AUBURN NATIONAL BANCORPORATION, INC
Form 10-Q
August 15, 2011
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.**
For the quarterly period ended June 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)

Delaware	**63-0885779**
(State or other jurisdiction of incorporation or organization)	**(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 x 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 x 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 x (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 x

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

Class	**Outstanding at July 31, 2011**
Common Stock, $0.01 par value per share	3,642,738 shares

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

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PART 1. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Condensed Consolidated Balance Sheets

(Unaudited)

(Dollars in thousands, except share data)	**June 30, 2011**	**December 31, 2010**
Assets:		
Cash and due from banks	$ 15,654	$ 11,432
Federal funds sold	40,835	7,500
Interest bearing bank deposits	1,091	2,492
Cash and cash equivalents	57,580	21,424
Securities available-for-sale	296,443	315,220
Loans held for sale	2,278	4,281
Loans, net of unearned income	373,795	374,215
Allowance for loan losses	(7,746)	(7,676)
Loans, net	366,049	366,539
Premises and equipment, net	8,237	8,105
Bank-owned life insurance	16,385	16,171
Other real estate owned	9,361	8,125
Other assets	23,392	23,964
Total assets	$ 779,725	$ 763,829
Liabilities:		
Deposits:		
Noninterest-bearing	$ 96,888	$ 87,660
Interest-bearing	531,081	519,467
Total deposits	627,969	607,127
Federal funds purchased and securities sold under agreements to repurchase	2,314	2,685
Long-term debt	85,322	93,331
Accrued expenses and other liabilities	3,020	4,318
Total liabilities	718,625	707,461
Stockholders equity:		
Preferred stock of $.01 par value; authorized 200,000 shares; no issued shares		
Common stock of $.01 par value; authorized 8,500,000 shares; issued 3,957,135 shares	39	39
Additional paid-in capital	3,753	3,752
Retained earnings	62,970	61,421

Accumulated other comprehensive income (loss), net	981	(2,201)
Less treasury stock, at cost - 314,397 shares and 314,417 shares at June 30, 2011 and December 31, 2010, respectively	(6,643)	(6,643)
Total stockholders equity	61,100	56,368
Total liabilities and stockholders equity	$ 779,725	$ 763,829

See accompanying notes to condensed consolidated financial statements

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Earnings

(Unaudited)

(Dollars in thousands, except share and per share data)	Quarter ended June 30, 2011	Quarter ended June 30, 2010	Six months ended June 30, 2011	Six months ended June 30, 2010
Interest income:				
Loans, including fees	$ 5,371	$ 5,492	$ 10,658	$ 10,925
Securities	2,613	2,959	5,151	6,178
Federal funds sold and interest bearing bank deposits	14	10	23	17
Total interest income	7,998	8,461	15,832	17,120
Interest expense:				
Deposits	2,092	2,615	4,262	5,255
Short-term borrowings	3	3	6	14
Long-term debt	846	1,155	1,693	2,332
Total interest expense	2,941	3,773	5,961	7,601
Net interest income	5,057	4,688	9,871	9,519
Provision for loan losses	600	750	1,200	2,200
Net interest income after provision for loan losses	4,457	3,938	8,671	7,319
Noninterest income:				
Service charges on deposit accounts	290	334	581	648
Mortgage lending	439	625	879	1,107
Bank-owned life insurance	107	106	214	232
Affordable housing investment losses	(230)	(57)	(230)	(114)
Other	355	353	708	734
Securities gains, net:				
Realized gains, net	445	1,431	450	2,531
Total other-than-temporary impairments	(51)	(20)	(312)	(260)
Non-credit portion of other-than-temporary impairments recognized in other comprehensive income		20	210	210
Total securities gains, net	394	1,431	348	2,481
Total noninterest income	1,355	2,792	2,500	5,088
Noninterest expense:				
Salaries and benefits	2,068	1,939	4,054	3,844
Net occupancy and equipment	328	364	674	748
Professional fees	189	191	360	367
FDIC and other regulatory assessments	199	286	481	562
Other real estate owned, net	718	911	701	972
Prepayment penalty on long-term debt		298		298
Other	861	820	1,743	1,654
Total noninterest expense	4,363	4,809	8,013	8,445

Earnings before income taxes	1,449	1,921	3,158	3,962
Income tax (benefit) expense	(8)	314	152	738
Net earnings	$ 1,457	$ 1,607	$ 3,006	$ 3,224
Net earnings per share:				
Basic and diluted	$ 0.40	$ 0.44	$ 0.83	$ 0.88
Weighted average shares outstanding:				
Basic and diluted	3,642,738	3,642,877	3,642,733	3,642,996

See accompanying notes to condensed consolidated financial statements

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Stockholders Equity and Comprehensive Income

(Unaudited)

(Dollars in thousands, except share data)	Common Stock Shares	Common Stock Amount	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income (loss)	Treasury stock	Total
Balance, December 31, 2009	3,957,135	$ 39	$ 3,751	$ 58,917	$ 111	$(6,635)	$ 56,183
Comprehensive income:							
Net earnings				3,224			3,224
Other comprehensive loss due to change in other-than-temporary impairment losses related to factors other than credit on available-for- sale, net					(133)		(133)
Other comprehensive income due to change in all other unrealized gains (losses) on securities available-for- sale, net					1,196		1,196
Total comprehensive income				3,224	1,063		4,287
Cash dividends paid ($0.39 per share)				(1,421)			(1,421)
Stock repurchases (484 shares)						(8)	(8)
Sale of treasury stock (60 shares)			1				1
Balance, June 30, 2010	3,957,135	$ 39	$ 3,752	$ 60,720	$ 1,174	$ (6,643)	$ 59,042
Balance, December 31, 2010	3,957,135	$ 39	$ 3,752	$ 61,421	$ (2,201)	$ (6,643)	$ 56,368
Comprehensive income:							
Net earnings				3,006			3,006
Other comprehensive loss due to change in other-than-temporary impairment losses related to factors other than credit on available-for- sale, net					(133)		(133)
Other comprehensive income due to change in all other unrealized gains (losses) on securities available-for- sale, net					3,315		3,315
Total comprehensive income				3,006	3,182		6,188
Cash dividends paid ($0.40 per share)				(1,457)			(1,457)
Sale of treasury stock (20 shares)			1				1
Balance, June 30, 2011	3,957,135	$ 39	$ 3,753	$ 62,970	$ 981	$ (6,643)	$ 61,100

See accompanying notes to condensed consolidated financial statements

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AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Condensed Consolidated Statements of Cash Flows

(Unaudited)

(In thousands)	Six months ended June 30, 2011	2010
Cash flows from operating activities:		
Net earnings	$ 3,006	$ 3,224
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Provision for loan losses	1,200	2,200
Depreciation and amortization	309	273
Premium amortization and discount accretion, net	1,074	916
Net gain on securities	(348)	(2,481)
Net gain on sale of loans held for sale	(683)	(927)
Net loss on other real estate owned	741	857
Loss on prepayment of long-term debt		298
Loans originated for sale	(22,317)	(38,702)
Proceeds from sale of loans	24,851	40,130
Increase in cash surrender value of bank owned life insurance	(214)	(232)
Net increase in other assets	(1,706)	(1,087)
Net (decrease) increase in accrued expenses and other liabilities	(1,298)	355
Net cash provided by operating activities	4,615	4,824
Cash flows from investing activities:		
Proceeds from sales of securities available-for-sale	97,407	120,083
Proceeds from maturities of securities available-for-sale	44,834	71,029
Purchase of securities available-for-sale	(119,147)	(186,208)
Net increase in loans	(3,268)	(3,113)
Net purchases of premises and equipment	(295)	(75)
Decrease in FHLB stock	423	
Proceeds from sale of other real estate owned	581	571
Net cash provided by investing activities	20,535	2,287
Cash flows from financing activities:		
Net increase in noninterest-bearing deposits	9,228	10,012
Net increase in interest-bearing deposits	11,614	16,334
Net decrease in federal funds purchased and securities sold under agreements to repurchase	(371)	(13,809)
Repayments or retirement of long-term debt	(8,009)	(5,307)
Proceeds from sale of treasury stock	1	1
Stock repurchases		(8)
Dividends paid	(1,457)	(1,421)
Net cash provided by financing activities	11,006	5,802
Net change in cash and cash equivalents	36,156	12,913
Cash and cash equivalents at beginning of period	21,424	12,395

Cash and cash equivalents at end of period	$ 57,580	$ 25,308
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$ 6,108	$ 7,770
Income taxes	332	843
Supplemental disclosure of non-cash transactions:		
Real estate acquired through foreclosure	2,558	477

See accompanying notes to condensed consolidated financial statements

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.

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 June 30, 2011. The Company does not believe there are any material subsequent events that would require further recognition or disclosure.

Accounting Developments

No new guidance was adopted by the Company during the second quarter of 2011. In the first quarter of 2011 the Company adopted new guidance related to the following Codification topic:

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

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

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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 six months ended June 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 June 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 six months ended June 30, 2011 and 2010 is presented below.

	Quarter ended June 30,		Six months ended June 30,	
(Dollars in thousands, except share and per share data)	**2011**	**2010**	**2011**	**2010**
Basic and diluted:				
Net earnings	$ 1,457	$ 1,607	$ 3,006	$ 3,224
Weighted average common shares outstanding	3,642,738	3,642,877	3,642,733	3,642,996
Earnings per share	$ 0.40	$ 0.44	$ 0.83	$ 0.88

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 six months ended June 30, 2011 and 2010 is presented below.

	Quarter ended June 30,		Six months ended June 30,	
(In thousands)	**2011**	**2010**	**2011**	**2010**
Comprehensive income:				
Net earnings	$ 1,457	$ 1,607	$ 3,006	$ 3,224
Other comprehensive income (loss):				
Due to change in other-than-temporary impairment losses related to factors other than credit on securities available-for-sale, net of tax		(13)	(133)	(133)
Due to change in all other unrealized gains on securities available-for-sale, net of tax	2,571	387	3,315	1,196
Total comprehensive income	$ 4,028	$ 1,981	$ 6,188	$ 4,287

NOTE 4: VARIABLE INTEREST ENTITIES

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 June 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 reported in interest expense on long-term debt. For regulatory reporting and capital adequacy purposes, the Federal Reserve Board has indicated that such trust preferred securities will continue to constitute Tier 1 Capital until further notice.

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 June 30, 2011 and December 31, 2010, the Company had limited partnership investments of $5.6 million and $3.4 million, respectively, related to these projects, which are included in other assets on the Condensed Consolidated Balance Sheets. At June 30, 2011 and December 31, 2010, the Company had unfunded commitments related to affordable housing investments of $0.5 million and $1.9 million, respectively, included in accrued expenses and other liabilities on the Condensed Consolidated Balance Sheets.

Additionally, the Company had outstanding loan commitments with certain of the partnerships totaling $4.1 million and $11.4 million at June 30, 2011 and December 31, 2010, respectively. The funded portion of these loans was approximately $3.0 and $8.9 million at June 30, 2011 and December 31, 2010, respectively. The funded portions of these loans are included in loans, net of unearned income on the Condensed Consolidated Balance Sheets.

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

(Dollars in thousands)	Maximum Loss Exposure	Liability Recognized	Classification
Type:			
Affordable housing investments (a)	$ 5,647	458	Other assets
Trust preferred issuances	N/A	7,217	Long-term debt

(a) Maximum loss exposure represents the Company s current investment of $5.6 million included in other assets. The current investment of $5.6 million includes $0.5 million of unfunded commitments related to affordable housing investments included in accrued expenses and other liabilities.

NOTE 5: SECURITIES

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

	June 30, 2011							
(Dollars in thousands)	**1 year or less**	**1 to 5 years**	**5 to 10 years**	**After 10 years**	**Fair Value**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Amortized Cost**
Available-for-sale:								
Agency obligations (a)	$		23,899	26,860	50,759	29	424	$ 51,154
Agency RMBS (a)			14,255	146,103	160,358	1,254	532	159,636
State and political subdivisions	20	932	15,389	66,734	83,075	1,737	353	81,691
Trust preferred securities:								
Pooled				20	20		210	230
Individual issuer				2,231	2,231	186	134	2,179
Total available-for-sale	$ 20	932	53,543	241,948	296,443	3,206	1,653	$ 294,890

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

	December 31, 2010							
(Dollars in thousands)	**1 year or less**	**1 to 5 years**	**5 to 10 years**	**After 10 years**	**Fair Value**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Amortized 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 $186.5 million and $171.1 million at June 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 on the Condensed Consolidated Balance Sheets are cost-method investments. The carrying amounts of cost-method investments were $5.4 and $5.8 million at June 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.

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Gross Unrealized Losses and Fair Value

The fair values and gross unrealized losses on securities at June 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	
(Dollars in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
June 30, 2011:						
Agency obligations	$ 27,704	424			27,704	$ 424
Agency RMBS	65,363	532			65,363	532
State and political subdivisions	10,604	193	3,459	160	14,063	353
Trust preferred securities:						
Pooled			20	210	20	210
Individual issuer			866	134	866	134
Total	$ 103,671	1,149	4,345	504	108,016	$ 1,653
December 31, 2010:						
Agency obligations	$ 45,351	1,017			45,351	$ 1,017
Agency RMBS	89,840	1,441			89,840	1,441
State and political subdivisions	49,176	2,323	3,207	478	52,383	2,801
Trust preferred securities:						
Pooled			20	210	20	210
Individual issuer			847	153	847	153
Total	$ 184,367	4,781	4,074	841	188,441	$ 5,622

The applicable date for determining when securities are in an unrealized loss position is June 30, 2011. As such, it is possible that a security in an unrealized loss position at June 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 has assessed each security for credit impairment. For debt securities, the Company evaluates, where necessary, whether credit impairment exists by comparing the present value of the expected cash flows to the securities amortized cost basis. For cost-method investments, the Company evaluates whether an event or change in circumstances has occurred during the reporting period that may have a significant adverse effect on the fair value of the investment.

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

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

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

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

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;

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

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

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

current delinquencies and nonperforming assets of underlying collateral;

expected future default rates; and

subordination levels or other credit enhancements.

Agency obligations

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

Agency residential mortgage-backed securities (RMBS)

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

Securities of U.S. states and political subdivisions

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

Pooled trust preferred securities

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

Individual issuer trust preferred securities

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

Cost-method investments

At June 30, 2011, cost-method investments with an aggregate cost of $5.4 million were not evaluated for impairment because the Company did not identify any events or changes in circumstances that may have a significant adverse effect on the fair value of these cost-method investments.

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

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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 June 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 June 30, 2011

	Credit Rating			Unrealized Losses			
(Dollars in thousands)	**Moody s**	**Fitch**	**Fair Value**	**Less than 12 months**	**12 months or Longer**	**Total**	**Life-to-date Impairment Charges**
Pooled:							
ALESCO Preferred Funding XVII Ltd (a)	C	CC	$ 20		210	210	$ 1,770
Individual issuer (b):							
Carolina Financial Capital Trust I	n/a	n/a	260				190
Main Street Bank Statutory Trust I (c)	n/a	n/a	459		41	41	
MNB Capital Trust I	n/a	n/a	143				362
PrimeSouth Capital Trust I	n/a	n/a	161				339
TCB Trust	n/a	n/a	407		93	93	
United Community Capital Trust	n/a	n/a	801				379
Total individual issuer			2,231		134	134	1,270
Total trust preferred securities			$ 2,251		344	344	$ 3,040

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			
(Dollars in thousands)	**Moody s**	**Fitch**	**Fair Value**	**Less than 12 months**	**12 months or Longer**	**Total**	**Life-to-date Impairment Charges**
Pooled:							
ALESCO Preferred Funding XVII Ltd (a)	Ca	C	$ 20		210	210	$ 1770
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	
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.

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

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 June 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 six months ended June 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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(Dollars in thousands)	Quarter ended June 30, 2011	2010	Six months ended June 30, 2011	2010
Balance, beginning of period	$ 2,989	$ 4,620	$ 2,938	$ 4,570
Additions:				
Subsequent credit impairments	51		102	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	$ 3,040	$ 4,620	$ 3,040	$ 4,620

Other-Than-Temporary Impairment

The following table presents details of the other-than-temporary impairment related to securities, including equity securities carried at cost, for the six months ended June 30, 2011 and 2010.

(Dollars in thousands)	Quarter ended June 30, 2011	2010	Six months ended June 30, 2011	2010
Other-than-temporary impairment charges (included in earnings):				
Debt securities:				
Pooled trust preferred securities	$	$	$	$ 50
Individual issuer trust preferred securities	51		102	
Total debt securities	51		102	50
Cost-method investments				
Total other-than-temporary impairment charges	$ 51	$	$ 102	$ 50
Other-than-temporary impairment on debt securities:				
Recorded as part of gross realized losses:				
Credit-related	$ 51		$ 102	$ 50
Securities with intent to sell				
Recorded directly to other comprehensive income for non-credit related impairment		20	210	210
Total other-than-temporary impairment on debt securities	$ 51	$ 20	$ 312	$ 260

Realized Gains and Losses

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

(Dollars in thousands)	Quarter ended June 30, 2011	2010	Six months ended June 30, 2011	2010
Gross realized gains	$ 877	$ 1,431	$ 905	$ 2,570
Gross realized losses	(483)		(557)	(89)
Realized gains, net	$ 394	$ 1,431	$ 348	$ 2,481

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NOTE 6: LOANS AND ALLOWANCE FOR LOAN LOSSES

(In thousands)	June 30, 2011	December 31, 2010
Commercial and industrial	$ 52,027	$ 53,288
Construction and land development	43,864	47,850
Commercial real estate:		
Owner occupied	74,928	76,252
Other	91,344	89,989
Total commercial real estate	166,272	166,241
Residential real estate:		
Consumer mortgage	58,816	57,562
Investment property	41,680	38,679
Total residential real estate	100,496	96,241
Consumer installment	11,248	10,676
Total loans	373,907	374,296
Less: unearned income	(112)	(81)
Loans, net of unearned income	$ 373,795	$ 374,215

Loans secured by real estate were approximately 83.1% of the total loan portfolio at June 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 June 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.

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.

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 June 30, 2011, and December 31, 2010

(In thousands)	Current	Accruing 30-89 Days Past Due	Accruing Greater than 90 days	Total Accruing Loans	Non-Accrual	Total Loans
June 30, 2011:						
Commercial and industrial	$ 51,885	94		51,979	48	$ 52,027
Construction and land development	41,020			41,020	2,844	43,864
Commercial real estate:						
Owner occupied	73,483	255		73,738	1,190	74,928
Other	88,465	201		88,666	2,678	91,344
Total commercial real estate	161,948	456		162,404	3,868	166,272
Residential real estate:						
Consumer mortgage	57,791		11	57,802	1,014	58,816
Investment property	41,089	360		41,449	231	41,680
Total residential real estate	98,880	360	11	99,251	1,245	100,496
Consumer installment	11,087	15		11,102	146	11,248
Total	$ 364,820	925	11	365,756	8,151	$ 373,907
December 31, 2010:						
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
Consumer installment	10,646	29		10,675	1	10,676

Total	$ 359,123	3,340	362,463	11,833	$ 374,296

At June 30, 2011 and December 31, 2010, nonaccrual loans amounted to $8.2 and $11.8 million, respectively. At June 30, 2011, there was $11,000 in loans 90 days past due and still accruing interest. At December 31, 2010, there were no loans 90 days past due and still accruing interest.

Allowance for Loan Losses

The Company assesses the adequacy of its allowance for loan losses prior to the end of each calendar quarter. The level of the allowance is based upon management s evaluation of the loan portfolios, past loan loss experience, current asset quality trends, known and inherent risks in the portfolio, adverse situations that may affect the borrower s ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan 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 Company believes it follows appropriate accounting and regulatory guidance in determining impairment and accrual status of impaired loans.

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

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

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

The allocation of the allowance for loan losses begins with a process of estimating the probable losses inherent for these types of loans. The estimates for these loans are established by category and based on the Company s internal system of credit risk ratings and historical loss data. The estimated loan loss allocation rate for the Company s internal system of credit risk grades is based on its experience with similarly graded loans. For loan segments where the Company believes it does not have sufficient historical loss data, the Company may make adjustments based, in part, on loss rates of peer bank groups. Consistent with prior periods, at June 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. An example is the imprecision in the overall measurement process.

The following table presents an analysis of the allowance for loan losses by portfolio segment as of June 30, 2011 and December 31, 2010. The total allowance for loan losses is then disaggregated to show the amounts derived through individual evaluation and the amounts calculated through collective evaluation.

	Six months ended June 30, 2011						
(In thousands)	**Commercial and industrial**	**Construction and land development**	**Commercial real estate**	**Residential real estate**	**Consumer installment**	**Unallocated**	**Total**
Allowance for loan losses:							
Beginning balance	$ 972	2,223	2,893	1,336	141	111	$ 7,676
Charge-offs	(362)	(145)	(339)	(446)	(3)		(1,295)
Recoveries	23	1		135	6		165
Net (charge-offs) recoveries	(339)	(144)	(339)	(311)	3		(1,130)
Provision	134	680	168	79	46	93	1,200
Ending balance	$ 767	2,759	2,722	1,104	190	204	$ 7,746
Individually evaluated		282	385	94			761
Collectively evaluated	767	2,477	2,337	1,010	190	204	6,985
Total loans:	$ 52,027	43,864	166,272	100,496	11,248		$ 373,907
Individually evaluated	233	2,844	4,319	949			8,345
Collectively evaluated	51,794	41,020	161,953	99,547	11,248		365,562

	December 31, 2010						
(In thousands)	**Commercial and industrial**	**Construction and land development**	**Commercial real estate**	**Residential real estate**	**Consumer installment**	**Unallocated**	**Total**
Allowance for loan losses:	$ 972	2,223	2,893	1,336	141	111	$ 7,676
Individually evaluated	277	123	765	144			1,309
Collectively evaluated	695	2,100	2,128	1,192	141	111	6,367
Total loans:	$ 53,288	47,850	166,241	96,241	10,676		$ 374,296
Individually evaluated	521	4,102	4,630	2,418			11,671
Collectively evaluated	52,767	43,748	161,611	93,823	10,676		362,625

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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.

	June 30, 2011				
(In thousands)	**Pass**	**Special Mention**	**Substandard Accruing**	**Nonaccrual**	**Total loans**
Commercial and industrial	$ 48,984	2,004	991	48	$ 52,027
Construction and land development	35,898	106	5,016	2,844	43,864
Commercial real estate:					
Owner occupied	67,161	4,814	1,763	1,190	74,928
Other	80,916	204	7,546	2,678	91,344
Total commercial real estate	148,077	5,018	9,309	3,868	166,272
Residential real estate:					
Consumer mortgage	51,067	2,822	3,913	1,014	58,816
Investment property	37,695	2,280	1,474	231	41,680
Total residential real estate	88,762	5,102	5,387	1,245	100,496
Consumer installment	10,893	100	109	146	11,248
Total	$ 332,614	12,330	20,812	8,151	$ 373,907

	December 31, 2010				
(In thousands)	**Pass**	**Special Mention**	**Substandard Accruing**	**Nonaccrual**	**Total 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
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

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Impaired loans

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

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

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

The following table sets forth certain information regarding the Company s impaired loans that were individually evaluated for impairment at June 30, 2011 and December 31, 2010.

	June 30, 2011				Six months ended June 30, 2011	
(In thousands)	Unpaid principal balance (1)	Charge-offs and payments applied (2)	Recorded investment (3)	Related allowance	Average recorded investment	Interest income recognized (4)
With no allowance recorded:						
Commercial and industrial	$ 233		233		$ 395	$ 2
Construction and land development					1,390	
Commercial real estate:						
Owner occupied	811	(5)	806		764	6
Other	1,580	(102)	1,478		1,508	
Total commercial real estate	2,391	(107)	2,284		2,272	6
Residential real estate:						
Consumer mortgages					58	
Investment property					51	
Total residential real estate					109	
Consumer installment						
Total	$ 2,624	(107)	2,517		$ 4,166	$ 8
With allowance recorded:						
Commercial and industrial	$			$	$	$
Construction and land development	2,959	(115)	2,844	282	2,562	
Commercial real estate:						
Owner occupied	848	(14)	834	159	956	
Other	1,229	(28)	1,201	226	1,229	
Total commercial real estate	2,077	(42)	2,035	385	2,185	
Residential real estate:						
Consumer mortgages	1,010	(61)	949	94	1,704	
Investment property						
Total residential real estate	1,010	(61)	949	94	1,704	
Consumer installment						

Total	$ 6,046	(218)	5,828	$ 761	$ 6,451	$
Total impaired loans	$ 8,670	(325)	8,345	$ 761	$ 10,617	$ 8

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

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	December 31, 2010			
(In thousands)	Unpaid principal balance (1)	Charge-offs and payments applied (2)	Recorded investment (3)	Related allowance
With no allowance recorded:				
Commercial and industrial	$			
Construction and land development	2,538	(54)	2,484	
Commercial real estate:				
Owner occupied				
Other	1,592	(51)	1,541	
Total commercial real estate	1,592	(51)	1,541	
Residential real estate:				
Consumer mortgages	1,072	(27)	1,045	
Investment property	356		356	
Total residential real estate	1,428	(27)	1,401	
Consumer installment				
Total	$ 5,558	(132)	5,426	
With allowance recorded:				
Commercial and industrial	$ 528	(7)	521	$ 277
Construction and land development	1,618		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
Total impaired loans	$ 11,901	(230)	11,671	$ 1,309

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

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

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

At June 30, 2011 and December 31, 2010, the Company had impaired loans classified as troubled debt restructurings (TDRs) of $7.4 million and $7.6 million, respectively. At June 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 $0.7 million and $1.0 million at June 30, 2011 and December 31, 2010, respectively. At June 30, 2011, there were no significant outstanding commitments to advance additional funds to customers whose loans had been restructured.

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NOTE 7: MORTGAGE SERVICING RIGHTS, NET

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

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

The change in amortized MSRs and the related valuation allowance for the quarters and six months ended June 30, 2011 and 2010 are presented below.

	Quarter ended June 30,		Six months ended June 30,	
(Dollars in thousands)	**2011**	**2010**	**2011**	**2010**
Beginning balance	$ 1,226	$ 851	$ 1,189	$ 834
Additions, net	65	62	152	111
Amortization expense	(52)	(36)	(102)	(68)
Ending balance	$ 1,239	$ 877	$ 1,239	$ 877
Fair value of amortized MSRs:				
Beginning of period	$ 1,491	$ 1,030	$ 1,335	$ 978
End of period	1,422	1,023	1,422	1,023

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

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. Securities measured with these valuation techniques are generally classified within Level 2 of the valuation hierarchy and often involve using quoted market prices for similar securities, pricing models or discounted cash flow analyses using inputs observable in the market where available. Examples include U.S. government agency securities and residential mortgage-backed securities.

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

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

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

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

Other assets The Company has certain financial assets carried at fair value on a recurring basis, including interest rate swap agreements. The carrying amount of interest rate swap agreements is based on information obtained from a third party bank. The Company classified these derivative assets within Level 2 of the valuation hierarchy. These swaps qualify as derivatives, but are not designated as hedging instruments. The Company had no derivative contracts to assist in managing interest rate sensitivity at June 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 June 30, 2011 or December 31, 2010.

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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 June 30, 2011 and December 31, 2010, respectively, by caption, on the Condensed Consolidated Balance Sheets by FASB ASC 820 valuation hierarchy (as described above).

(Dollars in thousands)	**Amount**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
June 30, 2011:				
Securities available-for-sale:				
Agency obligations	$ 50,759		50,759	
Agency RMBS	160,358		160,358	
State and political subdivisions	83,075		83,075	
Trust preferred securities:				
Pooled	20			20
Individual issuer	2,231			2,231
Total securities available-for-sale	296,443		294,192	2,251
Other assets [1]	1,090		1,090	
Total assets at fair value	$ 297,533		295,282	2,251
Other liabilities[1]	1,090		1,090	
Total liabilities at fair value	$ 1,090		1,090	
December 31, 2010:				
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 [1]	1,101		1,101	
Total assets at fair value	$ 316,321	2,690	311,482	2,149
Other liabilities[1]	1,101		1,101	
Total liabilities at fair value	$ 1,101		1,101	

[1] 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 six months ended June 30, 2011, there were no transfers between levels.

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:

(Dollars in thousands)	**Six months ended June 30, 2011**	**2010**
Beginning balance	$ 2,149	$ 1,463
Total realized and unrealized gains and (losses):		
Included in net earnings	(102)	(50)
Included in other comprehensive income	204	187
Purchases		
Issuances		
Settlements		
Transfers in and/or (out) of Level 3		
Ending balance	$ 2,251	$ 1,600

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 June 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):

(Dollars in thousands)	**Amount**	**Quoted Prices in Active Markets for Identical Assets (Level 1)**	**Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
June 30, 2011:				
Loans held for sale	$ 2,278		2,278	
Loans, net[1]	7,584			7,584
Other real estate owned	9,361			9,361
Other assets [2]	1,239			1,239
Total assets at fair value	$ 20,462		2,278	18,184
December 31, 2010:				
Loans held for sale	$ 4,281		4,281	
Loans, net[1]	10,362			10,362
Other real estate owned	8,125			8,125
Other assets [2]	1,189			1,189
Total assets at fair value	$ 23,957		4,281	19,676

(1) 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.

(2) Represents the carrying value of mortgage servicing rights, net.

NOTE 9: FAIR VALUE OF FINANCIAL INSTRUMENTS

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.

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

Cash and cash eq