 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                              | \$ 6,343                           | (98)                                       | 6,245                      | \$ 1,309             |
| <b>Total impaired loans</b>        | <b>\$ 11,901</b>                   | <b>(230)</b>                               | <b>11,671</b>              | <b>\$ 1,309</b>      |

(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.

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The following table provides the average recorded investment in impaired loans and the amount of interest income recognized on impaired loans after impairment by portfolio segment and class.

|                                   | Quarter ended September 30, 2011 |                                  | Nine months ended September 30, 2011 |                                  |
|-----------------------------------|----------------------------------|----------------------------------|--------------------------------------|----------------------------------|
|                                   | Average recorded investment      | Total interest income recognized | Average recorded investment          | Total interest income recognized |
| <i>(In thousands)</i>             |                                  |                                  |                                      |                                  |
| <b>Impaired loans:</b>            |                                  |                                  |                                      |                                  |
| Commercial and industrial         | \$ 229                           | 3                                | 345                                  | 5                                |
| Construction and land development | 3,589                            |                                  | 3,843                                |                                  |
| Commercial real estate:           |                                  |                                  |                                      |                                  |
| Owner occupied                    | 1,886                            | 10                               | 1,769                                | 17                               |
| Other                             | 2,096                            |                                  | 2,545                                |                                  |
| Total commercial real estate      | 3,982                            | 10                               | 4,314                                | 17                               |
| Residential real estate:          |                                  |                                  |                                      |                                  |
| Consumer mortgages                | 934                              |                                  | 1,514                                |                                  |
| Investment property               | 130                              |                                  | 75                                   |                                  |
| Total residential real estate     | 1,064                            |                                  | 1,589                                |                                  |
| Consumer installment              |                                  |                                  |                                      |                                  |
| <b>Total</b>                      | <b>\$ 8,864</b>                  | <b>13</b>                        | <b>10,091</b>                        | <b>22</b>                        |

**Troubled Debt Restructurings**

Impaired loans also included TDRs. In the normal course of business, management grants concessions to borrowers, which would not otherwise be considered where the borrowers are experiencing financial difficulty. A concession may include, but is not limited to, reduction of the stated interest rate of the loan, reduction of accrued interest, extension of the maturity date or reduction of the face amount or maturity amount of the debt. A concession has been granted when, as a result of the restructuring, the Bank does not expect to collect all amounts due, including interest at the original stated rate. A concession may have also been granted if the debtor is not able to access funds elsewhere at a market rate for debt with similar risk characteristics as the restructured debt. The Company's determination of whether a loan modification is a TDR considers the individual facts and circumstances surrounding each modification. As part of the credit approval process, the restructured loans are evaluated for adequate collateral protection in determining the appropriate accrual status at the time of restructure.

Similar to other impaired loans, TDRs are measured for impairment based on the present value of expected payments using the loan's original effective interest rate as the discount rate, or the fair value of the collateral, less selling costs if the loan is collateral dependent. If the recorded investment in the loan exceeds the measure of fair value, impairment is recognized by establishing a valuation allowance as part of the allowance for loan losses or a charge-off to the allowance for loan losses. In periods subsequent to the modification, all TDRs are evaluated, including those that have payment defaults, for possible impairment.

At September 30, 2011 and December 31, 2010, the Company had impaired loans classified as TDRs of \$9.5 million and \$7.6 million, respectively. At September 30, 2011 the Company had \$0.7 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 \$0.8 million and \$1.0 million at September 30, 2011 and December 31, 2010, respectively. At September 30, 2011, there were no significant outstanding commitments to advance additional funds to customers whose loans had been restructured.

Effective July 1, 2011, the Company adopted ASU 2011-02, *A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring*. See Note 1. As such, the Company reassessed all restructurings that occurred on or after January 1, 2011 for identification and disclosure as TDRs.





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The following table summarizes the recorded investment in loans modified in a TDR both before and after their modification during the respective period.

|                                   | Quarter ended September 30, 2011 |  |   | Nine months ended September 30, 2011 |  |   |
|-----------------------------------|----------------------------------|--|---|--------------------------------------|--|---|
|                                   | Number of contracts              | Pre-modification outstanding recorded investment | Post-modification outstanding recorded investment | Number of contracts                  | Pre-modification outstanding recorded investment | Post-modification outstanding recorded investment |
| (\$ in thousands)                 |                                  |  |   |                                      |  |   |
| <b>TDRs:</b>                      |                                  |  |   |                                      |  |   |
| Commercial and industrial         | 1                                | \$ 283   | 283   | 2                                    | \$ 791   | 523   |
| Construction and land development | 2                                | 4,432  | 4,419   | 3                                    | 4,925  | 4,894   |
| Commercial real estate:           |                                  |  |   |                                      |  |   |
| Owner occupied                    | 1                                | 256  | 256   | 4                                    | 2,202  | 1,915   |
| Other                             |                                  |  |   | 1                                    | 1,229  | 1,229   |
| Total commercial real estate      | 1                                | 256  | 256   | 5                                    | 3,431  | 3,144   |
| Residential real estate:          |                                  |  |   |                                      |  |   |
| Consumer mortgages                |                                  |  |   |                                      |  |   |
| Investment property               | 1                                | 391  | 391   | 1                                    | 391  | 391   |
| Total residential real estate     | 1                                | 391  | 391   | 1                                    | 391  | 391   |
| Consumer installment              |                                  |  |   |                                      |  |   |
| <b>Total</b>                      | <b>5</b>                         | <b>\$ 5,362</b>                                  | <b>5,349</b>                                      | <b>11</b>                            | <b>\$ 9,538</b>                                  | <b>8,952</b>                                      |

The majority of the loans modified in a TDR during the quarter and nine months ended September 30, 2011 included delays in required payments of principal and/or interest or where the only concession granted by the Company was that the interest rate at renewal was not considered to be a market rate. Only two modifications during the nine months ended September 30, 2011 were A/B note restructurings, where the B note was charged off. Total charge-offs related to B notes during the nine months ended September 30, 2011 were approximately \$0.6 million.

As of September 30, 2011, there were no loans modified in a TDR within the previous 12 months for which there was a payment default (defined as more than 90 days past due) and an outstanding loan balance.

**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.

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The change in amortized MSR's and the related valuation allowance for the quarters and nine months ended September 30, 2011 and 2010 are presented below.

| <i>(Dollars in thousands)</i> | Quarter ended September 30, |        | Nine months ended September 30, |        |
|-------------------------------|-----------------------------|--------|---------------------------------|--------|
|                               | 2011                        | 2010   | 2011                            | 2010   |
| Beginning balance             | \$ 1,239                    | \$ 877 | \$ 1,189                        | \$ 834 |
| Additions, net                | 79                          | 149    | 231                             | 260    |
| Amortization expense          | (61)                        | (44)   | (163)                           | (112)  |
| Change in valuation allowance | (20)                        |        | (20)                            |        |
| Ending balance                | \$ 1,237                    | \$ 982 | \$ 1,237                        | \$ 982 |

**Fair value of amortized MSR's:**

|                     |          |          |          |        |
|---------------------|----------|----------|----------|--------|
| Beginning of period | \$ 1,422 | \$ 1,023 | \$ 1,335 | \$ 978 |
| End of period       | 1,237    | 1,024    | 1,237    | 1,024  |

The Company periodically evaluates mortgage servicing rights for impairment. Impairment is determined by stratifying MSR's into groupings based on predominant risk characteristics, such as interest rate and loan type. If, by individual stratum, the carrying amount of the MSR's exceeds fair value, a valuation reserve is established. At September 30, 2011, the Company recorded a valuation allowance of \$20,000 and at December 31, 2010 there was no valuation allowance recorded for MSR's.

**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 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.

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 for a security. 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.



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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 certain 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* A loan is considered impaired when it is probable that the Company will be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreement. Impaired loans are measured based on the present value of expected payments using the loan's original effective rate as the discount rate, the loan's observable market price, or the fair value of the collateral less selling costs if the loan is collateral dependent. If the recorded investment in the impaired loan exceeds the measure of fair value, a valuation allowance may be established as a component of the allowance for loan losses or the expense is recognized as a charge-off. Impaired loans are classified within Level 3 of the valuation hierarchy.

*Other real estate owned* Other real estate owned, 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 September 30, 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 September 30, 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 September 30, 2011 and December 31, 2010, respectively, by caption, on the Condensed Consolidated Balance Sheets by FASB ASC 820 valuation hierarchy (as described above).

|  |                   | Quoted Prices in<br>Active<br>Markets<br>for<br><br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) |
|--|-------------------|--|---|--|
| <i>(Dollars in thousands)</i>          | <b>Amount</b>     |  |   |  |
| <b>September 30, 2011:</b>             |                   |  |   |  |
| Securities available-for-sale:         |                   |  |   |  |
| Agency obligations                     | \$ 41,259         |  | 41,259  |  |
| Agency RMBS                            | 157,060           |  | 157,060   |  |
| State and political subdivisions       | 82,800            |  | 82,800  |  |
| Trust preferred securities:            |                   |  |   |  |
| Pooled                                 | 100               |  |   | 100  |
| Individual issuer                      | 1,851             |  |   | 1,851  |
| Total securities available-for-sale    | 283,070           |  | 281,119   | 1,951  |
| Other assets <sup>(1)</sup>            | 1,334             |  | 1,334   |  |
| <b>Total assets at fair value</b>      | <b>\$ 284,404</b> |  | <b>282,453</b>  | <b>1,951</b>                                       |
| Other liabilities <sup>(1)</sup>       | 1,334             |  | 1,334   |  |
| <b>Total liabilities at fair value</b> | <b>\$ 1,334</b>   |  | <b>1,334</b>  |  |
| <b>December 31, 2010:</b>              |                   |  |   |  |
| Securities available-for-sale:         |                   |  |   |  |
| Agency obligations                     | \$ 90,471         |  | 90,471  |  |
| Agency RMBS                            | 143,144           |  | 143,144   |  |
| State and political subdivisions       | 76,766            |  | 76,766  |  |
| Trust preferred securities:            |                   |  |   |  |
| Pooled                                 | 20                |  |   | 20   |
| Individual issuer                      | 2,129             |  |   | 2,129  |
| Corporate debt                         | 2,690             | 2,690  |   |  |
| Total securities available-for-sale    | 315,220           | 2,690  | 310,381   | 2,149  |
| Other assets <sup>(1)</sup>            | 1,101             |  | 1,101   |  |
| <b>Total assets at fair value</b>      | <b>\$ 316,321</b> | <b>2,690</b>   | <b>311,482</b>  | <b>2,149</b>                                       |
| Other liabilities <sup>(1)</sup>       | 1,101             |  | 1,101   |  |
| <b>Total liabilities at fair value</b> | <b>\$ 1,101</b>   |  | <b>1,101</b>  |  |

<sup>(1)</sup> Represents the fair value of interest rate swap agreements.

**Level changes in fair value measurements**

Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally coincides with the Corporation's monthly and/or quarterly valuation process. The Company monitors the valuation techniques utilized for each category of financial assets and liabilities to ascertain when transfers between levels have been affected. The nature of the Company's financial assets and liabilities generally is such that transfers in and out of any level are expected to be rare. For the nine months ended September 30, 2011, there were no transfers between levels.

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The following is a reconciliation of the beginning and ending balances of recurring fair value measurements for trust preferred securities recognized in the accompanying Condensed Consolidated Balance Sheets using Level 3 inputs:

|   | Nine months ended September 30, |          |
|---|---------------------------------|----------|
|   | 2011                            | 2010     |
| <i>(Dollars in thousands)</i>                     |                                 |          |
| Beginning balance                                 | \$ 2,149                        | \$ 1,463 |
| Total realized and unrealized gains and (losses): |                                 |          |
| Included in net earnings                          | (338)                           | (390)    |
| Included in other comprehensive income            | 140                             | 1,327    |
| Purchases   |                                 |          |
| Issuances   |                                 |          |
| Settlements                                       |                                 |          |
| Transfers in and/or (out) of Level 3              |                                 |          |
| Ending balance                                    | \$ 1,951                        | \$ 2,400 |

**Assets and liabilities measured at fair value on a nonrecurring basis**

The following table presents the balances of the assets and liabilities measured at fair value on a nonrecurring basis as of September 30, 2011 and December 31, 2010, respectively, by caption, on the Condensed Consolidated Balance Sheets and by FASB ASC 820 valuation hierarchy (as described above):

|                               |           | Quoted Prices in<br>Active<br>Markets<br>for | Other<br>Observable<br>Inputs | Significant<br>Unobservable<br>Inputs |
|-------------------------------|-----------|--|-------------------------------|---------------------------------------|
|                               | Amount    | Identical<br>Assets<br>(Level 1)             | Inputs<br>(Level 2)           | (Level 3)                             |
| <i>(Dollars in thousands)</i> |           |  |                               |                                       |
| <b>September 30, 2011:</b>    |           |  |                               |                                       |
| Loans held for sale           | \$ 2,906  |  | 2,906                         |                                       |
| Loans, net <sup>(1)</sup>     | 9,513     |  |                               | 9,513                                 |
| Other real estate owned       | 7,770     |  |                               | 7,770                                 |
| Other assets <sup>(2)</sup>   | 1,237     |  |                               | 1,237                                 |
| Total assets at fair value    | \$ 21,426 |  | 2,906                         | 18,520                                |
| <b>December 31, 2010:</b>     |           |  |                               |                                       |
| Loans held for sale           | \$ 4,281  |  | 4,281                         |                                       |
| Loans, net <sup>(1)</sup>     | 10,362    |  |                               | 10,362                                |
| Other real estate owned       | 8,125     |  |                               | 8,125                                 |
| Other assets <sup>(2)</sup>   | 1,189     |  |                               | 1,189                                 |
| Total assets at fair value    | \$ 23,957 |  | 4,281                         | 19,676                                |

<sup>(1)</sup> Loans considered impaired under FASB ASC 310-10-35 Receivables. This amount reflects the recorded investment in impaired loans, net of any related allowance for loan losses.

<sup>(2)</sup> Represents the carrying value of MSRs, net.

**NOTE 9: FAIR VALUE OF FINANCIAL INSTRUMENTS**

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FASB ASC 825, *Financial Instruments*, requires disclosure of 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 explained below. Where quoted market prices are not available, fair values are based on estimates using discounted cash flow and other valuation techniques. Discounted cash flows can be significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. The following fair value estimates cannot be substantiated by comparison to independent markets and should not be considered representative of the liquidation value of the Company's financial instruments, but rather a good faith estimate of the fair value of financial instruments held by the Company. FASB ASC 825 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements.



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The following methods and assumptions were used by the Company in estimating the fair value of its financial instruments:

### ***Cash and cash equivalents***

Due to their short-term nature, the carrying amounts reported in the balance sheet are assumed to approximate fair value for these assets. For purposes of disclosure, cash equivalents include federal funds sold and other interest bearing bank deposits.

### ***Securities available-for-sale***

Fair value measurement is based upon quoted prices if available. If quoted market prices are not available, estimated fair values are based on quoted market prices of comparable instruments. See Note 5 for additional disclosure related to fair value measurements for 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.

### ***Loans, net***

The fair value of loans is calculated using discounted cash flows. The discount rates used to determine the present value of the loan portfolio are estimated market discount rates that reflect the credit and interest rate risk inherent in the loan portfolio. This method of estimating fair value does not incorporate the exit-price concept of fair value prescribed by FASB ASC 820 and generally produces a higher value than an exit-price approach. The estimated maturities are based on the Company's historical experience with repayments adjusted to estimate the effect of current market conditions.

### ***Deposits***

Under FASB ASC 825, the fair value of deposits with no stated maturity, such as noninterest bearing demand deposits, interest bearing demand deposits and savings and certain types of money market accounts, is equal to the amount payable on demand at the reporting date (i.e., their carrying amount). The carrying amounts of variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using discounted cash flows. The discount rates used are based on estimated market rates for deposits of similar remaining maturities.

### ***Short-term borrowings***

The fair value of federal funds purchased, securities sold under agreements to repurchase, and other short term borrowings approximate their carrying value.

### ***Long-term debt***

The fair value of the Company's fixed rate long-term debt is estimated using discounted cash flows based on estimated current market rates for similar types of borrowing arrangements. The carrying amount of the Company's variable rate long-term debt approximates its fair value.

### ***Derivative Instruments***

The carrying amounts of derivative instruments approximate their fair value.

### ***Off-balance sheet Instruments***

The fair values of the Company's off-balance-sheet financial instruments are based on fees charged to enter into similar agreements. However, commitments to extend credit do not represent a significant value to the Company until such commitments are funded. The Company has determined that the estimated fair value of commitments to extend credit approximates the carrying amount and is immaterial to the financial statements.



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The carrying value and related estimated fair value of the Company's financial instruments at September 30, 2011 and December 31, 2010 are presented below.

|                               | September 30, 2011 |                      | December 31, 2010 |                      |
|-------------------------------|--------------------|----------------------|-------------------|----------------------|
|                               | Carrying amount    | Estimated fair value | Carrying amount   | Estimated fair value |
| <i>(Dollars in thousands)</i> |                    |                      |                   |                      |
| <b>Financial Assets:</b>      |                    |                      |                   |                      |
| Cash and cash equivalents     | \$ 55,645          | \$ 55,645            | \$ 21,424         | \$ 21,424            |
| Securities available-for-sale | 283,070            | 283,070              | 315,220           | 315,220              |
| Loans held for sale           | 2,906              | 2,906                | 4,281             | 4,281                |
| Loans, net                    | 368,448            | 377,683              | 366,539           | 372,869              |
| Derivative assets             | 1,334              | 1,334                | 1,101             | 1,101                |
| <b>Financial Liabilities:</b> |                    |                      |                   |                      |
| Deposits                      | \$ 609,070         | \$ 615,518           | \$ 607,127        | \$ 615,300           |
| Short-term borrowings         | 2,613              | 2,613                | 2,685             | 2,685                |
| Long-term debt                | 85,317             | 93,833               | 93,331            | 99,505               |
| Derivative liabilities        | 1,334              | 1,334                | 1,101             | 1,101                |

**NOTE 10: DERIVATIVE INSTRUMENTS**

Financial derivatives are reported at fair value in other assets or other liabilities. The accounting for changes in the fair value of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as part of a hedging relationship, the gain or loss is recognized in current earnings. From time to time, the Company may enter into interest rate swaps ( swaps ) to facilitate customer transactions and meet their financing needs. Upon entering into these instruments to meet customer needs, the Company enters into offsetting positions in order to minimize the risk to the Company. These swaps qualify as derivatives, but are not designated as hedging instruments. At September 30, 2011, the Company had no derivative contracts to assist in managing its interest rate sensitivity.

Interest rate swap agreements involve the risk of dealing with counterparties and their ability to meet contractual terms. When the fair value of a derivative instrument is positive, this generally indicates that the counterparty or customer owes the Company, and results in credit risk to the Company. When the fair value of a derivative instrument is negative, the Company owes the customer or counterparty and therefore, has no credit risk.

A summary of the Company's interest rate swaps as of and for the nine months ended September 30, 2011 is presented below.

|                                       | Notional  | Other Assets<br>Estimated<br>Fair Value | Other Liabilities<br>Estimated<br>Fair Value | Other noninterest<br>income<br>Gains<br>(Losses) |
|---------------------------------------|-----------|---|--|--|
| <i>(Dollars in thousands)</i>         |           |   |  |  |
| <b>Interest rate swap agreements:</b> |           |   |  |  |
| Pay fixed / receive variable          | \$ 5,804  |   | 1,334  | \$ (233)   |
| Pay variable / receive fixed          | 5,804     | 1,334                                   |  | 233  |
| Total interest rate swap agreements   | \$ 11,608 | 1,334                                   | 1,334  | \$   |

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### **ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion and analysis is designed to provide a better understanding of various factors related to the results of operations and financial condition of the Auburn National Bancorporation, Inc. (the "Company") and its wholly owned subsidiary, AuburnBank (the "Bank"). This discussion is intended to supplement and highlight information contained in the accompanying unaudited condensed consolidated financial statements and related notes for the quarters and nine months ended September 30, 2011 and 2010, as well as the information contained in our annual report on Form 10-K for the year ended December 31, 2010 and our quarterly reports on Form 10-Q for the quarters ended March 31, 2011 and June 30, 2011.

Certain of the statements made herein under the caption "MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS," and elsewhere, including information incorporated herein by reference to other documents, are forward-looking statements within the meaning of, and subject to, the protections of Section 27A of the Securities Act of 1933, as amended, (the "Securities Act") and Section 21E of the Securities Exchange Act of 1934, as amended (the "Exchange Act").

Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, anticipations, assumptions, estimates, intentions, and future performance, and involve known and unknown risks, uncertainties and other factors, which may be beyond our control, and which may cause our actual results, performance or achievements to be materially different from future results, performance or achievements expressed or implied by such forward-looking statements.

All statements other than statements of historical fact are statements that could be forward-looking statements. You can identify these forward-looking statements through our use of words such as "may," "will," "anticipate," "assume," "should," "desired," "indicate," "would," "believe," "contemplate," "expect," "seek," "estimate," "evaluate," "continue," "plan," "point to," "project," "predict," "could," "intend," "target," "potential," and expressions of the future. These forward-looking statements may not be realized due to a variety of factors, including, without limitation:

the effects of future economic, business and market conditions and changes, domestic and foreign, including seasonality;

governmental monetary and fiscal policies;

legislative and regulatory changes, including changes in banking, securities and tax laws, regulations and rules and their application by our regulators, and changes in the scope and cost of FDIC insurance and other coverage;

changes in accounting policies, rules and practices;

the risks of changes in interest rates on the levels, composition and costs of deposits, loan demand, and the values and liquidity of loan collateral, securities, and interest sensitive assets and liabilities, and the risks and uncertainty of the amounts realizable and the timing of dispositions of assets by the FDIC where we may have a participation or other interest;

changes in borrower credit risks and payment behaviors;

changes in the availability and cost of credit and capital in the financial markets, and the types of instruments that may be included as capital for regulatory purposes;

changes in the prices, values and sales volumes of residential and commercial real estate;

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the effects of competition from a wide variety of local, regional, national and other providers of financial, investment and insurance services;

the failure of assumptions and estimates underlying the establishment of reserves for possible loan losses and other estimates, including estimates of potential losses due to claims from purchases of mortgages that we originated;

the risks of mergers, acquisitions and divestitures, including, without limitation, the related time and costs of implementing such transactions, integrating operations as part of these transactions and possible failures to achieve expected gains, revenue growth and/or expense savings from such transactions;

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changes in technology or products that may be more difficult, costly, or less effective than anticipated;

the effects of war or other conflicts, acts of terrorism or other catastrophic events, such as the recent oil spill in the Gulf of Mexico, that may affect general economic conditions;

the failure of assumptions and estimates, as well as differences in, and changes to, economic, market and credit conditions, including changes in borrowers' credit risks and payment behaviors from those used in our loan portfolio stress test;

the risks that our deferred tax assets could be reduced if estimates of future taxable income from our operations and tax planning strategies are less than currently estimated, and sales of our capital stock could trigger a reduction in the amount of net operating loss carry-forwards that we may be able to utilize for income tax purposes; and

other factors and information in this report and other filings that we make with the SEC under the Exchange Act, including our annual report on Form 10-K for the year ended December 31, 2010 and subsequent quarterly and current reports. See Part II, Item 1A, RISK FACTORS.

All written or oral forward-looking statements that are made by or attributable to us are expressly qualified in their entirety by this cautionary notice. We have no obligation and do not undertake to update, revise or correct any of the forward-looking statements after the date of this report, or after the respective dates on which such statements otherwise are made.

**Business**

The Company was incorporated in 1990 under the laws of the State of Delaware and became a bank holding company after it acquired its Alabama predecessor, which was a bank holding company established in 1984. The Bank, the Company's principal subsidiary, is an Alabama state-chartered bank that is a member of the Federal Reserve System and has operated continuously since 1907. Both the Company and the Bank are headquartered in Auburn, Alabama. The Bank conducts its business primarily in East Alabama, including Lee County and surrounding areas. The Bank operates full-service branches in Auburn, Opelika, Hurtsboro and Notasulga, Alabama. In-store branches are located in the Auburn and Opelika Kroger stores, as well as Wal-Mart SuperCenter stores in Auburn, Opelika and Phenix City, Alabama. Mortgage loan offices are located in Phenix City, Valley, and Mountain Brook, Alabama.

**Summary of Results of Operations**

|   | Quarter ended September 30, |          | Nine months ended September 30, |           |
|---|-----------------------------|----------|---------------------------------|-----------|
|   | 2011                        | 2010     | 2011                            | 2010      |
| <i>(Dollars in thousands, except per share amounts)</i> |                             |          |                                 |           |
| Net interest income (a)                                 | \$ 5,274                    | \$ 5,187 | \$ 16,020                       | \$ 15,581 |
| Less: tax-equivalent adjustment                         | 429                         | 449      | 1,304                           | 1,324     |
| Net interest income (GAAP)                              | 4,845                       | 4,738    | 14,716                          | 14,257    |
| Noninterest income                                      | 1,398                       | 1,857    | 3,898                           | 6,945     |
| Total revenue   | 6,243                       | 6,595    | 18,614                          | 21,202    |
| Provision for loan losses                               | 600                         | 730      | 1,800                           | 2,930     |
| Noninterest expense                                     | 4,339                       | 4,366    | 12,352                          | 12,811    |
| Income tax expense                                      | (63)                        | 255      | 89                              | 993       |
| Net earnings  | \$ 1,367                    | \$ 1,244 | \$ 4,373                        | \$ 4,468  |
| Basic and diluted earnings per share                    | \$ 0.38                     | \$ 0.34  | \$ 1.20                         | \$ 1.23   |

**Financial Summary**

The Company's net earnings were \$4.4 million for the first nine months of 2011, compared to \$ 4.5 million for the first nine months of 2010. Basic and diluted earnings per share were \$1.20 per share for the first nine months of 2011, compared to \$1.23 per share for the first nine months of 2010.

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Net interest income was \$14.7 million for the first nine months of 2011, compared to 14.3 million for the first nine months of 2010. Average loans were \$374.4 million in the first nine months of 2011, a decrease of \$2.9 million, or 1%, from the first nine months of 2010. Average deposits were \$619.8 million in the first nine months of 2011, an increase of \$18.2 million, or 3%, from the first nine months of 2010.

The provision for loan losses during the first nine months of 2011 was \$1.8 million, compared to \$2.9 million in the first nine months of 2010. The Company's annualized net charge-off ratio was 1.12% in the first nine months of 2011, compared to 0.79% in the first nine months of 2010. Despite the increase in net charge-offs during the first nine months of 2011, the provision for loan losses decreased during the period primarily due to the level of allowance for loan losses related to the construction and land development loan portfolio segment. The decline in the allowance for loan losses for the construction and land development portfolio segment is due to a decline in both total loans outstanding in the construction and land development portfolio and adversely risk-graded construction and land development loans.

Noninterest income was \$3.9 million for the first nine months of 2011, compared to noninterest income of \$6.9 million in the first nine months of 2010. The decrease in noninterest income was primarily due to a decrease in net securities gains of \$2.0 million, a decrease in mortgage lending income of \$0.6 million, and an increase in affordable housing investment losses of \$0.3 million.

Noninterest expense was \$12.4 million during the first nine months of 2011, compared to noninterest expense of \$12.8 million in the first nine months of 2010. The decrease in noninterest expense was primarily due to a decrease in prepayment penalties on long-term debt of \$0.7 million and FDIC and other regulatory assessments of \$0.2 million, which were partially offset by an increase in salaries and benefits expense of \$0.4 million.

Income tax expense was approximately \$0.1 million in the first nine months of 2011, compared to \$1.0 million in the first nine months of 2010. The Company's effective tax rate in the first nine months of 2011 was approximately 1.99%, compared to 18.18% in the first nine months of 2010. The decrease in the Company's effective tax rate during the first nine months of 2011 when compared to the first nine months of 2010 was due to a decline in the level of earnings before taxes and an increase in federal tax credits related to the Company's investments in affordable housing limited partnerships, which increased in 2011.

In the first nine months of 2011, the Company paid cash dividends of \$2.2 million, or \$0.60 per share. The Company's balance sheet remains strong and well capitalized under current regulatory guidelines with a total risk-based capital ratio of 16.51% and a Tier 1 leverage ratio of 8.87% at September 30, 2011.

## **CRITICAL ACCOUNTING POLICIES**

The accounting and financial reporting policies of the Company conform with U.S. generally accepted accounting principles and with general practices within the banking industry. In connection with the application of those principles, we have made judgments and estimates which, in the case of the determination of our allowance for loan losses, our assessment of other-than-temporary impairment, recurring and non-recurring fair value measurements, the valuation of other real estate owned, and the valuation of deferred tax assets, were critical to the determination of our financial position and results of operations. Other policies also require subjective judgment and assumptions and may accordingly impact our financial position and results of operations.

### **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 loss rates 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.





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An impairment allowance is recognized if the fair value of the loan is less than the recorded investment in the loan. 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 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. Consistent with prior periods, at September 30, 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 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 conditions, changes in lending personnel experience, changes in lending policies or procedures and other influencing factors. These qualitative and environmental factors are considered for each of the five loan segments and the allowance allocation, as determined by the processes noted above, is increased or decreased based on the incremental assessment of these factors.

The Company maintains an unallocated amount for inherent factors that cannot be practically assigned to individual loan segments or categories. An example is the imprecision in the overall measurement process.

### **Assessment for Other-Than-Temporary Impairment of 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 for 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).

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 entity will be required to sell the debt security before recovery of its amortized cost basis, or (3) the entity 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-

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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 Company assesses impairment for pooled trust preferred securities using a cash flow model. The key assumptions include default probabilities of the underlying collateral and recoveries on collateral defaults. These assumptions may have a significant effect on the determination of the present value of expected future cash flows and the resulting amount of other-than-temporary impairment. As such, the use of different models and assumptions, as well as changes in market conditions, could result in materially different net earnings and retained earnings results.

### **Fair Value Determination**

GAAP requires management to value and disclose certain of the Company's assets and liabilities at fair value, including investments classified as available-for-sale and derivatives. FASB ASC 820, *Fair Value Measurements and Disclosures*, which defines fair value, establishes a framework for measuring fair value in accordance with U.S. generally accepted accounting principles and expands disclosures about fair value measurements. For more information regarding fair value measurements and disclosures, please refer to Note 8 of the Condensed Consolidated Financial Statements.

Fair values are based on active market prices of identical assets or liabilities when available. Comparable assets or liabilities or a composite of comparable assets in active markets are used when identical assets or liabilities do not have readily available active market pricing. However, some of the Company's assets or liabilities lack an available or comparable trading market characterized by frequent transactions between willing buyers and sellers. In these cases, fair value is estimated using pricing models that use discounted cash flows and other pricing techniques. Pricing models and their underlying assumptions are based upon management's best estimates for appropriate discount rates, default rates, prepayments, market volatility and other factors, taking into account current observable market data and experience.

These assumptions may have a significant effect on the reported fair values of assets and liabilities and the related income and expense. As such, the use of different models and assumptions, as well as changes in market conditions, could result in materially different net earnings and retained earnings results.

### **Other Real Estate Owned**

Other real estate owned (OREO), consists of properties obtained through foreclosure or in satisfaction of loans and is reported at the lower of cost or fair value, less estimated costs to sell at the date acquired with any loss recognized as a charge-off through the allowance for loan losses. Additional OREO losses for subsequent valuation adjustments are determined on a specific property basis and are included as a component of other noninterest expense along with holding costs. Any gains or losses on disposal realized at the time of disposal are also reflected in noninterest expense. Significant judgments and complex estimates are required in estimating the fair value of OREO, and the period of time within which such estimates can be considered current is significantly shortened during periods of market volatility, as experienced during 2011 and 2010. As a result, the net proceeds realized from sales transactions could differ significantly from appraisals, comparable sales, and other estimates used to determine the fair value of other OREO.

### **Deferred Tax Asset Valuation**

A valuation allowance is recognized for a deferred tax asset if, based on the weight of available evidence, it is more-likely-than-not that some portion or the entire deferred tax asset will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based upon the historical level of taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more-likely-than-not that the Company will realize the benefits of these deductible differences at September 30, 2011. The amount of the deferred tax assets considered realizable, however, could be reduced in the near term if estimates of future taxable income during future periods are reduced.

**Table of Contents****RESULTS OF OPERATIONS****Average Balance Sheet and Interest Rates**

|   | Nine months ended September 30,<br>2011 |                | 2010               |                |
|---|---|----------------|--------------------|----------------|
|   | Average<br>Balance                      | Yield/<br>Rate | Average<br>Balance | Yield/<br>Rate |
| <i>(Dollars in thousands)</i>   |   |                |                    |                |
| Loans and loans held for sale   | \$ 376,273                              | 5.70%          | \$ 380,569         | 5.75%          |
| Securities - taxable  | 225,802                                 | 2.89%          | 248,539            | 3.51%          |
| Securities - tax-exempt   | 80,024                                  | 6.40%          | 81,319             | 6.40%          |
| Total securities  | 305,826                                 | 3.81%          | 329,858            | 4.23%          |
| Federal funds sold  | 26,688                                  | 0.18%          | 14,265             | 0.21%          |
| Interest bearing bank deposits  | 1,557                                   | 0.09%          | 920                | 0.15%          |
| Total interest-earning assets   | 710,344                                 | 4.67%          | 725,612            | 4.94%          |
| Deposits:   |   |                |                    |                |
| NOW   | 91,125                                  | 0.62%          | 90,370             | 0.71%          |
| Savings and money market  | 139,037                                 | 0.72%          | 113,334            | 1.11%          |
| Certificates of deposits less than \$100,000                          | 114,981                                 | 1.99%          | 113,529            | 2.49%          |
| Certificates of deposits and other time deposits of \$100,000 or more | 183,841                                 | 2.42%          | 200,360            | 2.80%          |
| Total interest-bearing deposits                                       | 528,984                                 | 1.57%          | 517,593            | 2.00%          |
| Short-term borrowings   | 2,383                                   | 0.50%          | 3,902              | 0.65%          |
| Long-term debt  | 87,433                                  | 3.89%          | 115,430            | 4.03%          |
| Total interest-bearing liabilities                                    | 618,800                                 | 1.90%          | 636,925            | 2.36%          |
| Net interest income and margin  | \$ 16,020                               | 3.02%          | \$ 15,581          | 2.87%          |

**Net Interest Income and Margin**

Net interest income (tax-equivalent) was \$16.0 million in the first nine months of 2011, compared to \$15.6 million for the first nine months of 2010, as net interest margin improvement offset a decline in average interest-earnings assets of 2%. Net interest margin (tax-equivalent) was 3.02% for the first nine months of 2011, compared to 2.87% for the first nine months of 2010.

The tax-equivalent yield on total interest-earning assets decreased 27 basis points in the first nine months of 2011 from the first nine months of 2010 to 4.67%. This decrease was primarily driven by a 42 basis point decrease in the tax-equivalent yield on total securities to 3.81%.

The cost of total interest-bearing liabilities decreased 46 basis points in the first nine months of 2011 from the first nine months of 2010 to 1.90%. This decrease was primarily driven by a 43 basis point decrease in the cost of total interest-bearing deposits to 1.57% and a 14 basis point decrease in the cost of long-term debt to 3.89%.

**Provision for Loan Losses**

The provision for loan losses represents a charge to earnings necessary to provide an allowance for loan losses that, management believes, based on its processes and estimates should be adequate to provide coverage for the probable losses on outstanding loans. The provisions for loan losses amounted to \$1.8 million and \$2.9 million for the nine months ended September 30, 2011 and 2010, respectively. The provision for loan losses decreased due to a decline in the level of allowance for loan losses related to the construction and land development loan portfolio segment. The decline in the allowance for loan losses for the construction and land development portfolio segment is due to a decline in both total loans outstanding in the construction and land development portfolio and adversely risk-graded construction and land development loans.

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Based upon its assessment of the loan portfolio, management adjusts the allowance for loan losses to an amount it believes should be appropriate to adequately cover probable losses in the loan portfolio. The Company's allowance for loan losses as a percentage of total loans was 1.69% at September 30, 2011, compared to 2.05% at December 31, 2010. Based upon our evaluation of the loan portfolio, management believes the allowance for loan losses to be adequate to absorb our

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estimate of probable losses existing in the loan portfolio at September 30, 2011. While the policies and procedures used to estimate the allowance for loan losses, as well as the resultant provision for loan losses charged to operations, are considered adequate by management and are reviewed from time to time by our regulators, they are necessarily approximate and imprecise. Factors beyond our control (such as conditions in the local and national economy, local real estate market, or industry conditions) may have a material adverse effect on our asset quality and the adequacy of our allowance for loan losses resulting in significant increases in the provision for loan losses.

**Noninterest Income**

| <i>(Dollars in thousands)</i>        | <b>Quarter ended September 30,</b> |                 | <b>Nine months ended September 30,</b> |                 |
|--------------------------------------|------------------------------------|-----------------|--|-----------------|
|                                      | <b>2011</b>                        | <b>2010</b>     | <b>2011</b>                            | <b>2010</b>     |
| Service charges on deposit accounts  | \$ 301                             | \$ 328          | \$ 882                                 | \$ 976          |
| Mortgage lending income              | 637                                | 1,007           | 1,516                                  | 2,114           |
| Bank-owned life insurance            | 127                                | 118             | 341                                    | 350             |
| Securities gains, net                | 215                                | 129             | 563                                    | 2,610           |
| Affordable housing investment losses | (231)                              | (57)            | (461)                                  | (171)           |
| Other                                | 349                                | 332             | 1,057                                  | 1,066           |
| <b>Total noninterest income</b>      | <b>\$ 1,398</b>                    | <b>\$ 1,857</b> | <b>\$ 3,898</b>                        | <b>\$ 6,945</b> |

The Company's income from mortgage lending is primarily attributable to the (1) origination and sale of new mortgage loans and (2) servicing mortgage loans. The Company's normal practice is to originate mortgage loans for sale in the secondary market and to either release or retain the associated mortgage servicing rights (MSRs) when the loan is sold. MSR's are recognized based on the fair value of the servicing right on the date the corresponding mortgage loan is sold. Subsequent to the date of transfer, the Company has elected to measure its MSR's under the amortization method. Servicing fee income is reported net of any related amortization expense.

The following table presents a breakdown of the Company's mortgage lending income.

| <i>(Dollars in thousands)</i>        | <b>Quarter ended September 30,</b> |                 | <b>Nine months ended September 30,</b> |                 |
|--------------------------------------|------------------------------------|-----------------|--|-----------------|
|                                      | <b>2011</b>                        | <b>2010</b>     | <b>2011</b>                            | <b>2010</b>     |
| Origination income                   | \$ 570                             | \$ 921          | \$ 1,253                               | \$ 1,848        |
| Servicing fees, net                  | 87                                 | 86              | 283                                    | 266             |
| Increase in MSR valuation allowance  | (20)                               |                 | (20)                                   |                 |
| <b>Total mortgage lending income</b> | <b>\$ 637</b>                      | <b>\$ 1,007</b> | <b>\$ 1,516</b>                        | <b>\$ 2,114</b> |

Mortgage lending income was \$1.5 million for the first nine months of 2011, compared to \$2.1 million for the first nine months of 2010. The decline in mortgage lending income was primarily due to a decrease in the volume of loans originated and sold as the level of mortgage activity slowed during the first nine months of 2011, compared to the first nine months of 2010.

Mortgage lending income decreased in the third quarter of 2011 when compared to the third quarter of 2010 due to the same factors described above.

The Company recorded net securities gains of \$0.6 million in the first nine months of 2011, compared to net securities gains of \$2.6 million in the first nine months of 2010. The decrease was primarily due to \$0.9 million in net gains realized on the sale of securities during the third quarter of 2011, compared to \$3.0 million during the third quarter of 2010.

Net securities gains increased in the third quarter of 2011 when compared to the third quarter of 2010 primarily due to a decrease in other than temporary impairment charges on individual issuer trust preferred securities.

Losses related to affordable housing partnership investments were \$0.5 million for the first nine months of 2011, compared to \$0.2 million for the first nine months of 2010. The increase in losses on affordable housing partnership investments was primarily due to the Company's

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increased total investment in these projects. While the losses incurred by the partnerships are recognized in pre-tax earnings, these investments are designed to generate a return primarily through the realization of federal tax credits. As a result, these investments have significantly reduced the Company's income tax expense during 2011 when compared to 2010.

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Losses related to affordable housing partnership investments increased in the third quarter of 2011 when compared to the third quarter of 2010 due to the same factors described above.

**Noninterest Expense**

| <i>(Dollars in thousands)</i>         | Quarter ended September 30, |          | Nine months ended September 30, |           |
|---------------------------------------|-----------------------------|----------|---------------------------------|-----------|
|                                       | 2011                        | 2010     | 2011                            | 2010      |
| Salaries and benefits                 | \$ 2,218                    | \$ 2,051 | \$ 6,272                        | \$ 5,895  |
| Net occupancy and equipment           | 364                         | 359      | 1,038                           | 1,107     |
| Professional fees                     | 190                         | 164      | 550                             | 531       |
| FDIC and other regulatory assessments | 178                         | 277      | 659                             | 839       |
| Other real estate owned, net          | 506                         | 268      | 1,207                           | 1,240     |
| Prepayment penalty on long-term debt  |                             | 381      |                                 | 679       |
| Other                                 | 883                         | 866      | 2,626                           | 2,520     |
| Total noninterest expense             | \$ 4,339                    | \$ 4,366 | \$ 12,352                       | \$ 12,811 |

Salaries and benefits expense was \$6.3 million for the first nine months of 2011, compared to \$5.9 million for the first nine months of 2010. The increase was primarily due to increased salaries and wages, cash incentive compensation costs, and group medical insurance costs. Offsetting the increase in salaries and wages, cash incentive compensation costs, and group medical insurance costs was a decrease in commissions paid to our mortgage originators as a result of decreased origination volume in the first nine months of 2011, compared the first nine months of 2010.

Salaries and benefits expense increased in the third quarter of 2011 when compared to the third quarter of 2010 due to the same factors described above.

FDIC and other regulatory assessments expense was \$0.7 million for the first nine months of 2011, compared to \$0.8 million for the first nine months of 2010. The decrease was primarily due to the FDIC redefining the deposit insurance assessment base effective April 1, 2011. Most FDIC insured institutions with less than \$10 billion in assets experienced a reduction in their FDIC deposit insurance assessments.

FDIC and other regulatory assessments expense decreased in the third quarter of 2011 when compared to the third quarter of 2010 due to the same factors described above.

OREO expense, net was \$1.2 million for the first nine months of 2011, and 2010, respectively. Approximately \$1.3 million and \$1.2 million of OREO expense during the first nine months of 2011 and 2010, respectively, related to holding losses on the valuations of certain OREO properties. These properties could also be subject to future valuation adjustments as a result of updated appraisal information and further deterioration in real estate values, thus causing additional fluctuations in other real estate owned expense, net. Additionally, the Company will continue to incur expenses associated with maintenance costs and property taxes associated with these assets. During the first nine months of 2011, rental income on OREO properties exceeded these costs.

OREO expense, net increased in the third quarter of 2011 when compared to the third quarter of 2010 due to an increase in holding losses on the valuation of certain OREO properties.

Noninterest expense for the third quarter and first nine months of 2010 included \$0.4 million and \$0.7 million in prepayment penalties on long-term debt, respectively. During the third quarter and first nine months of 2010, the Company repaid \$5.0 million and \$10.0 million, respectively, of securities sold under agreements to repurchase, included in long-term debt, as part of its efforts to reduce wholesale funding sources.

**Income Tax Expense**

Income tax expense was approximately \$0.1 million in the first nine months of 2011, compared to \$1.0 million in the first nine months of 2010. The Company's annualized effective tax rate for the first nine months of 2011 was 1.99%, compared to an annualized effective income tax rate of 18.18% for the first nine months of 2010. The decrease in the Company's effective tax rate during the first nine months of 2011 when compared to the first nine months of 2010 was due to a decrease in the level of earnings before taxes and an increase in federal tax credits related to the Company's investments in affordable housing limited partnerships.





**Table of Contents****BALANCE SHEET ANALYSIS****Securities**

Securities available-for-sale were \$283.1 million and \$315.2 million as of September 30, 2011 and December 31, 2010, respectively. The decrease in securities available-for-sale of \$32.2 million, or 10%, was primarily due to management's decision to limit the level of reinvestment of proceeds from sales, calls, and maturities of securities available-for-sale while long-term interest rates are at historically low levels. Unrealized net gains on securities available-for-sale were \$5.8 million at September 30, 2011 compared to unrealized net losses of \$3.5 million at December 31, 2010. The increase in unrealized gains on securities available-for-sale was due to a decline in long-term interest rates and the narrowing of credit spreads.

The average tax-equivalent yields earned on total securities were 3.81% in the first nine months of 2011 and 4.23% in the first nine months of 2010.

On November 9, 2011, Jefferson County, Alabama filed for protection under the United States Bankruptcy Code. We own no securities issued by Jefferson County that are subject to this bankruptcy proceeding. We do own securities issued by several suburban municipalities in Jefferson County, including Mountain Brook, Vestavia Hills, Irondale, Helena, and Bessemer, none of which are included in the Jefferson County bankruptcy. At September 30, 2011, the carrying value of these securities was approximately \$2.9 million.

**Loans**

|                                   |            | 2011    |         | 2010    |         |
|-----------------------------------|------------|---------|---------|---------|---------|
|                                   | Third      | Second  | First   | Fourth  | Third   |
| (In thousands)                    | Quarter    | Quarter | Quarter | Quarter | Quarter |
| Commercial and industrial         | \$ 53,888  | 52,027  | 51,323  | 53,288  | 58,400  |
| Construction and land development | 40,781     | 43,864  | 48,814  | 47,850  | 46,928  |
| Commercial real estate            | 166,059    | 166,272 | 161,882 | 166,241 | 161,676 |
| Residential real estate           | 102,030    | 100,496 | 95,997  | 96,241  | 96,888  |
| Consumer installment              | 12,105     | 11,248  | 10,968  | 10,676  | 11,312  |
| Total loans                       | 374,863    | 373,907 | 368,984 | 374,296 | 375,204 |
| Less: unearned income             | (75)       | (112)   | (75)    | (81)    | (106)   |
| Loans, net of unearned income     | \$ 374,788 | 373,795 | 368,909 | 374,215 | 375,098 |

Total loans, net of unearned income, were \$374.8 million as of September 30, 2011, compared to \$374.2 million at December 31, 2010. Four loan categories represented the majority of the loan portfolio as of September 30, 2011. Commercial real estate loans represented 44%, residential real estate loans represented 27%, construction and land development loans represented 11% and commercial and industrial loans represented 14% of the Company's total loans at September 30, 2011. Approximately 43% of the Company's commercial real estate loans were classified as owner-occupied at September 30, 2011.

Within the residential real estate portfolio segment, the Company had junior lien mortgages of approximately \$24.4 million at September 30, 2011, compared to \$24.3 million at December 31, 2010. For residential real estate mortgage loans with a consumer purpose, approximately \$1.9 million and \$4.1 million required interest only payments at September 30, 2011 and December 31, 2010, respectively. The Company's residential real estate mortgage portfolio does not include any option ARM loans, subprime loans, or any material amount of other high risk consumer mortgage products.

Purchased loan participations included in the Company's loan portfolio were approximately \$3.8 million and \$7.2 million at September 30, 2011 and December 31, 2010, respectively. All purchased loan participations are underwritten by the Company independent of the selling bank. In addition, all loans, including purchased participations, are evaluated for collectability during the course of the Company's normal loan review procedures. If the Company deems a participation loan impaired, it applies the same accounting policies and procedures described under

CRITICAL ACCOUNTING POLICIES Allowance for Loan Losses .

The average yield earned on loans and loans held for sale was 5.70% in the first nine months of 2011 and 5.75% in the first nine months of 2010.



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The specific economic and credit risks associated with our loan portfolio include, but are not limited to, the impact of recessionary economic conditions on our borrowers' cash flows, real estate market sales volumes, valuations, availability and cost of financing properties, real estate industry concentrations, deterioration in certain credits, interest rate fluctuations, reduced collateral values or non-existent collateral, title defects, inaccurate appraisals, financial deterioration of borrowers, fraud, and any violation of laws and regulations.

The Company attempts to reduce these economic and credit risks by adhering to loan to value ( LTV ) guidelines for collateralized loans, investigating the creditworthiness of borrowers and monitoring borrowers' financial position. Also, we establish and periodically review our lending policies and procedures. Banking regulations limit our credit exposure by prohibiting unsecured loan relationships that exceed 10% of the capital accounts of the Bank; or 20% of the capital accounts if loans in excess of 10% are fully secured, the upper legal lending limit is approximately \$14.5 million. Furthermore, we have an internal limit for aggregate credit exposure (loans outstanding plus unfunded commitments) to a single borrower of \$13.1 million. Our loan policy requires that the Loan Committee of the Bank's Board of Directors approve any loan relationships that exceed this internal limit. At September 30, 2011 and December 31, 2010, the Company had no loan relationships exceeding these limits.

We periodically analyze our commercial loan portfolio to determine if a concentration of credit risk exists in any industries. We use broadly accepted industry classification systems in order to classify borrowers into various industry classifications. Loan concentrations to borrowers in the following industries exceeded 25% of the Bank's total risk-based capital at September 30, 2011 (and related balances at December 31, 2010).

|   | September 30,<br>2011 | December 31,<br>2010 |
|---|-----------------------|----------------------|
| <i>(In thousands)</i>                           |                       |                      |
| Lessors of 1 to 4 family residential properties | \$ 43,095             | \$ 38,679            |
| Office buildings                                | 20,281                | 24,185               |

**Allowance for Loan Losses**

The Company maintains the allowance for loan losses at a level that management believes appropriate to adequately cover the Company's estimate of probable losses in the loan portfolio. At September 30, 2011 and December 31, 2010, the allowance for loan losses was \$6.3 million and \$7.7 million, respectively, which management deemed to be adequate at each of the respective dates. The judgments and estimates associated with the determination of the allowance for loan losses are described under CRITICAL ACCOUNTING POLICIES.

A summary of the changes in the allowance for loan losses and certain asset quality ratios for the third quarter of 2011 and the previous four quarters is presented below.

|                                   | Third<br>Quarter | 2011<br>Second<br>Quarter | First<br>Quarter | 2010<br>Fourth<br>Quarter | Third<br>Quarter |
|-----------------------------------|------------------|---------------------------|------------------|---------------------------|------------------|
| <i>(Dollars in thousands)</i>     |                  |                           |                  |                           |                  |
| Balance at beginning of period    | \$ 7,746         | 7,855                     | 7,676            | 7,181                     | 6,580            |
| Charge-offs:                      |                  |                           |                  |                           |                  |
| Commercial and industrial         | (298)            | (306)                     | (56)             | (66)                      | (77)             |
| Construction and land development | (1,572)          | (112)                     | (33)             | (20)                      | (5)              |
| Commercial real estate            | (79)             |                           | (339)            |                           |                  |
| Residential real estate           | (73)             | (389)                     | (57)             | (153)                     | (91)             |
| Consumer installment              | (7)              | (2)                       | (1)              | (9)                       | (14)             |
| Total charge-offs                 | (2,029)          | (809)                     | (486)            | (248)                     | (187)            |
| Recoveries                        | 23               | 100                       | 65               | 93                        | 58               |
| Net charge-offs                   | (2,006)          | (709)                     | (421)            | (155)                     | (129)            |
| Provision for loan losses         | 600              | 600                       | 600              | 650                       | 730              |
| Ending balance                    | \$ 6,340         | 7,746                     | 7,855            | 7,676                     | 7,181            |
| as a % of loans                   | 1.69%            | 2.07                      | 2.13             | 2.05                      | 1.91             |

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|   |       |      |      |      |      |
|---|-------|------|------|------|------|
| as a % of nonperforming loans           | 60%   | 95   | 70   | 65   | 82   |
| Net charge-offs as a % of average loans | 2.14% | 0.76 | 0.45 | 0.16 | 0.14 |

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As described under CRITICAL ACCOUNTING POLICIES, management assesses the adequacy of the allowance 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, 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 loss rates and other pertinent factors. This evaluation is inherently subjective as it requires various material estimates and judgments including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. The ratio of our allowance for loan losses to total loans outstanding was 1.69% at September 30, 2011, compared to 2.05% at December 31, 2010. In the future, the allowance to total loans outstanding ratio will increase or decrease to the extent the factors that influence our quarterly allowance assessment in their entirety either improve or weaken. In addition, our regulators, as an integral part of their examination process, will periodically review the Company's allowance for loan losses, and may require the Company to make additional provisions to the allowance for losses based on their judgement about information available to them at the time of their examinations.

Approximately \$1.6 million in net charge-offs during the first nine months of 2011 related to one construction and land development loan. An additional \$0.6 million in net charge-offs during the first nine months of 2011 related to two A/B note restructurings, where the B notes were charged off.

At September 30, 2011, the ratio of our allowance for loan losses as a percentage of nonperforming loans was 60%, compared to 65% at December 31, 2010. The decrease is primarily due to a decrease in the level of allowance for loan losses related to the construction and land development portfolio segment. The decline in the allowance for loan losses for the construction and land development portfolio segment is due to a decline in both total loans outstanding in the construction and land development portfolio and adversely risk-graded construction and land development loans.

At September 30, 2011, the Company's recorded investment in loans considered impaired was \$10.4 million, with a corresponding valuation allowance (included in the allowance for loan losses) of \$0.9 million. At December 31, 2010, the Company's recorded investment in loans considered impaired was \$11.7 million, with a corresponding valuation allowance (included in the allowance for loan losses) of \$1.3 million.

At September 30, 2011 and December 31, 2010, the Company had impaired loans classified as troubled debt restructurings (TDRs) of \$9.5 million and \$7.6 million, respectively. At September 30, 2011 the Company had \$0.7 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 \$0.8 million and \$1.0 million at September 30, 2011 and December 31, 2010, respectively. At September 30, 2011, there were no significant outstanding commitments to advance additional funds to customers whose loans had been restructured.

**Nonperforming Assets**

At September 30, 2011, the Company had \$18.3 million in nonperforming assets compared to \$20.0 million at December 31, 2010. Included in nonperforming assets were nonperforming loans of \$10.5 million and \$11.8 million at September 30, 2011 and December 31, 2010, respectively. The majority of the balance in nonperforming assets at September 30, 2011 related to deterioration in the construction and land development loan portfolio.

The table below provides information concerning total nonperforming assets and certain asset quality ratios for the third quarter of 2011 and the previous four quarters.

|   | Third<br>Quarter | 2011<br>Second<br>Quarter | First<br>Quarter | 2010<br>Fourth<br>Quarter | 2010<br>Third<br>Quarter |
|---|------------------|---------------------------|------------------|---------------------------|--------------------------|
| <i>(Dollars in thousands)</i>                                     |                  |                           |                  |                           |                          |
| <b>Nonperforming assets:</b>                                      |                  |                           |                  |                           |                          |
| Nonaccrual loans  | \$ 10,506        | 8,151                     | 11,166           | 11,833                    | 8,776                    |
| Other nonperforming assets<br>(primarily other real estate owned) | 7,770            | 9,361                     | 8,450            | 8,125                     | 8,163                    |
| <b>Total nonperforming assets</b>                                 | <b>\$ 18,276</b> | <b>17,512</b>             | <b>19,616</b>    | <b>19,958</b>             | <b>16,939</b>            |
| <b>as a % of loans and other real estate owned</b>                | <b>4.78%</b>     | <b>4.57%</b>              | <b>5.20</b>      | <b>5.22</b>               | <b>4.42</b>              |
| <b>as a % of total assets</b>                                     | <b>2.39%</b>     | <b>2.25%</b>              | <b>2.51</b>      | <b>2.61</b>               | <b>2.18</b>              |

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|   |       |       |      |      |      |
|---|-------|-------|------|------|------|
| Nonperforming loans as a % of total loans | 2.80% | 2.18% | 3.03 | 3.16 | 2.34 |
| Accruing loans 90 days or more past due   | \$    | 11    | 158  |      | 62   |

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The Lee County Association of Realtors ( LCAR ) of Alabama reported that the average median selling price for residential homes during the quarter ended September 30, 2011 was \$169,672 a decrease of 6.6% from the same quarter a year earlier. LCAR also reported that residential inventory at September 30, 2011 was 1,139 homes, a decrease of 13.3% from a year earlier. The average number of days on the market for residential homes sold during the quarter ended September 30, 2011 was 198 days, an increase of 8.8% from the same quarter last year. Continued weakness in the real estate market and the overall economy could adversely affect the Company's volume of nonperforming assets. For additional discussion of risk factors, see Part I Item 1A. Risk Factors on page 17 in our annual report on Form 10-K for the year ended December 31, 2010.

The table below provides information concerning the composition of nonaccrual loans for the third quarter of 2011 and the previous four quarters.

|                                   |                  | 2011         |               | 2010          |              |
|-----------------------------------|------------------|--------------|---------------|---------------|--------------|
|                                   | Third            | Second       | First         | Fourth        | Third        |
| (In thousands)                    | Quarter          | Quarter      | Quarter       | Quarter       | Quarter      |
| <b>Nonaccrual loans:</b>          |                  |              |               |               |              |
| Commercial and industrial         | \$ 32            | 48           | 508           | 521           | 535          |
| Construction and land development | 5,156            | 2,844        | 4,043         | 4,102         | 2,689        |
| Commercial real estate            | 3,616            | 3,868        | 3,954         | 4,735         | 2,688        |
| Residential real estate           | 1,559            | 1,245        | 2,510         | 2,474         | 2,862        |
| Consumer installment              | 143              | 146          | 151           | 1             | 2            |
| <b>Total nonaccrual loans</b>     | <b>\$ 10,506</b> | <b>8,151</b> | <b>11,166</b> | <b>11,833</b> | <b>8,776</b> |

The Company discontinues the accrual of interest income when (1) there is a significant deterioration in the financial condition of the borrower and full repayment of principal and interest is not expected or (2) the principal or interest is more than 90 days past due, unless the loan is both well-secured and in the process of collection. At September 30, 2011, the Company had \$10.5 million in loans on nonaccrual, compared to \$11.8 million at December 31, 2010.

At both September 30, 2011 and December 31, 2010, there were no loans 90 days past due and still accruing interest.

The table below provides information concerning the composition of other real estate owned for the third quarter of 2011 and the previous four quarters.

|                                      |                 | 2011         |              | 2010         |              |
|--------------------------------------|-----------------|--------------|--------------|--------------|--------------|
|                                      | Third           | Second       | First        | Fourth       | Third        |
| (In thousands)                       | Quarter         | Quarter      | Quarter      | Quarter      | Quarter      |
| <b>Other real estate owned:</b>      |                 |              |              |              |              |
| Residential condo developments       | \$ 3,991        | 5,015        | 5,494        | 5,494        | 5,449        |
| New home construction                | 97              | 346          | 346          | 369          | 243          |
| Developed lots                       | 141             | 209          | 282          | 136          | 136          |
| Commercial lots                      | 1,528           | 1,528        |              |              |              |
| Undeveloped land                     | 1,401           | 1,401        | 1,746        | 1,746        | 1,746        |
| Other                                | 612             | 862          | 582          | 380          | 589          |
| <b>Total other real estate owned</b> | <b>\$ 7,770</b> | <b>9,361</b> | <b>8,450</b> | <b>8,125</b> | <b>8,163</b> |

The Company held \$7.8 million in OREO at September 30, 2011, which we had acquired from borrowers, compared to \$8.1 million at December 31, 2010. OREO primarily relates to four properties with a total carrying value of \$6.9 million at September 30, 2011. One of the properties, with a book value of \$2.7 million at September 30, 2011, is a completed condominium project on the Florida Gulf Coast. The Company had previously purchased a participation interest in the first lien mortgage loan on the condominium project on the Florida Gulf Coast from Silverton Bank. Subsequently, this loan defaulted and was foreclosed upon and the Company's interest in the property is currently included in OREO. Following Silverton Bank's failure on May 1, 2009, the FDIC has held this property as the receiver of Silverton Bank. CB Richard



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Ellis, a national real estate firm, has been managing this property and selling condominiums in the project as an FDIC contractor. The Company depends upon the FDIC and CB Richard Ellis for information regarding this property and its

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performance. Based upon the latest information available to us, including appraisals, current unit sales, and comparable sales, we believe that the fair value of the Company's interest in these properties, less selling costs, is greater than or equal to the Company's recorded investment at September 30, 2011. The FDIC has approved a bulk sale of the condominiums and club amenities, which may speed the disposition of this property in which we hold an interest.

**Potential Problem Loans**

Potential problem loans represent those loans with a well-defined weakness and where information about possible credit problems of borrowers has caused management to have serious doubts about the borrower's ability to comply with present repayment terms. Potential problem loans, which are not included in nonperforming assets, amounted to \$18.0 million, or 4.8% of total loans outstanding, net of unearned income at September 30, 2011, compared to \$13.2 million, or 3.5% of total loans outstanding, net of unearned income at December 31, 2010.

The table below provides information concerning the composition of performing potential problem loans for the third quarter of 2011 and the previous four quarters.

|                                      |                  | 2011          |               | 2010          |               |
|--------------------------------------|------------------|---------------|---------------|---------------|---------------|
|                                      | Third            | Second        | First         | Fourth        | Third         |
| (In thousands)                       | Quarter          | Quarter       | Quarter       | Quarter       | Quarter       |
| <b>Potential problem loans:</b>      |                  |               |               |               |               |
| Commercial and industrial            | \$ 794           | 991           | 1,051         | 413           | 658           |
| Construction and land development    | 1,113            | 5,016         | 5,027         | 1,075         | 1,235         |
| Commercial real estate               | 9,715            | 9,309         | 5,553         | 5,016         | 7,032         |
| Residential real estate              | 6,238            | 5,387         | 5,657         | 6,600         | 5,425         |
| Consumer installment                 | 106              | 109           | 112           | 116           | 67            |
| <b>Total potential problem loans</b> | <b>\$ 17,966</b> | <b>20,812</b> | <b>17,400</b> | <b>13,220</b> | <b>14,417</b> |

At September 30, 2011, approximately \$1.1 million or 5.9% of total potential problem loans were past due at least 30 days but less than 90 days. At September 30, 2011, the remaining balance of potential problem loans were current or past due less than 30 days.

The following table is a summary of the Company's performing loans that were past due at least 30 days but less than 90 days for the third quarter of 2011 and the previous four quarters.

|   |                 | 2011       |              | 2010         |              |
|---|-----------------|------------|--------------|--------------|--------------|
|   | Third           | Second     | First        | Fourth       | Third        |
| (In thousands)                                  | Quarter         | Quarter    | Quarter      | Quarter      | Quarter      |
| <b>Performing loans past due 30 to 89 days:</b> |                 |            |              |              |              |
| Commercial and industrial                       | \$ 253          | 94         | 136          | 124          | 179          |
| Construction and land development               | 173             |            | 493          | 201          |              |
| Commercial real estate                          |                 | 456        | 419          |              | 361          |
| Residential real estate                         | 1,094           | 360        | 2,001        | 2,986        | 497          |
| Consumer installment                            | 25              | 15         | 60           | 29           | 102          |
| <b>Total</b>                                    | <b>\$ 1,545</b> | <b>925</b> | <b>3,109</b> | <b>3,340</b> | <b>1,139</b> |

**Deposits**

Total deposits were \$609.1 million at September 30, 2011, compared to \$607.1 million at December 31, 2010. An \$11.5 million increase in noninterest bearing demand deposits was offset by a \$9.5 million decrease in interest bearing deposits. The decrease in interest bearing demand deposits was primarily due to a decline in brokered certificates of deposit.

The average rate paid on total interest-bearing deposits was 1.57% in the first nine months of 2011 and 2.00% in the first nine months of 2010.

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Noninterest bearing deposits were 16% and 14% of total deposits as of September 30, 2011 and December 31, 2010, respectively.

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### **Other Borrowings**

Other borrowings consist of short-term borrowings and long-term debt. Short-term borrowings consist of federal funds purchased, securities sold under agreements to repurchase, and other short-term borrowings. The Bank had available federal funds lines totaling \$ 40.0 million and \$34.0 million with none outstanding at September 30, 2011 and December 31, 2010, respectively. Securities sold under agreements to repurchase totaled \$2.6 million at September 30, 2011, compared to \$2.7 million at December 31, 2010.

The average rate paid on short-term borrowings was 0.50% in the first nine months of 2011 and 0.65% in the first nine months of 2010.

Long-term debt includes FHLB advances with an original maturity greater than one year, securities sold under agreements to repurchase with an original maturity greater than one year, and subordinated debentures related to trust preferred securities. The Bank had \$15.0 million at September 30, 2011 and December 31, 2010, respectively, in securities sold under agreements to repurchase with an original maturity greater than one year. The Bank had \$63.1 million and \$71.1 million in long-term FHLB advances at September 30, 2011 and December 31, 2010, respectively, and the Company had \$7.2 million in junior subordinated debentures related to trust preferred securities outstanding at both September 30, 2011 and December 31, 2010.

The average rate paid on long-term debt was 3.89% in the first nine months of 2011 and 4.03% in the first nine months of 2010.

### **CAPITAL ADEQUACY**

The Company's consolidated stockholders' equity balances were \$64.4 million and \$56.4 million as of September 30, 2011 and December 31, 2010, respectively. The increase from December 31, 2010 was primarily driven by net earnings of \$4.4 million and other comprehensive income due to the change in net unrealized gains (losses) on securities available-for-sale of \$5.9 million, which was reduced by cash dividends paid of approximately \$2.2 million.

The Company's tier 1 leverage ratio was 8.87%, tier 1 risk-based capital ratio was 15.25% and total risk-based capital ratio was 16.51% at September 30, 2011. These ratios exceed the minimum regulatory capital percentages of 5.0% for tier 1 leverage ratio, 6.0% for tier 1 risk-based capital ratio and 10.0% for total risk-based capital ratio to be considered well-capitalized. Based on current regulatory standards, the Company is classified as well capitalized.

### **MARKET AND LIQUIDITY RISK MANAGEMENT**

Management's objective is to manage assets and liabilities to provide a satisfactory, consistent level of profitability within the framework of established liquidity, loan, investment, borrowing, and capital policies. The Bank's Asset Liability Management Committee (ALCO) is charged with the responsibility of monitoring these policies, which are designed to ensure acceptable composition of asset/liability mix. Two critical areas of focus for ALCO are interest rate sensitivity and liquidity risk management.

#### **Interest Rate Sensitivity Management**

In the normal course of business, the Company is exposed to market risk arising from fluctuations in interest rates. ALCO measures and evaluates interest rate risk so that the Bank can meet customer demands for various types of loans and deposits. Measurements used to help manage interest rate sensitivity include an earnings simulation model and an economic value of equity model.

Management believes that interest rate risk is best estimated by our earnings simulation modeling. Forecasted levels of earning assets, interest-bearing liabilities, and off-balance sheet financial instruments are combined with ALCO forecasts of market interest rates for the next 12 months and are combined with other factors in order to produce various earnings simulations and estimates. To limit interest rate risk, we have guidelines for earnings at risk which seek to limit the variance of net interest income to less than a 10 percent decline for a 200 basis point change up or down in rates from management's flat interest rate forecast over the next twelve months. The results of our current simulation model would indicate that we are in compliance with our current guidelines at September 30, 2011.

Economic value of equity measures the extent that estimated economic values of our assets, liabilities and off-balance sheet items will change as a result of interest rate changes. Economic values are estimated by discounting expected cash flows from assets, liabilities and off-balance sheet items, which establishes a base case economic value of equity. To help limit interest rate risk, we have a guideline stating that for a 200 basis point instantaneous change in interest rates up or down, the economic value of equity should not decrease by more than 25 percent. The results of our current economic value of equity model would indicate that we are in compliance with our guidelines at September 30, 2011.



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Each of the above analyses may not, on its own, be an accurate indicator of how our net interest income will be affected by changes in interest rates. Income associated with interest-earning assets and costs associated with interest-bearing liabilities may not be affected uniformly by changes in interest rates. In addition, the magnitude and duration of changes in interest rates may have a significant impact on net interest income. For example, although certain assets and liabilities may have similar maturities or periods of repricing, they may react in different degrees to changes in market interest rates, and other economic and market factors. Interest rates on certain types of assets and liabilities fluctuate in advance of changes in general market rates, while interest rates on other types may lag behind changes in general market rates. In addition, certain assets, such as adjustable rate mortgage loans, have features (generally referred to as interest rate caps and floors) which limit changes in interest rates. Prepayment and early withdrawal levels also could deviate significantly from those assumed in calculating the maturity of certain instruments. The ability of many borrowers to service their debts also may decrease during periods of rising interest rates or economic stress, which may differ across industries and economic sectors. ALCO reviews each of the above interest rate sensitivity analyses along with several different interest rate scenarios in seeking satisfactory, consistent levels of profitability within the framework of the Company's established liquidity, loan, investment, borrowing, and capital policies.

The Company may also use derivative financial instruments to improve the balance between interest-sensitive assets and interest-sensitive liabilities and as one tool to manage interest rate sensitivity while continuing to meet the credit and deposit needs of our customers. From time to time, the Company may enter into interest rate swaps (swaps) to facilitate customer transactions and meet their financing needs. These swaps qualify as derivatives, but are not designated as hedging instruments. At September 30, 2011 and December 31, 2010, the Company had no derivative contracts to assist in managing interest rate sensitivity.

### **Liquidity Risk Management**

Liquidity is the Company's ability to convert assets into cash equivalents in order to meet daily cash flow requirements, primarily for deposit withdrawals, loan demand and maturing obligations. Without proper management of its liquidity, the Company could experience higher costs of obtaining funds due to insufficient liquidity, while excessive liquidity can lead to a decline in earnings due to the cost of foregoing alternative higher-yielding investment opportunities.

Liquidity is managed at two levels. The first is the liquidity of the Company. The second is the liquidity of the Bank. The management of liquidity at both levels is essential, because the Company and the Bank are separate legal entities with different funding needs and sources, and each are subject to regulatory guidelines and requirements.

The primary source of funding and the primary source of liquidity for the Company include dividends received from the Bank, and secondarily proceeds from the possible issuance of common stock or other securities. Primary uses of funds for the Company include dividends paid to shareholders, stock repurchases, and interest payments on junior subordinated debentures issued by the Company in connection with trust preferred securities. The junior subordinated debentures are presented as long-term debt in the Consolidated Balance Sheets and the related trust preferred securities are includible in Tier 1 Capital for regulatory capital purposes.

Primary sources of funding for the Bank include customer deposits, other borrowings, repayment and maturity of securities, sales of securities, and sale and repayment of loans. The Bank has access to federal funds lines from various banks and borrowings from the Federal Reserve discount window. In addition to these sources, the Bank has participated in the FHLB's advance program to obtain funding for its growth. Advances include both fixed and variable terms and are taken out with varying maturities. At September 30, 2011, the Bank had an available line of credit with the FHLB totaling \$229.5 million with \$63.1 million outstanding. At September 30, 2011, the Bank also had \$40.0 million of available federal funds lines with none outstanding. Primary uses of funds include repayment of maturing obligations and growing the loan portfolio.

Management believes that the Company and the Bank have adequate sources of liquidity to meet all known contractual obligations and unfunded commitments, including loan commitments and reasonable borrower, depositor, and creditor requirements over the next twelve months.

### **Off-Balance Sheet Arrangements, Commitments and Contingencies**

At September 30, 2011, the Bank had outstanding standby letters of credit of \$8.3 million and unfunded loan commitments outstanding of \$38.9 million. Because these commitments generally have fixed expiration dates and many will expire without being drawn upon, the total commitment level does not necessarily represent future cash requirements. If needed to fund these outstanding commitments, the Bank could liquidate federal funds sold or a portion of securities available-for-sale, or draw on its available credit facilities.



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The Company also has commitments to fund certain affordable housing investments. The Company invests 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. 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. As of September 30, 2011, the Company had net investments of \$5.4 million, related to these projects, which are included in other assets on the Consolidated Balance Sheets. At September 30, 2011, the Company had \$0.3 million of unfunded commitments related to affordable housing investments included in other liabilities.

The Company also makes various customary representations and warranties to the purchasers, including government agencies and government sponsored utilities such as Fannie Mae, of mortgage loans that the Company originates and sells in the secondary market. These representations and warranties may include, among other things:

ownership of the loan;

validity of the lien securing the loan;

the absence of delinquent taxes or liens against the property;

the process used to select the loan for inclusion in a transaction;

the loan's compliance with any applicable loan criteria established by the buyer, including underwriting standards;

delivery of all required documents to the trust; and

the loan's compliance with applicable federal, state and local laws.

A breach of these presentations and warranties with respect to a particular mortgage loan or mortgage loans could result in the Company being required to repurchase the loan. During the first nine months of 2011 and 2010, no loans have been repurchased by the Company. At September 30, 2011, no reserves have been deemed necessary for potential repurchase claims.

Management believes that the Company's foreclosure process related to mortgage loans continues to operate effectively, and reflects the Company's interest in these loans and their status appropriately. Foreclosures are approved by Senior Vice Presidents and Division Managers in concert with collection personnel. All documents and activities related to the foreclosure process are completed by the Company's attorneys.

## **Effects of Inflation and Changing Prices**

The Condensed Consolidated Financial Statements and related consolidated financial data presented herein have been prepared in accordance with U.S. generally accepted accounting principles and practices within the banking industry which require the measurement of financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. Unlike most industrial companies, virtually all the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution's performance than the effects of general levels of inflation.



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### **CURRENT ACCOUNTING DEVELOPMENTS**

The following accounting pronouncements have been issued by the FASB, but are not yet effective:

ASU 2011-03, *Transfers and Servicing: Reconsideration of Effective Control for Repurchase Agreements*,

ASU 2011-04, *Fair Value Measurement: Amendments to Achieve Common Fair Value Measurement and Disclosure*,

ASU 2011-05, *Comprehensive Income: Presentation of Comprehensive Income*, and

ASU 2011-08, *Testing Goodwill for Impairment*.

Information about these pronouncements are described in more detail below.

ASU 2011-03, *Transfers and Servicing: Reconsideration of Effective Control for Repurchase Agreements*, removes from the assessment of effective control the criterion relating to the transferor's ability to repurchase or redeem financial assets on substantially the agreed-upon terms, even if the transferee were to default. The requirement to demonstrate that the transferor possesses adequate collateral to fund substantially all the cost of purchasing replacement assets is also eliminated. The amendments in this ASU are effective for interim and annual periods beginning after December 31, 2011, with prospective application to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. The Company will adopt these amendments when required, and does not anticipate that the ASU will have a material impact on its financial position or results of operations.

ASU 2011-04, *Fair Value Measurement: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS*, outlines the collaborative effort of the FASB and the International Accounting Standards Board (IASB) to consistently define fair value and to come up with a set of consistent disclosures for fair value. The amendments in this ASU explain how to measure fair value. They do not require additional fair value measurements and are not intended to establish valuation standards or affect valuation practices outside of financial reporting. The amendments in this ASU are to be applied prospectively. For public entities, the amendments are effective for interim and annual periods beginning after December 31, 2011. Early application is not permitted. The Company will adopt these amendments when required, and does not believe the application will have a material effect on its financial position or results of operations.

ASU 2011-05, *Comprehensive Income: Presentation of Comprehensive Income*, amends existing standards allowing either a single continuous statement of comprehensive income or in two separate but consecutive statements. An entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income in both options. Any changes pursuant to the options allowed in the amendments should be applied retrospectively. For public entities, the amendments are effective for fiscal years, and interim periods within those years, beginning after December 15, 2011. Early adoption is permitted. The Company is evaluating its timing of adoption, but will adopt it retrospectively by the effective date.

ASU 2011-08, *Testing Goodwill for Impairment*, permits an entity to make a qualitative assessment of whether it is more likely than not that a reporting unit's fair value is less than the carrying amount before applying the two-step goodwill impairment test. If an entity concludes that it is more likely than not that the fair value of a reporting unit for which goodwill is recorded is less than its carrying amount, it would not be required to perform the two-step impairment test for the reporting unit. This ASU is effective for annual and interim periods beginning after December 15, 2011 with early adoption permitted. The Company does not expect the adoption of this guidance will have a material impact on the Company's consolidated financial statements as no Goodwill is currently recorded in the consolidated financial statements.

**Table of Contents****Table 1 Explanation of Non-GAAP Financial Measures**

In addition to results presented in accordance with U.S. generally accepted accounting principles (GAAP), this quarterly report on Form 10-Q includes certain designated net interest income amounts presented on a tax-equivalent basis, a non-GAAP financial measure, including the presentation of total revenue and the calculation of the efficiency ratio.

The Company believes the presentation of net interest income on a tax-equivalent basis provides comparability of net interest income from both taxable and tax-exempt sources and facilitates comparability within the industry. Although the Company believes these non-GAAP financial measures enhance investors' understanding of its business and performance, these non-GAAP financial measures should not be considered an alternative to GAAP. The reconciliation of these non-GAAP financial measures from GAAP to non-GAAP is presented below.

|   | Third<br>Quarter | 2011<br>Second<br>Quarter | First<br>Quarter | 2010<br>Fourth<br>Quarter | Third<br>Quarter |
|---|------------------|---------------------------|------------------|---------------------------|------------------|
| <i>(in thousands)</i>                       |                  |                           |                  |                           |                  |
| <b>Net interest income (GAAP)</b>           | <b>\$ 4,845</b>  | <b>5,057</b>              | <b>4,814</b>     | <b>4,642</b>              | <b>4,738</b>     |
| Tax-equivalent adjustment                   | 429              | 440                       | 435              | 441                       | 449              |
| <b>Net interest income (Tax-equivalent)</b> | <b>\$ 5,274</b>  | <b>5,497</b>              | <b>5,249</b>     | <b>5,083</b>              | <b>5,187</b>     |

|   | Nine months ended<br>September 30, |               |
|---|------------------------------------|---------------|
|   | 2011                               | 2010          |
| <i>(In thousands)</i>                       |                                    |               |
| <b>Net interest income (GAAP)</b>           | <b>\$ 14,716</b>                   | <b>14,257</b> |
| Tax-equivalent adjustment                   | 1,304                              | 1,324         |
| <b>Net interest income (Tax-equivalent)</b> | <b>\$ 16,020</b>                   | <b>15,581</b> |

**Table of Contents****Table 2 - Selected Quarterly Financial Data**

|   | Third<br>Quarter | 2011<br>Second<br>Quarter | First<br>Quarter | 2010<br>Fourth<br>Quarter | Third<br>Quarter |
|---|------------------|---------------------------|------------------|---------------------------|------------------|
| <i>(Dollars in thousands, except per share amounts)</i> |                  |                           |                  |                           |                  |
| <b>Results of Operations</b>                            |                  |                           |                  |                           |                  |
| Net interest income (a)                                 | \$ 5,274         | 5,497                     | 5,249            | 5,083                     | 5,187            |
| Less: tax-equivalent adjustment                         | 429              | 440                       | 435              | 441                       | 449              |
| Net interest income (GAAP)                              | 4,845            | 5,057                     | 4,814            | 4,642                     | 4,738            |
| Noninterest income (loss)                               | 1,398            | 1,355                     | 1,145            | 321                       | 1,857            |
| Total revenue   | 6,243            | 6,412                     | 5,959            | 4,963                     | 6,595            |
| Provision for loan losses                               | 600              | 600                       | 600              | 650                       | 730              |
| Noninterest expense                                     | 4,339            | 4,363                     | 3,650            | 3,630                     | 4,366            |
| Income tax expense                                      | (63)             | (8)                       | 160              | (195)                     | 255              |
| Net earnings  | \$ 1,367         | 1,457                     | 1,549            | 878                       | 1,244            |
| <b>Per share data:</b>                                  |                  |                           |                  |                           |                  |
| Basic and diluted net earnings                          | \$ 0.38          | 0.40                      | 0.43             | 0.24                      | 0.34             |
| Cash dividends declared                                 | 0.20             | 0.20                      | 0.20             | 0.195                     | 0.195            |
| Weighted average shares outstanding:                    |                  |                           |                  |                           |                  |
| Basic and diluted                                       | 3,642,738        | 3,642,738                 | 3,642,728        | 3,642,718                 | 3,642,701        |
| Shares outstanding, at period end                       | 3,642,738        | 3,642,738                 | 3,642,738        | 3,642,718                 | 3,642,718        |
| Book value  | \$ 17.69         | 16.77                     | 15.87            | 15.47                     | 16.73            |
| Common stock price                                      |                  |                           |                  |                           |                  |
| High  | \$ 19.70         | 19.91                     | 20.37            | 22.00                     | 22.00            |
| Low   | 19.10            | 19.40                     | 19.51            | 19.50                     | 18.08            |
| Period end:   | 19.65            | 19.75                     | 19.56            | 20.06                     | 20.35            |
| To earnings ratio                                       | 13.55 x          | 14.01                     | 13.49            | 13.74                     | 15.78            |
| To book value   | 111 %            | 118                       | 123              | 130                       | 122              |
| <b>Performance ratios:</b>                              |                  |                           |                  |                           |                  |
| Return on average equity                                | 8.81 %           | 9.90                      | 10.84            | 5.68                      | 8.31             |
| Return on average assets                                | 0.72 %           | 0.75                      | 0.80             | 0.45                      | 0.64             |
| Dividend payout ratio                                   | 52.63 %          | 50.00                     | 46.51            | 81.25                     | 57.35            |
| <b>Asset Quality:</b>                                   |                  |                           |                  |                           |                  |
| Allowance for loan losses as a % of:                    |                  |                           |                  |                           |                  |
| Loans   | 1.69 %           | 2.07                      | 2.13             | 2.05                      | 1.91             |
| Nonperforming loans                                     | 60 %             | 95                        | 70               | 65                        | 82               |
| Nonperforming assets as a % of:                         |                  |                           |                  |                           |                  |
| Loans and foreclosed properties                         | 4.78 %           | 4.57                      | 5.20             | 5.22                      | 4.42             |
| Total assets  | 2.39 %           | 2.25                      | 2.51             | 2.61                      | 2.18             |
| Nonperforming loans as a % of total loans               | 2.80 %           | 2.18                      | 3.03             | 3.16                      | 2.34             |
| Net charge-offs as a % of average loans                 | 2.14 %           | 0.76                      | 0.45             | 0.16                      | 0.14             |
| <b>Capital Adequacy:</b>                                |                  |                           |                  |                           |                  |
| Tier 1 risk-based capital ratio                         | 15.25 %          | 14.95                     | 14.84            | 14.57                     | 14.53            |
| Total risk-based capital ratio                          | 16.51 %          | 16.20                     | 16.09            | 15.82                     | 15.78            |
| Tier 1 Leverage Ratio                                   | 8.87 %           | 8.65                      | 8.56             | 8.47                      | 8.39             |
| <b>Other financial data:</b>                            |                  |                           |                  |                           |                  |
| Net interest margin (a)                                 | 2.98 %           | 3.09                      | 2.98             | 2.81                      | 2.85             |
| Effective income tax rate                               | NM%              | NM                        | 9.36             | NM                        | 17.01            |
| Efficiency ratio (b)                                    | 65.03 %          | 63.67                     | 57.08            | 67.17                     | 61.98            |
| <b>Selected average balances:</b>                       |                  |                           |                  |                           |                  |
| Securities  | \$ 292,027       | 305,564                   | 320,194          | 321,956                   | 331,913          |
| Loans, net of unearned income                           | 375,614          | 375,192                   | 372,319          | 376,861                   | 374,224          |
| Total assets  | 763,771          | 777,181                   | 776,795          | 773,393                   | 779,879          |
| Total deposits  | 610,961          | 625,941                   | 622,720          | 602,934                   | 599,708          |
| Long-term debt  | 85,319           | 85,323                    | 91,728           | 103,061                   | 113,120          |
| Total stockholders' equity                              | 62,041           | 58,888                    | 57,171           | 61,841                    | 59,900           |
| <b>Selected period end balances:</b>                    |                  |                           |                  |                           |                  |

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|                               |            |         |         |         |         |
|-------------------------------|------------|---------|---------|---------|---------|
| Securities                    | \$ 283,070 | 296,443 | 321,098 | 315,220 | 322,118 |
| Loans, net of unearned income | 374,788    | 373,795 | 368,909 | 374,215 | 375,098 |
| Allowance for loan losses     | 6,340      | 7,746   | 7,855   | 7,676   | 7,181   |
| Total assets                  | 764,637    | 779,725 | 781,557 | 763,829 | 777,846 |
| Total deposits                | 609,070    | 627,969 | 631,394 | 607,127 | 602,508 |
| Long-term debt                | 85,317     | 85,322  | 85,327  | 93,331  | 108,335 |
| Total stockholders' equity    | 64,422     | 61,100  | 57,801  | 56,368  | 60,937  |

(a) Tax-equivalent. See Table 1 - Explanation of Non-GAAP Financial Measures.

(b) Efficiency ratio is the result of noninterest expense divided by the sum of noninterest income and tax-equivalent net interest income.

NM - not meaningful

**Table of Contents****Table 3 - Selected Financial Data**

|   | Nine months ended<br>September 30, |           |
|---|------------------------------------|-----------|
|   | 2011                               | 2010      |
| <i>(Dollars in thousands, except per share amounts)</i> |                                    |           |
| <b>Results of Operations</b>                            |                                    |           |
| Net interest income (a)                                 | \$ 16,020                          | 15,581    |
| Less: tax-equivalent adjustment                         | 1,304                              | 1,324     |
| Net interest income (GAAP)                              | 14,716                             | 14,257    |
| Noninterest income (loss)                               | 3,898                              | 6,945     |
| Total revenue   | 18,614                             | 21,202    |
| Provision for loan losses                               | 1,800                              | 2,930     |
| Noninterest expense                                     | 12,352                             | 12,811    |
| Income tax expense                                      | 89                                 | 993       |
| Net earnings  | \$ 4,373                           | 4,468     |
| <b>Per share data:</b>                                  |                                    |           |
| Basic and diluted net earnings                          | \$ 1.20                            | 1.23      |
| Cash dividends declared                                 | 0.60                               | 0.585     |
| Weighted average shares outstanding:                    |                                    |           |
| Basic and diluted                                       | 3,642,735                          | 3,642,896 |
| Shares outstanding, at period end                       | 3,642,738                          | 3,642,718 |
| Book value  | \$ 17.69                           | 16.73     |
| Common stock price                                      |                                    |           |
| High  | \$ 20.37                           | 22.00     |
| Low   | 19.10                              | 16.86     |
| Period end:   | 19.65                              | 20.35     |
| To earnings ratio                                       | 13.55 x                            | 15.78     |
| To book value   | 111 %                              | 122       |
| <b>Performance ratios:</b>                              |                                    |           |
| Return on average equity                                | 9.82 %                             | 10.17     |
| Return on average assets                                | 0.75 %                             | 0.76      |
| Dividend payout ratio                                   | 50.00 %                            | 47.56     |
| <b>Asset Quality:</b>                                   |                                    |           |
| Allowance for loan losses as a % of:                    |                                    |           |
| Loans   | 1.69 %                             | 1.91      |
| Nonperforming loans                                     | 60 %                               | 82        |
| Nonperforming assets as a % of:                         |                                    |           |
| Loans and foreclosed properties                         | 4.78 %                             | 4.42      |
| Total assets  | 2.39 %                             | 2.18      |
| Nonperforming loans as a % of total loans               | 2.80 %                             | 2.34      |
| Net charge-offs as a % of average loans                 | 1.12 %                             | 0.79      |
| <b>Capital Adequacy:</b>                                |                                    |           |
| Tier 1 risk-based capital ratio                         | 15.25 %                            | 14.53     |
| Total risk-based capital ratio                          | 16.51 %                            | 15.78     |
| Tier 1 Leverage Ratio                                   | 8.87 %                             | 8.39      |
| <b>Other financial data:</b>                            |                                    |           |
| Net interest margin (a)                                 | 3.02 %                             | 2.87      |
| Effective income tax rate                               | 1.99 %                             | 18.18     |
| Efficiency ratio (b)                                    | 62.01 %                            | 56.87     |
| <b>Selected average balances:</b>                       |                                    |           |
| Securities  | \$ 305,826                         | 329,858   |
| Loans, net of unearned income                           | 374,387                            | 377,251   |
| Total assets  | 772,534                            | 783,100   |
| Total deposits  | 619,827                            | 601,593   |
| Long-term debt  | 87,433                             | 115,430   |
| Total stockholders' equity                              | 59,384                             | 58,595    |
| <b>Selected period end balances:</b>                    |                                    |           |

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|                               |            |         |
|-------------------------------|------------|---------|
| Securities                    | \$ 283,070 | 322,118 |
| Loans, net of unearned income | 374,788    | 375,098 |
| Allowance for loan losses     | 6,340      | 7,181   |
| Total assets                  | 764,637    | 777,846 |
| Total deposits                | 609,070    | 602,508 |
| Long-term debt                | 85,317     | 108,335 |
| Total stockholders' equity    | 64,422     | 60,937  |

(a) Tax-equivalent. See Table 1 - Explanation of Non-GAAP Financial Measures.

(b) Efficiency ratio is the result of noninterest expense divided by the sum of noninterest income and tax-equivalent net interest income.

**Table of Contents****Table 4 - Average Balances and Net Interest Income Analysis**

|   | Quarter ended September 30, |          |        |            |          |        |
|---|-----------------------------|----------|--------|------------|----------|--------|
|   | Average                     | 2011     | Yield/ | Average    | 2010     | Yield/ |
| (Dollars in thousands)  | Balance                     | Interest | Rate   | Balance    | Interest | Rate   |
| <b>Interest-earning assets:</b>                                       |                             |          |        |            |          |        |
| Loans and loans held for sale (1)                                     | \$ 377,695                  | \$ 5,393 | 5.66%  | \$ 378,355 | \$ 5,442 | 5.71%  |
| Securities - taxable  | 212,913                     | 1,423    | 2.65%  | 249,185    | 2,053    | 3.27%  |
| Securities - tax-exempt (2)   | 79,114                      | 1,259    | 6.31%  | 82,728     | 1,318    | 6.32%  |
| Total securities  | 292,027                     | 2,682    | 3.64%  | 331,913    | 3,371    | 4.03%  |
| Federal funds sold  | 31,635                      | 14       | 0.18%  | 10,467     | 6        | 0.23%  |
| Interest bearing bank deposits  | 1,010                       |          |        | 1,099      |          |        |
| Total interest-earning assets   | 702,367                     | \$ 8,089 | 4.57%  | 721,834    | \$ 8,819 | 4.85%  |
| Cash and due from banks   | 12,681                      |          |        | 12,275     |          |        |
| Other assets  | 48,723                      |          |        | 45,770     |          |        |
| Total assets  | \$ 763,771                  |          |        | \$ 779,879 |          |        |
| <b>Interest-bearing liabilities:</b>                                  |                             |          |        |            |          |        |
| Deposits:   |                             |          |        |            |          |        |
| NOW   | \$ 87,543                   | \$ 114   | 0.52%  | \$ 84,854  | \$ 139   | 0.65%  |
| Savings and money market  | 137,692                     | 246      | 0.71%  | 121,835    | 321      | 1.05%  |
| Certificates of deposits less than \$100,000                          | 114,947                     | 555      | 1.92%  | 113,398    | 673      | 2.35%  |
| Certificates of deposits and other time deposits of \$100,000 or more | 178,173                     | 1,043    | 2.32%  | 195,493    | 1,346    | 2.73%  |
| Total interest-bearing deposits                                       | 518,355                     | 1,958    | 1.50%  | 515,580    | 2,479    | 1.91%  |
| Short-term borrowings   | 2,333                       | 3        | 0.51%  | 3,257      | 5        | 0.61%  |
| Long-term debt  | 85,319                      | 854      | 3.97%  | 113,120    | 1,148    | 4.03%  |
| Total interest-bearing liabilities                                    | 606,007                     | \$ 2,815 | 1.84%  | 631,957    | \$ 3,632 | 2.28%  |
| Noninterest-bearing deposits  | 92,606                      |          |        | 84,128     |          |        |
| Other liabilities   | 3,117                       |          |        | 3,894      |          |        |
| Stockholders' equity  | 62,041                      |          |        | 59,900     |          |        |
| Total liabilities and stockholders' equity                            | \$ 763,771                  |          |        | \$ 779,879 |          |        |
| Net interest income and margin  |                             | \$ 5,274 | 2.98%  |            | \$ 5,187 | 2.85%  |

- (1) Average loan balances are shown net of unearned income and loans on nonaccrual status have been included in the computation of average balances.
- (2) Yields on tax-exempt securities have been computed on a tax-equivalent basis using an income tax rate of 34%.

**Table of Contents****Table 5 - Average Balances and Net Interest Income Analysis**

|   | Nine months ended September 30, |           |        |            |           |        |
|---|---------------------------------|-----------|--------|------------|-----------|--------|
|   | Average                         | 2011      | Yield/ | Average    | 2010      | Yield/ |
| (Dollars in thousands)  | Balance                         | Interest  | Rate   | Balance    | Interest  | Rate   |
| <b>Interest-earning assets:</b>                                       |                                 |           |        |            |           |        |
| Loans and loans held for sale (1)                                     | \$ 376,273                      | \$ 16,051 | 5.70%  | \$ 380,569 | \$ 16,367 | 5.75%  |
| Securities - taxable  | 225,802                         | 4,875     | 2.89%  | 248,539    | 6,530     | 3.51%  |
| Securities - tax-exempt (2)   | 80,024                          | 3,833     | 6.40%  | 81,319     | 3,894     | 6.40%  |
| Total securities  | 305,826                         | 8,708     | 3.81%  | 329,858    | 10,424    | 4.23%  |
| Federal funds sold  | 26,688                          | 36        | 0.18%  | 14,265     | 22        | 0.21%  |
| Interest bearing bank deposits  | 1,557                           | 1         | 0.09%  | 920        | 1         | 0.15%  |
| Total interest-earning assets   | 710,344                         | \$ 24,796 | 4.67%  | 725,612    | \$ 26,814 | 4.94%  |
| Cash and due from banks   | 13,021                          |           |        | 12,347     |           |        |
| Other assets  | 49,169                          |           |        | 45,141     |           |        |
| Total assets  | \$ 772,534                      |           |        | \$ 783,100 |           |        |
| <b>Interest-bearing liabilities:</b>                                  |                                 |           |        |            |           |        |
| <b>Deposits:</b>  |                                 |           |        |            |           |        |
| NOW   | \$ 91,125                       | \$ 424    | 0.62%  | \$ 90,370  | \$ 483    | 0.71%  |
| Savings and money market  | 139,037                         | 752       | 0.72%  | 113,334    | 945       | 1.11%  |
| Certificates of deposits less than \$100,000                          | 114,981                         | 1,710     | 1.99%  | 113,529    | 2,116     | 2.49%  |
| Certificates of deposits and other time deposits of \$100,000 or more | 183,841                         | 3,334     | 2.42%  | 200,360    | 4,190     | 2.80%  |
| Total interest-bearing deposits                                       | 528,984                         | 6,220     | 1.57%  | 517,593    | 7,734     | 2.00%  |
| Short-term borrowings   | 2,383                           | 9         | 0.50%  | 3,902      | 19        | 0.65%  |
| Long-term debt  | 87,433                          | 2,547     | 3.89%  | 115,430    | 3,480     | 4.03%  |
| Total interest-bearing liabilities                                    | 618,800                         | \$ 8,776  | 1.90%  | 636,925    | \$ 11,233 | 2.36%  |
| Noninterest-bearing deposits  | 90,843                          |           |        | 84,000     |           |        |
| Other liabilities   | 3,503                           |           |        | 3,580      |           |        |
| Stockholders' equity  | 59,384                          |           |        | 58,595     |           |        |
| Total liabilities and stockholders' equity                            | \$ 772,530                      |           |        | \$ 783,100 |           |        |
| Net interest income and margin  |                                 | \$ 16,020 | 3.02%  |            | \$ 15,581 | 2.87%  |

- (1) Average loan balances are shown net of unearned income and loans on nonaccrual status have been included in the computation of average balances.
- (2) Yields on tax-exempt securities have been computed on a tax-equivalent basis using an income tax rate of 34%.



**Table of Contents****Table 6 - Loan Portfolio Composition**

|                                   |            | 2011    |         | 2010    |         |
|-----------------------------------|------------|---------|---------|---------|---------|
|                                   | Third      | Second  | First   | Fourth  | Third   |
| (In thousands)                    | Quarter    | Quarter | Quarter | Quarter | Quarter |
| Commercial and industrial         | \$ 53,888  | 52,027  | 51,323  | 53,288  | 58,400  |
| Construction and land development | 40,781     | 43,864  | 48,814  | 47,850  | 46,928  |
| Commercial real estate            | 166,059    | 166,272 | 161,882 | 166,241 | 161,676 |
| Residential real estate           | 102,030    | 100,496 | 95,997  | 96,241  | 96,888  |
| Consumer installment              | 12,105     | 11,248  | 10,968  | 10,676  | 11,312  |
| Total loans                       | 374,863    | 373,907 | 368,984 | 374,296 | 375,204 |
| Less: unearned income             | (75)       | (112)   | (75)    | (81)    | (106)   |
| Loans, net of unearned income     | 374,788    | 373,795 | 368,909 | 374,215 | 375,098 |
| Less: allowance for loan losses   | (6,340)    | (7,746) | (7,855) | (7,676) | (7,181) |
| Loans, net                        | \$ 368,448 | 366,049 | 361,054 | 366,539 | 367,917 |

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**Table 7 - Allowance for Loan Losses and Nonperforming Assets**

|   | Third<br>Quarter | 2011<br>Second<br>Quarter | First<br>Quarter | 2010<br>Fourth<br>Quarter | Third<br>Quarter |
|---|------------------|---------------------------|------------------|---------------------------|------------------|
| <i>(Dollars in thousands)</i>                                     |                  |                           |                  |                           |                  |
| <b>Allowance for loan losses:</b>                                 |                  |                           |                  |                           |                  |
| Balance at beginning of period                                    | \$ 7,746         | 7,855                     | 7,676            | 7,181                     | 6,580            |
| Charge-offs:  |                  |                           |                  |                           |                  |
| Commercial and industrial   | (298)            | (306)                     | (56)             | (66)                      | (77)             |
| Construction and land development                                 | (1,572)          | (112)                     | (33)             | (20)                      | (5)              |
| Commercial real estate  | (79)             |                           | (339)            |                           |                  |
| Residential real estate   | (73)             | (389)                     | (57)             | (153)                     | (91)             |
| Consumer installment  | (7)              | (2)                       | (1)              | (9)                       | (14)             |
| Total charge-offs   | (2,029)          | (809)                     | (486)            | (248)                     | (187)            |
| Recoveries  | 23               | 100                       | 65               | 93                        | 58               |
| Net charge-offs   | (2,006)          | (709)                     | (421)            | (155)                     | (129)            |
| Provision for loan losses   | 600              | 600                       | 600              | 650                       | 730              |
| Ending balance  | \$ 6,340         | 7,746                     | 7,855            | 7,676                     | 7,181            |
| as a % of loans   | 1.69 %           | 2.07                      | 2.13             | 2.05                      | 1.91             |
| as a % of nonperforming loans                                     | 60 %             | 95                        | 70               | 65                        | 82               |
| Net charge-offs as a % of average loans                           | 2.14 %           | 0.76                      | 0.45             | 0.16                      | 0.14             |
| <b>Nonperforming assets:</b>                                      |                  |                           |                  |                           |                  |
| Nonaccrual loans  | \$ 10,506        | 8,151                     | 11,166           | 11,833                    | 8,776            |
| Other nonperforming assets<br>(primarily other real estate owned) | 7,770            | 9,361                     | 8,450            | 8,125                     | 8,163            |
| Total nonperforming assets  | \$ 18,276        | 17,512                    | 19,616           | 19,958                    | 16,939           |
| as a % of loans and foreclosed properties                         | 4.78 %           | 4.57                      | 5.20             | 5.22                      | 4.42             |
| as a % of total assets  | 2.39 %           | 2.25                      | 2.51             | 2.61                      | 2.18             |
| Nonperforming loans as a % of total loans                         | 2.80 %           | 2.18                      | 3.03             | 3.16                      | 2.34             |
| Accruing loans 90 days or more past due                           | \$ 11            | 158                       |                  |                           | 62               |

**Table of Contents****Table 8 - Allocation of Allowance for Loan Losses**

|                                   |               |      | 2011           |      |               |      |                |      | 2010          |      |
|-----------------------------------|---------------|------|----------------|------|---------------|------|----------------|------|---------------|------|
|                                   | Third Quarter |      | Second Quarter |      | First Quarter |      | Fourth Quarter |      | Third Quarter |      |
| <i>(Dollars in thousands)</i>     | Amount        | %*   | Amount         | %*   | Amount        | %*   | Amount         | %*   | Amount        | %*   |
| Commercial and industrial         | \$ 762        | 14.4 | \$ 767         | 13.9 | \$ 1,142      | 13.9 | \$ 972         | 14.2 | \$ 874        | 15.6 |
| Construction and land development | 1,138         | 10.9 | 2,759          | 11.7 | 2,257         | 13.2 | 2,223          | 12.8 | 2,177         | 12.5 |
| Commercial real estate            | 2,643         | 44.3 | 2,722          | 44.5 | 2,697         | 43.9 | 2,893          | 44.4 | 2,308         | 43.1 |
| Residential real estate           | 1,404         | 27.2 | 1,104          | 26.9 | 1,284         | 26.0 | 1,336          | 25.7 | 1,292         | 25.8 |
| Consumer installment              | 178           | 3.2  | 190            | 3.0  | 202           | 3.0  | 141            | 2.9  | 133           | 3.0  |
| Unallocated                       | 215           |      | 204            |      | 273           |      | 111            |      | 397           |      |
| Total allowance for loan losses   | \$ 6,340      |      | \$ 7,746       |      | \$ 7,855      |      | \$ 7,676       |      | \$ 7,181      |      |

\* Loan balance in each category expressed as a percentage of total loans.

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**Table 9 - CDs and Other Time Deposits of \$100,000 or More**

| <i>(Dollars in thousands)</i>                          |    | September 30, 2011 |
|--|----|--------------------|
| <b>Maturity of:</b>                                    |    |                    |
| 3 months or less                                       | \$ | 29,613             |
| Over 3 months through 6 months                         |    | 25,745             |
| Over 6 months through 12 months                        |    | 29,688             |
| Over 12 months   |    | 90,743             |
| Total CDs and other time deposits of \$100,000 or more | \$ | 175,789            |

**Table of Contents****ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

The information called for by ITEM 3 is set forth in ITEM 2 under the caption MARKET AND LIQUIDITY RISK MANAGEMENT and is incorporated herein by reference.

**ITEM 4. CONTROLS AND PROCEDURES**

The Company, with the participation of its management, including its Chief Executive Officer and Principal Financial and Accounting Officer, carried out an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended) as of the end of the period covered by this report. Based upon that evaluation and as of the end of the period covered by this report, the Company's Chief Executive Officer and Principal Financial and Accounting Officer concluded that the Company's disclosure controls and procedures were effective to allow timely decisions regarding disclosure in its reports that the Company files or submits to the Securities and Exchange Commission under the Securities Exchange Act of 1934, as amended. There have been no changes in the Company's internal control over financial reporting that occurred during the period covered by this report that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II. OTHER INFORMATION****ITEM 1. LEGAL PROCEEDINGS**

In the normal course of business, the Company and the Bank from time to time are involved in legal proceedings. The Company and Bank management believe there are no pending or threatened legal, governmental, or regulatory proceedings that upon resolution are expected to have a material adverse effect upon the Company's or the Bank's financial condition or results of operations. See also, Part I, Item 3 of the Company's annual report on Form 10-K for the year ended December 31, 2010.

**ITEM 1A. RISK FACTORS**

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I Item 1A. Risk Factors in our annual report on Form 10-K for the year ended December 31, 2010, which could materially affect our business, financial condition or future results. The risks described in our annual report on Form 10-K are not the only the risks facing our Company. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results in the future.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**  
**ISSUER PURCHASES OF EQUITY SECURITIES**

| Period <sup>(1)</sup>         | Total Number of<br>Shares<br>Purchased | Average Price Paid<br>per Share | Total Number of Shares<br>Purchased as Part of<br>Publicly Announced<br>Plans or Programs | Maximum Number of Shares<br>that May Yet Be Purchased<br>Under the Plans or Programs |
|-------------------------------|--|---------------------------------|---|--|
| July 1 -<br>July 31           |  |                                 |   |  |
| August 1 -<br>August 31       |  |                                 |   |  |
| September 1 -<br>September 30 |  |                                 |   |  |
| Total                         |  |                                 |   |  |

<sup>(1)</sup> Based on trade date, not settlement date.



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### **ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

### **ITEM 4. REMOVED AND RESERVED**

### **ITEM 5. OTHER INFORMATION**

Not applicable.

### **ITEM 6. EXHIBITS**

| <b>Exhibit</b> |   |
|----------------|---|
| <b>Number</b>  | <b>Description</b>  |
| 3.1            | Certificate of Incorporation of Auburn National Bancorporation, Inc. and all amendments thereto.*   |
| 3.2            | Amended and Restated Bylaws of Auburn National Bancorporation, Inc., adopted as of November 13, 2007. **  |
| 31.1           | Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, As Adopted Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002, by E.L. Spencer, Jr., President, Chief Executive Officer and Chairman of the Board.                                      |
| 31.2           | Certification Pursuant to Rule 13a-14(a) of the Securities Exchange Act of 1934, As Adopted Pursuant To Section 302 of the Sarbanes-Oxley Act of 2002, by David A. Hedges, Vice President, Controller and Chief Financial Officer (Principal Financial and Accounting Officer). |
| 32.1           | Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 of the Sarbanes-Oxley Act of 2002, by David A. Hedges, Vice President, Controller and Chief Financial Officer (Principal Financial and Accounting Officer).***                             |
| 32.2           | Certification Pursuant to 18 U.S.C. Section 1350, As Adopted Pursuant To Section 906 of the Sarbanes-Oxley Act of 2002, by E.L. Spencer, Jr., President, Chief Executive Officer and Chairman of the Board.***  |
| 101.INS        | XBRL Instance Document****  |
| 101.SCH        | XBRL Taxonomy Extension Schema Document****   |
| 101.CAL        | XBRL Taxonomy Extension Calculation Linkbase Document****   |
| 101.DEF        | XBRL Taxonomy Extension Definition Linkbase Document****  |
| 101.LAB        | XBRL Taxonomy Extension Label Linkbase Document****   |
| 101.PRE        | XBRL Taxonomy Extension Presentation Linkbase Document****  |

\* Incorporated by reference from Registrant's Form 10-Q dated September 30, 2002.

\*\* Incorporated by reference from Registrant's Form 10-K dated March 31, 2008.

\*\*\* The certifications attached as exhibits 32.1 and 32.2 to this quarterly report on Form 10-Q are furnished to the Securities and Exchange Commission pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 and shall not be deemed filed by the Company for purposes of Section 18 of the Securities Exchange Act of 1934, as amended.

\*\*\*\* Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

AUBURN NATIONAL BANCORPORATION, INC.  
(Registrant)

Date: November 14, 2011

By: /s/ E. L. Spencer, Jr.  
E. L. Spencer, Jr.  
President, Chief Executive Officer and  
Chairman of the Board

Date: November 14, 2011

By: /s/ David A. Hedges  
David A. Hedges  
VP, Controller and Chief Financial Officer  
(Principal Financial and Accounting Officer)