AUBURN NATIONAL BANCORPORATION, INC
Form 10-Q
November 02, 2012
Table of Contents

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 September 30, 2012

[ ] Transition report pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934.

For the transition period __________ to __________

Commission File Number: 0-26486

Auburn National Bancorporation, Inc.

(Exact Name of Registrant as Specified in Its Charter)

Delaware	**63-0885779**
(State or other jurisdiction of	(I.R.S. Employer

incorporation or organization)	Identification No.)

100 N. Gay Street

Auburn, Alabama 36830

(334) 821-9200

(Address and telephone number of principal executive offices)

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

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No ¨

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

Yes x No ¨

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

Large Accelerated filer ¨	Accelerated filer ¨	Non-accelerated filer x	Smaller reporting company ¨
(Do not check if a smaller reporting company)			

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

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

Class	Outstanding at October 31, 2012
Common Stock, $0.01 par value per share	3,642,903 shares

Table of Contents

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

INDEX

Table of Contents

PART 1. FINANCIAL INFORMATION

ITEM 1. FINANCIAL STATEMENTS

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

(Unaudited)

(Dollars in thousands, except share data)	**September 30, 2012**	**December 31, 2011**
Assets:		
Cash and due from banks	$ 14,943	$ 12,395
Federal funds sold	41,765	41,840
Interest bearing bank deposits	583	1,193
Cash and cash equivalents	57,291	55,428
Securities available-for-sale	254,819	299,582
Loans held for sale	5,682	3,346
Loans, net of unearned income	397,738	370,263
Allowance for loan losses	(6,045)	(6,919)
Loans, net	391,693	363,344
Premises and equipment, net	10,199	9,345
Bank-owned life insurance	16,963	16,631
Other real estate owned	4,925	7,898
Other assets	11,895	20,644
Total assets	$ 753,467	$ 776,218
Liabilities:		
Deposits:		
Noninterest-bearing	$ 116,017	$ 106,276
Interest-bearing	513,807	513,276
Total deposits	629,824	619,552
Federal funds purchased and securities sold under agreements to repurchase	2,547	2,805
Long-term debt	47,217	85,313
Accrued expenses and other liabilities	3,673	3,132
Total liabilities	683,261	710,802
Stockholders equity:		
Preferred stock of $.01 par value; authorized 200,000 shares; no issued shares		
Common stock of $.01 par value; authorized 8,500,000 shares; issued 3,957,135 shares	39	39
Additional paid-in capital	3,756	3,753
Retained earnings	66,908	64,045
Accumulated other comprehensive income, net	6,145	4,222
	(6,642)	(6,643)

Less treasury stock, at cost - 314,232 shares and 314,397 shares at September 30, 2012 and December 31, 2011, respectively				
Total stockholders equity		70,206		65,416
Total liabilities and stockholders equity	$	753,467	$	776,218

See accompanying notes to consolidated financial statements

Table of Contents

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Earnings

(Unaudited)

	Quarter ended September 30,		Nine months ended September 30,	
(In thousands, except share and per share data)	**2012**	**2011**	**2012**	**2011**
Interest income:				
Loans, including fees	$ 5,548	$ 5,393	$ 16,303	$ 16,051
Securities	1,653	2,253	5,482	7,404
Federal funds sold and interest bearing bank deposits	11	14	32	37
Total interest income	7,212	7,660	21,817	23,492
Interest expense:				
Deposits	1,509	1,958	4,839	6,220
Short-term borrowings	4	3	13	9
Long-term debt	440	854	1,393	2,547
Total interest expense	1,953	2,815	6,245	8,776
Net interest income	5,259	4,845	15,572	14,716
Provision for loan losses	1,550	600	2,750	1,800
Net interest income after provision for loan losses	3,709	4,245	12,822	12,916
Noninterest income:				
Service charges on deposit accounts	268	301	838	882
Mortgage lending	1,038	566	2,492	1,334
Bank-owned life insurance	120	127	332	341
Gain on sale of affordable housing investments			3,268	
Affordable housing investment losses		(231)		(461)
Other	413	349	1,157	1,057
Securities gains, net:				
Realized gains, net	178	451	738	901
Total other-than-temporary impairments		(156)	(130)	(468)
Non-credit portion of other-than-temporary impairments (transferred from) recognized in other comprehensive income		(80)		130
Total securities gains, net	178	215	608	563
Total noninterest income	2,017	1,327	8,695	3,716
Noninterest expense:				
Salaries and benefits	2,209	2,147	6,557	6,090
Net occupancy and equipment	345	364	1,019	1,038
Professional fees	163	190	538	550
FDIC and other regulatory assessments	153	178	521	659
Other real estate owned, net	119	506	182	1,207

Prepayment penalty on long-term debt						3,720		
Other		781		883		2,823		2,626
Total noninterest expense		3,770		4,268		15,360		12,170
Earnings before income taxes		1,956		1,304		6,157		4,462
Income tax expense (benefit)		347		(63)		1,054		89
Net earnings	$	1,609	$	1,367	$	5,103	$	4,373
Net earnings per share:								
Basic and diluted	$	0.44	$	0.38	$	1.40	$	1.20
Weighted average shares outstanding:								
Basic and diluted		3,642,876		3,642,738		3,642,807		3,642,735

See accompanying notes to consolidated financial statements

4

Table of Contents

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

(Unaudited)

	Quarter ended September 30,		Nine months ended September 30,	
(Dollars in thousands)	**2012**	**2011**	**2012**	**2011**
Net earnings	$ 1,609	$ 1,367	$ 5,103	$ 4,373
Other comprehensive income, net of tax:				
Unrealized net holding gain (loss) on other-than-temporarily impaired securities due to factors other than credit		51		(82)
Unrealized net holding gain on all other securities	1,162	2,768	2,307	6,303
Reclassification adjustment for net gain on securities recognized in net earnings	(113)	(135)	(384)	(355)
Other comprehensive income	1,049	2,684	1,923	5,866
Comprehensive income	$ 2,658	$ 4,051	$ 7,026	$ 10,239

See accompanying notes to consolidated financial statements

5

Table of Contents

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Stockholders Equity

(Unaudited)

(Dollars in thousands, except share data)	Common Stock Shares	Common Stock Amount	Additional paid-in capital	Retained earnings	Accumulated other comprehensive (loss) income	Treasury stock	Total
Balance, December 31, 2010	3,957,135	$ 39	$ 3,752	$ 61,421	$ (2,201)	$ (6,643)	$ 56,368
Net earnings				4,373			4,373
Other comprehensive income					5,866		5,866
Cash dividends paid ($0.60 per share)				(2,186)			(2,186)
Sale of treasury stock (20 shares)			1				1
Balance, September 30, 2011	3,957,135	$ 39	$ 3,753	$ 63,608	$ 3,665	$ (6,643)	$ 64,422
Balance, December 31, 2011	3,957,135	$ 39	$ 3,753	$ 64,045	$ 4,222	$ (6,643)	$ 65,416
Net earnings				5,103			5,103
Other comprehensive income					1,923		1,923
Cash dividends paid ($0.615 per share)				(2,240)			(2,240)
Sale of treasury stock (165 shares)			3			1	4
Balance, September 30, 2012	3,957,135	$ 39	$ 3,756	$ 66,908	$ 6,145	$ (6,642)	$ 70,206

See accompanying notes to consolidated financial statements

Table of Contents

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(Unaudited)

	Nine months ended September 30,	
(In thousands)	**2012**	**2011**
Cash flows from operating activities:		
Net earnings	$ 5,103	$ 4,373
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Provision for loan losses	2,750	1,800
Depreciation and amortization	609	496
Premium amortization and discount accretion, net	2,351	1,634
Net gain on securities available for sale	(608)	(563)
Net gain on sale of loans held for sale	(2,488)	(1,071)
Net loss on other real estate owned	121	1,233
Loss on prepayment of long-term debt	3,720	
Loans originated for sale	(111,476)	(44,028)
Proceeds from sale of loans	110,932	46,243
Increase in cash surrender value of bank owned life insurance	(332)	(341)
Gain on sale of affordable housing partnership investments	(3,268)	
Loss on affordable housing partnership investments		461
Net decrease in other assets	687	315
Net increase in accrued expenses and other liabilities	541	458
Net cash provided by operating activities	8,642	11,010
Cash flows from investing activities:		
Proceeds from sales of securities available-for-sale	49,693	113,841
Proceeds from maturities of securities available-for-sale	93,377	73,989
Purchase of securities available-for-sale	(97,002)	(147,455)
Increase in loans, net	(31,740)	(6,364)
Net purchases of premises and equipment	(1,128)	(811)
Decrease in FHLB stock	2,067	631
Capital contributions to affordable housing limited partnerships		(4,069)
Proceeds from sale of affordable housing limited partnerships	8,499	
Proceeds from sale of other real estate owned	3,493	1,777
Net cash provided by investing activities	27,259	31,539
Cash flows from financing activities:		
Net increase in noninterest-bearing deposits	9,741	11,488
Net increase (decrease) in interest-bearing deposits	531	(9,545)
Net decrease in federal funds purchased and securities sold under agreements to repurchase	(258)	(72)
Repayments or retirement of long-term debt	(41,816)	(8,014)
Proceeds from sale of treasury stock	4	1
Dividends paid	(2,240)	(2,186)
Net cash used in financing activities	(34,038)	(8,328)
Net change in cash and cash equivalents	1,863	34,221
Cash and cash equivalents at beginning of period	55,428	21,424

Cash and cash equivalents at end of period	$	57,291	$	55,645
Supplemental disclosures of cash flow information:				
Cash paid during the period for:				
Interest	$	6,570	$	9,122
Income taxes		818		347
Supplemental disclosure of non-cash transactions:				
Real estate acquired through foreclosure		641		2,655

See accompanying notes to consolidated financial statements

Table of Contents

AUBURN NATIONAL BANCORPORATION, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements

NOTE 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

General

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

Basis of Presentation and Use of Estimates

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

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

Reclassifications

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

Subsequent Events

The Company has evaluated the effects of events or transactions through the date of this filing that have occurred subsequent to September 30, 2012. The Company does not believe there are any material subsequent events that would require further recognition or disclosure.

Accounting Developments

In the first quarter of 2012, the Company adopted new guidance related to the following Codification topics:

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

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

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

ASU 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting; and Standards Update No. 2011-05*.

Information about these pronouncements are described in more detail below.

ASU 2011-03, *Transfers and Servicing: Reconsideration of Effective Control for Repurchase Agreements,* removes from the assessment of effective control the criterion relating to the transferor s ability to repurchase or redeem financial assets on substantially the agreed-upon terms, even if the transferee were to default. The requirement to demonstrate that the transferor possesses adequate collateral to fund substantially all the cost of purchasing replacement assets is also eliminated. The amendments in this ASU were effective for interim and annual periods beginning after December 31, 2011, with prospective application to transactions or modifications of existing transactions that occur on or after the effective date. Adoption of this ASU did not have a significant impact on the financial statements of the Company.

ASU 2011-04, *Fair Value Measurement: Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and IFRS,* outlines the collaborative effort of the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) to consistently define fair value and to come up with a set of consistent disclosures for fair value. The ASU changes certain fair value measurement principles and enhances the disclosure requirements particularly for level 3 fair value measurements. This update was effective for the Company in the first quarter of 2012 and will be applied prospectively. Adoption of the ASU required expanded disclosure of the Company s fair value disclosures. See Note 8, Fair Value.

ASU 2011-05, *Comprehensive Income: Presentation of Comprehensive Income,* amends existing standards allowing either a single continuous statement of comprehensive income or two separate but consecutive statements. An entity is required to present each component of net income along with total net income, each component of other comprehensive income along with a total for other comprehensive income, and a total amount for comprehensive income in both options. This update also requires companies to present amounts reclassified out of other comprehensive income and into net income on the face of the statement of income. In December 2011, the FASB issued ASU 2011-12, *Deferral of the Effective Date for Amendments to the Presentation of Reclassifications of Items Out of Accumulated Other Comprehensive Income in Accounting Standards Update No. 2011-05,* which defers indefinitely the requirement to present reclassification adjustments on the statement of income. The remaining provisions were effective for the Company in the first quarter of 2012 with retrospective application. Adoption of the ASU required the Company to add a statement of comprehensive income. See Consolidated Statements of Comprehensive Income.

NOTE 2: BASIC AND DILUTED EARNINGS PER SHARE

Basic net earnings per share is computed by dividing net earnings by the weighted average common shares outstanding for the quarters and nine months ended September 30, 2012 and 2011, respectively. Diluted net earnings per share reflect the potential dilution that could occur upon exercise of securities or other rights for, or convertible into, shares of the Company s common stock. At September 30, 2012 and 2011, respectively, the Company had no such securities or rights issued or outstanding, and therefore, no dilutive effect to consider for the diluted earnings per share calculation.

A reconciliation of the numerator and denominator of the basic and diluted earnings per share computation for the quarter and nine months ended September 30, 2012 and 2011 is presented below.

	Quarter ended September 30,		Nine months ended September 30,	
(In thousands, except share and per share data)	**2012**	**2011**	**2012**	**2011**
Basic and diluted:				
Net earnings	$ 1,609	$ 1,367	$ 5,103	$ 4,373
Weighted average common shares outstanding	3,642,876	3,642,738	3,642,807	3,642,735
Earnings per share	$ 0.44	$ 0.38	$ 1.40	$ 1.20

NOTE 3: VARIABLE INTEREST ENTITIES

Under ASC 810, the Company is deemed to be the primary beneficiary and required to consolidate a variable interest entity (VIE) if it has a variable interest in the VIE that provides it with a controlling financial interest. For such purposes, the determination of whether a controlling financial interest exists is based on whether a single party has both the power to direct the activities of the VIE that most significantly impact the VIE s economic performance and the obligation to absorb losses of the VIE or the right to receive benefits from the VIE that could potentially be significant to the VIE. ASC 810, requires continual reconsideration of conclusions reached regarding which interest holder is a VIE s primary beneficiary and disclosures surrounding those VIE s which have not been consolidated. The consolidation methodology provided in this footnote for the quarter ended September 30, 2012, and the year ended December 31, 2011 has been prepared in accordance with ASC 810.

At September 30, 2012, the Company did not have any consolidated VIEs to disclose but did have one nonconsolidated VIE, discussed below.

Trust Preferred Securities

The Company owns the common stock of a subsidiary business trust, Auburn National Bancorporation Capital Trust I, which issued mandatorily redeemable preferred capital securities (trust preferred securities) in the aggregate of approximately $7.0 million at the time of issuance. This trust meets the definition of a VIE of which the Company is not the primary beneficiary; the trust s only assets are junior subordinated debentures issued by the Company, which were acquired by the trust using the proceeds from the issuance of the trust preferred securities and common stock. The junior subordinated debentures of approximately $7.2 million are included in long-term debt and the Company s equity interest in the business trust is included in other assets on the accompanying Consolidated Balance Sheets. Interest expense on the junior subordinated debentures is included in interest expense on long-term debt. For regulatory reporting and capital adequacy purposes, the Federal Reserve Board has proposed, as part of its Basel III capital rules, to phase out trust preferred securities as Tier 1 Capital over 10 years for institutions with total assets under $15 billion.

The following table summarizes VIEs that are not consolidated by the Company as of September 30, 2012.

(Dollars in thousands)	**Maximum Loss Exposure**	**Liability Recognized**	**Classification**
Type:			

Trust preferred issuances	N/A	$ 7,217	Long-term debt

Table of Contents

NOTE 4: SECURITIES

At September 30, 2012 and December 31, 2011, respectively, all securities within the scope of ASC 320, *Investments Debt and Equity Securities,* were classified as available-for-sale. The fair value and amortized cost for securities available-for-sale by contractual maturity at September 30, 2012 and December 31, 2011, respectively, are presented below.

	September 30, 2012							
(Dollars in thousands)	1 year or less	1 to 5 years	5 to 10 years	After 10 years	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Amortized Cost
Available-for-sale:								
Agency obligations (a)	$		10,113	24,503	34,616	247		$ 34,369
Agency RMBS (a)			4,986	132,627	137,613	4,077		133,536
State and political subdivisions	112	1,706	19,464	60,687	81,969	5,486		76,483
Trust preferred securities:								
Individual issuer				621	621	101	173	693
Total available-for-sale	$ 112	1,706	34,563	218,438	254,819	9,911	173	$ 245,081

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

	December 31, 2011							
(Dollars in thousands)	1 year or less	1 to 5 years	5 to 10 years	After 10 years	Fair Value	Gross Unrealized Gains	Gross Unrealized Losses	Amortized Cost
Available-for-sale:								
Agency obligations (a)	$		5,013	46,072	51,085	182	1	$ 50,904
Agency RMBS (a)			14,935	149,863	164,798	2,534	129	162,393
State and political subdivisions		414	17,761	63,538	81,713	4,339	48	77,422
Trust preferred securities:								
Pooled				100	100		130	230
Individual issuer				1,886	1,886	186	243	1,943
Total available-for-sale	$	414	37,709	261,459	299,582	7,241	551	$ 292,892

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

Securities with aggregate fair values of $133.4 million and $161.5 million at September 30, 2012 and December 31, 2011, respectively, were pledged to secure public deposits, securities sold under agreements to repurchase, Federal Home Loan Bank (FHLB) advances, and for other purposes required or permitted by law.

Included in other assets are cost-method investments. The carrying amounts of cost-method investments were $3.0 million and $5.0 million at September 30, 2012 and December 31, 2011, respectively. Cost-method investments primarily include non-marketable equity investments, such as FHLB of Atlanta stock and Federal Reserve Bank (FRB) stock.

Table of Contents

Gross Unrealized Losses and Fair Value

The fair values and gross unrealized losses on securities at September 30, 2012 and December 31, 2011, respectively, segregated by those securities that have been in an unrealized loss position for less than 12 months and 12 months or longer, are presented below.

	Less than 12 Months		12 Months or Longer		Total	
(Dollars in thousands)	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
September 30, 2012:						
Trust preferred securities:						
Individual issuer	$		327	173	$ 327	173
Total	$		327	173	$ 327	173
December 31, 2011:						
Agency obligations	$ 5,000	1			$ 5,000	1
Agency RMBS	17,020	129			17,020	129
State and political subdivisions	1,686	11	718	37	2,404	48
Trust preferred securities:						
Pooled			100	130	100	130
Individual issuer			757	243	757	243
Total	$ 23,706	141	1,575	410	$ 25,281	551

The applicable date for determining when securities are in an unrealized loss position is September 30, 2012. As such, it is possible that a security in an unrealized loss position at September 30, 2012 had a market value that exceeded its amortized cost on other days during the past twelve-month period.

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

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

- the length of time and the extent to which the fair value has been less than the amortized cost basis;
- adverse conditions specifically related to the security, an industry, or a geographic area (for example, changes in the financial condition of the issuer of the security, or in the case of an asset-backed debt security, in the financial condition of the underlying loan obligors, including changes in technology or the discontinuance of a segment of the business that may affect the future earnings potential of the issuer or underlying loan obligors of the security or changes in the quality of the credit enhancement);
- the historical and implied volatility of the fair value of the security;

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

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

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

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

Table of Contents

Agency obligations

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

Agency residential mortgage-backed securities (RMBS)

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

Securities of U.S. states and political subdivisions

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

Individual issuer trust preferred securities

The unrealized losses associated with individual issuer trust preferred securities were related to securities issued on behalf of individual community bank holding companies. Management evaluates the financial performance of individual community bank holding companies on a quarterly basis to determine if it is probable that such issuer can make all contractual principal and interest payments. Based upon its evaluation, the Company expects to recover the remaining amortized cost basis of these securities.

Cost-method investments

At September 30, 2012, cost-method investments with an aggregate cost of $3.0 million were not evaluated for impairment because the Company did not identify any events or changes in circumstances that may have a significant adverse effect on the fair value of these cost-method investments.

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

The following tables show the applicable credit ratings, fair values, gross unrealized losses, and life-to-date impairment charges for trust preferred securities at September 30, 2012 and December 31, 2011, respectively, segregated by those securities that have been in an unrealized loss position for less than 12 months and 12 months or longer.

Trust Preferred Securities as of September 30, 2012

	Credit Rating			**Unrealized Losses**			**Life-to-date**
(Dollars in thousands)	**Moody s**	**Fitch**	**Fair Value**	**Less than 12 months**	**12 months or Longer**	**Total**	**Impairment Charges**
Individual issuer (a):							
Carolina Financial Capital Trust I	n/a	n/a	$ 294				257
TCB Trust	n/a	n/a	327		173	173	

Total trust preferred securities	$ 621	173	173	257

n/a not applicable, securities not rated.

(a) 144A Floating Rate Capital Securities. Issuers are individual community bank holding companies.

Trust Preferred Securities as of December 31, 2011

	Credit Rating			Unrealized Losses			
(Dollars in thousands)	Moody s	Fitch	Fair Value	Less than 12 months	12 months or Longer	Total	Life-to-date Impairment Charges
Pooled:							
ALESCO Preferred Funding XVII Ltd (a)	C	CC	$ 100		130	130	1,770
Individual issuer (b):							
Carolina Financial Capital Trust I	n/a	n/a	193				257
Main Street Bank Statutory Trust I (c)	n/a	n/a	389		111	111	
MNB Capital Trust I	n/a	n/a	55				445
PrimeSouth Capital Trust I	n/a	n/a	75				425
TCB Trust	n/a	n/a	368		132	132	
United Community Capital Trust	n/a	n/a	806				379
Total individual issuer			1,886		243	243	1,506
Total trust preferred securities			$ 1,986		373	373	3,276

n/a not applicable securities not rated.

(a) Class B Deferrable Third Priority Secured Floating Rate Notes. The underlying collateral is primarily composed of trust preferred securities issued by community banks and thrifts.

(b) 144A Floating Rate Capital Securities. Issuers are individual community bank holding companies.

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

Other-Than-Temporarily Impaired Securities

The following table presents a roll-forward of the credit loss component of the amortized cost of debt securities that the Company has written down for other-than-temporary impairment and the credit component of the loss is recognized in earnings (referred to as credit-impaired debt securities). Other-than-temporary impairments recognized in earnings for the quarters and nine months ended September 30, 2012 and 2011, for credit-impaired debt securities are presented as additions in two components based upon whether the current period is the first time the debt security was credit-impaired (initial credit impairment) or is not the first time the debt security was credit-impaired (subsequent credit impairments). The credit loss component is reduced if the Company sells, intends to sell, or believes it will be required to sell previously credit-impaired debt securities. Additionally, the credit loss component is reduced if the Company receives cash flows in excess of what it expected to receive over the remaining life of the credit-impaired debt security, the security matures or the security is fully written-down and deemed worthless. Changes in the credit loss component of credit-impaired debt securities were:

	Quarter ended September 30,	Nine months ended September 30,

(Dollars in thousands)	**2012**	**2011**	**2012**	**2011**
Balance, beginning of period	$ 1,257	$ 3,040	$ 3,276	$ 2,938
Additions:				
Subsequent credit impairments		236	130	338
Reductions:				
Securities sold			2,149	
Balance, end of period	$ 1,257	$ 3,276	$ 1,257	$ 3,276

Table of Contents

Other-Than-Temporary Impairment

The following table presents details of the other-than-temporary impairment related to securities, including equity securities carried at cost, for the quarters and nine months ended September 30, 2012 and 2011.

(Dollars in thousands)	Quarter ended September 30, 2012	2011	Nine months ended September 30, 2012	2011
Other-than-temporary impairment charges (included in earnings):				
Debt securities:				
Individual issuer trust preferred securities	$	$ 236	$ 130	$ 338
Total debt securities		236	130	338
Total other-than-temporary impairment charges	$	$ 236	$ 130	$ 338
Other-than-temporary impairment on debt securities:				
Recorded as part of gross realized losses:				
Credit-related	$	236	$ 130	$ 338
Securities with intent to sell				
(Transferred from) recorded directly to other comprehensive income for non-credit related impairment		(80)		130
Total other-than-temporary impairment on debt securities	$	$ 156	$ 130	$ 468

Realized Gains and Losses

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

(Dollars in thousands)	Quarter ended September 30, 2012	2011	Nine months ended September 30, 2012	2011
Gross realized gains	$ 203	$ 474	$ 927	$ 1,379
Gross realized losses	(25)	(23)	(189)	(478)
Other-than-temporary impairment charges		(236)	(130)	(338)
Realized gains, net	$ 178	$ 215	$ 608	$ 563

Table of Contents

NOTE 5: LOANS AND ALLOWANCE FOR LOAN LOSSES

(In thousands)	September 30, 2012	December 31, 2011
Commercial and industrial	$ 58,579	$ 54,988
Construction and land development	40,573	39,814
Commercial real estate:		
Owner occupied	68,299	70,202
Other	115,458	92,233
Total commercial real estate	183,757	162,435
Residential real estate:		
Consumer mortgage	56,992	57,958
Investment property	46,327	43,767
Total residential real estate	103,319	101,725
Consumer installment	11,747	11,454
Total loans	397,975	370,416
Less: unearned income	(237)	(153)
Loans, net of unearned income	$ 397,738	$ 370,263

Loans secured by real estate were approximately 82.3% of the Company s total loan portfolio at September 30, 2012. Due to declines in economic indicators and real estate values, loans secured by real estate may have a greater risk of non-collection than other loans. At September 30, 2012, the Company s geographic loan distribution was concentrated primarily in Lee County, Alabama and surrounding areas.

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

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

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

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

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

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

Other primarily includes loans to finance income-producing commercial and multi-family properties that are not owner occupied. Loans in this class include loans for neighborhood retail centers, hotels, medical and professional offices, single retail stores, industrial buildings, warehouses and apartments leased generally to local businesses and residents. Generally the primary source of repayment is dependent upon income generated from the real estate collateral. The underwriting of these loans takes into consideration the occupancy and rental rates, as well as the financial health of the borrower.

Table of Contents

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

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

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

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

The following is a summary of current, accruing past due and nonaccrual loans by portfolio segment and class as of September 30, 2012, and December 31, 2011.

(In thousands)	Current	Accruing 30-89 Days Past Due	Accruing Greater than 90 days	Total Accruing Loans	Non-Accrual	Total Loans
September 30, 2012:						
Commercial and industrial	$ 58,081	393	12	58,486	93	$ 58,579
Construction and land development	36,733			36,733	3,840	40,573
Commercial real estate:						
Owner occupied	66,920			66,920	1,379	68,299
Other	109,630			109,630	5,828	115,458
Total commercial real estate	176,550			176,550	7,207	183,757
Residential real estate:						
Consumer mortgage	55,601	452		56,053	939	56,992
Investment property	44,505	266		44,771	1,556	46,327
Total residential real estate	100,106	718		100,824	2,495	103,319
Consumer installment	11,719	27	1	11,747		11,747
Total	$ 383,189	1,138	13	384,340	13,635	$ 397,975
December 31, 2011:						
Commercial and industrial	$ 53,721	1,191		54,912	76	$ 54,988
Construction and land development	34,402	317		34,719	5,095	39,814
Commercial real estate:						
Owner occupied	68,551			68,551	1,651	70,202
Other	90,427			90,427	1,806	92,233
Total commercial real estate	158,978			158,978	3,457	162,435
Residential real estate:						
Consumer mortgage	56,610	400		57,010	948	57,958

Investment property	42,144	845	42,989	778	43,767
Total residential real estate	98,754	1,245	99,999	1,726	101,725
Consumer installment	11,397	57	11,454		11,454
Total	$ 357,252	2,810	360,062	10,354	$ 370,416

Allowance for Loan Losses

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

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

An impairment allowance is recognized if the fair value of the loan is less than the recorded investment in the loan. The impairment is recognized through the allowance. Loans that are impaired are recorded at the present value of expected future cash flows discounted at the loan s effective interest rate, or if the loan is collateral dependent, impairment measurement is based on the fair value of the collateral, less estimated disposal costs.

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

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

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

The allocation of the allowance for loan losses begins with a process of estimating the probable losses inherent for these types of loans. The estimates for these loans are established by category and based on the Company s internal system of credit risk ratings and historical loss data. The estimated loan loss allocation rate for the Company s internal system of credit risk grades is based on its experience with similarly graded loans. For loan segments where the Company believes it does not have sufficient historical loss data, the Company may make adjustments based, in part, on loss rates of peer bank groups. At September 30, 2012 and December 31, 2011, and for the periods then ended, the Company adjusted its historical loss rates for one segment, the commercial real estate portfolio segment, based in part, on loss rates of peer bank groups.

The estimated loan loss allocation for all five loan portfolio segments is then adjusted for management s estimate of probable losses for several qualitative and environmental factors. The allocation for qualitative and environmental factors is particularly subjective and does not lend itself to exact mathematical calculation. This amount represents estimated probable inherent credit losses which exist, but have not yet been identified, as of the balance sheet date, and are based upon quarterly trend assessments in delinquent and nonaccrual loans, credit concentration changes, prevailing economic conditions, changes in lending personnel experience, changes in lending policies or procedures and other influencing factors. These qualitative and environmental factors are considered for each of the five loan segments and the allowance allocation, as determined by the processes noted above, is increased or decreased based on the incremental assessment of these factors.

The Company periodically re-evaluates its practices in determining the allowance for loan losses. During the fourth quarter of 2011, the Company s management decided to eliminate a previously unallocated component of the allowance. As a result, the Company had no unallocated amount included in the allowance at September 30, 2012.

Table of Contents

The following table details the changes in the allowance for loan losses by portfolio segment for the respective periods.

						September 30, 2012
(In thousands)	**Commercial and industrial**	**Construction and land development**	**Commercial real estate**	**Residential real estate**	**Consumer installment**	**Total**
Quarter ended:						
Beginning balance	$ 731	1,623	2,817	1,278	54	$ 6,503
Charge-offs	(152)		(1,626)	(324)	(35)	(2,137)
Recoveries	20		71	35	3	129
Net charge-offs	(132)		(1,555)	(289)	(32)	(2,008)
Provision	155	(14)	1,396	(42)	55	1,550
Ending balance	$ 754	1,609	2,658	947	77	$ 6,045
Nine months ended:						
Beginning balance	$ 948	1,470	3,009	1,363	129	$ 6,919
Charge-offs	(246)	(231)	(2,844)	(435)	(68)	(3,824)
Recoveries	28	1	71	85	15	200
Net charge-offs	(218)	(230)	(2,773)	(350)	(53)	(3,624)
Provision	24	369	2,422	(66)	1	2,750
Ending balance	$ 754	1,609	2,658	947	77	$ 6,045

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

Provision		421	630	169	438	38	104	1,800
Ending balance	$	762	1,138	2,643	1,404	178	215	$ 6,340

Table of Contents

The following table presents an analysis of the allowance for loan losses and recorded investment in loans by portfolio segment and impairment methodology as of September 30, 2012 and 2011.

	Collectively evaluated (1)			Individually evaluated (2)		Total	
(In thousands)		Allowance for loan losses	Recorded investment in loans	Allowance for loan losses	Recorded investment in loans	Allowance for loan losses	Recorded investment in loans
September 30, 2012:							
Commercial and industrial	$	754	58,395		184	754	58,579
Construction and land development		1,468	36,817	141	3,756	1,609	40,573
Commercial real estate		2,519	175,733	139	8,024	2,658	183,757
Residential real estate		915	101,297	32	2,022	947	103,319
Consumer installment		77	11,747			77	11,747
Total	$	5,733	383,989	312	13,986	6,045	397,975
September 30, 2011:							
Commercial and industrial	$	762	53,661		227	762	53,888
Construction and land development		929	35,625	209	5,156	1,138	40,781
Commercial real estate		2,221	162,374	422	3,685	2,643	166,059
Residential real estate		1,163	100,713	241	1,317	1,404	102,030
Consumer installment		178	12,105			178	12,105
Unallocated		215				215	
Total	$	5,468	364,478	872	10,385	6,340	374,863

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

Table of Contents

Credit Quality Indicators

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

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

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

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

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

					September 30, 2012
(In thousands)	**Pass**	**Special Mention**	**Substandard Accruing**	**Nonaccrual**	**Total loans**
Commercial and industrial	$ 57,787	196	503	93	$ 58,579
Construction and land development	35,311	570	852	3,840	40,573
Commercial real estate:					
Owner occupied	60,793				