PLUMAS BANCORP
Form 10-K
March 22, 2013
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x **Annual report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
For the fiscal year ended December 31, 2012

or

¨ **Transaction report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**
Commission file number: 000-49883

PLUMAS BANCORP

(Exact name of Registrant as specified in its charter)

California	**75-2987096**
(State or other jurisdiction of	**(IRS Employer**
incorporation or organization)	**Identification No.)**
35 S. Lindan Avenue, Quincy, CA	**95971**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (530) 283-7305

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class:	**Name of Each Exchange on which Registered:**
Common Stock, no par value	**The NASDAQ Stock Market LLC**

Securities registered pursuant to Section 12(g) of the Act: None.

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. ¨ Yes x No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. ¨ Yes x No

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. x Yes ¨ No

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

Indicated by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this form 10-K. x

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 definition of large accelerated filer, accelerated filer and smaller reporting company in Rule12b-2 of the Exchange Act:

Large Accelerated Filer	¨	Accelerated Filer	¨
Non-Accelerated Filer	¨	Smaller Reporting Company	x

Indicate by check mark if the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). ¨ Yes x No

As of June 30, 2012, the aggregate market value of the voting and non-voting common equity held by non-affiliates of the Registrant was approximately $13.3 million, based on the closing price reported to the Registrant on that date of $3.12 per share.

Shares of Common Stock held by each officer and director have been excluded in that such persons may be deemed to be affiliates. This determination of the affiliate status is not necessarily a conclusive determination for other purposes.

The number of shares of Common Stock of the registrant outstanding as of March 22, 2013 was 4,776,339.

Documents Incorporated by Reference: Portions of the definitive proxy statement for the 2013 Annual Meeting of Shareholders to be filed with the Securities and Exchange Commission pursuant to SEC Regulation 14A are incorporated by reference in Part III, Items 10-14.

Table of Contents

TABLE OF CONTENTS

Table of Contents

PART I

Forward-Looking Information

This Annual Report on Form 10-K includes forward-looking statements and information is subject to the safe harbor provisions of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. These forward-looking statements (which involve Plumas Bancorp s (the Company s) plans, beliefs and goals, refer to estimates or use similar terms) involve certain risks and uncertainties that could cause actual results to differ materially from those in the forward-looking statements. Such risks and uncertainties include, but are not limited to, the following factors:

Local, regional, national and international economic conditions and the impact they may have on us and our customers, and our assessment of that impact on our estimates including, but not limited to, the allowance for loan losses.

The effects of and changes in trade, monetary and fiscal policies and laws, including the interest rate policies of the Federal Open Market Committee of the Federal Reserve Board.

The ability to receive regulatory approval for the Bank to declare and pay dividends to the Company.

Changes imposed by regulatory agencies to increase our capital to a level greater than the current level required for well-capitalized financial institutions (including the impact of the recent joint rule proposals by the Federal Reserve Board, Office of the Comptroller of the Currency, and the FDIC to revise the regulatory capital rules, including the implementation of the Basel III standards), the failure to maintain capital above the level required to be well-capitalized under the regulatory capital adequacy guidelines, the availability of capital from private or government sources, or the failure to raise additional capital as needed.

The effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies, as well as the Public Company Accounting Oversight Board, the Financial Accounting Standards Board and other accounting standard setters.

The costs and effects of changes in laws and regulations and of other legal and regulatory developments, including, but not limited to, increases in FDIC insurance premiums, the resolution of legal proceedings or regulatory or other governmental inquiries, and the results of regulatory examinations, reviews or other inquires.

Changes in the interest rate environment and volatility of rate sensitive assets and liabilities.

Declines in the health of the economy, nationally or regionally, which could reduce the demand for loans, reduce the ability of borrowers to repay loans and/or reduce the value of real estate collateral securing most of the Company s loans.

Credit quality deterioration, which could cause an increase in the provision for loan and lease losses.

Devaluation of fixed income securities.

Asset/liability matching risks and liquidity risks.

Loss of key personnel.

Operational interruptions including data processing systems failure and fraud.

Our success at managing the risks involved in the foregoing items.

The Company undertakes no obligation to revise or publicly release the results of any revision to these forward-looking statements.

Table of Contents

ITEM 1. BUSINESS

General

The Company. Plumas Bancorp (the Company) is a California corporation registered as a bank holding company under the *Bank Holding Company Act* of 1956, as amended, and is headquartered in Quincy, California. The Company was incorporated in January 2002 and acquired all of the outstanding shares of Plumas Bank (the Bank) in June 2002. The Company s principal subsidiary is the Bank, and the Company exists primarily for the purpose of holding the stock of the Bank and of such other subsidiaries it may acquire or establish. At the present time, the Company s only other subsidiaries are Plumas Statutory Trust I and Plumas Statutory Trust II, which were formed in 2002 and 2005 solely to facilitate the issuance of trust preferred securities.

The Company s principal source of income is dividends from the Bank, but the Company may explore supplemental sources of income in the future. The Bank cannot currently pay dividends without the prior approval of its primary regulators. The cash outlays of the Company, including (but not limited to) the payment of dividends to shareholders, if and when declared by the Board of Directors, costs of repurchasing Company common stock, the cost of servicing debt and preferred stock dividends, will generally be paid from dividends paid to the Company by the Bank. The Company cannot currently pay dividends without the prior approval of its primary regulators.

At December 31, 2012, the Company had consolidated assets of $478 million, deposits of $412 million, other liabilities of $24 million and shareholders equity of $42 million. The Company s liabilities include $10.3 million in junior subordinated deferrable interest debentures issued in conjunction with the trust preferred securities issued by Plumas Statutory Trust I (the Trust I) in September 2002 and Plumas Statutory Trust II (the Trust II) in September 2005. Both Trust I and Trust II are further discussed in the section titled Trust Preferred Securities. Shareholders equity includes $11.9 million in preferred stock issued pursuant to the U.S. government s Capital Purchase Program which is discussed in the section titled "Capital Purchase Program TARP Preferred Stock and Stock Warrant."

References herein to the Company, we, us and our refer to Plumas Bancorp and its consolidated subsidiary, unless the context indicates otherwise. Our operations are conducted at 35 South Lindan Avenue, Quincy, California. Our annual, quarterly and other reports, required under the Securities Exchange Act of 1934 and filed with the Securities and Exchange Commission, (the SEC) are posted and are available at no cost on the Company s website, *www.plumasbank.com*, as soon as reasonably practicable after the Company files such documents with the SEC. These reports are also available through the SEC s website at *www.sec.gov*.

The Bank. The Bank is a California state-chartered bank that was incorporated in July 1980 and opened for business in December 1980. The Bank is not a member of the Federal Reserve System. The Bank s Administrative Office is located at 35 South Lindan Avenue, Quincy, California. At December 31, 2012 the Bank had approximately $476 million in assets, $310 million in net loans and $412 million in deposits (including deposits of $0.5 million from the Bancorp). It is currently the largest independent bank headquartered in Plumas County. The Bank s deposit accounts are insured by the Federal Deposit Insurance Corporation (the FDIC) up to maximum insurable amounts.

The Bank s primary service area covers the Northeastern portion of California, with Lake Tahoe to the South and the Oregon border to the North. The Bank, through its eleven branch network, serves the seven contiguous California counties of Plumas, Nevada, Sierra, Placer, Lassen, Modoc and Shasta. The branches are located in the communities of Quincy, Portola, Greenville, Truckee, Fall River Mills, Alturas, Susanville, Chester, Tahoe City, Kings Beach and Redding. The Bank maintains fifteen automated teller machines (ATMs) tied in with major statewide and national networks. In addition to its branch network, the Bank operates a lending office specializing in government-guaranteed lending in Auburn, California. The Bank s primary business is servicing the banking needs of these communities. Its marketing strategy stresses its local ownership and commitment to serve the banking needs of individuals living and working in the Bank s primary service areas.

Table of Contents

With a predominant focus on personal service, the Bank has positioned itself as a multi-community independent bank serving the financial needs of individuals and businesses within the Bank s geographic footprint. Our principal retail lending services include consumer, automobile and home equity loans. Our principal commercial lending services include term real estate, commercial and industrial term loans. In addition, we provide government-guaranteed and agricultural loans as well as credit lines. We provide land development and construction loans on a limited basis.

The Bank s Government-guaranteed lending center, headquartered in Auburn, California with additional personnel in Truckee, provides Small Business Administration and USDA Rural Development loans to qualified borrowers throughout Northern California and Northern Nevada. During 2007 the Bank was granted nationwide Preferred Lender status with the U.S. Small Business Administration and we expect government-guaranteed lending to continue to be an important part of our overall lending operation. During 2012 proceeds from the sale of government-guaranteed loans totaled $20.1 million and we generated a gain on sale of $1.3 million. In 2011 proceeds from the sale of government guaranteed loans totaled $23.4 million and we generated a gain on sale of $1.9 million.

The Agricultural Credit Centers located in Susanville and Alturas provide a complete line of credit services in support of the agricultural activities which are key to the continued economic development of the communities we serve. Ag lending clients include a full range of individual farming customers, small- to medium-sized business farming organizations and corporate farming units.

As of December 31, 2012, the principal areas to which we directed our lending activities, and the percentage of our total loan portfolio comprised by each, were as follows: (i) commercial real estate 44.3%; (ii) commercial and industrial loans 9.4%; (iii) consumer loans (including residential equity lines of credit) 19.2%; (iv) agricultural loans (including agricultural real estate loans) 11.1%; (v) residential real estate 11.0%; and (vi) construction and land development 5.0% .

In addition to the lending activities noted above, we offer a wide range of deposit products for the retail and commercial banking markets including checking, interest-bearing checking, business sweep, public funds sweep, savings, time deposit and retirement accounts, as well as remote deposit, telephone and mobile banking and internet banking with bill-pay options. Interest bearing deposits include high yield sweep accounts designed for our commercial customers and for public entities such as municipalities. In addition we offer a premium interest bearing checking account for our consumer customers. As of December 31, 2012, the Bank had 30,997 deposit accounts with balances totaling approximately $412 million, compared to 29,359 deposit accounts with balances totaling approximately $392 million at December 31, 2011. We attract deposits through our customer-oriented product mix, competitive pricing, convenient locations, extended hours, remote deposit operations and drive-up banking, all provided with a high level of customer service.

Most of our deposits are attracted from individuals, business-related sources and smaller municipal entities. This mix of deposit customers resulted in a relatively modest average deposit balance of approximately $13,000 at December 31, 2012. However, it makes us less vulnerable to adverse effects from the loss of depositors who may be seeking higher yields in other markets or who may otherwise draw down balances for cash needs.

We also offer a variety of other products and services to complement the lending and deposit services previously reviewed. These include cashier s checks, bank-by-mail, ATMs, night depository, safe deposit boxes, direct deposit, electronic funds transfers, on-line banking, remote deposit, mobile banking and other customary banking services.

Through our offering of a Remote Deposit product our customers are able to make non-cash deposits remotely from their physical location. With this product, we have extended our service area and can now meet the deposit needs of customers who may not be located within a convenient distance of one of our branch offices.

Additionally, the Bank has devoted a substantial amount of time and capital to the improvement of existing Bank services, during 2009 we replaced our on-line banking service with a new state of the art product that greatly expands the features available to our customers. In addition we utilized this platform to add mobile banking services during the first quarter of 2010. During 2010 Plumas Bank began offering a new Green Account which promotes protecting the environment, reducing clutter and making life simpler for the customer through technological advancements such as eStatements, online banking, and debit card usage while providing the customer with the opportunity to grow their savings through monthly monetary rewards for green behavior. In 2011, we introduced a new product for our larger business customers which use repurchase agreements as an alternative to interest-bearing deposits. The balance in this product at December 31, 2012 was $7.4 million. Interest paid on this product is similar to that which can be earned on the Bank s premium money market account; however, these are not deposits and are not FDIC insured. During the first quarter of 2012 we replaced our ATMs with new state of the art machines that are capable of accepting check and cash deposits without a deposit envelope.

The officers and employees of the Bank are continually engaged in marketing activities, including the evaluation and development of new products and services, to enable the Bank to retain and improve its competitive position in its service area.

We hold no patents or licenses (other than licenses required by appropriate bank regulatory agencies or local governments), franchises, or concessions. Our business has a modest seasonal component due to the heavy agricultural and tourism orientation of some of the communities we serve. As our branches in less rural areas such as Truckee have expanded and with the opening of our Auburn commercial lending office, the agriculture-related base has become less significant. We are not dependent on a single customer or group of related customers for a material portion of our deposits, nor are a material portion of our loans concentrated within a single industry or group of related industries. There has been no material effect upon our capital expenditures, earnings, or competitive position as a result of federal, state, or local environmental regulation.

Commitment to our Communities. The Board of Directors and Management believe that the Company plays an important role in the economic well being of the communities it serves. Our Bank has a continuing responsibility to provide a wide range of lending and deposit services to both individuals and businesses. These services are tailored to meet the needs of the communities served by the Company and the Bank.

We offer various loan products which promote home ownership and affordable housing, encourage job growth and support community economic development. Types of loans offered range from personal and commercial loans to real estate, construction, agricultural, and government-guaranteed community infrastructure loans. Many banking decisions are made locally with the goal of maintaining customer satisfaction through the timely delivery of high quality products and services.

Capital Purchase Program TARP Preferred Stock and Stock Warrant. On January 30, 2009 the Company entered into a Letter Agreement (the Purchase Agreement) with the United States Department of the Treasury (Treasury), pursuant to which the Company issued and sold (i) 11,949 shares of the Company s Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the Series A Preferred Stock) and (ii) a warrant (the Warrant) to purchase 237,712 shares of the Company s common stock, no par value (the Common Stock), for an aggregate purchase price of $11,949,000 in cash.

The Series A Preferred Stock qualifies as Tier 1 capital and pays cumulative dividends quarterly at a rate of 5% per annum for the first five years, and 9% per annum thereafter. The Company may redeem the Series A Preferred Stock at its liquidation preference ($1,000 per share) plus accrued and unpaid dividends under the American Recovery and Reinvestment Act of 2009, subject to the Treasury s consultation with the Company s appropriate federal regulator.

The Warrant has a 10-year term and was immediately exercisable with an exercise price, subject to antidilution adjustments, equal to $7.54 per share of the Common Stock. Treasury has agreed not to exercise voting power with respect to any shares of Common Stock issued upon exercise of the Warrant.

Prior to January 30, 2012, unless the Company has redeemed the Series A Preferred Stock, or the Treasury has transferred the Series A Preferred Stock to a third party, the consent of the Treasury will be required for the Company to: (1) declare or pay any dividend or make any distribution on shares of the Common Stock (other than regular quarterly cash dividends of not more than $0.04 per share or regular semi-annual cash dividends of not more than $0.08 per share); or (2) redeem, purchase or acquire any shares of Common Stock or other equity or capital securities, other than in connection with benefit plans consistent with past practice and certain other circumstances specified in the Purchase Agreement. At the request of the Federal Reserve Bank of San Francisco (FRB), Plumas Bancorp suspended quarterly cash dividend payments on its Series A Preferred Stock. As of December 31, 2012 the amount of the arrearage on the dividend payments of the Series A Preferred Stock is $1,643,000 representing eleven quarterly payments.

Table of Contents

Trust Preferred Securities. During the third quarter of 2002, the Company formed a wholly owned Connecticut statutory business trust, Plumas Statutory Trust I (the Trust I). On September 26, 2002, the Company issued to the Trust I, Floating Rate Junior Subordinated Deferrable Interest Debentures due 2032 (the Debentures) in the aggregate principal amount of $6,186,000. In exchange for these debentures the Trust I paid the Company $6,186,000. The Trust I funded its purchase of debentures by issuing $6,000,000 in floating rate capital securities (trust preferred securities), which were sold to a third party. These trust preferred securities qualify as Tier I capital under current Federal Reserve Board guidelines. The Debentures are the only asset of the Trust I. The interest rate and terms on both instruments are substantially the same. The rate is based on the three-month LIBOR (London Interbank Offered Rate) plus 3.40%, not to exceed 11.9%, adjustable quarterly. The proceeds from the sale of the Debentures were primarily used by the Company to inject capital into the Bank.

During the third quarter of 2005, the Company formed a wholly owned Connecticut statutory business trust, Plumas Statutory Trust II (the Trust II). On September 28, 2005, the Company issued to the Trust II, Floating Rate Junior Subordinated Deferrable Interest Debentures due 2035 (the Debentures) in the aggregate principal amount of $4,124,000. In exchange for these debentures the Trust II paid the Company $4,124,000. The Trust II funded its purchase of debentures by issuing $4,000,000 in floating rate capital securities (trust preferred securities), which were sold to a third party. These trust preferred securities qualify as Tier I capital under current Federal Reserve Board guidelines. The Debentures are the only asset of the Trust II. The interest rate and terms on both instruments are substantially the same. The rate is based on the three-month LIBOR (London Interbank Offered Rate) plus 1.48%, adjustable quarterly. The proceeds from the sale of the Debentures were primarily used by the Company to inject capital into the Bank.

The Debentures and trust preferred securities accrue and pay distributions quarterly based on the floating rate described above on the stated liquidation value of $1,000 per security. The Company has entered into contractual agreements which, taken collectively, fully and unconditionally guarantee payment of: (1) accrued and unpaid distributions required to be paid on the capital securities; (2) the redemption price with respect to any capital securities called for redemption by either Trust I or Trust II, and (3) payments due upon voluntary or involuntary dissolution, winding up, or liquidation of either Trust I or Trust II.

The trust preferred securities are mandatorily redeemable upon maturity of the Debentures on September 26, 2032 for Trust I and September 28, 2035 for Trust II, or upon earlier redemption as provided in the indenture.

Neither Trust I nor Trust II are consolidated into the Company s consolidated financial statements and, accordingly, both entities are accounted for under the equity method and the junior subordinated debentures are reflected as debt on the consolidated balance sheet. At the request of the FRB, Plumas Bancorp deferred its regularly scheduled quarterly interest payments on its outstanding junior subordinated debentures relating to its two trust preferred securities. As of December 31, 2012 the amount of the arrearage on the payments on the subordinated debt associated with the trust preferred securities is $906,000 representing eleven quarterly payments. On March 15, 2013, with the approval of the FRB, the Company made all current and deferred interest payments on its trust preferred securities.

Recent Developments. Effective February 8, 2012, the Bank entered into an informal agreement with the FDIC and DFI which, among other things, requests that the Bank maintain a Tier 1 Leverage Capital Ratio of 9% which is in excess of that required for well capitalized institutions and continue to reduce its level of classified asset balances that were outstanding as of September 30, 2011 to not more than 50% of Tier 1 Capital plus the allowance for loan losses. At December 31, 2012 this ratio was 32% and the Bank s Tier 1 Leverage Capital Ratio was 10.4%. The FDIC and DFI terminated the informal agreement effective January 24, 2013.

Table of Contents

On July 28, 2011 the Company entered into an agreement with the Federal Reserve Bank of San Francisco (the "FRB Agreement"). Under the terms of the FRB Agreement, Plumas Bancorp has agreed to take certain actions that are designed to maintain its financial soundness so that it may continue to serve as a source of strength to the Bank. Among other things, the FRB Agreement requires prior written approval related to the payment or taking of dividends and distributions, making any distributions of interest, principal or other sums on subordinated debentures or trust preferred securities, incurrence of debt, and the purchase or redemption of stock. In addition, the FRB Agreement requires Plumas Bancorp to submit, within 60 days of the FRB Agreement, a written statement of Plumas Bancorp s planned sources and uses of cash for debt service, operating expense and other purposes (Cash Flow Statement) for the remainder of 2011 and annually thereafter. The Company submitted the Cash Flow Statements within the required time frames.

See Note 2 Regulatory Matters of the Company s Consolidated Financial Statements in Item 8 Financial Statements and Supplementary Data of this Annual Report on Form 10K for additional information related to the Order and FRB Agreement.

Business Concentrations. No individual or single group of related customer accounts is considered material in relation to the Banks' assets or deposits, or in relation to our overall business. However, at December 31, 2012 approximately 78% of the Bank's total loan portfolio consisted of real estate-secured loans, including real estate mortgage loans, real estate construction loans, consumer equity lines of credit, and agricultural loans secured by real estate. Moreover, our business activities are currently focused in the California counties of Plumas, Nevada, Placer, Lassen, Modoc, Shasta and Sierra and Washoe County in Nevada. Consequently, our results of operations and financial condition are dependent upon the general trends in these economies and, in particular, the residential and commercial real estate markets. In addition, the concentration of our operations in these areas of California and Nevada exposes us to greater risk than other banking companies with a wider geographic base in the event of catastrophes, such as earthquakes, fires and floods in these regions in California and Nevada.

Competition. With respect to commercial bank competitors, the business is largely dominated by a relatively small number of major banks with many offices operating over a wide geographical area. These banks have, among other advantages, the ability to finance wide-ranging and effective advertising campaigns and to allocate their resources to regions of highest yield and demand. Many of the major banks operating in the area offer certain services that we do not offer directly but may offer indirectly through correspondent institutions. By virtue of their greater total capitalization, such banks also have substantially higher lending limits than we do. For customers whose loan demands exceed our legal lending limit, we attempt to arrange for such loans on a participation basis with correspondent or other banks.

In addition to other banks, our competitors include savings institutions, credit unions, and numerous non-banking institutions such as finance companies, leasing companies, insurance companies, brokerage firms, and investment banking firms. In recent years, increased competition has also developed from specialized finance and non-finance companies that offer wholesale finance, credit card, and other consumer finance services, including on-line banking services and personal financial software. Strong competition for deposit and loan products affects the rates of those products as well as the terms on which they are offered to customers. Mergers between financial institutions have placed additional competitive pressure on banks within the industry to streamline their operations, reduce expenses, and increase revenues. Competition has also intensified due to federal and state interstate banking laws enacted in the mid-1990 s, which permit banking organizations to expand into other states. The relatively large California market has been particularly attractive to out-of-state institutions. The Financial Modernization Act, which became effective March 11, 2000, has made it possible for full affiliations to occur between banks and securities firms, insurance companies, and other financial companies, and has also intensified competitive conditions.

Currently, within the Bank s branch service area there are 63 banking branch offices of competing institutions, including 30 branches of 8 major banks. As of June 30, 2012, the Federal Deposit Insurance Corporation (FDIC) estimated the Bank s market share of insured deposits within the communities it serves to be as follows: Chester 65%, Quincy 59%, Portola 56%, Alturas 45%, Fall River Mills 36%, Kings Beach 31%, Susanville 24%,Truckee 15%, Tahoe City 8%, Redding less than 1% and 100% in Greenville. Redding is the location of our most recently opened branch, which became operational in June 2007.

Table of Contents

Technological innovations have also resulted in increased competition in financial services markets. Such innovation has, for example, made it possible for non-depository institutions to offer customers automated transfer payment services that previously were considered traditional banking products. In addition, many customers now expect a choice of delivery systems and channels, including home computer, mobile, telephone, ATMs, mail, full-service branches and/or in-store branches. The sources of competition in such products include traditional banks as well as savings associations, credit unions, brokerage firms, money market and other mutual funds, asset management groups, finance and insurance companies, internet-only financial intermediaries, and mortgage banking firms.

For many years we have countered rising competition by providing our own style of community-oriented, personalized service. We rely on local promotional activity, personal contacts by our officers, directors, employees, and shareholders, automated 24-hour banking, and the individualized service that we can provide through our flexible policies. This approach appears to be well-received by our customers who appreciate a more personal and customer-oriented environment in which to conduct their financial transactions. To meet the needs of customers who prefer to bank electronically, we offer telephone banking, mobile banking, remote deposit, and personal computer and internet banking with bill payment capabilities. This high tech and high touch approach allows the customers to tailor their access to our services based on their particular preference.

Employees. At December 31, 2012, the Company and its subsidiary employed 151 persons. On a full-time equivalent basis, we employed 138 persons. None of the Company s employees are represented by a labor union, and management considers its relations with employees to be good.

Code of Ethics. The Board of Directors has adopted a code of business conduct and ethics for directors, officers (including Plumas Bancorp s principal executive officer and principal financial officer) and financial personnel, known as the Corporate Governance Code of Ethics. This Code of Ethics Policy is available on Plumas Bancorp s website at www.plumasbank.com. Shareholders may request a free copy of the Code of Ethics Policy from Plumas Bancorp, Ms. Elizabeth Kuipers, Investor Relations, 35 S. Lindan Avenue, Quincy, California 95971.

Supervision and Regulation

General. We are extensively regulated under federal and state law. These laws and regulations are generally intended to protect depositors and customers, not shareholders. To the extent that the following information describes statutory or regulatory provisions, it is qualified in its entirety by reference to the particular statute or regulation. Any change in applicable laws or regulations may have a material effect on our business and prospects. Our operations may be affected by legislative changes and by the policies of various regulatory authorities. We cannot accurately predict the nature or the extent of the effects on our business and earnings that fiscal or monetary policies, or new federal or state legislation may have in the future. The Company is subject to the disclosure and regulatory requirements of the Securities Act of 1933, as amended, and the Securities Exchange Act of 1934, as amended, both as administered by the Securities and Exchange Commission. As a listed company on NASDAQ, the Company is subject to NASDAQ rules for listed companies.

Holding Company Regulation. We are a registered bank holding company under the Bank Holding Company Act, and are subject to the supervision of, and regulation by, the Board of Governors of the Federal Reserve System (the Federal Reserve). As a bank holding company, we are examined by and file reports with the Federal Reserve. The Federal Reserve expects a bank holding company to serve as a source of financial and managerial strength to its subsidiary bank and, under appropriate circumstances, to commit resources to support the subsidiary bank.

Federal and State Bank Regulation. The Bank, as a state chartered bank with deposits insured by the FDIC, is primarily subject to the supervision and regulation of the California Department of Financial Institutions, the FDIC, and the Consumer Financial Protection Bureau (CFPB). These agencies may prohibit the Bank from engaging in what they believe constitute unsafe or unsound banking practices. The California Department of Financial Institutions regularly examines the Bank or participates in joint examinations with the FDIC.

The Community Reinvestment Act (CRA) requires that, in connection with examinations of financial institutions within its jurisdiction, the FDIC evaluate the record of the financial institutions in meeting the credit needs of their local communities, including low- and moderate-income neighborhoods, consistent with the safe and sound operation of those institutions. These factors are also considered in evaluating mergers, acquisitions and applications to open a branch or new facility. A less than Satisfactory rating would result in the suspension of any growth of the Bank through acquisitions or opening de novo branches until the rating is improved. As of the most recent CRA examination the Bank s CRA rating was Satisfactory.

Table of Contents

Banks are also subject to certain restrictions imposed by the Federal Reserve Act on extensions of credit to executive officers, directors, principal shareholders or any related interest of such persons. Extensions of credit must be made on substantially the same terms, including interest rates and collateral as, and follow credit underwriting procedures that are not less stringent than, those prevailing at the time for comparable transactions with persons not affiliated with the bank, and must not involve more than the normal risk of repayment or present other unfavorable features. Banks are also subject to certain lending limits and restrictions on overdrafts to such persons. A violation of these restrictions may result in the assessment of substantial civil monetary penalties on the affected bank or any officer, director, employee, agent or other person participating in the conduct of the affairs of that bank, the imposition of a cease and desist order, and other regulatory sanctions.

The Federal Reserve Act and related Regulation W limit the amount of certain loan and investment transactions between the Bank and its affiliates, require certain levels of collateral for such loans, and limit the amount of advances to third parties that may be collateralized by the securities of the Company or its subsidiaries. Regulation W requires that certain transactions between the Bank and its affiliates be on terms substantially the same, or at least as favorable to the Bank, as those prevailing at the time for comparable transactions with or involving nonaffiliated companies or, in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to or would apply to nonaffiliated companies. The Company and its subsidiaries have adopted an Affiliate Transactions Policy and have entered into various affiliate agreements in compliance with Regulation W.

The Federal Reserve and the FDIC have adopted non-capital safety and soundness standards for institutions. These standards cover internal controls, information and internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, fees and benefits, and standards for asset quality, earnings and stock valuation. An institution that fails to meet these standards must develop a plan acceptable to the agency, specifying the steps that it will take to meet the standards. Failure to submit or implement such a plan may subject the institution to regulatory sanctions. We believe that the Bank is in compliance with these standards.

Federal Deposit Insurance. Substantially all deposits with the Bank are insured up to applicable limits by the Deposit Insurance Fund (DIF) of the FDIC and are subject to deposit insurance assessments to maintain the DIF.

The FDIC utilizes a risk-based assessment system to set quarterly insurance premium assessments which categorizes banks into four risk categories based on capital levels and supervisory CAMELS ratings and names them Risk Categories I, II, III and IV. The CAMELS rating system is based upon an evaluation of the six critical elements of an institution s operations: Capital adequacy, Asset quality, Management, Earnings, Liquidity, and Sensitivity to risk.

This rating system is designed to take into account and reflect all significant financial and operational factors financial institution examiners assess in their evaluation of an institution s performance. The following table sets forth these four Risk Categories:

Capital Group	Supervisory Subgroup		
	A	B	C
1. Well Capitalized	I	II	III
2. Adequately Capitalized	II	II	III
3. Undercapitalized	III	III	IV

10

Within Risk Category I, the assessment system combines supervisory ratings with other risk measures to differentiate risk. For most institutions, the assessment system combines CAMELS component ratings with financial ratios to determine an institution s assessment rate. The base assessment rates as of April 1, 2011 (which are still in effect as of December 31, 2012) are as follows (expressed in terms of cents per $100 in insured deposits):

Initial Base Assessment Rates

	Risk Category					
	I*					
	Minimum	Maximum	II	III	IV	Large & Highly Complex Institutions
Annual Rates (in basis points)	5	9	14	23	35	5-35

*   Initial base rates that were not the minimum or maximum rates will vary between these rates.

After applying all possible adjustments, minimum and maximum total base assessment rates for each Risk Category are as follows:

Total Base Assessment Rates*

	Risk Category I	Risk Category II	Risk Category III	Risk Category IV	Large & Highly Complex Institutions
Initial base assessment rate	5 9	14	23	35	5 35
Unsecured debt adjustment**	-4.5 0	-5 0	-5 0	-5 0	-5 0
Brokered deposit adjustment	N/A	0 10	0 10	0 10	0 10
Total base assessment rate	2.5 9	9 24	18 33	30 45	2.5 45

*   Total base assessment rates do not include the depository institution debt adjustment.

**   The unsecured debt adjustment cannot exceed the lesser of 5 basis points or 50% of an insured depository institution s initial base assessment rate.

The Dodd-Frank Act requires the FDIC to take such steps as necessary to increase the reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits by 2020. In setting the assessments, the FDIC is required to offset the effect of the higher reserve ratio against insured depository institutions with total consolidated assets of less than $10 billion. The Dodd-Frank Act also broadens the base for FDIC insurance assessments so that assessments will be based on the average consolidated total assets less average tangible equity capital of a financial institution rather than on its insured deposits.

In October 2010, the FDIC adopted a new DIF restoration plan to ensure that the fund reserve ratio reaches 1.35% by September 30, 2020, as required by the Dodd-Frank Act. Under the new restoration plan, the FDIC on a semi-annual or more frequent basis will update its loss and income projections for the DIF and, if needed, increase or decrease assessment rates. Further increases in the assessment rate could have a material adverse effect on our earnings, depending upon the amount of the increase.

The enactment of the Dodd-Frank Act also permanently raised the current standard maximum federal deposit insurance amount from $100,000 to $250,000 per qualified deposit account.

In November 2008, the FDIC approved the final ruling establishing the Transaction Account Guarantee Program (TAGP) as part of the Temporary Liquidity Guarantee Program (TLGP). Under this program, all non-interest bearing transaction accounts became fully guaranteed by the FDIC for the entire amount in the account. This unlimited coverage also extended to NOW (interest bearing deposit accounts) earning an interest rate no greater than 0.50% and all IOLTAs (lawyers trust accounts). TAGP was extended with the enactment of the Dodd-Frank Act providing for unlimited deposit insurance for noninterest bearing transactions accounts (excluding NOW, but including IOLTAs) expiring on December 31, 2012.

Table of Contents

The FDIC may terminate the deposit insurance of any insured depository institution if it determines that the institution has engaged in or is engaging in unsafe and unsound banking practices, is in an unsafe or unsound condition or has violated any applicable law, regulation or order or any condition imposed in writing by, or pursuant to, any written agreement with the FDIC. The termination of deposit insurance for the Bank could have a material adverse effect on our financial condition and results of operations due to the fact that the Bank s liquidity position would likely be affected by deposit withdrawal activity.

Capital Adequacy. The FDIC has risk-based capital adequacy guidelines intended to provide a measure of capital adequacy that reflects the degree of risk associated with a banking organization s operations for both transactions reported on the balance sheet as assets, and transactions, such as letters of credit and recourse arrangements, which are reported as off-balance-sheet items. Under these guidelines, nominal dollar amounts of assets and credit equivalent amounts of off-balance-sheet items are multiplied by one of several risk adjustment percentages, which range from 0% for assets with low credit risk, such as certain U.S. government securities, to 100% for assets with relatively higher credit risk, such as business loans.

A banking organization s risk-based capital ratios are obtained by dividing its qualifying capital by its total risk-adjusted assets and off-balance-sheet items. The regulators measure risk-adjusted assets and off-balance-sheet items against both total qualifying capital (the sum of Tier 1 capital and limited amounts of Tier 2 capital) and Tier 1 capital. Tier 1 capital consists of common stock, retained earnings, noncumulative perpetual preferred stock and minority interests in certain subsidiaries, less most other intangible assets. Tier 2 capital may consist of a limited amount of the allowance for loan and lease losses and certain other instruments with some characteristics of equity. The inclusion of elements of Tier 2 capital is subject to certain other requirements and limitations of the federal banking agencies. Since December 31, 1992, the FRB and the FDIC have required a minimum ratio of qualifying total capital to risk-adjusted assets and off-balance-sheet items of 8%, and a minimum ratio of Tier 1 capital to risk-adjusted assets and off-balance-sheet items of 4%.

In addition to the risk-based guidelines, the FRB requires banking organizations to maintain a minimum amount of Tier 1 capital to average total assets, referred to as the leverage ratio. For a banking organization rated in the highest of the five categories used by regulators to rate banking organizations, the minimum leverage ratio of Tier 1 capital to total assets is 3%. It is improbable; however, that an institution with a 3% leverage ratio would receive the highest rating by the regulators since a strong capital position is a significant part of the regulators ratings. For all banking organizations not rated in the highest category, the minimum leverage ratio is at least 100 to 200 basis points above the 3% minimum. Thus, the effective minimum leverage ratio, for all practical purposes, is at least 4% or 5%. In addition to these uniform risk-based capital guidelines and leverage ratios that apply across the industry, the FRB and FDIC have the discretion to set individual minimum capital requirements for specific institutions at rates significantly above the minimum guidelines and ratios.

A bank that does not achieve and maintain the required capital levels may be issued a capital directive by the FRB and/or DFI to ensure the maintenance of required capital levels. As discussed above, the Company and the Bank are required to maintain certain levels of capital, as is the Bank. The regulatory capital guidelines as well as the actual capitalization for the Bank and Bancorp as of December 31, 2012 follow:

	Requirement for the Bank to be:			
	Adequately Capitalized	Well Capitalized	Plumas Bank	Plumas Bancorp
Tier 1 leverage capital ratio	4.0%	5.0%	10.4%	10.3%
Tier 1 risk-based capital ratio	4.0%	6.0%	14.1%	13.9%
Total risk-based capital ratio	8.0%	10.0%	15.3%	15.1%

Table of Contents

Management believes that the Company and the Bank met all of the above capital adequacy requirements as of December 31, 2012 and 2011.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) requires federal banking regulators to take prompt corrective action with respect to a capital-deficient institution, including requiring a capital restoration plan and restricting certain growth activities of the institution. The Company could be required to guarantee any such capital restoration plan required of the Bank if the Bank became undercapitalized. Pursuant to FDICIA, regulations were adopted defining five capital levels: well capitalized, adequately capitalized, undercapitalized, severely undercapitalized and critically undercapitalized.

If capital falls below the minimum levels established by these regulatory capital guidelines, a holding company or a bank may be denied approval to acquire or establish additional banks or non-bank businesses or to open new facilities.

Banks with capital ratios below the required minimums are subject to certain administrative actions, including prompt corrective action, the termination of deposit insurance upon notice and hearing, or a temporary suspension of insurance without a hearing.

New Proposed Capital Rules. During 2012 the federal bank regulatory agencies issued joint proposed rules that implement Basel III regulatory capital reforms and changes required by the Reform Act. "Basel III" refers to two consultative documents released by the Basel Committee on Banking Supervision in December 2009, the rules text released in December 2010 and loss absorbency rules issued in January 2011, which include significant changes to bank capital, leverage and liquidity requirements. The proposed rules received extensive comments. In a joint press release issued in November 2012, the agencies stated that they do not expect any of the proposed rules to become effective on the original target date of January 1, 2013. Industry participants are expecting further guidance in early 2013. Management has completed a preliminary assessment of the impact of the proposed rules and believes Plumas Bank's ratios would be in compliance with the requirements of the proposed rules if they were presently in effect.

Effects of Government Monetary Policy. Our earnings and growth are affected not only by general economic conditions, but also by the fiscal and monetary policies of the federal government, particularly the Federal Reserve. The Federal Reserve implements national monetary policy for such purposes as curbing inflation and combating recession, through its open market operations in U.S. Government securities, control of the discount rate applicable to borrowings from the Federal Reserve, and establishment of reserve requirements against certain deposits. These activities influence growth of bank loans, investments and deposits, and also affect interest rates charged on loans or paid on deposits. The nature and impact of future changes in monetary policies and their impact on us cannot be predicted with certainty.

Consumer Protection Laws and Regulations. The banking regulatory agencies are focusing greater attention on compliance with consumer protection laws and their implementing regulations. Examination and enforcement have become more intense in nature, and insured institutions have been advised to monitor carefully compliance with such laws and regulations. The Company is subject to many federal and state consumer protection and privacy statutes and regulations, some of which are discussed below.

The *Equal Credit Opportunity Act* (the ECOA) generally prohibits discrimination in any credit transaction, whether for consumer or business purposes, on the basis of race, color, religion, national origin, sex, marital status, age (except in limited circumstances), receipt of income from public assistance programs, or good faith exercise of any rights under the Consumer Credit Protection Act.

The *Truth in Lending Act* (the TILA) is designed to ensure that credit terms are disclosed in a meaningful way so that consumers may compare credit terms more readily and knowledgeably. As a result of the TILA, all creditors must use the same credit terminology to express rates and payments, including the annual percentage rate, the finance charge, the amount financed, the total of payments and the payment schedule, among other things. As a result of Dodd Frank, Regulation Z promulgated under TILA includes new limits on loan originator compensation for all closed-end mortgages. These changes include, prohibiting certain payments to a mortgage broker or loan officer based on the transaction s terms or conditions, prohibiting dual compensation, and prohibiting a mortgage broker or loan officer from steering consumers to transactions not in their interest, to increase mortgage broker or loan officer compensation.

Table of Contents

The *Fair Housing Act* (the FH Act) regulates many practices, including making it unlawful for any lender to discriminate in its housing-related lending activities against any person because of race, color, religion, national origin, sex, handicap or familial status. A number of lending practices have been found by the courts to be, or may be considered, illegal under the FH Act, including some that are not specifically mentioned in the FH Act itself.

The *Home Mortgage Disclosure Act* (the HMDA), in response to public concern over credit shortages in certain urban neighborhoods, requires public disclosure of information that shows whether financial institutions are serving the housing credit needs of the neighborhoods and communities in which they are located. The HMDA also includes a "fair lending" aspect that requires the collection and disclosure of data about applicant and borrower characteristics as a way of identifying possible discriminatory lending patterns and enforcing anti-discrimination statutes.

The *Right to Financial Privacy Act* (the RFPA) imposes a new requirement for financial institutions to provide new privacy protections to consumers. Financial institutions must provide disclosures to consumers of its privacy policy, and state the rights of consumers to direct their financial institution not to share their nonpublic personal information with third parties.

Finally, the *Real Estate Settlement Procedures Act* (the RESPA) requires lenders to provide noncommercial borrowers with disclosures regarding the nature and cost of real estate settlements. Also, RESPA prohibits certain abusive practices, such as kickbacks, and places limitations on the amount of escrow accounts.

Penalties for noncompliance or violations under the above laws may include fines, reimbursement and other penalties. Due to heightened regulatory concern related to compliance with CRA, ECOA, TILA, FH Act, HMDA, RFPA and RESPA generally, the Company may incur additional compliance costs or be required to expend additional funds for investments in its local communities.

Recent Legislation and Other Changes. Federal and state laws affecting banking are enacted from time to time, and similarly federal and state regulations affecting banking are also adopted from time to time. The following include some of the recent laws and regulations affecting banking.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), signed into law in July, 2010, will significantly change the current bank regulatory structure and affect the lending, investment, trading and operating activities of financial institutions and their holding companies. The Dodd-Frank Act creates of a new interagency council, the Financial System Oversight Council that is charged with identifying and monitoring the systemic risk to the U.S. economy posed by systemically significant, large financial companies, including bank holding companies and non-bank financial companies. The Office of Thrift Supervision will be eliminated and its powers distributed among the Office of the Comptroller of the Currency, the Federal Reserve Board and the FDIC. The legislation also establishes a floor for capital of insured depository institutions that cannot be lower than the standards in effect today, and directs the federal banking regulators to implement new leverage and capital requirements within 18 months that take into account off-balance sheet activities and other risks, including risks relating to securitized products and derivatives.

The Dodd-Frank Act additionally creates a new independent federal regulator to administer federal consumer protection laws. The Dodd-Frank Act is expected to have a significant impact on our banks operations as its provisions take effect. Among the provisions that may affect the Bank are the following:

Deposit Insurance

The Dodd-Frank Act permanently increases the maximum deposit insurance amount for banks, savings institutions and credit unions to $250,000 per depositor, retroactive to January 1, 2009, and extends unlimited deposit insurance to non-interest bearing transaction accounts and interest on lawyers trust accounts through December 31, 2012. The Dodd-Frank Act also broadened the base for FDIC insurance assessments. Assessments are now based on the average consolidated total assets less tangible equity capital of a financial institution. The Dodd-Frank Act requires the FDIC to increase the reserve ratio of the Deposit Insurance Fund from 1.15% to 1.35% of insured deposits by 2020 and eliminates the requirement that the FDIC pay dividends to insured depository institutions when the reserve ratio exceeds certain thresholds. The Dodd-Frank Act eliminates the federal statutory prohibition against the payment of interest on business checking accounts.

Table of Contents

Interstate Branching

The Dodd-Frank Act authorizes national and state banks to establish branches in other states to the same extent as a bank chartered by that state would be permitted to branch. Previously, banks could only establish branches in other states if the host state expressly permitted out-of-state banks to establish branches in that state. Accordingly, banks will be able to enter new markets more freely.

Limits on Derivatives

The Dodd-Frank Act prohibits state chartered banks from engaging in derivatives transactions unless the loans to one borrower limits of the state in which the bank is chartered takes into consideration credit exposure to derivatives transactions. For this purpose, derivative transactions include any contract, agreement, swap, warrant, note or option that is based in whole or in part on the value of, any interest in, or any quantitative measure or the occurrence of any event relating to, one or more commodities securities, currencies, interest or other rates, indices or other assets.

Transactions with Affiliates and Insiders

The Dodd-Frank Act expands the definition of affiliate for purposes of quantitative and qualitative limitations of Section 23A of the Federal Reserve Act to include mutual funds advised by a depository institution or its affiliates. The Dodd-Frank Act applies Section 23A and Section 22(h) of the Federal Reserve Act (governing transactions with insiders) to derivative transactions, repurchase agreements and securities lending and borrowing transactions that create credit exposure to an affiliate or an insider. Any such transactions with affiliates must be fully secured. The current exemption from Section 23A for transactions with financial subsidiaries will be eliminated. The Dodd-Frank Act will additionally prohibit an insured depository institution from purchasing an asset from or selling an asset to an insider unless the transaction is on market terms and, if representing more than 10% of capital, is approved in advance by disinterested directors.

Debit Card Interchange Fees

The Dodd-Frank Act requires that the amount of any interchange fee charged by a debit card issuer with respect to a debit card transaction must be reasonable and proportional to the cost incurred by the issuer. The Federal Reserve Board (FRB) has established standards for reasonable and proportional fees which take into account the costs of preventing fraud. The restrictions on interchange fees, however, do not apply to banks that, together with their affiliates, have assets of less than $10 billion, such as the Bank.

Consumer Financial Protection Bureau

The Dodd-Frank Act creates a new, independent federal agency called the Consumer Financial Protection Bureau (CFPB), which is granted broad rulemaking, supervisory and enforcement powers under various federal consumer financial protection laws, including the Equal Credit Opportunity Act, Truth in Lending Act, Real Estate Settlement Procedures Act, Fair Credit Reporting Act, Fair Debt Collection Act, the Consumer Financial Privacy provisions of the Gramm-Leach-Bliley Act and certain other statutes. The CFPB has examination and primary enforcement authority with respect to depository institutions with $10 billion or more in assets. Smaller institutions will be subject to rules promulgated by the CFPB but will continue to be examined and supervised by federal banking regulators for consumer compliance purposes. The CFPB will have authority to prevent unfair, deceptive or abusive practices in connection with the offering of consumer financial products. The Dodd-Frank Act authorizes the CFPB to establish certain minimum standards for the origination of residential mortgages including a determination of the borrower s ability to repay. In addition, the Dodd-Frank Act will allow borrowers to raise certain defenses to foreclosure if they receive any loan other than a qualified mortgage as defined by the CFPB. The Dodd-Frank Act permits states to adopt consumer protection laws and standards that are more stringent than those adopted at the federal level and, in certain circumstances, permits state attorneys general to enforce compliance with both the state and federal laws and regulations.

Table of Contents

The Electronic Funds Transfer Act (the EFTA) provides a basic framework for establishing the rights, liabilities, and responsibilities of consumers who use electronic funds transfer (EFT) systems. The EFTA is implemented by the Federal Reserve's Regulation E, which governs transfers initiated through ATMs, point-of-sale terminals, payroll cards, automated clearinghouse (ACH) transactions, telephone bill-payment plans, or remote banking services. Regulation E was amended in January 2010 to require consumers to opt in (affirmatively consent) to participation in the Bank s overdraft service program for ATM and one-time debit card transactions before overdraft fees may be assessed on the consumer s account. Notice of the opt-in right must be provided to all existing and new customers who are consumers, and the customer s affirmative consent must be obtained, before charges may be assessed on the consumer s account for paying such overdrafts.

The new rule provides bank customers with an ongoing right to revoke consent to participation in an overdraft service program for ATM and one-time debit card transactions, as opposed to being automatically enrolled in such a program. The new rule also prohibits banks from conditioning the payment of overdrafts for checks, ACH transactions, or other types of transactions that overdraw the consumer s account on the consumer s opting into an overdraft service for ATM and one-time debit card transactions. For customers who do not affirmatively consent to overdraft service for ATM and one-timedebit card transactions, a bank must provide those customers with the same account terms, conditions, and features that it provides to consumers who do affirmatively consent, except for the overdraft service for ATM and one-time debit card transactions.

The Bank s compliance with the new Regulation E amendments may have an impact on the Bank s revenue from overdraft service fees and non-sufficient funds (NSF) charges.

Many of the provisions of the Dodd-Frank Act are still pending various federal agencies to promulgate numerous and extensive implementing regulations over the next several years. Although the substance and scope of these regulations cannot be determined at this time, it is expected that the legislation and implementing regulations, particularly those provisions relating to the new Consumer Financial Protection Bureau, will increase the Bank s operating and compliance costs as it is likely that the Bank s existing regulatory agencies will adopt the same or similar consumer protections as the new Consumer Financial Protection Bureau will adopt.

On June 21, 2010, the federal banking agencies issued final guidance on incentive compensation. The final guidance is largely unchanged from the FRB s preliminary guidance published in 2009, with the exception of a few adjustments/clarifications in response to feedback the FRB received during the open comment period. The guidance became effective on June 25, 2010 (the date published in the Federal Register, and applies to all banks. Except for the largest banking organizations, enforcement of this guidance will be handled through the supervisors regular risk-focused examination process. The guidance is principles-based, rather than prescriptive, and also identifies expectations of large banking organizations that go beyond what will be expected of community banks, and emphasizes that the application of the guidance should be scaled appropriately for the complexity of the organization and the extent to which incentive arrangements are utilized. The employees covered by the final guidance are senior executives and others who are responsible for oversight of the organization s firm-wide activities or material business lines; individual employees, including non-executive employees, whose activities may expose the organization to material amounts of risk; and groups of employees who are subject to the same or similar incentive compensation arrangements and who, in the aggregate, may expose the organization to material amounts of risk, even if no individual employee is likely to expose the organization to material risk. The guidance provides for three principles for safe and sound incentive compensation arrangements:

- Balanced Risk-Taking: Incentive compensation arrangements should balance risk and financial results in a manner that does not encourage employees to expose their organizations to imprudent risks;

- Compatibility with Effective Controls and Risk-Management: A banking organization s risk-management processes and internal controls should reinforce and support the development and maintenance of balanced incentive compensation arrangements;

- Strong Corporate Governance: Banking organizations should have strong and effective corporate governance to help ensure sound compensation practices, including active and effective oversight by the board of directors.

Table of Contents

The Electronic Funds Transfer Act (the EFTA) provides a basic framework for establishing the rights, liabilities, and responsibilities of consumers who use electronic funds transfer (EFT) systems. The EFTA is implemented by the Federal Reserve s Regulation E, which governs transfers initiated through ATMs, point-of-sale terminals, payroll cards, automated clearinghouse (ACH) transactions, telephone bill-payment plans, or remote banking services. Regulation E was amended in January 2010 to require consumers to opt in (affirmatively consent) to participation in the Bank s overdraft service program for ATM and one-time debit card transactions before overdraft fees may be assessed on the consumer s account. Notice of the opt-in right must be provided to all existing and new customers who are consumers, and the customer s affirmative consent must be obtained, before charges may be assessed on the consumer s account for paying such overdrafts.

The new rule provides bank customers with an ongoing right to revoke consent to participation in an overdraft service program for ATM and one-time debit card transactions, as opposed to being automatically enrolled in such a program. The new rule also prohibits banks from conditioning the payment of overdrafts for checks, ACH transactions, or other types of transactions that overdraw the consumer s account on the consumer s opting into an overdraft service for ATM and one-time debit card transactions. For customers who do not affirmatively consent to overdraft service for ATM and one-time debit card transactions, a bank must provide those customers with the same account terms, conditions, and features that it provides to consumers who do affirmatively consent, except for the overdraft service for ATM and one-time debit card transactions.

The mandatory compliance date for the Regulation E amendments is July 1, 2010 provided that the Bank may continue to assess overdraft service fees or charges on existing customer accounts prior to August 15, 2010, without obtaining the consumer s affirmative consent. The Bank s compliance with the new Regulation E amendments may have an impact on the Bank s revenue from overdraft service fees and non-sufficient funds (NSF) charges.

In May 2009 the Helping Families Save Their Homes Act of 2009 was enacted to help consumers avoid mortgage foreclosures on their homes through certain loss mitigation actions including special forbearance, loan modification, pre-foreclosure sale, deed in lieu of foreclosure, support for borrower housing counseling, subordinate lien resolution, and borrower relocation. The new law permits the Secretary of Housing and Urban Development (HUD), for mortgages either in default or facing imminent default, to: (1) authorize the modification of such mortgages; and (2) establish a program for payment of a partial claim to a mortgagee who agrees to apply the claim amount to payment of a mortgage on a 1- to 4-family residence. In implementing the law, the Secretary of HUD is authorized to (1) provide compensation to the mortgagee for lost income on monthly mortgage payments due to interest rate reduction; (2) reimburse the mortgagee from a guaranty fund in connection with activities that the mortgagee is required to undertake concerning repayment by the mortgagor of the amount owed to HUD; (3) make payments to the mortgagee on behalf of the borrower, under terms defined by HUD; and (4) make mortgage modification with terms extended up to 40 years from the modification date. The new law also authorizes the Secretary of HUD to: (1) reassign the mortgage to the mortgagee; (2) act as a Government National Mortgage Association (GNMA, or Ginnie Mae) issuer, or contract with an entity for such purpose, in order to pool the mortgage into a Ginnie Mae security; or (3) resell the mortgage in accordance with any program established for purchase by the federal government of insured mortgages. The new law also amends the Foreclosure Prevention Act of 2008, with respect to emergency assistance for the redevelopment of abandoned and foreclosed homes (neighborhood stabilization), to authorize each state that has received certain minimum allocations and has fulfilled certain requirements, to distribute any remaining amounts to areas with homeowners at risk of foreclosure or in foreclosure without regard to the percentage of home foreclosures in such areas.

Also in May 2009, the Credit Card Act of 2009 was enacted to help consumers and ban certain practices of credit card issuers. The new law allows interest rate hikes on existing balances only under limited conditions, such as when a promotional rate ends, there is a variable rate or if the cardholder makes a late payment. Interest rates on new transactions can increase only after the first year. Significant changes in terms on accounts cannot occur without 45 days' advance notice of the change. The new law bans raising interest rates on customers based on their payment records with other unrelated credit issuers (such as utility companies and other creditors) for existing credit card balances, though card issuers would still be allowed to use universal default on future credit card balances if they give at least 45 days' advance notice of the change. The new law allows consumers to opt out of certain significant changes in terms on their accounts. Opting out means cardholders agree to close their accounts and pay off the balance under the old terms. They have at least five years to pay the balance. Credit card issuers will be banned from issuing credit cards to anyone under 21, unless they have adult co-signers on the accounts or can show proof they have enough income to repay the card debt.

Table of Contents

The new law requires card issuers to give card account holders "a reasonable amount of time" to make payments on monthly bills. That means payments would be due at least 21 days after they are mailed or delivered. Credit card issuers would no longer be able to set early morning or other arbitrary deadlines for payments. When consumers have accounts that carry different interest rates for different types of purchases payments in excess of the minimum amount due must go to balances with higher interest rates first. Consumers must "opt in" to over-limit fees. Those who opt out would have their transactions rejected if they exceed their credit limits, thus avoiding over-limit fees. Fees charged for going over the limit must be reasonable. Finance charges on outstanding credit card balances would be computed based on purchases made in the current cycle rather than going back to the previous billing cycle to calculate interest charges. Fees on credit cards cannot exceed 25 percent of the available credit limit in the first year of the card.

On February 17, 2009, the American Recovery and Reinvestment Act of 2009 (ARRA) was enacted to provide stimulus to the struggling US economy. ARRA authorizes spending of $787 billion, including about $288 billion for tax relief, $144 billion for state and local relief aid, and $111 billion for infrastructure and science. In addition, ARRA includes additional executive compensation restrictions for recipients of funds from the US Treasury under the Troubled Assets Relief Program of the Emergency Economic Stimulus Act of 2008 (EESA).

EESA was amended by ARRA to provide additional incentive compensation restrictions for financial institutions receiving TARP funds and also require additional corporate governance provisions with respect to limiting golden parachutes, lavish expenditures and requiring officer certifications of compliance and clawbacks for improperly earned incentive compensation at such institutions.

In addition, EESA as amended by ARRA provides that for any TARP recipient, its annual meeting materials shall include a nonbinding shareholder approval proposal of executive compensation for shareholders to vote.

ARRA also provides $730 million to the SBA and makes changes to the agency s lending and investment programs so that they can reach more small businesses that need help. The funding includes:

- $375 million for temporarily eliminating fees on SBA-backed loans and raising SBA's guarantee percentage on some loans to 90 percent.
- $255 million for a new loan program to help small businesses meet existing debt payments
- $30 million for expanding SBA s Microloan program, enough to finance up to $50 million in new lending and $24 million in technical assistance grants to microlenders.

On January 1, 2012, SB 664 (Committee on Banking and Financial Institutions, Chapter 243, Statutes of 2011) became operative. While some substantive changes were included in this legislation due to the passage of the Dodd-Frank federal legislation and some technical corrections that resulted from earlier amendments to the Code, the majority of the work involved in SB 664 was to reorder the section numbering in the Code. Among other things, the law requires a bank that establishes a branch office in this state in accordance with the National Bank Act, as amended by the Dodd-Frank Act to provide a specified notice to the Commissioner of DFI within 10 days of the establishment, relocation, or redesignation of offices.

In 2010, California SB 931 was enacted and provides that the first lien holder of a California residential loan accepts as full payment and satisfaction of such lien after the successful completion of the short sale of such residence, and furthermore such lender is prevented from pursuing a deficiency against the noncorporate borrower. In 2011, the benefits of SB 931 was extended to such borrowers with a second or subordinate lien in SB458 where such lien holder agreed to the short sale.

In California, the enactment of AB329 in 2009, the Reverse Mortgage Elder Protection Act of 2009 prohibits a lender or any other person who participates in the origination of the mortgage from participation in, being associated with, or employing any party that participates in or is associated with any other financial or insurance activity or referring a prospective borrower to anyone for the purchase of other financial or insurance products; and imposes certain disclosure requirements on the lender.

Table of Contents

The enactment of AB1160 in 2009, requires a supervised financial institution in California that negotiates primarily in any of a number of specified languages in the course of entering into a contract or agreement for a loan or extension of credit secured by residential real property, to deliver, prior to the execution of the contract or agreement, and no later than 3 business days after receiving the written application, a specified form in that language summarizing the terms of the contract or agreement; provides for administrative penalties for violations; and requires the California Department of Corporations and the Department of Financial Institutions to create a form for providing translations and make it available in Spanish, Chinese, Tagalog, Vietnamese and Korean. The statute becomes operative on July 1, 2010, or 90 days after issuance of the form, whichever occurs later.

The enactment of AB 1291 in 2009 makes changes to the California Unclaimed Property Law including (among other things): allowing electronic notification to customers who have consented to electronic notice; requiring that notices contain certain information and allow the holder to provide electronic means to enable the owner to contact the holder in lieu of returning the prescribed form to declare the owner s intent; authorizing the holder to give additional notices; and requiring, beginning January 1, 2011, a banking or financial organization to provide a written notice regarding escheat at the time a new account or safe deposit box is opened.

The enactment of SB306 makes specified changes to clarify existing law related to filing a notice of default on residential real property in California, including (among other things): clarifying that the provisions apply to mortgages and deeds of trust recorded from January 1, 2003 through December 31, 2007, secured by owner-occupied 3 4 residential real property containing no more than 4 dwelling units; revising the declaration to be filed with the notice of default; specifying how the loan servicers have to maximize net present value under their pooling and servicing agreements applies to certain investors; specifying how and when the notice to residents of property subject to foreclosure is to be mailed; and extending the time during which the notice of sale must be recorded from 14 to 20 days. The bill also makes certain changes related to short-pay agreements and short-pay demand statements.

On February 20, 2009, Governor Schwarzenegger signed ABX2 7 and SBX2 7, which established the California Foreclosure Prevention Act. The California Foreclosure Prevention Act modifies the foreclosure process to provide additional time for borrowers to work out loan modifications while providing an exemption for mortgage loan servicers that have implemented a comprehensive loan modification program. Civil Code Section 2923.52 requires an additional 90 day period beyond the period already provided before a Notice of Sale can be given in order to allow all parties to pursue a loan modification to prevent foreclosure of loans meeting certain criteria identified in that section.

A mortgage loan servicer who has implemented a comprehensive loan modification program may file an application for exemption from the provisions of Civil Code Section 2923.52. Approval of this application provides the mortgage loan servicer an exemption from the additional 90-day period before filing the Notice of Sale when foreclosing on real property covered by the new law.

Recent Accounting Pronouncements

See Note 3 Summary of Significant Accounting Policies Adoption of New Accounting Standards of the Company s Consolidated Financial Statements in Item 8 Financial Statements and Supplementary Data of this Annual Report on Form 10K for information related to recent accounting pronouncements.

ITEM 1A. RISK FACTORS

As a smaller reporting company we are not required to provide the information required by this item.

ITEM 1B. UNRESOLVED STAFF COMMENTS

No comments have been submitted to the registrant by the staff of the Securities Exchange Commission.

Table of Contents

ITEM 2. PROPERTIES

Of the Company s eleven depository branches, ten are owned and one is leased. The Company also leases one lending office and one administrative office, and owns four administrative facilities.

Owned Properties

35 South Lindan Avenue Quincy, California (1)	32 Central Avenue Quincy, California (1)	80 W. Main St. Quincy, California (3)
424 N. Mill Creek Quincy, California (1)	336 West Main Street Quincy, California	120 North Pine Street Portola, California
43163 Highway 299E Fall River Mills, California	121 Crescent Street Greenville, California	255 Main Street Chester, California
510 North Main Street Alturas, California	3000 Riverside Drive Susanville, California	8475 North Lake Boulevard Kings Beach, California
11638 Donner Pass Road Truckee, California	2175 Civic Center Drive Redding, California	

Leased Properties

243 North Lake Boulevard Tahoe City, California	1755 E. Plumb Lane, Suite 270 Reno, Nevada (1)	470 Nevada St., Suite 108 Auburn, California (2)

(1) Non-branch administrative or credit administrative offices.
(2) Commercial lending office.
(3) Leased to a third party.

Total rental expenses under all leases, including premises, totaled $153,000, $150,000 and $20,000, in 2012, 2011 and 2010 respectively. The decline in rental expense during 2010 resulted from the purchase of our Redding branch building on March 31, 2010. Previously we had leased this building. Under the terms of the lease agreement we were provided free rent for a period of time; however, in accordance with accounting principles we recognized monthly rent expense equal to the total payments required under the lease dividend by the term of the lease in months. At the time of the purchase we reversed this accrual recognizing a $184 thousand reduction in rental expense. The expiration dates of the leases vary, with the first such lease expiring during 2012 and the last such lease expiring during 2015.

Future minimum lease payments in thousands of dollars are as follows:

Year Ending December 31,	
2013	$ 91,000
2014	60,000
2015	31,000
	$ 182,000

The Company maintains insurance coverage on its premises, leaseholds and equipment, including business interruption and record reconstruction coverage. The branch properties and non-branch offices are adequate, suitable, in good condition and have adequate parking facilities for customers and employees. The Company and Bank are limited in their investments in real property under Federal and state banking laws. Generally, investments in real property are either for the Company and Bank use or are in real property and real property interests in the ordinary course of the Bank s business.

Table of Contents

ITEM 3. LEGAL PROCEEDINGS

From time to time, the Company and/or its subsidiary are a party to claims and legal proceedings arising in the ordinary course of business. In the opinion of the Company's management, the amount of ultimate liability with respect to such proceedings will not have a material adverse effect on the financial condition or results of operations of the Company taken as a whole.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

Table of Contents

PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCK-HOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES.

The Company s common stock is quoted on the NASDAQ Capital Market under the ticker symbol "PLBC". As of December 31, 2012, there were 4,776,339 shares of the Company s stock outstanding held by approximately 1,640 shareholders of record as of the same date. The following table shows the high and low sales prices for the common stock, for each quarter as reported by Yahoo Finance.

Quarter	Common Dividends	High	Low
4th Quarter 2012		$ 4.37	$ 3.00
3rd Quarter 2012		$ 3.94	$ 2.59
2nd Quarter 2012		$ 4.18	$ 2.67
1st Quarter 2012		$ 4.22	$ 1.84
4th Quarter 2011		$ 2.92	$ 1.63
3rd Quarter 2011		$ 2.72	$ 1.46
2nd Quarter 2011		$ 2.85	$ 1.94
1st Quarter 2011		$ 4.00	$ 1.85

Dividends paid to shareholders by the Company are subject to restrictions set forth in California General Corporation Law, which provides that a corporation may make a distribution to its shareholders if retained earnings immediately prior to the dividend payout are at least equal to the amount of the proposed distribution. As a bank holding company without significant assets other than its equity position in the Bank, the Company s ability to pay dividends to its shareholders depends primarily upon dividends it receives from the Bank.

It is the policy of the Company to periodically distribute excess retained earnings to the shareholders through the payment of cash dividends. Such dividends help promote shareholder value and capital adequacy by enhancing the marketability of the Company s stock. All authority to provide a return to the shareholders in the form of a cash or stock dividend or split rests with the Board of Directors (the Board). The Board will periodically, but on no regular schedule and in accordance with regulatory restrictions, if any, review the appropriateness of a cash dividend payment. No common cash dividends were paid in 2012 or 2011 and none are anticipated to be paid in 2013.

The Company is subject to various restrictions on the payment of dividends. See Note 2 Regulatory Matters and Note 13 Shareholders Equity Dividend Restrictions of the Company s Consolidated Financial Statements in Item 8 Financial Statements and Supplementary Data of this Annual Report on Form 10K.

On January 30, 2009, under the Capital Purchase Program, the Company entered into a Letter Agreement (the Purchase Agreement) with the United States Department of the Treasury (Treasury), pursuant to which the Company issued and sold (i) 11,949 shares of the Company s Fixed Rate Cumulative Perpetual Preferred Stock, Series A (the Preferred Shares) and (ii) a ten-year warrant to purchase up to 237,712 shares of the Company s common stock, no par value at an exercise price, subject to anti-dilution adjustments, of $7.54 per share, for an aggregate purchase price of $11,949,000 in cash. The Series A Preferred Stock and the Warrant were issued in a private placement exempt from registration pursuant to Section 4(2) of the Securities Act of 1933, as amended. As described in the following paragraph the Purchase Agreement contains provisions that restrict the payment of dividends on Plumas Bancorp common stock and restrict the Company s ability to repurchase Plumas Bancorp common stock.

Under the Purchase Agreement, prior to January 30, 2012, unless the Company has redeemed the Preferred Shares, or the Treasury has transferred the Preferred Shares to a third party, the consent of the Treasury will be required for the Company to: (1) declare or pay any dividend or make any distribution on shares of the Common Stock (other than regular quarterly cash dividends of not more than $0.04 per share or regular semi-annual cash dividends of not more than $0.08 per share); or (2) redeem, purchase or acquire any shares of Common Stock or other equity or capital securities, other than in connection with benefit plans consistent with past practice and certain other circumstances specified in the Purchase Agreement.

Table of Contents

Securities Authorized for Issuance under Equity Compensation Plans. The following table sets forth securities authorized for issuance under equity compensation plans as of December 31, 2012.

Plan Category	Number of securities to be issued upon exercise of outstanding options (a)	Weighted-average exercise price of outstanding options (b)	Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column (a)) (c)
Equity compensation plans approved by security holders	419,806	$ 8.67	0
Equity compensation plans not approved by security holders	None	Not Applicable	None
Total	419,806	$ 8.67	0

For additional information related to the above plans see Note 13 of the Company s Consolidated Financial Statements in Item 8 Financial Statements and Supplementary Data of this Annual Report on Form 10K.

Issuer Purchases of Equity Securities. There were no purchases of Plumas Bancorp common stock by the Company during 2012.

Table of Contents

ITEM 6. SELECTED FINANCIAL DATA

The following table presents a summary of selected financial data and should be read in conjunction with the Company s consolidated financial statements and notes thereto included under Item 8 Financial Statements and Supplementary Data.

	At or for the year ended December 31,				
	2012	2011	2010	2009	2008
	(dollars in thousands except per share information)				
Statement of Operations					
Interest income	$ 18,425	$ 18,668	$ 20,680	$ 22,836	$ 25,440
Interest expense	1,274	1,848	3,147	3,655	5,364
Net interest income	17,151	16,820	17,533	19,181	20,076
Provision for loan losses	2,350	3,500	5,500	14,500	4,600
Noninterest income	6,596	7,162	8,468	5,664	5,091
Noninterest expense	18,377	19,246	19,141	26,266	20,475
Provision for (benefit from) income taxes	1,070	295	389	(6,775)	(212)
Net income (loss)	$ 1,950	$ 941	$ 971	$ (9,146)	$ 304
Preferred Stock dividends and discount accretion	684	684	684	628	
Net income (loss) available to common shareholders	$ 1,266	$ 257	$ 287	$ (9,774)	$ 304
Balance sheet (end of period)					
Total assets	$ 477,802	$ 455,349	$ 484,480	$ 528,117	$ 457,175
Total loans	$ 315,057	$ 293,865	$ 314,200	$ 332,678	$ 366,017
Allowance for loan losses	$ 5,686	$ 6,908	$ 7,324	$ 9,568	$ 7,224
Total deposits	$ 411,562	$ 391,140	$ 424,887	$ 433,255	$ 371,493
Total shareholders equity	$ 41,850	$ 39,634	$ 37,988	$ 38,231	$ 35,437
Balance sheet (period average)					
Total assets	$ 464,609	$ 467,354	$ 500,082	$ 490,000	$ 447,720
Total loans	$ 301,799	$ 302,841	$ 323,906	$ 354,482	$ 355,416
Total deposits	$ 401,110	$ 407,982	$ 430,777	$ 403,896	$ 382,279
Total shareholders equity	$ 41,023	$ 39,244	$ 38,941	$ 43,839	$ 37,343
Capital ratios					
Leverage ratio	10.3%	9.8%	8.9%	7.9%	9.8%
Tier 1 risk-based capital	13.9%	13.7%	12.7%	10.4%	11.0%
Total risk-based capital	15.1%	15.0%	13.9%	11.6%	12.2%
Asset quality ratios					
Nonperforming loans/total loans	4.35%	5.73%	8.07%	4.30%	7.31%
Nonperforming assets/total assets	3.98%	5.60%	7.07%	4.84%	6.78%
Allowance for loan losses/total loans	1.80%	2.35%	2.33%	2.88%	1.97%
Net loan charge-offs	$ 3,572	$ 3,916	$ 7,744	$ 12,156	$ 1,587
Performance ratios					
Return (loss) on average assets	0.42%	0.20%	0.19%	(1.87)%	0.07%
Return (loss) on average common equity	4.3%	0.9%	1.1%	(29.5)%	0.8%
Return (loss) on average equity	4.8%	2.4%	2.5%	(20.9)%	0.8%
Net interest margin	4.18%	4.08%	4.24%	4.52%	4.99%
Loans to deposits	76.6%	75.1%	73.9%	76.8%	98.5%
Efficiency ratio	77.4%	80.3%	73.6%	105.7%	81.4%
Per share information					
Basic earnings (loss)	$ 0.26	$ 0.05	$ 0.06	$ (2.05)	$ 0.06
Diluted earnings (loss)	$ 0.26	$ 0.05	$ 0.06	$ (2.05)	$ 0.06
Common cash dividends	$ 0.00	$ 0.00	$ 0.00	$ 0.00	$ 0.24

Dividend payout ratio	%	%	%	%	400%
Book value per common share	$ 6.28	$ 5.83	$ 5.51	$ 5.58	$ 7.42
Common shares outstanding at period end	4,776,339	4,776,339	4,776,339	4,776,339	4,775,339

Table of Contents

ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

We are a bank holding company for Plumas Bank, a California state-chartered commercial bank. We derive our income primarily from interest received on real estate related, commercial and consumer loans and, to a lesser extent, interest on investment securities, fees received in connection with servicing deposit and loan customers and fees from the sale of loans. Our major operating expenses are the interest we pay on deposits and borrowings and general operating expenses. We rely on locally-generated deposits to provide us with funds for making loans.

We are subject to competition from other financial institutions and our operating results, like those of other financial institutions operating in California, are significantly influenced by economic conditions in California, including the strength of the real estate market. In addition, both the fiscal and regulatory policies of the federal and state government and regulatory authorities that govern financial institutions and market interest rates also impact the Bank s financial condition, results of operations and cash flows.

Critical Accounting Policies

Our accounting policies are integral to understanding the financial results reported. Our most complex accounting policies require management s judgment to ascertain the valuation of assets, liabilities, commitments and contingencies. We have established detailed policies and internal control procedures that are intended to ensure valuation methods are applied in an environment that is designed and operating effectively and applied consistently from period to period. The following is a brief description of our current accounting policies involving significant management valuation judgments.

Allowance for Loan Losses. The allowance for loan losses is an estimate of credit losses inherent in the Company's loan portfolio that have been incurred as of the balance-sheet date. The allowance is established through a provision for loan losses which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan growth. Credit exposures determined to be uncollectible are charged against the allowance. Cash received on previously charged off amounts is recorded as a recovery to the allowance. The overall allowance consists of two primary components, specific reserves related to impaired loans and general reserves for inherent losses related to loans that are collectively evaluated for impairment.

We evaluate our allowance for loan losses quarterly. We believe that the allowance for loan losses is a critical accounting estimate because it is based upon management s assessment of various factors affecting the collectability of the loans, including current economic conditions, past credit experience, delinquency status, the value of the underlying collateral, if any, and a continuing review of the portfolio of loans.

We cannot provide you with any assurance that economic difficulties or other circumstances which would adversely affect our borrowers and their ability to repay outstanding loans will not occur which would be reflected in increased losses in our loan portfolio, which could result in actual losses that exceed reserves previously established.

Other Real Estate Owned. Other real estate owned (OREO) represents properties acquired through foreclosure or physical possession. OREO is initially recorded at fair value less costs to sell when acquired. Write-downs to fair value at the time of transfer to OREO is charged to allowance for loan losses. Subsequent to foreclosure, we periodically evaluate the value of OREO held for sale and record a valuation allowance for any subsequent declines in fair value less selling costs. Subsequent declines in value are charged to operations. Fair value is based on our assessment of information available to us at the end of a reporting period and depends upon a number of factors, including our historical experience, economic conditions, and issues specific to individual properties. Our evaluation of these factors involves subjective estimates and judgments that may change.

Income Taxes. The Company files its income taxes on a consolidated basis with its subsidiary. The allocation of income tax expense (benefit) represents each entity's proportionate share of the consolidated provision for income taxes.

Deferred income taxes reflect the estimated future tax effects of temporary differences between the reported amount of assets and liabilities for financial reporting purposes and such amounts as measured by tax laws and regulations. We use an estimate of future earnings to support our position that the benefit of our deferred tax assets will be realized. A valuation allowance is recognized if, based on the weight of available evidence, management believes it is more likely than not that some portion or all of the deferred tax assets will not be realized. If future income should prove non-existent or less than the amount of the deferred tax assets within the tax years to which they may be applied, the asset may not be realized and our net income will be reduced.

When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination.

The following discussion is designed to provide a better understanding of significant trends related to the Company's financial condition, results of operations, liquidity and capital. It pertains to the Company's financial condition, changes in financial condition and results of operations as of December 31, 2012 and 2011 and for each of the three years in the period ended December 31, 2012. The discussion should be read in conjunction with the Company's audited consolidated financial statements and notes thereto and the other financial information appearing elsewhere herein.

Overview

The Company recorded net income of $1.95 million for the year ended December 31, 2012, a 107% increase over net income of $941 thousand during the year ended December 31, 2011.

Net interest income increased by $331 thousand from $16.8 million during 2011 to $17.2 million for the year ended December 31, 2012. This increase in net interest income resulted from a decrease in interest expense of $574 thousand partially offset by a decrease in interest income of $243 thousand. The provision for loan losses declined by $1.1 million from $3.5 million during 2011 to $2.4 million during 2012 resulting in an increase in net interest income after provision for loan losses of $1.5 million.

During the year ended December 31, 2012 non-interest income decreased by $566 thousand to $6.6 million, from $7.2 million during the year ended December 31, 2011. This decrease was related to declines of $615 thousand in gain on sale of loans and $263 thousand in gain on sale of securities partially offset by an increase of $140 thousand in service charge income and a net increase in all other categories of non-interest income totaling $172 thousand.

We continue to achieve savings in many categories of non-interest expense resulting in a reduction in non-interest expense of $869 thousand from $19.2 million during the twelve months ended December 31, 2011 to $18.4 million during 2012. Reductions of $227 thousand in salary and benefits expense, $486 thousand in FDIC insurance, $590 thousand in loss on sale of OREO, $235 thousand in OREO expense, and $86 thousand in postage were partially offset by an increase in the provision for changes in valuation of OREO of $328 thousand, an increase in outside service fees of $233 thousand, an increase in professional fees of $145 thousand and an increase in insurance expense of $78 thousand.

The provision for income taxes increased from $295 thousand in 2011 to $1.1 million during the year ended December 31, 2012.

Table of Contents

Net income allocable to common shareholders increased by $1 million from $257 thousand during the year ended December 31, 2011 to $1.3 million during 2012. Income allocable to common shareholders is calculated by subtracting dividends and discount amortized on preferred stock from net income.

Total assets at December 31, 2012 were $478 million, an increase of $22.5 million from $455 million at December 31, 2011. Increases included $23.0 million in investments and $22.8 million in net loans. These were partially offset by declines of $18.4 million in cash, $3.3 million in OREO and $1.6 million in other assets.

Core deposit growth has been strong in 2012 as evidenced by increases of $17.7 million in demand deposits and $11.1 million in savings and money market accounts. Time deposits declined by $9.8 million, much of which we attribute to migration into other types of deposits given the low rates and lack of liquidity associated with time deposits.

Shareholders equity increased by $2.2 million from $39.6 million at December 31, 2011 to $41.8 million at December 31, 2012. This increase includes the $1.95 million earned in 2012, a $171 thousand increase in unrealized gain on investment securities and a $95 thousand increase in common stock related to stock-based compensation expense.

The return on average assets was 0.42% for 2012, up from 0.20% for 2011. The return on average common equity was 4.3% for 2012, up from 0.9% for 2011.

Table of Contents

Results of Operations

Net Interest Income

The following table presents, for the years indicated, the distribution of consolidated average assets, liabilities and shareholders' equity. Average balances are based on average daily balances. It also presents the amounts of interest income from interest-earning assets and the resultant yields expressed in both dollars and yield percentages, as well as the amounts of interest expense on interest-bearing liabilities and the resultant cost expressed in both dollars and rate percentages. Nonaccrual loans are included in the calculation of average loans while nonaccrued interest thereon is excluded from the computation of yields earned:

	Year ended December 31,								
	2012			2011			2010		
	Average balance	Interest income/ expense	Rates earned / paid	Average balance	Interest income/ expense	Rates earned / paid	Average balance	Interest income/ expense	Rates earned / paid
	(dollars in thousands)								
Assets									
Interest bearing deposits	$ 38,783	$ 106	0.27%	$ 49,628	$ 124	0.25%	$ 19,808	$ 48	0.24%
Investment securities(1)	69,664	892	1.28	59,439	1,144	1.92	69,357	1,772	2.55
Total loans (2)(3)	301,799	17,427	5.77	302,841	17,400	5.75	323,906	18,860	5.82
Total earning assets	410,246	18,425	4.49%	411,908	18,668	4.53%	413,071	20,680	5.01%
Cash and due from banks	14,560			13,204			38,945		
Other assets	39,803			42,242			48,066		
Total assets	$ 464,609			$ 467,354			$ 500,082		
Liabilities and shareholders equity									
Interest bearing demand deposits	$ 82,648	111	0.13%	$ 93,925	187	0.20%	$ 101,519	382	0.38%
Money market deposits	42,957	91	0.21	40,050	115	0.29	42,514	221	0.52
Savings deposits	68,755	132	0.19	58,996	106	0.18	51,011	86	0.17
Time deposits	76,138	513	0.67	96,961	1,061	1.09	124,810	2,007	1.61
Short-term borrowings							986	5	0.51
Long-term borrowings							9,973	130	1.30
Junior subordinated debentures	10,310	344	3.34	10,310	326	3.16	10,310	312	3.03
Other	6,003	83	1.38	3,188	53	1.66	123	4	3.25
Total interest bearing liabilities	286,811	1,274	0.44%	303,430	1,848	0.61%	341,246	3,147	0.92%
Noninterest bearing demand deposits	130,612			118,050			110,923		
Other liabilities	6,163			6,630			8,972		
Shareholders equity	41,023			39,244			38,941		
Total liabilities and shareholders equity	$ 464,609			$ 467,354			$ 500,082		
Net interest income		$ 17,151			$ 16,820			$ 17,533	
Net interest spread (4)			4.05%			3.92%			4.09%
Net interest margin (5)			4.18%			4.08%			4.24%

(1) Interest income is reflected on an actual basis and is not computed on a tax-equivalent basis.
(2) Average nonaccrual loan balances of $14.6 million for 2012, $20.2 million for 2011 and $18.8 million for 2010 are included in average loan balances for computational purposes.
(3) Loan origination fees and costs are included in interest income as adjustments of the loan yields over the life of the loan using the interest method. Loan interest income includes net loan fees (costs) of $(75,000), $49,000 and $(20,000) for 2012, 2011 and 2010, respectively.
(4) Net interest spread represents the average yield earned on interest-earning assets less the average rate paid on interest-bearing liabilities.
(5) Net interest margin is computed by dividing net interest income by total average earning assets.

Table of Contents

The following table sets forth changes in interest income and interest expense, for the years indicated and the amount of change attributable to variances in volume, rates and the combination of volume and rates based on the relative changes of volume and rates:

	2012 compared to 2011 Increase (decrease) due to change in:				2011 compared to 2010 Increase (decrease) due to change in:			
	Average Volume(1)	Average Rate(2)	Mix(3)	Total	Average Volume(1)	Average Rate(2)	Mix(3)	Total
				(dollars in thousands)				
Interest-earning assets:								
Interest bearing deposits	$ (27)	$ 12	$ (3)	$ (18)	$ 72	$ 2	$ 2	$ 76
Investment securities	197	(383)	(66)	(252)	(253)	(437)	62	(628)
Loans	(60)	87		27	(1,226)	(250)	16	(1,460)
Total interest income	110	(284)	(69)	(243)	(1,407)	(685)	80	(2,012)
Interest-bearing liabilities:								
Interest bearing demand deposits	(22)	(61)	7	(76)	(28)	(180)	13	(195)
Money market deposits	8	(30)	(2)	(24)	(13)	(99)	6	(106)
Savings deposits	18	7	1	26	13	6	1	20
Time deposits	(227)	(407)	86	(548)	(448)	(641)	143	(946)
Junior subordinated debentures		18		18		14		14
Short-term borrowings					(5)	(5)	5	(5)
Long-term borrowings					(130)	(130)	130	(130)
Other borrowings	47	(9)	(8)	30	100	(2)	(49)	49
Total interest expense	(176)	(482)	84	(574)	(511)	(1,037)	249	(1,299)
Net interest income	$ 286	$ 198	$ (153)	$ 331	$ (896)	$ 352	$ (169)	$ (713)

(1) The volume change in net interest income represents the change in average balance multiplied by the previous year s rate.
(2) The rate change in net interest income represents the change in rate multiplied by the previous year s average balance.
(3) The mix change in net interest income represents the change in average balance multiplied by the change in rate.

2012 compared to 2011. Net interest income is the difference between interest income and interest expense. Net interest income, on a nontax-equivalent basis, was $17.2 million for the year ended December 31, 2012, up $331 thousand, or 2%, from $16.8 million for 2011. A decrease of $243 thousand, or 1.3% in interest income, from $18.7 million during 2011 to $18.4 million during the current year, was offset by a decline in interest expense of $574 thousand.

Interest and fees on loans increased by $27 thousand; however, this was offset by a $252 thousand decline in interest on investment securities and an $18 thousand decline in interest on deposits. The increase in interest and fees on loans was related to an increase in yield partially offset by a decrease in average loan balances. Interest on investments securities declined related to a decrease in yield partially offset by an increase in average balance.

Interest and fees on loans was $17.4 million for the years ended December 31, 2012 and 2011. The average loan balances were $301.8 million for 2012, down $1.0 million from the $302.8 million for 2011. This decline in loans was mostly related to normal pay downs and prepayments, loan charge-offs and real estate acquired through foreclosure mostly offset by growth in our auto loan and commercial real estate loan portfolios. The average yields on loans were 5.77% for 2012 up from 5.75% for 2011.

As a result of a decrease in yield of 64 basis points from 1.92% during 2011 to 1.28% during 2012, interest on investment securities decreased by $252 thousand. The effect of the decrease in yield on interest income was partially offset by an increase in average investment securities of $10.2 million from $59.4 million during 2011 to $69.6 million during 2012. The decline in yield is primarily related to the replacement of matured and sold investment securities with new investments with market yields below those which they replaced.

Interest income on interest-bearing deposits, which totaled $106 thousand in 2012 and $124 thousand in 2011, mostly relates to interest on cash balances held at the Federal Reserve.

Table of Contents

Interest expense on deposits decreased by $622 thousand, or 42%, to $847 thousand for the twelve months ended December 31, 2012, down from $1.5 million in 2011. This decrease primarily relates to decreases in the average balance and rate paid on time and interest bearing demand deposits (NOW) and a decline in the rate paid on money market accounts.

Interest on time deposits declined by $548 thousand. Average time deposits declined by $20.9 million from $97.0 million during 2011 to $76.1 million for the year ended December 31, 2012. The decrease in average time deposits is mostly related to a promotional time deposit product we began offering in June, 2009 and continued to offer until April 30, 2010. During 2011 the average balance of promotional deposits was $21.8 million; these promotional time deposits had all matured by December 31, 2011. The average rate paid on promotional deposits during 2011 was 2%. In addition, the Bank has held down the rate paid on time deposits in 2012 as it has excess liquidity and does not need to pay for deposits at above market rates. The average rate paid on time deposits decreased from 1.09% during 2011 to 0.67% during the current twelve month period. This decrease primarily relates to a decline in market rates paid in the Company s service area and the maturity of the higher rate promotional deposits.

Interest expense on NOW accounts declined by $76 thousand. Rates paid on NOW accounts declined by 7 basis points from 0.20% during 2011 to 0.13% during 2012, mostly related to a decline in market rates in the Company s service area. Average balances declined by $11.3 million from 2011. During 2011 we significantly lowered the rate paid on local public agencies NOW accounts as we determined that the previous rate did not meet our profitability targets, as a result some of these deposits moved out of the Bank. During 2012 average public NOW accounts declined by $7.4 million from $24.3 million during 2011 to $16.9 million during the year ended December 21, 2012. At December 31, 2012 balances in this account type were $11.8 million. We do not expect significant additional declines in public NOW balances during 2013.

Interest expense on money market accounts decreased by $24 thousand related to a decrease in rate paid on these accounts of 8 basis points from 0.29% during 2011 to 0.21% during 2012. This was primarily related to a money market sweep product we offered in 2011. We no longer offer the money market sweep account having replaced it with a product that utilizes repurchase agreements during the third quarter of 2011. Average money market balances increased by $2.9 million from $40.0 million during 2011 to $42.9 million in 2012.

Interest expense on junior subordinated debentures, which increased by $18 thousand from 2011, fluctuates with changes in the 3-month London Interbank Offered Rate (LIBOR) rate.

Interest on other borrowings primarily relates to interest paid on repurchase agreements.

Net interest margin is net interest income expressed as a percentage of average interest-earning assets. As a result of the changes noted above, the net interest margin for 2012 increased 10 basis points to 4.18%, from 4.08% for 2011.

2011 compared to 2010. Net interest income, on a nontax-equivalent basis, was $16.8 million for the year ended December 31, 2011, a decline of $0.7 million, or 4.1%, from $17.5 million for 2010.

The overall change in net interest income was primarily a result of a decrease of $1.5 million in loan interest income and a decline of $628 thousand in interest income on investment securities. The decline in interest on loans was mostly related to a decline in average loans outstanding. Interest on investment securities declined related to a decrease in both yield and average balance. Partially offsetting these decreases in interest income was a decline in rates paid on the Company s deposits and a decline in the average balance of time deposits, interest bearing demand deposits and long-term borrowings.

Interest income decreased $2.0 million, or 9.7%, to $18.7 million for the year ended December 31, 2011. Interest and fees on loans decreased by $1.5 million from $18.9 million for the year ended December 31, 2010 to $17.4 million for 2011. The average loan balances were $302.8 million for 2011, down $21.1 million from the $323.9 million for 2010. This decline in loans was mostly related to normal pay downs and prepayments, loan charge-offs, real estate acquired through foreclosure and our efforts to reduce the level of construction and land development loan balances. The average yields on loans were 5.75% for 2011 down from the 5.82% for 2010.

Table of Contents

Interest on investment securities decreased by $628 thousand resulting from a decrease in yield of 63 basis points and a decline in average investment securities of $9.9 million. The decline in yield is primarily related to the replacement of matured and sold investment securities with new investments with market yields below those which they replaced.

Interest income on other interest-earning assets, which totaled $124 thousand in 2011 and $48 thousand in 2010, relates to interest on cash balances held at the Federal Reserve.

Interest expense on deposits decreased by $1.2 million, or 46%, to $1.5 million for the twelve months ended December 31, 2011, down from $2.7 million in 2010. This decrease primarily relates to decreases in the average balance and rate paid on time deposits and a decline in the rate paid on demand deposit (NOW) and money market accounts.

Interest on time deposits declined by $946 thousand. Average time deposits declined by $27.8 million from $124.8 million during 2010 to $97.0 million for the year ended December 31, 2011. The decrease in time deposits is mostly related to promotional time deposits as previously discussed. The average rate paid on these promotional deposits during 2011 was 2%. The average rate paid on time deposits decreased from 1.61% during 2010 to 1.09% during 2011. This decrease primarily relates to a decline in market rates paid in the Company s service area and the maturity of the higher rate promotional deposits.

Interest expense on NOW accounts declined by $195 thousand. Rates paid on NOW accounts declined by 18 basis points from 0.38% during 2010 to 0.20% during 2011, as we significantly lowered the rate paid on local public agencies NOW accounts. Although we lost deposits by lowering this rate; we continue to focus on the profitability of the public sweep accounts rather than growing public sweep balances.

Interest expense on money market accounts decreased by $106 thousand related primarily to a decrease in rate paid on these accounts of 23 basis points from 0.52% during 2010 to 0.29% during 2011. This was primarily related to a significant drop in the rates paid on our money market sweep product.

Interest on FHLB long term borrowings decreased by $130 thousand as there were no outstanding long term borrowings during 2011. Interest expense on junior subordinated debentures, which increased by $14 thousand from 2010, fluctuates with changes in the 3-month London Interbank Offered Rate (LIBOR) rate.

Interest on other borrowings in 2011 primarily relates to interest paid on repurchase agreements.

Net interest margin is net interest income expressed as a percentage of average interest-earning assets. As a result of the changes noted above, the net interest margin for 2011 decreased 16 basis points to 4.08%, from 4.24% for 2010.

Provision for Loan Losses

During the year ended December 31, 2012 we recorded a provision for loan losses of $2.35 million down $1.15 million from the $3.50 million provision recorded during 2011. See Analysis of Asset Quality and Allowance for Loan Losses for further discussion of loan quality trends and the provision for loan losses.

The allowance for loan losses is maintained at a level that management believes will be appropriate to absorb inherent losses on existing loans based on an evaluation of the collectability of the loans and prior loan loss experience. The evaluations take into consideration such factors as changes in the nature and volume of the portfolio, overall portfolio quality, review of specific problem loans, and current economic conditions that may affect the borrower's ability to repay their loan. The allowance for loan losses is based on estimates, and ultimate losses may vary from the current estimates. These estimates are reviewed periodically and, as adjustments become necessary, they are reported in earnings in the periods in which they become known.

Based on information currently available, management believes that the allowance for loan losses is appropriate to absorb potential risks in the portfolio. However, no assurance can be given that the Company may not sustain charge-offs which are in excess of the allowance in any given period.

Table of Contents

Non-Interest Income

The following table sets forth the components of non-interest income for the years ended December 31, 2012, 2011 and 2010.

	Years Ended December 31,			Change during Year	
	2012	2011	2010	2012	2011
	(dollars in thousands)				
Service charges on deposit accounts	$ 3,617	$ 3,477	$ 3,642	$ 140	$ (165)
Gain on sale of loans, net	1,324	1,939	1,055	(615)	884
Gain on sale of investments	403	666	1,160	(263)	(494)
Earnings on bank owned life insurance policies	345	352	351	(7)	1
Loan servicing fees	215	202	188	13	14
Customer service fees	149	141	135	8	6
Safe deposit box and night depository income	65	66	66	(1)	
Merchant processing	24	15	141	9	(126)
Sale of merchant processing portfolio			1,435		(1,435)
Other income	454	304	295	150	9
Total non-interest income	$ 6,596	$ 7,162	$ 8,468	$ (566)	$ (1,306)

2012 compared to 2011. During the twelve months ended December 31, 2012 non-interest income decreased by $566 thousand to $6.6 million from $7.2 million during 2011. The largest component of this decrease was a decrease of $615 thousand in gains on the sale of government guaranteed loans from $1.9 million during 2011 to $1.3 million during the year ended December 31, 2012. Beginning in the first quarter of 2011, related to a change in SBA requirements, guaranteed portions of SBA loans were no longer required to be sold with a 90 day premium recourse requirement. This resulted in recording gains on sales of loans during 2011 representing both loans sold during the twelve months ended December 31, 2011 and loans sold during the fourth quarter of 2010. In addition, gain on sale of loans during 2011benefited from a government program temporarily increasing the government guarantee in order to stimulate small business lending. The remaining decrease in non-interest income was related to a decline in gains on sale of investment securities from $666 thousand during the twelve months ended December 31, 2011 to $403 thousand during 2012. During the 2011 period proceeds of $29.4 million were generated on the sale of twenty-seven securities and during the 2012 proceeds of $20.8 million were received on the sale of twenty-five securities.

Service charges on deposit accounts increased by $140 thousand primarily related to an increase in use of overdraft protection services. During the fourth quarter of 2011 we introduced a new overdraft protection (ODP) program which we made available to a larger portion of our customer base than the prior program, resulting in an increase in service fee income. This new program has enabled us to increase income while strengthening our regulatory compliance over the ODP function. The increase in other non-interest income mostly relates to a $99 thousand adjustment to accrued life insurance.

2011 compared to 2010. During the year ended December 31, 2011 non-interest income decreased by $1.3 million to $7.2 million, from $8.5 million during the year ended December 31, 2010. This decrease was related to the sale of our merchant processing portfolio in 2010. During June 2010 we entered into an alliance with a world-wide merchant processing leader. In conjunction with this alliance we sold our merchant processing business, recording a one-time gain of $1.4 million. Related to this sale we experienced a decrease in merchant processing income of $126 thousand during the comparison periods. Service charges on deposit accounts declined by $165 thousand primarily related to a decline in overdraft fees as new regulations placed additional restrictions on the Bank in charging overdraft fees on ATM and Point of Sale transactions. Gain on sale of investments declined by $494 thousand. During the year ended December 31, 2011 we sold twenty-seven investment securities classified as available-for-sale for $29.4 million recognizing a $0.7 million gain on sale. During the 2010 period we sold sixty-five investment securities classified as available-for sale for $40.9 million and recorded a $1.2 million gain on sale.

Table of Contents

We chose to sell some of the securities in our investment portfolio in order to lock in gains; this had the additional benefit of partially offsetting some nonrecurring expense items such as losses on sale of OREO.

Partially offsetting these declines in income was an $884 thousand increase in gain on sale of government guaranteed loans. Gains on sale in 2011 were particularly strong related to two factors. First, during the first quarter of 2011 the SBA eliminated the recourse provision related to loan sales allowing us to record both gains on sales from loans sold during the fourth quarter of 2010 and the first quarter of 2011. In addition, many loans sold in 2011 were 90% guaranteed related to a temporary increase in guarantee percentage enacted on February 17, 2009 as part of the Recovery Act. Currently loans made through the SBA 7(a) program carry a 75% to 85% guarantee.

Non-Interest Expense

The following table sets forth the components of other non-interest expense for the years ended December 31, 2012, 2011 and 2010.

	Years Ended December 31,			Change during Year	
	2012	2011	2010	2012	2011
	(dollars in thousands)				
Salaries and employee benefits	$ 8,968	$ 9,195	$ 9,732	$ (227)	$ (537)
Occupancy and equipment	3,023	3,088	3,096	(65)	(8)
Outside service fees	1,503	1,270	1,212	233	58
Provision for OREO losses	907	579	356	328	223
Professional fees	875	730	587	145	143
FDIC insurance	613	1,099	1,009	(486)	90
Telephone and data communications	308	331	338	(23)	(7)
Business development	268	262	250	6	12
Director compensation and retirement	255	229	233	26	(4)
Advertising and promotion	251	236	252	15	(16)
Armored car and courier	224	225	239	(1)	(14)
Loan collection costs	219	261	261	(42)	
OREO costs	187	422	573	(235)	(151)
Core deposit intangible	173	173	173		
Stationery and supplies	124	140	145	(16)	(5)
Insurance	120	42	125	78	(83)
Postage	104	190	207	(86)	(17)
Loss (gain) on sale of OREO	16	606	(43)	(590)	649
Other operating expense	239	168	396	71	(228)
Total non-interest expense	$ 18,377	$ 19,246	$ 19,141	$ (869)	$ 105

2012 compared to 2011. We continue to achieve savings in many categories of non-interest expense resulting in a reduction in non-interest expense of $869 thousand from $19.2 million during the twelve months ended December 31, 2011 to $18.4 million during 2012. Significant reductions in salary and benefits expense, FDIC insurance, loss on sale of OREO, OREO expense, and postage were partially offset by an increase in the provision for changes in valuation of OREO of $328 thousand, an increase in outside service fees of $233 thousand, an increase in professional fees of $145 thousand and an increase in insurance expense of $78 thousand.

Salaries and employee benefits decreased by $227 thousand related to a decline of $80 thousand in commission expense, $88 thousand in medical and dental insurance expense (group insurance), $50 thousand in workers compensation expense and an increase of $247 thousand in deferred loan origination costs partially offset by an increase of $92 thousand in salary continuation expense and $131 thousand in stock compensation expense. Commission expense, which relates to government-guaranteed lending personnel, decreased by $80 thousand consistent with the decline in government-guaranteed loan sales during the comparison periods. The decrease in group insurance was mostly related to a decline in employees enrolled in the insurance plans. The decrease in workers compensation was related to changing providers. Previously we were members of a small group plan and our premiums were adversely affected by claims within the group. We have exited this plan and have seen a considerable reduction in workers compensation premiums. Related to an increase in lending activity, the deferral of loan origination costs increased by $247 thousand.

Table of Contents

During 2012, related to a significant reduction in long term market interest rates, we reduced the discount rates used in calculating the present value of our salary continuation liabilities. This had the effect of increasing salary continuation expense by $195 thousand. Absent this adjustment salary continuation expense would have declined by $103 thousand, as salary continuation expense during 2011 included a one-time adjustment to reflect the early retirement of the Company s Chief Credit officer. Employee stock compensation expense increased by $131 thousand from a credit of $38 thousand during 2011 to expense of $93 thousand during the current period. The credit in stock compensation expense during the 2011 period was related to a revision in the estimated forfeiture rate. We expect a reduction in stock compensation expense in 2013 as the unamortized balance continues to decline.

A decline of $486 thousand in FDIC insurance expense relates to a decline in the rate charged Plumas Bank by the FDIC. This decline in rate includes a change in the assessment base and assessment rate under new rules enacted pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act. These new rules changed the assessment base from total deposits to average total assets less tangible capital, but also significantly lowered the assessment rates, causing a net favorable impact on our FDIC insurance premiums.

OREO represents real property taken by the Bank either through foreclosure or through a deed in lieu thereof from the borrower. Loss on sale of OREO totaled $16 thousand during the twelve months ended December 31, 2012, a decrease of $590 thousand from the $606 thousand incurred in 2011. In the second quarter of 2011 the Bank sold its largest OREO holding which represented approximately half of its OREO holdings at that time. The Bank incurred a $617 thousand loss on sale of this large OREO holding in 2011.

OREO expense declined by $235 thousand from $422 thousand during 2011 to $187 thousand for the year ended December 31, 2012. OREO expense benefited from a decline in OREO balances in 2012. In addition, 2011 OREO expense was adversely affected by significant cleanup costs on one property and considerable legal costs related to another property. Both of these properties where sold during 2011.

Postage declined by $86 thousand related to the outsourcing of our statement processing activities during 2012. Effective with the outsourcing, the cost of mailing statements, notices and similar documents is included in outside service costs.

When other real estate is acquired, any excess of the Bank s recorded investment in the loan balance and accrued interest income over the estimated fair market value of the property less costs to sell is charged against the allowance for loan losses. A valuation allowance for losses on other real estate is maintained to provide for temporary declines in value. The allowance is established through a provision for subsequent losses on other real estate which is included in other expenses. Subsequent gains or losses on sales or write-downs resulting from permanent impairment are recorded in other income or expenses as incurred. The $907 thousand in OREO provision, an increase of $328 thousand from $579 thousand during the twelve months ended December 31, 2011, was related to a decline in the value of twenty-one properties based on appraisals received during 2012. Of these twenty-one properties, seven have been sold and the remaining fourteen represent 61% of the Bank s OREO balance as of December 31, 2012.

The largest component of the $233 thousand increase in outside service costs was $112 thousand in costs related to the outsourcing of our statement processing operations in June, 2012. The Company anticipates meaningful savings, related to the statement outsourcing. During 2012 the Bank modernized its ATM network by purchasing new ATM machines which have the ability to accept currency and checks and provide an imaged receipt. A large portion of the remaining increase in outside service costs relates to maintaining these advanced machines which are considerably more complicated than our previous ATMs many of which were over ten years old. The $145 thousand increase in professional fees mostly relates to an increase in consulting costs in the Company s data processing and network administration functions. Insurance expense was abnormally low during 2011 as it included the reversal of the accrual for split dollar life insurance for the Bank s former Chief Credit Officer who forfeited his right to this insurance when he left the Bank prior to reaching the age of sixty-five.

Table of Contents

2011 compared to 2010. While we have achieved savings in many categories of non-interest expense these were offset in 2011 by an increase of $649 thousand in loss on sale of OREO. Non-interest expense increased by $105 thousand from $19.1 million during the year ended December 31, 2010 to $19.2 million during 2011.

Loss on sale of OREO totaled $606 thousand primarily related to the sale of one property. During June, 2011 the Bank sold its largest OREO holding which represented $4.3 million, or 48% of the total balance in OREO at January 1, 2011. The Bank incurred a $617 thousand loss on sale; however, management believes the loss was prudent given the significant affect this transaction had in decreasing nonperforming assets.

Outside service fees increased by $58 thousand which mostly relates to our on-line banking and bill payment platform. FDIC insurance costs increased related to an increase in the rate the FDIC charges Plumas Bank. Professional fees increased by $143 thousand the largest portion of which was related to an increase in consulting cost of $97 thousand. During the second half of 2011 we contracted with an outside party to provide assistance in the management of our nonperforming assets. Total costs incurred related to this consultant were $42 thousand. In addition we incurred $21 thousand in costs related to an outside management study.

The largest reduction in expense was a decrease of $537 thousand in salaries and employee benefits. Salary expense, excluding commissions, declined by $667 thousand mostly related to a reduction in staffing, during the second quarter of 2010, which affected most functional areas with the exception of government guaranteed lending and problem assets. On a full-time equivalent basis, we employed 142 persons at December 31, 2011 down from 146 at December 31, 2010 and 163 at December 31, 2009. Commission expense, which relates to government guaranteed lending personnel and is included in salary expense, increased by $318 thousand resulting from the increase in government guaranteed loan gains.

The provision for OREO losses increased by $223 thousand related to one land development property that, based on a 2011 appraisal, declined in value by $417 thousand. At December 31, 2011, this property had a value of approximately $1 million. OREO carrying costs declined by $151 thousand from $573 thousand during 2010 to $422 thousand during 2011. These savings were primarily related to property taxes on OREO properties and refunds on prior year tax payments related to some of our OREO properties being reassessed.

Insurance expense declined by $83 thousand primarily related to the forfeiture of retirement split dollar life insurance benefits by one of our executive officers who chose to terminate his employment during 2011 prior to age sixty-five.

Other non-interest expense declined by $228 thousand related to a $226 thousand prepayment penalty incurred upon the prepayment of our long-term Federal Home Loan Bank borrowings during July, 2010.

Provision for Income Taxes. The Company recorded an income tax provision of $1.1 million, or 35.4% of pre-tax income for the year ended December 31, 2012. During 2011 the Company recorded an income tax provision of $295 thousand, or 23.9% of pre-tax income for the year ended December 31, 2011. The percentages for 2012 and 2011 differ from the statutory rate as tax exempt income such as earnings on Bank owned life insurance, municipal loan interest, and in the state of California enterprise zone interest decrease taxable income.

Deferred tax assets and liabilities are recognized for the tax consequences of temporary differences between the reported amount of assets and liabilities and their tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The determination of the amount of deferred income tax assets which are more likely than not to be realized is primarily dependent on projections of future earnings, which are subject to uncertainty and estimates that may change given economic conditions and other factors. The realization of deferred income tax assets is assessed and a valuation allowance is recorded if it is "more likely than not" that all or a portion of the deferred tax asset will not be realized. "More likely than not" is defined as greater than a 50% chance. All available evidence, both positive and negative is considered to determine whether, based on the weight of that evidence, a valuation allowance is needed.

Table of Contents

As part of its analysis, the Company considered the following positive evidence:

The Company has a long history of earnings and profitability.

The Company has been profitable for each of the years in the three year period ended December 31, 2012. Additionally, the Company is projecting future taxable and book income will be generated by operations.

The volume of potential problem loans in the Company s loan portfolio has significantly decreased.

The Company does not have a history of net operating losses carry forwards or tax credits expiring unused.

Based upon the analysis of available evidence, management has determined that it is "more likely than not" that all deferred income tax assets as of December 31, 2012 and 2011 will be fully realized and therefore no valuation allowance was recorded.

Financial Condition

Loan Portfolio. The Company continues to manage the mix of its loan portfolio consistent with its identity as a community bank serving the financing needs of all sectors of the area it serves. Although the Company offers a broad array of financing options, it continues to concentrate its focus on small to medium sized commercial businesses. These commercial loans offer diversification as to industries and types of businesses, thus limiting material exposure in any industry concentrations. The Company offers both fixed and floating rate loans and obtains collateral in the form of real property, business assets and deposit accounts, but looks to business and personal cash flows as its primary source of repayment.

The Company s largest lending categories are commercial real estate loans, agricultural loans and residential real estate loans. These categories accounted for approximately 44.3%, 11.1% and 11.0%, respectively of the Company's total loan portfolio at December 31, 2012, and approximately 40.6%, 13.2% and 13.3%, respectively of the Company's total loan portfolio at December 31, 2011. Construction and land development loans continue to decline and represented 5.0% and 5.8% of the loan portfolio as of December 31, 2012 and December 31, 2011, respectively. The construction and land development portfolio component has been identified by Management as a higher-risk loan category. The quality of the construction and land development category is highly dependent on property values both in terms of the likelihood of repayment once the property is transacted by the current owner as well as the level of collateral the Company has securing the loan in the event of default. Loans in this category are characterized by the speculative nature of commercial and residential development properties and can include property in various stages of development from raw land to finished lots. The decline in these loans as a percentage of the Company s loan portfolio reflects management s continued efforts, which began in 2009, to reduce its exposure to construction and land development loans due to the severe valuation decrease in the real estate market.

The Company s real estate related loans, including real estate mortgage loans, real estate construction loans, consumer equity lines of credit, and agricultural loans secured by real estate comprised 78% and 81% of the total loan portfolio at December 31, 2012 and December 31, 2011, respectively. Moreover, the business activities of the Company currently are focused in the California counties of Plumas, Nevada, Placer, Lassen, Modoc, Shasta, Sierra and in Washoe County in Northern Nevada. Consequently, the results of operations and financial condition of the Company are dependent upon the general trends in these economies and, in particular, the residential and commercial real estate markets. In addition, the concentration of the Company's operations in these areas of Northeastern California and Northwestern Nevada exposes it to greater risk than other banking companies with a wider geographic base in the event of catastrophes, such as earthquakes, fires and floods in these regions.

Table of Contents

The rates of interest charged on variable rate loans are set at specific increments in relation to the Company's lending rate or other indexes such as the published prime interest rate or U.S. Treasury rates and vary with changes in these indexes. At December 31, 2012 and December 31, 2011, approximately 73% of the Company's loan portfolio was comprised of variable rate loans. While real estate mortgage, commercial and consumer lending remain the foundation of the Company's historical loan mix, some changes in the mix have occurred due to the changing economic environment and the resulting change in demand for certain loan types. In addition, the Company remains committed to the agricultural industry in Northeastern California and will continue to pursue high quality agricultural loans. Agricultural loans include both commercial and commercial real estate loans. The Company s agricultural loan balances totaled $35 million at December 31, 2012 and $39 million at December 31, 2011.

The following table sets forth the amounts of loans outstanding by category as of the dates indicated.

	At December 31,				
	2012	2011	2010	2009	2008
	(dollars in thousands)				
Real estate mortgage	$ 174,212	$ 158,431	$ 162,513	$ 161,397	$ 151,943
Real estate construction and land development	15,801	17,063	31,199	38,061	73,820
Commercial	29,552	30,235	33,433	37,056	42,528
Consumer (1)	60,368	49,268	48,586	54,442	61,706
Agriculture (2)	35,124	38,868	38,469	41,722	36,020
Total loans	315,057	293,865	314,200	332,678	366,017
Less:					
Deferred costs	(900)	(475)	(275)	(298)	(279)
Allowance for loan losses	5,686	6,908	7,324	9,568	7,224
Net loans	$ 310,271	$ 287,432	$ 307,151	$ 323,408	$ 359,072

(1) Includes equity lines of credit
(2) Includes agriculture real estate

The following table sets forth the maturity of gross loan categories as of December 31, 2012. Also provided with respect to such loans are the amounts due after one year, classified according to sensitivity to changes in interest rates:

	Within One Year	After One Through Five Years	After Five Years	Total
		(dollars in thousands)		
Real estate mortgage	$ 12,051	$ 44,623	$ 117,538	$ 174,212
Real estate construction and land development	7,684	4,709	3,408	15,801
Commercial	6,489	13,336	9,727	29,552
Consumer	6,238	22,102	32,028	60,368
Agriculture	12,783	9,303	13,038	35,124
Total	$ 45,245	$ 94,073	$ 175,739	$ 315,057
Loans maturing after one year with:				
Fixed interest rates		$ 34,873	$ 37,514	$ 72,387
Variable interest rates		59,200	138,225	167,425
Total		$ 94,073	$ 175,739	$ 269,812

Analysis of Asset Quality and Allowance for Loan Losses. The Company attempts to minimize credit risk through its underwriting and credit review policies. The Company s credit review process includes internally prepared credit reviews as well as contracting with an outside firm to conduct periodic credit reviews. The Company s management and lending officers evaluate the loss exposure of classified and impaired loans on a quarterly basis, or more frequently as loan conditions change. The Management Asset Resolution Committee (MARC) reviews the asset quality of criticized loans on a monthly basis and reports the findings to the full Board of Directors. The Board s Loan Committee reviews the asset quality of new loans on a monthly basis and reports the findings to the full Board of Directors. In management's opinion, this loan review system helps facilitate the early identification of potential criticized loans.

Table of Contents

The Company has implemented MARC to develop an action plan to significantly reduce nonperforming loans. It consists of members of executive management and credit administration management, and the activities are governed by a formal written charter. The MARC meets at least monthly and reports to the Board of Directors.

More specifically, a formal plan to effect repayment and/or disposition of every significant nonperforming loan relationship is developed and documented for review and on-going oversight by the MARC. Some of the strategies used include but are not limited to: 1) obtaining additional collateral, 2) obtaining additional investor cash infusion, 3) sale of the promissory note to an outside party, 4) proceeding with foreclosure on the underlying collateral, and 5) legal action against borrower/guarantors to encourage settlement of debt and/or collect any deficiency balance owed. Each step includes a benchmark timeline to track progress.

MARC also provides guidance for the maintenance and timely disposition of OREO properties; including developing financing and marketing programs to incent individuals to purchase OREO.

The allowance for loan losses is established through charges to earnings in the form of the provision for loan losses. Loan losses are charged to and recoveries are credited to the allowance for loan losses. The allowance for loan losses is maintained at a level deemed appropriate by management to provide for known and inherent risks in the loan portfolio. The adequacy of the allowance for loan losses is based upon management's continuing assessment of various factors affecting the collectability of loans; including current economic conditions, maturity of the portfolio, size of the portfolio, industry concentrations, borrower credit history, collateral, the existing allowance for loan losses, independent credit reviews, current charges and recoveries to the allowance for loan losses and the overall quality of the portfolio as determined by management, regulatory agencies, and independent credit review consultants retained by the Company. There is no precise method of predicting specific losses or amounts which may ultimately be charged off on particular segments of the loan portfolio. The collectability of a loan is subjective to some degree, but must relate to the borrower s financial condition, cash flow, quality of the borrower s management expertise, collateral and guarantees, and state of the local economy.

Formula allocations are calculated by applying loss factors to outstanding loans with similar characteristics. Loss factors are based on the Company s historical loss experience as adjusted for changes in the business cycle and may be adjusted for significant factors that, in management's judgment, affect the collectability of the portfolio as of the evaluation date. Effective for the third quarter of 2012, the Company modified its method of estimating the allowance for loan losses for non-impaired loans. This modification incorporated historical losses from the beginning of the latest business cycle. Previously we utilized historical loss experience based on a rolling eight quarters ending with the most recently completed calendar quarter. This modification had the effect of increasing the required allowance by approximately $250,000 for 2012 related to the expanded historical loss period. The Company believes that, given the recent trend in historical losses, it was prudent to increase the period examined and that a full business cycle was the appropriate period.

The discretionary allocation is based upon management s evaluation of various loan segment conditions that are not directly measured in the determination of the formula and specific allowances. The conditions may include, but are not limited to, general economic and business conditions affecting the key lending areas of the Company, credit quality trends, collateral values, loan volumes and concentrations, and other business conditions.

Table of Contents

The following table provides certain information for the years indicated with respect to the Company's allowance for loan losses as well as charge-off and recovery activity.

	For the Year Ended December 31,				
	2012	2011	2010	2009	2008
	(dollars in thousands)				
Balance at beginning of period	$ 6,908	$ 7,324	$ 9,568	$ 7,224	$ 4,211
Charge-offs:					
Commercial and agricultural	1,159	539	1,219	663	477
Real estate mortgage	616	483	3,105	1,145	95
Real estate construction	1,524	2,603	3,617	10,133	522
Consumer	602	622	408	559	689
Total charge-offs	3,901	4,247	8,349	12,500	1,783
Recoveries:					
Commercial and agricultural	66	199	26	18	11
Real estate mortgage	8	18	396	8	14
Real estate construction	81	5	65	90	
Consumer	174	109	118	228	171
Total recoveries	329	331	605		