FIRST DEFIANCE FINANCIAL CORP
Form 10-Q
August 06, 2010

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. For the Quarterly Period Ended June 30, 2010**

OR

¨ **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 For the Transition Period from __________ to __________**

Commission file number 0-26850

First Defiance Financial Corp.

(Exact name of registrant as specified in its charter)

Ohio	**34-1803915**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification Number)**
601 Clinton Street, Defiance, Ohio	**43512**
(Address or principal executive office)	**(Zip Code)**

Registrant s telephone number, including area code: (419) 782-5015

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

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

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

Large accelerated filer ¨	Accelerated filer x
Non-accelerated filer ¨	Smaller reporting company ¨

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

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practical date. Common Stock, $.01 Par Value 8,117,770 shares outstanding at July 31, 2010.

FIRST DEFIANCE FINANCIAL CORP.

INDEX

PART 1-FINANCIAL INFORMATION

Item 1. Financial Statements

FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Financial Condition

(UNAUDITED)

(Amounts in Thousands, except share and per share data)

	June 30, 2010	December 31, 2009
Assets		
Cash and cash equivalents:		
Cash and amounts due from depository institutions	**$ 33,528**	$ 29,613
Interest-bearing deposits	**88,544**	91,503
	122,072	121,116
Securities:		
Available-for-sale, carried at fair value	**159,131**	137,458
Held-to-maturity, carried at amortized cost (fair value $1,868 and $1,958 at June 30, 2010 and December 31, 2009, respectively)	**1,836**	1,920
	160,967	139,378
Loans held for sale	**16,000**	10,346
Loans receivable, net of allowance of $38,852 at June 30, 2010 and $36,547 at December 31, 2009, respectively	**1,532,561**	1,580,575
Accrued interest receivable	**6,973**	6,851
Federal Home Loan Bank stock	**21,376**	21,376
Bank owned life insurance	**30,767**	30,804
Premises and equipment	**42,378**	43,597
Real estate and other assets held for sale	**12,735**	13,527
Goodwill	**57,556**	56,585
Core deposit and other intangibles	**6,841**	6,888
Mortgage servicing rights	**8,720**	8,958
Deferred taxes	**3,495**	3,289
Other assets	**16,215**	14,233
Total assets	**$ 2,038,656**	$ 2,057,523

(continued)

FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Financial Condition

(UNAUDITED)

(Amounts in Thousands, except share and per share data)

	June 30, 2010	December 31, 2009
Liabilities and stockholders equity		
Liabilities:		
Deposits	**$ 1,580,520**	$ 1,580,226
Advances from the Federal Home Loan Bank	**126,906**	146,927
Securities sold under repurchase agreements	**44,702**	48,398
Subordinated debentures	**36,083**	36,083
Advance payments by borrowers	**379**	665
Other liabilities	**11,628**	11,138
Total liabilities	**1,800,218**	1,823,437
Stockholders equity:		
Preferred stock, $.01 par value per share: 37,000 shares authorized and issued with a liquidation preference of $37,236, net of discount	**36,375**	36,293
Preferred stock, $.01 par value per share: 4,963,000 shares authorized; no shares issued		
Common stock, $.01 par value per share: 25,000,000 shares authorized; 12,739,496 and 12,739,496 shares issued and 8,117,770 and 8,117,520 shares outstanding, respectively	**127**	127
Common stock warrant	**878**	878
Additional paid-in capital	**140,767**	140,677
Accumulated other comprehensive income (loss), net of tax of $535 and $(85), respectively	**1,460**	(158)
Retained earnings	**131,459**	128,900
Treasury stock, at cost, 4,621,726 and 4,621,976 shares respectively	**(72,628)**	(72,631)
Total stockholders equity	**238,438**	234,086
Total liabilities and stockholders equity	**$ 2,038,656**	$ 2,057,523

See accompanying notes

FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Income

(UNAUDITED)

(Amounts in Thousands, except per share data)

	Three Months Ended June 30, 2010	Three Months Ended June 30, 2009	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Interest Income				
Loans	**$ 22,477**	$ 23,086	**$ 44,874**	$ 46,463
Investment securities:				
Taxable	**1,078**	996	**2,068**	2,079
Non-taxable	**491**	478	**953**	887
Interest-bearing deposits	**69**	33	**130**	47
FHLB stock dividends	**234**	229	**453**	468
Total interest income	**24,349**	24,822	**48,478**	49,944
Interest Expense				
Deposits	**5,126**	6,859	**10,524**	14,042
FHLB advances and other	**1,220**	1,279	**2,438**	2,598
Subordinated debentures	**327**	369	**650**	795
Notes payable	**115**	136	**220**	293
Total interest expense	**6,788**	8,643	**13,832**	17,728
Net interest income	**17,561**	16,179	**34,646**	32,216
Provision for loan losses	**5,440**	3,965	**12,329**	6,711
Net interest income after provision for loan losses	**12,121**	12,214	**22,317**	25,505
Non-interest Income				
Service fees and other charges	**3,397**	3,326	**6,555**	6,412
Insurance commission income	**1,309**	1,293	**2,417**	2,816
Mortgage banking income	**985**	3,983	**2,792**	6,697
Gain on sale of non-mortgage loans	**50**	45	**87**	100
Gain on sale or call of securities		125	**6**	125
Other-than-temporary impairment (OTTI) losses on investment securities				
Total impairment losses on investment securities	**(71)**	(947)	**(145)**	(1,861)
Losses recognized in other comprehensive income		72	**4**	314
Net impairment loss recognized in earnings	**(71)**	(875)	**(141)**	(1,547)
Trust income	**132**	103	**254**	205
Income from Bank Owned Life Insurance	**212**	78	**691**	137
Other non-interest income	**(223)**	281	**(103)**	218
Total non-interest income	**5,791**	8,359	**12,558**	15,163
Non-interest Expense				
Compensation and benefits	**6,589**	7,585	**13,047**	14,950
Occupancy	**1,701**	1,924	**3,529**	4,041

FDIC insurance premium	**929**	1,497	**1,975**	2,064
State franchise tax	**516**	596	**1,079**	1,097
Data processing	**1,174**	1,176	**2,370**	2,230
Acquisition related charges	**37**		**37**	
Amortization of intangibles	**345**	355	**783**	746
Other non-interest expense	**3,754**	3,000	**7,057**	6,001
Total non-interest expense	**15,045**	16,133	**29,877**	31,129
Income before income taxes	**2,867**	4,440	**4,998**	9,539
Federal income taxes	**808**	1,539	**1,432**	3,230
Net Income	**$ 2,059**	$ 2,901	**$ 3,566**	$ 6,309
Dividends accrued on preferred shares	**$ (462)**	$ (468)	**$ (925)**	$ (930)
Accretion on preferred shares	**$ (42)**	$ (40)	**$ (82)**	$ (78)
Net income applicable to common shares	**$ 1,555**	$ 2,393	**$ 2,559**	$ 5,301
Earnings per common share (Note 7)				
Basic	**$ 0.19**	$ 0.29	**$ 0.32**	$ 0.65
Diluted	**$ 0.19**	$ 0.29	**$ 0.31**	$ 0.65
Dividends declared per share (Note 6)	**$**	$ 0.085	**$**	$ 0.255
Average shares outstanding (Note 7)				
Basic	**8,118**	8,117	**8,118**	8,117
Diluted	**8,193**	8,182	**8,169**	8,117

See accompanying notes

FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Changes in Stockholders Equity

(UNAUDITED)

(Amounts in Thousands)

	Preferred Stock	Common Stock	Common Stock Warrant	Treasury Stock	Additional Paid-In Capital	Accumulated Other Comprehensive Income (Loss)	Retained Earnings	Total Stockholders Equity
Balance at January 1, 2010	$ 36,293	$ 127	$ 878	$ (72,631)	$ 140,677	$ (158)	$ 128,900	$ 234,086
Comprehensive income:								
Net income							3,566	3,566
Change in net unrealized gains and losses on available-for-sale securities, net of income taxes of $871						1,618		1,618
Total comprehensive income								5,184
Stock option expense					90			90
Stock options exercised				3				3
Preferred Stock Dividends							(925)	(925)
Accretion on preferred shares	82						(82)	
Balance at June 30, 2010	**$ 36,375**	**$ 127**	**$ 878**	**$ (72,628)**	**$ 140,767**	**$ 1,460**	**$ 131,459**	**$ 238,438**
Balance at January 1, 2009	$ 36,134	$ 127	$ 878	$ (72,638)	$ 140,447	$ (1,904)	$ 126,115	$ 229,159
Comprehensive income:								
Net income							6,309	6,309
Change in net unrealized gains and losses on available-for-sale securities, net of income taxes of $51						91		91
Total comprehensive income								6,400
Stock option expense					120			120
Stock options exercised				7			(2)	5
Preferred stock dividends							(930)	(930)
Accretion on preferred shares	77						(77)	
Common stock dividends declared							(2,071)	(2,071)
Balance at June 30, 2009	$ 36,211	$ 127	$ 878	$ (72,631)	$ 140,567	$ (1,813)	$ 129,344	$ 232,683

See Accompanying Notes

FIRST DEFIANCE FINANCIAL CORP.

Consolidated Condensed Statements of Cash Flows

(UNAUDITED)

(Amounts in Thousands)

	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Operating Activities		
Net income	**$ 3,566**	$ 6,309
Items not requiring (providing) cash		
Provision for loan losses	**12,329**	6,711
Depreciation	**1,722**	1,917
Amortization of mortgage servicing rights, net of impairment (recoveries)	**1,086**	422
Amortization of core deposit and other intangible assets	**783**	746
Net amortization of premiums and discounts on loans and deposits	**545**	555
Amortization of premiums and discounts on securities	**229**	(500)
Change in deferred taxes	**(1,077)**	233
Proceeds from the sale of loans held for sale	**111,243**	340,315
Originations of loans held for sale	**(115,369)**	(350,181)
Gain from sale of loans	**(2,463)**	(5,839)
OTTI losses on investment securities	**141**	1,547
Gain from sale or call of securities	**(6)**	(125)
Loss on sale or write-down of real estate and other assets held for sale	**1,037**	714
Loss on sale of premises and equipment	**1**	6
Stock option expense	**90**	120
Income from bank owned life insurance	**(423)**	(137)
Gain on life insurance	**(268)**	
Changes in:		
Accrued interest receivable	**(122)**	271
Other assets	**(1,982)**	(1,509)
Other liabilities	**283**	(1,458)
Net cash provided by (used in) operating activities	**11,345**	117
Investing Activities		
Proceeds from maturities of held-to-maturity securities	**84**	55
Proceeds from maturities, calls and pay-downs of available-for-sale securities	**17,473**	10,139
Proceeds from sale of real estate and other assets held for sale	**7,405**	1,329
Proceeds from the sale of available-for-sale securities	**28**	3,604
Proceeds from sale of non-mortgage loans	**6,204**	2,867
Purchases of available-for-sale securities	**(37,049)**	(29,958)
Proceeds from bank owned life insurance	**728**	
Purchases of premises and equipment, net	**(505)**	(1,002)
Net cash paid for group benefits line of business	**(1,500)**	
Net decrease (increase) in loans receivable	**21,321**	(5,749)
Net cash provided by investing activities	**14,190**	(18,715)
Financing Activities		

Net increase in deposits and advance payments by borrowers	**60**	83,098
Repayment of Federal Home Loan Bank long-term advances	**(20,021)**	(20)
Net increase (decrease) in Federal Home Loan Bank short-term advances		(9,100)
Increase (decrease) in securities sold under repurchase agreements	**(3,696)**	(9,170)
Proceeds from the exercise of stock options	**3**	5
Cash dividends paid on common stock		(2,761)
Cash dividends paid on preferred stock	**(925)**	(822)
Net cash provided by (used in) financing activities	**(24,579)**	61,230
Increase (decrease) in cash and cash equivalents	**956**	42,632
Cash and cash equivalents at beginning of period	**121,116**	46,152
Cash and cash equivalents at end of period	**$ 122,072**	$ 88,784
Supplemental cash flow information:		
Interest paid	**$ 13,942**	$ 17,585
Income taxes paid	**$ 2,650**	$ 6,000
Transfers from loans to other real estate owned and other assets held for sale	**$ 9,172**	$ 3,610

See accompanying notes.

FIRST DEFIANCE FINANCIAL CORP.

Notes to Consolidated Condensed Financial Statements

(Unaudited at June 30, 2010 and 2009)

1. Basis of Presentation

First Defiance Financial Corp. (First Defiance or the Company) is a unitary thrift holding company that conducts business through its two wholly owned subsidiaries, First Federal Bank of the Midwest (First Federal) and First Insurance and Investments, Inc. (First Insurance). All significant intercompany transactions and balances are eliminated in consolidation.

First Federal is primarily engaged in attracting deposits from the general public through its offices and using those and other available sources of funds to originate loans primarily in the counties in which its offices are located. First Federal s traditional banking activities include originating and servicing residential, commercial and consumer loans and providing a broad range of depository, trust and wealth management services. First Insurance is an insurance agency that does business in the Defiance, Archbold, Bryan, and Bowling Green, Ohio areas offering property and casualty, and group health and life insurance products. In May 2010, First Insurance acquired a group medical benefits business line from Andres O Neil & Lowe Insurance Agency.

The consolidated condensed statement of financial condition at December 31, 2009 has been derived from the audited financial statements at that date, which were included in First Defiance s Annual Report on Form 10-K.

The accompanying consolidated condensed financial statements as of June 30, 2010 and for the three and six month periods ended June 30, 2010 and 2009 have been prepared by First Defiance without audit and do not include information or footnotes necessary for the complete presentation of financial condition, results of operations, and cash flows in conformity with accounting principles generally accepted in the United States. These consolidated condensed financial statements should be read in conjunction with the financial statements and notes thereto included in First Defiance s 2009 Annual Report on Form 10-K for the year ended December 31, 2009. However, in the opinion of management, all adjustments, consisting of only normal recurring items, necessary for the fair presentation of the financial statements have been made. The results for the three and six month periods ended June 30, 2010 are not necessarily indicative of the results that may be expected for the entire year.

2. Significant Accounting Policies

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. Significant areas where First Defiance uses estimates are the valuation of certain investment securities, the determination of the allowance for loan losses, the valuation of mortgage servicing rights and goodwill, the determination of unrecognized income tax benefits, and the determination of post-retirement benefits.

Earnings Per Common Share

Basic earnings per common share is net income applicable to common shares divided by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per common share include the dilutive effect of additional potential common shares issuable under stock options, warrants and stock grants.

Reclassifications

Some items in the prior financial statements were reclassified to conform to the current presentation.

Adoption of New Accounting Standards

In July 2010, the FASB issued ASU No. 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, which requires significant new disclosures about the allowance for credit losses and the credit quality of financing receivables. The requirements are intended to enhance transparency regarding credit losses and the credit quality of loan and lease receivables. Under this statement, allowance for credit losses and fair value are to be disclosed by portfolio segment, while credit quality information, impaired financing receivables and nonaccrual status are to be presented by class of financing receivable. Disclosure of the nature and extent, the financial impact and segment information of troubled debt restructurings will also be required. The disclosures are to be presented at the level of disaggregation that management uses when assessing and monitoring the portfolio s risk and performance. This ASU is effective for interim and annual reporting periods after December 15, 2010. The Company will include these disclosures in the notes to the December 31, 2010 financial statements.

3. Comprehensive Income

Comprehensive income consists of net income and other comprehensive income (loss) (OCI). Other comprehensive income (loss) includes unrealized gains and losses on securities available-for-sale and the net unrecognized actuarial losses and unrecognized prior services costs associated with the Company s Defined Benefit Postretirement Medical Plan. All items reported in other comprehensive income (loss) are reported net of tax. Following is a summary of other comprehensive income (loss) for the three and six months ended June 30, 2010 and 2009:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2010	2009	2010	2009
	(In thousands)			
Net income	**$ 2,059**	$ 2,901	**$ 3,566**	$ 6,309
Change in securities available-for-sale (AFS):				
Unrealized gains (losses) on securities AFS for which other-than-temporary impairment losses have been recognized in income	**(52)**	(373)	**(81)**	(1,378)
Other-than-temporary impairment losses on AFS realized in income	**71**	875	**141**	1,547
Net unrealized gains (losses)	**19**	502	**60**	169
Unrealized holding gains (losses) on securities AFS arising during the period	**1,741**	43	**2,435**	98
Reclassification adjustment for (gains) losses realized in income		(125)	**(6)**	(125)
Net unrealized gains (losses)	**1,741**	(82)	**2,429**	(27)
Income tax effect	**(615)**	(149)	**(871)**	(51)
Other comprehensive income (loss)	**1,145**	271	**1,618**	91
Comprehensive income	**$ 3,204**	$ 3,172	**$ 5,184**	$ 6,400

The following table summarizes the changes within each classification of accumulated comprehensive income for the six months ended June 30, 2010 and 2009:

	Unrealized gains (losses) on available for sale securities	Postretirement Benefit	Accumulated other comprehensive income (loss),net
		(In thousands)	
Balance at December 31, 2009	$ 468	$ (626)	$ (158)
Other comprehensive income (loss), net	1,618		1,618
Balance at June 30, 2010	$ 2,086	$ (626)	$ 1,460

	Unrealized gains (losses) on available for sale securities	Postretirement Benefit	Accumulated other comprehensive income (loss), net
		(In thousands)	
Balance at December 31, 2008	$ (1,100)	$ (804)	$ (1,904)
Other comprehensive income (loss), net	91		91
Balance at June 30, 2009	$ (1,009)	$ (804)	$ (1,813)

4. Fair Value

FASB ASC Topic 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact and (iv) willing to transact.

FASB ASC Topic 820 requires the use of valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement cost). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on the best information available. In that regard, FASB ASC Topic 820 established a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1: Quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2: Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by a correlation or other means.

Level 3: Unobservable inputs for determining fair value of assets and liabilities that reflect an entity s own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

Available for sale securities - Securities classified as available for sale are generally reported at fair value utilizing Level 2 inputs where the Company obtains fair value measurements from an independent pricing service which uses matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities relationship to other benchmark quoted securities (Level 2 inputs). The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows and the bonds terms and conditions, among other things. Securities in Level 1 include federal agency preferred stock securities. Securities in Level 2 include U.S. Government agencies, mortgage-backed securities and municipal securities. The Company classifies its pooled trust preferred collateralized debt obligations as Level 3. The portfolio consists of collateralized debt obligations backed by pools of trust preferred securities issued by financial institutions and insurance companies. Based on the lack of observable market data, the Company estimated fair values based on the observable data available and reasonable unobservable market data. The Company estimated fair value based on a discounted cash flow model which used appropriately adjusted discount rates reflecting credit and liquidity risks. The Company s valuations were supported by analysis prepared by an independent third party that is described further in Note 8.

Impaired loans - The fair value of impaired loans with specific allocations of the allowance for loan loss is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are typically significant and result in impaired loans being valued using Level 3 inputs.

Mortgage servicing rights - Mortgage servicing rights are reported at fair value utilizing Level 2 inputs. MSRs are valued by a third party consultant using a proprietary cash flow valuation model.

Mortgage banking derivative - The fair value of mortgage banking derivatives are based on derivative valuation models using market data inputs as of the valuation date (Level 2).

Real estate held for sale - Real estate held for sale is determined using Level 3 inputs which include current and prior appraisals and estimated costs to sell.

The following table summarizes the financial assets measured at fair value on a recurring basis segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

Assets and Liabilities Measured on a Recurring Basis

June 30, 2010	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
		(In Thousands)		
Available for sale securities:				
Obligations of U.S. Government corporations and agencies	$	$ 19,189	$	$ 19,189
Mortgage-backed residential		35,117		35,117
REMICs		3,702		3,702
Collateralized mortgage obligations		52,033		52,033
Trust preferred stock			1,516	1,516
Preferred stock	27			27
Obligations of state and political subdivisions		47,547		47,547
Mortgage banking derivative asset		825		825
Mortgage banking derivative liability		341		341

December 31, 2009	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
		(In Thousands)		
Available for sale securities:				
Obligations of U.S. Government corporations and agencies	$	$ 14,251	$	$ 14,251
Mortgage-backed residential		31,504		31,504
REMICs		3,923		3,923
Collateralized mortgage obligations		41,371		41,371
Trust preferred stock			1,589	1,589
Preferred stock	87			87
Obligations of state and political subdivisions		44,733		44,733
Mortgage banking derivative asset		380		380
Mortgage banking derivative liability				

The table below presents a reconciliation and income classification of gains and losses for all assets measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the three and six months ended June 30, 2010 and June 30, 2009:

	Fair Value Measurements Using Significant Unobservable Inputs (Level 3) (In Thousands)
Beginning balance, January 1, 2010	**$ 1,589**
Total gains or losses (realized/unrealized)	
Included in earnings	**(141)**
Included in other comprehensive income (presented gross of taxes)	**87**
Purchases, issuances, and settlements	**6**
Sales	**(25)**
Transfers in and/or out of Level 3	
Ending balance, June 30, 2010	**$ 1,516**

		Fair Value Measurements Using Significant Unobservable Inputs (Level 3) (In Thousands)
Beginning balance, April 1, 2010	$	1,579
Total gains or losses (realized/unrealized)		
Included in earnings		(71)
Included in other comprehensive income (presented gross of taxes)		5
Purchases, issuances, and settlements		3
Sales		
Transfers in and/or out of Level 3		
Ending balance, June 30, 2010	$	1,516

		Fair Value Measurements Using Significant Unobservable Inputs (Level 3) (In Thousands)
Beginning balance, January 1, 2009	$	3,873
Total gains or losses (realized/unrealized)		
Included in earnings		(1,547)
Included in other comprehensive income (presented gross of taxes)		(161)
Purchases, issuances, and settlements		(4)
Transfers in and/or out of Level 3		
Ending balance, June 30, 2009	$	2,161

		Fair Value Measurements Using Significant Unobservable Inputs (Level 3) (In Thousands)
Beginning balance, April 1, 2009	$	2,371
Total gains or losses (realized/unrealized)		
Included in earnings		(875)
Included in other comprehensive income (presented gross of taxes)		663
Purchases, issuances, and settlements		2
Transfers in and/or out of Level 3		
Ending balance, June 30, 2009	$	2,161

The following table summarizes the financial assets measured at fair value on a non-recurring basis segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

Assets and Liabilities Measured on a Non-Recurring Basis

June 30, 2010	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
		(In Thousands)		
Impaired loans	$	$	$ 28,377	$ 28,377
Mortgage servicing rights		8,720		8,720
Real estate held for sale			1,148	1,148

December 31, 2009	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
		(In Thousands)		
Impaired loans	$	$	$ 28,336	$ 28,336
Mortgage servicing rights		8,958		8,958
Real estate held for sale			935	935

Impaired loans, which are measured for impairment using the fair value of the collateral for collateral dependent loans, had a fair value of $28,377,000, with a valuation allowance of $14,226,000 at June 30, 2010. A provision expense of $3,576,000 and $9,467,000 for the three and six months ended June 30, 2010 was included in earnings.

Mortgage servicing rights which are carried at lower of cost or fair value had a fair value of $8,720,000 at June 30, 2010, resulting in a valuation allowance of $1,728,000. A charge of $571,000 and $250,000 for the three and six months ended June 30, 2010 was included in earnings.

Real estate held for sale is determined using Level 3 inputs which include appraisals and estimated costs to sell. The change in fair value of real estate held for sale was $607,000 and $1,028,000 for the three and six months ended June 30, 2010 which was recorded directly as an adjustment to current earnings through non-interest expense.

In accordance with FASB ASC Topic 825, the table below is a comparative condensed consolidated statement of financial condition based on carrying amount and estimated fair values of financial instruments as of June 30, 2010 and December 31, 2009. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of First Defiance.

Much of the information used to arrive at fair value is highly subjective and judgmental in nature and therefore the results may not be precise. Subjective factors include, among other things, estimated cash flows, risk characteristics and interest rates, all of which are subject to change. With the exception of investment securities, the Company s financial instruments are not readily marketable and market prices do not exist. Since negotiated prices for the instruments, which are not readily marketable depend greatly on the motivation of the buyer and seller, the amounts that will actually be realized or paid per settlement or maturity of these instruments could be significantly different.

The carrying amount of cash and cash equivalents, term notes payable and advance payments by borrowers for taxes and insurance, as a result of their short-term nature, is considered to be equal to fair value.

Fair value for available for sale securities is as previously described. For investment securities held to maturity, fair has been based on current market quotations. If market prices are not available, fair value has been estimated based upon the quoted price of similar instruments.

It was not practicable to determine the fair value of the Federal Home Loan Bank (FHLB) stock due to restrictions placed on its transferability.

The fair value of loans which reprice within 90 days is equal to their carrying amount. For other loans, the estimated fair value is calculated based on discounted cash flow analysis, using interest rates currently being offered for loans with similar terms. The allowance for loan losses is considered to be a reasonable adjustment for credit risk.

FASB ASC Topic 825 requires that the fair value of demand, savings, NOW and certain money market accounts be equal to their carrying amount. The Company believes that the fair value of these deposits may be greater or less than that prescribed by FASB ASC Topic 825.

The carrying value of subordinated debentures and deposits with fixed maturities is estimated based on interest rates currently being offered on instruments with similar characteristics and maturities. FHLB advances with maturities greater than 90 days are valued based on discounted cash flow analysis, using interest rates currently being quoted for similar characteristics and maturities. The cost or value of any call or put options is based on the estimated cost to settle the option at June 30, 2010.

	June 30, 2010		December 31, 2009	
	Carrying Value	Estimated Fair Values	Carrying Value	Estimated Fair Values
	(In Thousands)			
Assets:				
Cash and cash equivalents	**$ 122,072**	**$ 122,072**	$ 121,116	$ 121,116
Investment securities	**160,967**	**160,999**	139,378	139,416
Federal Home Loan Bank Stock	**21,376**	**N/A**	21,376	N/A
Loans, net, including loans held for sale	**1,548,561**	**1,559,692**	1,590,921	1,586,101
Mortgage banking derivative asset	**825**	**825**	380	380
Accrued interest receivable	**6,973**	**6,973**	6,851	6,851
	1,860,774	**$ 1,850,561**	1,880,022	$ 1,853,864
Other assets	**177,882**		177,501	
Total assets	**$ 2,038,656**		$ 2,057,523	
Liabilities and stockholders equity:				
Deposits	**$ 1,580,520**	**$ 1,585,426**	$ 1,580,226	$ 1,586,466
Advances from Federal Home Loan Bank	**126,906**	**133,820**	146,927	152,643
Securities sold under repurchase agreements	**44,702**	**44,702**	48,398	48,398
Subordinated debentures	**36,083**	**33,382**	36,083	32,057
Mortgage banking derivative liability	**341**	**341**		
Accrued interest payable	**1,124**	**1,124**	1,234	1,234
Advance payments by borrowers for taxes and insurance	**379**	**379**	665	665
	1,790,055	**$ 1,799,174**	1,813,533	$ 1,821,463
Other liabilities	**10,163**		9,904	
Total liabilities	**1,800,218**		1,823,437	
Stockholders equity	**238,438**		234,086	
Total liabilities and stockholders equity	**$ 2,036,656**		$ 2,057,523	

5. Stock Compensation Plans

First Defiance has established incentive stock option plans for its directors and employees. On March 15, 2010, the Board adopted, and the shareholders approved at the 2010 Annual Shareholders Meeting, the First Defiance Financial Corp. 2010 Equity Incentive Plan (the 2010 Equity Plan). The 2010 Equity Plan replaces all existing plans. All awards currently outstanding under the prior plans will remain in effect in accordance with their respective terms. Any new awards will be made under the 2010 Equity Plan. As of June 30, 2010, 425,550 options (403,550 for employees and 22,000 for directors) had been granted under prior option plans and remain outstanding at option prices based on the market value of the underlying shares on the date the options were granted. Options granted under all plans vest 20% per year except for the options granted in 2009 to the Company s then five most-highly compensated employees, which options vest 40% in 2011 and then 20% annually, subject to certain other limitations. As of June 30, 2010, 294,670 of the outstanding options were currently exercisable. No options have been granted under the 2010 Equity Plan. All options expire ten years from date of grant. Vested options of retirees expire on the earlier of the scheduled expiration date or three months after the retirement date.

The fair value of each option award is estimated on the date of grant using the Black-Scholes model. Expected volatilities are based on historical volatilities of the Company s common stock. The Company uses historical data to estimate option exercise and post-vesting termination behavior. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant.

	Six Months Ended June 30,	
	2010	**2009**
Expected average risk-free rate		3.38%
Expected average life		6.41 years
Expected volatility		26.10%
Expected dividend yield		3.62%

There were no options granted during the six months ended June 30, 2010. The weighted-average fair value of options granted for the six months ended June 30, 2009 was $1.87.

Following is activity under the prior option plans:

	Options Outstanding	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)	Aggregate Intrinsic Value
Options outstanding, beginning of period	**467,500**	**$ 19.41**		
Forfeited or cancelled	**(41,700)**	**20.82**		
Exercised	**(250)**	**9.22**		
Granted				
Options outstanding, end of period	**425,550**	**$ 19.28**	**5.3**	**$**
Vested or expected to vest at period end	**425,550**	**$ 19.28**	**5.3**	**$**
Exercisable at period end	**294,670**	**$ 20.63**	**4.1**	**$**

Proceeds, related tax benefits realized from options exercised and intrinsic value of options exercised were as follows:

	Six Months Ended June 30, 2010	Six Months Ended June 30, 2009
Cash received from option exercises	**$ 3,000**	$ 5,000
Tax benefit realized from option exercises		
Intrinsic value of options exercised	**1,000**	1,000

As of June 30, 2010, there was $311,000 of total unrecognized compensation costs related to unvested stock options granted under the Company s prior stock option plans. The cost is expected to be recognized over a weighted-average period of 2.57 years.

6. Dividends on Common Stock

No common stock dividends were declared by First Defiance in the first six months of 2010. A quarterly cash dividend of $0.17 and $0.085 per common share was declared for the first and second quarter of 2009, respectively.

As a result of its participation in the U.S. Treasury s Capital Purchase Program (CPP), First Defiance is prohibited without prior approval of the U.S. Treasury, from paying a quarterly cash dividend of more than $0.26 per share until the earlier of December 5, 2011 or the date the preferred stock issued to the U.S. Treasury by First Defiance is redeemed or transferred to an unaffiliated third party. Further, First Defiance has agreed with its primary regulator to obtain approval of cash dividends prior to declaration.

7. Earnings Per Common Share

The following table sets forth the computation of basic and diluted earnings per common share (in thousands except per share data):

	Three months ended June 30,		Six months ended June 30,	
	2010	**2009**	**2010**	**2009**
Numerator for basic and diluted earnings per common share Net income applicable to common shares	**$ 1,555**	$ 2,393	**$ 2,559**	$ 5,301
Denominator:				
Denominator for basic earnings per common share weighted average common shares	**8,118**	8,117	**8,118**	8,117
Effect of warrants	**71**	65	**49**	
Effect of employee stock options	**4**		**2**	
Denominator for diluted earnings per common share	**8,193**	8,182	**8,169**	8,117
Basic earnings per common share	**$ 0.19**	$ 0.29	**$ 0.32**	$ 0.65
Diluted earnings per common share	**$ 0.19**	$ 0.29	**$ 0.31**	$ 0.65

There were 421,230 and 423,551 shares under option granted to employees excluded from the diluted earnings per common share calculation as they were anti-dilutive for the three and six months ended June 30, 2010. There were 490,750 shares under option granted to employees excluded from the diluted earnings per common share calculation as they were anti-dilutive for the three and six months ended June 30, 2009. Shares under option of 550,595 issuable related to warrants were excluded from the diluted earnings per common share calculations as they were anti-dilutive for the six months ended June 30, 2009.

8. Investment Securities

The following is a summary of available-for-sale and held-to-maturity securities (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
At June 30, 2010				
Available-for-Sale Securities:				
Obligations of U.S. government corporations and agencies	**$ 18,978**	**$ 211**	**$**	**$ 19,189**
Mortgage-backed securities residential	**33,402**	**1,715**		**35,117**
REMICs	**3,530**	**172**		**3,702**
Collateralized mortgage obligations	**49,858**	**2,205**	**(30)**	**52,033**
Trust preferred securities and preferred stock	**3,962**		**(2,419)**	**1,543**
Obligations of state and political subdivisions	**46,191**	**1,578**	**(222)**	**47,547**
Totals	**$ 155,921**	**$ 5,881**	**$ (2,671)**	**$ 159,131**
Held-to-Maturity Securities*:				
FHLMC certificates	**$ 101**	**$ 7**	**$**	**$ 108**
FNMA certificates	**282**	**7**		**289**
GNMA certificates	**94**	**3**		**97**
Obligations of state and political subdivisions	**1,359**	**15**		**1,374**
Totals	**$ 1,836**	**$ 32**	**$**	**$ 1,868**
At December 31, 2009				
Available-for-Sale Securities:				
Obligations of U.S. government corporations and agencies	$ 14,038	$ 252	$ (39)	$ 14,251
Mortgage-backed securities residential	30,341	1,194	(31)	31,504
REMICs	3,718	205		3,923
Collateralized mortgage obligations	40,878	824	(331)	41,371
Trust preferred securities and preferred stock	4,122		(2,446)	1,676
Obligations of state and political subdivisions	43,640	1,251	(158)	44,733
Totals	$ 136,737	$ 3,726	$ (3,005)	$ 137,458
Held-to-Maturity Securities*:				
FHLMC certificates	$ 119	$ 7	$	$ 126
FNMA certificates	304	9		313
GNMA certificates	107	3		110
Obligations of state and political subdivisions	1,390	19		1,409
Totals	$ 1,920	$ 38	$	$ 1,958

* FHLMC, FNMA, and GNMA certificates are residential mortgage-backed securities.

The amortized cost and fair value of securities at June 30, 2010 by contractual maturity are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. For purposes of the maturity table, mortgage-backed securities (MBS), collateralized mortgage obligations (CMO) and real estate mortgage investment conduits (REMICs), which are not due at a single maturity date, have not been allocated over the maturity groupings. The MBS, CMO and REMIC securities may mature earlier than their weighted-average contractual maturities because of principal prepayments.

	Available-for-Sale		Held-to-Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
	(In Thousands)			
Due in one year or less	**$ 2,955**	**$ 2,943**		