

PEOPLES BANCORP OF NORTH CAROLINA INC
Form 10-Q
November 09, 2012

UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended: September 30, 2012

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

PEOPLES BANCORP OF NORTH CAROLINA, INC.
(Exact name of registrant as specified in its charter)

North Carolina
(State or other jurisdiction of incorporation or organization)

000-27205
(Commission File No.)

56-2132396
(IRS Employer Identification No.)

518 West C Street, Newton, North Carolina
(Address of principal executive offices)

28658
(Zip Code)

(828) 464-5620
(Registrant's telephone number, including area code)

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

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate 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, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerate
Filer

Accelerated
Filer

Non-Accelerated
Filer

Smaller Reporting Company X

Indicate by check mark whether the registrant is a shell company (as defined in Exchange Act Rule 12b-2 of the Exchange Act).

Yes No X

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

5,596,978 shares of common stock, outstanding at October 31, 2012.

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Statements made in this Form 10-Q, other than those concerning historical information, should be considered forward-looking statements pursuant to the safe harbor provisions of the Securities Exchange Act of 1934 and the

Private Securities Litigation Act of 1995. These forward-looking statements involve risks and uncertainties and are based on the beliefs and assumptions of management and on the information available to management at the time that this Form 10-Q was prepared. These statements can be identified by the use of words like “expect,” “anticipate,” “estimate,” and “believe,” variations of these words and other similar expressions. Readers should not place undue reliance on forward-looking statements as a number of important factors could cause actual results to differ materially from those in the forward-looking statements. Factors that could cause actual results to differ materially include, but are not limited to, (1) competition in the markets served by Peoples Bank, (2) changes in the interest rate environment, (3) general national, regional or local economic conditions may be less favorable than expected, resulting in, among other things, a deterioration in credit quality and the possible impairment of collectibility of loans, (4) legislative or regulatory changes, including changes in accounting standards, (5) significant changes in the federal and state legal and regulatory environments and tax laws, (6) the impact of changes in monetary and fiscal policies, laws, rules and regulations and (7) other risks and factors identified in other filings with the Securities and Exchange Commission, including but not limited to those described in Peoples Bancorp of North Carolina, Inc.’s Annual Report on Form 10-K for the year ended December 31, 2011.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Balance Sheets

| Assets | (Dollars in thousands) | |
|--|--------------------------------------|-----------------------------------|
| | September 30, 2012 (Unaudited) | December 31, 2011 (Audited) |
| Cash and due from banks, including reserve requirements of \$9,620 in 2012 and \$8,492 in 2011 | \$ 24,323 | 22,532 |
| Interest bearing deposits | 31,581 | 6,704 |
| Cash and cash equivalents | 55,904 | 29,236 |
| Investment securities available for sale | 281,785 | 321,388 |
| Other investments | 5,599 | 5,712 |
| Total securities | 287,384 | 327,100 |
| Mortgage loans held for sale | 5,984 | 5,146 |
| Loans | 625,782 | 670,497 |
| Less allowance for loan losses | (16,551) | (16,604) |
| Net loans | 609,231 | 653,893 |
| Premises and equipment, net | 16,091 | 16,896 |
| Cash surrender value of life insurance | 13,142 | 12,835 |
| Other real estate | 6,595 | 7,576 |
| Accrued interest receivable and other assets | 12,277 | 14,381 |
| Total assets | \$ 1,006,608 | 1,067,063 |
| Liabilities and Shareholders' Equity | | |
| Deposits: | | |
| Non-interest bearing demand | \$ 152,281 | 136,878 |
| NOW, MMDA & savings | 354,386 | 366,133 |
| Time, \$100,000 or more | 143,189 | 193,045 |
| Other time | 118,614 | 131,055 |
| Total deposits | 768,470 | 827,111 |
| Securities sold under agreements to repurchase | 43,136 | 39,600 |
| FHLB borrowings | 70,000 | 70,000 |
| Junior subordinated debentures | 20,619 | 20,619 |

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| | | |
|--|--------------|-----------|
| Accrued interest payable and other liabilities | 7,549 | 6,706 |
| Total liabilities | 909,774 | 964,036 |
| Commitments | | |
| Shareholders' equity: | | |
| Series A preferred stock, \$1,000 stated value; authorized 5,000,000 shares; issued and outstanding 12,524 shares in 2012 and 25,054 shares in 2011 | | |
| | 12,524 | 24,758 |
| Common stock, no par value; authorized 20,000,000 shares; issued and outstanding 5,596,978 shares in 2012 and 5,544,160 shares in 2011 | | |
| | 48,004 | 48,298 |
| Retained earnings | 30,815 | 26,895 |
| Accumulated other comprehensive income | 5,491 | 3,076 |
| Total shareholders' equity | 96,834 | 103,027 |
| Total liabilities and shareholders' equity | \$ 1,006,608 | 1,067,063 |

See accompanying Notes to Consolidated Financial Statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Earnings

Three and Nine Months Ended September 30, 2012 and 2011

(Dollars in thousands, except per share amounts)

| | Three months ended September 30, | | Nine months ended September 30, | |
|--|-------------------------------------|---------------------|------------------------------------|---------------------|
| | 2012 (Unaudited) | 2011 (Unaudited) | 2012 (Unaudited) | 2011 (Unaudited) |
| Interest income: | | | | |
| Interest and fees on loans | \$ 8,170 | 8,921 | 24,822 | 27,695 |
| Interest on due from banks | 15 | 4 | 34 | 19 |
| Interest on investment securities: | | | | |
| U.S. Government sponsored enterprises, including mortgage-backed securities | 519 | 1,504 | 2,327 | 3,998 |
| States and political subdivisions | 877 | 792 | 2,463 | 2,387 |
| Other | 74 | 70 | 206 | 171 |
| Total interest income | 9,655 | 11,291 | 29,852 | 34,270 |
| Interest expense: | | | | |
| NOW, MMDA & savings deposits | 274 | 517 | 913 | 1,836 |
| Time deposits | 737 | 1,221 | 2,632 | 3,901 |
| FHLB borrowings | 689 | 761 | 2,064 | 2,258 |
| Junior subordinated debentures | 110 | 100 | 332 | 300 |
| Other | 32 | 74 | 105 | 231 |
| Total interest expense | 1,842 | 2,673 | 6,046 | 8,526 |
| Net interest income | 7,813 | 8,618 | 23,806 | 25,744 |
| Provision for loan losses | 761 | 3,378 | 4,413 | 9,696 |
| Net interest income after provision for loan losses | 7,052 | 5,240 | 19,393 | 16,048 |
| Non-interest income: | | | | |
| Service charges | 1,222 | 1,273 | 3,601 | 3,845 |
| Other service charges and fees | 417 | 493 | 1,532 | 1,603 |
| Gain on sale of securities | 12 | 1,239 | 1,203 | 2,495 |
| Mortgage banking income | 296 | 127 | 793 | 531 |
| Insurance and brokerage commissions | 150 | 121 | 404 | 350 |
| Loss on sale and write-down of other real estate | (326) | (318) | (710) | (1,026) |

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| | | | | |
|---|----------|-------|--------|--------|
| Miscellaneous | 1,115 | 787 | 3,035 | 2,233 |
| Total non-interest income | 2,886 | 3,722 | 9,858 | 10,031 |
| Non-interest expense: | | | | |
| Salaries and employee benefits | 4,187 | 3,489 | 11,960 | 10,829 |
| Occupancy | 1,291 | 1,334 | 3,891 | 4,030 |
| Other | 2,678 | 2,341 | 7,420 | 7,083 |
| Total non-interest expense | 8,156 | 7,164 | 23,271 | 21,942 |
| Earnings before income taxes | 1,782 | 1,798 | 5,980 | 4,137 |
| Income tax expense | 369 | 406 | 1,400 | 755 |
| Net earnings | 1,413 | 1,392 | 4,580 | 3,382 |
| Dividends and accretion on preferred stock | 157 | 348 | 853 | 1,045 |
| Net earnings available to common shareholders | \$ 1,256 | 1,044 | 3,727 | 2,337 |
| Basic and diluted net earnings per common share | \$ 0.23 | 0.19 | 0.67 | 0.42 |
| Cash dividends declared per common share | \$ 0.02 | 0.02 | 0.11 | 0.04 |

See accompanying Notes to Consolidated Financial Statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Comprehensive Income

Three and Nine Months Ended September 30, 2012 and 2011

(Dollars in thousands)

| | Three months ended September 30, | | Nine months ended September 30, | |
|---|-------------------------------------|---------------------|------------------------------------|---------------------|
| | 2012 (Unaudited) | 2011 (Unaudited) | 2012 (Unaudited) | 2011 (Unaudited) |
| Net earnings | \$ 1,413 | 1,392 | 4,580 | 3,382 |
| Other comprehensive income: | | | | |
| Unrealized holding gains on securities available for sale | 1,427 | 3,612 | 5,156 | 9,653 |
| Reclassification adjustment for gains on securities available for sale included in net earnings | (12) | (1,239) | (1,203) | (2,495) |
| Unrealized holding losses on derivative financial instruments qualifying as cash flow hedges | - | - | - | (648) |
| Total other comprehensive income, before income taxes | 1,415 | 2,373 | 3,953 | 6,510 |
| Income tax expense related to other comprehensive income: | | | | |
| Unrealized holding gains on securities available for sale | 555 | 1,407 | 2,008 | 3,760 |
| Reclassification adjustment for gains on securities available for sale included in net earnings | (4) | (483) | (470) | (972) |
| Unrealized holding losses on derivative financial instruments qualifying as cash flow | | | | |

| | | | | |
|--|----------|-------|-------|-------|
| hedges | - | - | - | (253) |
| Total income tax expense related to other comprehensive income | 551 | 924 | 1,538 | 2,535 |
| Total other comprehensive income, net of tax | 864 | 1,449 | 2,415 | 3,975 |
| Total comprehensive income | \$ 2,277 | 2,841 | 6,995 | 7,357 |

See accompanying Notes to Consolidated Financial Statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows

Nine Months Ended September 30, 2012 and 2011

(Dollars in thousands)

| | 2012 (Unaudited) | 2011 (Unaudited) |
|--|---------------------|---------------------|
| Cash flows from operating activities: | | |
| Net earnings | \$ 4,580 | 3,382 |
| Adjustments to reconcile net earnings to net cash provided by operating activities: | | |
| Depreciation, amortization and accretion | 6,651 | 3,915 |
| Provision for loan losses | 4,413 | 9,696 |
| Gain on sale of investment securities | (1,203) | (2,495) |
| Loss on sale of other real estate | 21 | 181 |
| Write-down of other real estate | 689 | 845 |
| Restricted stock expense | 17 | 5 |
| Change in: | | |
| Mortgage loans held for sale | (838) | 1,666 |
| Cash surrender value of life insurance | (307) | (182) |
| Other assets | 565 | 1,546 |
| Other liabilities | 826 | 438 |
| Net cash provided by operating activities | 15,414 | 18,997 |
| Cash flows from investing activities: | | |
| Net change in certificates of deposit | - | 735 |
| Purchases of investment securities available for sale | (55,617) | (158,631) |
| Proceeds from calls, maturities and paydowns of investment securities available for sale | 48,123 | 39,813 |
| Proceeds from sales of investment securities available for sale | 47,062 | 72,292 |
| Purchases of other investments | (493) | (215) |
| Proceeds from sale of other investments | 606 | 197 |
| Net change in loans | 35,910 | 36,659 |
| Purchases of premises and equipment | (657) | (775) |
| Purchases of bank owned life insurance | - | (5,000) |
| Proceeds from sale of other real estate | 4,611 | 2,656 |
| Net cash provided (used) by investing activities | 79,545 | (12,269) |
| Cash flows from financing activities: | | |
| Net change in deposits | (58,641) | 2,329 |

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| | | |
|---|-----------|----------|
| Net change in demand notes payable to U.S. Treasury | - | (504) |
| Net change in securities sold under agreement to repurchase | 3,536 | 13,607 |
| Proceeds from FHLB borrowings | 25,400 | 5,000 |
| Repayments of FHLB borrowings | (25,400) | (5,000) |
| Preferred stock repurchase | (11,695) | - |
| Warrant repurchase | (425) | - |
| Restricted stock payout | - | 9 |
| Stock options exercised | 410 | - |
| Cash dividends paid on preferred stock | (866) | (940) |
| Cash dividends paid on common stock | (610) | (333) |
| Net cash (used) provided by financing activities | (68,291) | 14,168 |
| Net change in cash and cash equivalent | 26,668 | 20,896 |
| Cash and cash equivalents at beginning of period | 29,236 | 23,977 |
| Cash and cash equivalents at end of period | \$ 55,904 | 44,873 |

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Consolidated Statements of Cash Flows, continued

Nine Months Ended September 30, 2012 and 2011

(Dollars in thousands)

| | 2012 (Unaudited) | 2011 (Unaudited) |
|--|---------------------|---------------------|
| Supplemental disclosures of cash flow information: | | |
| Cash paid during the year for: | | |
| Interest | \$ 6,609 | 8,613 |
| Income taxes | \$ 1,190 | 132 |
| Noncash investing and financing activities: | | |
| Change in unrealized gain on investment securities available for sale, net | | |
| | \$ 2,414 | (4,370) |
| Change in unrealized gain on derivative financial instruments, net | | |
| | \$ - | 395 |
| Transfer of loans to other real estate and repossessions | \$ 4,669 | 7,041 |
| Financed portion of sale of other real estate | \$ 330 | 4,047 |
| Accretion of Series A preferred stock | \$ 70 | 106 |
| Discount on preferred stock | \$ 835 | - |

See accompanying Notes to Consolidated Financial Statements.

PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

Notes to Consolidated Financial Statements (Unaudited)

(1) Summary of Significant Accounting Policies

The consolidated financial statements include the financial statements of Peoples Bancorp of North Carolina, Inc. and its wholly-owned subsidiaries, Peoples Bank (the “Bank”) and Community Bank Real Estate Solutions, LLC, along with the Bank’s wholly-owned subsidiaries, Peoples Investment Services, Inc. and Real Estate Advisory Services, Inc. (“REAS”) (collectively called the “Company”). All significant intercompany balances and transactions have been eliminated in consolidation.

The consolidated financial statements in this report (other than the Consolidated Balance Sheet at December 31, 2011) are unaudited. In the opinion of management, all adjustments (none of which were other than normal accruals) necessary for a fair presentation of the financial position and results of operations for the periods presented have been included. Management of the Company has made a number of estimates and assumptions relating to reporting of assets and liabilities and the disclosure of contingent assets and liabilities to prepare these consolidated financial statements in conformity with generally accepted accounting principles in the United States (“GAAP”). Actual results could differ from those estimates.

The Company’s accounting policies are fundamental to understanding management’s discussion and analysis of results of operations and financial condition. Many of the Company’s accounting policies require significant judgment regarding valuation of assets and liabilities and/or significant interpretation of the specific accounting guidance. A description of the Company’s significant accounting policies can be found in Note 1 of the Notes to Consolidated Financial Statements in the Company’s 2011 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 3, 2012 Annual Meeting of Shareholders.

Recently Issued Accounting Pronouncements

In April 2011, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2011-02, A Creditor’s Determination of Whether a Restructuring is a Troubled Debt Restructuring. ASU No. 2011-02 provides additional guidance for determining what constitutes a troubled debt restructuring. ASU No. 2011-02 is effective for interim and annual periods ending after June 15, 2011. The adoption of this guidance did not have a material impact on the Company’s results of operations, financial position or disclosures.

In May 2011, FASB issued ASU No. 2011-04, Fair Value Measurement (Topic 820): Amendments to Achieve Common Fair Value Measurement and Disclosure Requirements in U.S. GAAP and International Financial Reporting Standards (“IFRS”). ASU No. 2011-04 is intended to result in convergence between GAAP and IFRS requirements for measurement of and disclosures about fair value. ASU No. 2011-04 is effective for interim and annual periods beginning after December 15, 2011. The adoption of this guidance did not have a material impact on the Company’s results of operations, financial position or disclosures.

In June 2011, FASB issued ASU No. 2011-05, Comprehensive Income (Topic 220): Presentation of Comprehensive Income. ASU No. 2011-05 requires companies to present the components of net income and other comprehensive income either as one continuous statement or as two consecutive statements. It eliminates the option to present components of other comprehensive income as part of the statement of changes in shareholders’ equity. ASU No. 2011-05 does not change the items which must be reported in other comprehensive income, how such items are measured or when they must be reclassified to net income. ASU No. 2011-05 is effective for interim and annual periods beginning after December 15, 2011. Because ASU No. 2011-05 impacts presentation only, it has no impact on the Company’s results of operations or financial position.

In December 2011, FASB issued ASU No. 2011-12, Comprehensive Income (Topic 220): 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. ASU No. 2011-12 defers the effective date of the requirement to present separate line items on the income statement for reclassification adjustments of items out of accumulated other comprehensive income into net income. This deferral is temporary until FASB reconsiders the operational concerns and needs of financial statement users. FASB has not yet established a timetable for its reconsideration. Entities are still required to present reclassification adjustments within other comprehensive income either on the face of the statement that reports other comprehensive income or in the notes to the financial statements. The requirement to present comprehensive income in either a single continuous statement or two consecutive condensed statements remains for both annual and interim reporting. Because ASU No. 2011-12 impacts presentation only, it will have no impact on the Company's results of operations or financial position.

Other accounting standards that have been issued or proposed by FASB or other standards-setting bodies are not expected to have a material impact on the Company's results of operations, financial position or disclosures.

(2) Investment Securities

Investment securities available for sale at September 30, 2012 and December 31, 2011 are as follows:

(Dollars in thousands)

| | Amortized Cost | September 30, 2012 | | Estimated Fair Value |
|--|-------------------|------------------------------|-------------------------------|----------------------------|
| | | Gross Unrealized Gains | Gross Unrealized Losses | |
| Mortgage-backed securities | \$ 158,548 | 1,982 | 444 | 160,086 |
| U.S. Government sponsored enterprises | 1,254 | 40 | - | 1,294 |
| State and political subdivisions | 109,456 | 6,739 | 46 | 116,149 |
| Corporate bonds | 1,535 | 16 | - | 1,551 |
| Trust preferred securities | 1,250 | - | - | 1,250 |
| Equity securities | 748 | 707 | - | 1,455 |
| Total | \$ 272,791 | 9,484 | 490 | 281,785 |

(Dollars in thousands)

| | Amortized Cost | December 31, 2011 | | Estimated Fair Value |
|--|-------------------|------------------------------|-------------------------------|----------------------------|
| | | Gross Unrealized Gains | Gross Unrealized Losses | |
| Mortgage-backed securities | \$ 213,378 | 1,371 | 1,056 | 213,693 |
| U.S. Government sponsored enterprises | 7,429 | 265 | - | 7,694 |
| State and political subdivisions | 92,996 | 4,157 | 56 | 97,097 |
| Corporate bonds | 546 | - | 3 | 543 |
| Trust preferred securities | 1,250 | - | - | 1,250 |
| Equity securities | 748 | 363 | - | 1,111 |
| Total | \$ 316,347 | 6,156 | 1,115 | 321,388 |

The current fair value and associated unrealized losses on investments in securities with unrealized losses at September 30, 2012 and December 31, 2011 are summarized in the tables below, with the length of time the individual securities have been in a continuous loss position.

(Dollars in thousands)

| | September 30, 2012 | | | | | |
|-------------------------------------|---------------------|----------------------|-------------------|----------------------|---------------|----------------------|
| | Less than 12 Months | | 12 Months or More | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Mortgage-backed securities | \$ 38,125 | 379 | 5,750 | 65 | 43,875 | 444 |
| State and political subdivisions | 4,406 | 46 | - | - | 4,406 | 46 |
| Total | \$ 42,531 | 425 | 5,750 | 65 | 48,281 | 490 |

(Dollars in thousands)

| | December 31, 2011 | | | | | |
|----------------------------------|---------------------|-------------------|-------------------|-------------------|----------------|-------------------|
| | Less than 12 Months | | 12 Months or More | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Mortgage-backed securities | \$ 95,122 | 991 | 4,125 | 65 | 99,247 | 1,056 |
| State and political subdivisions | 4,444 | 56 | - | - | 4,444 | 56 |
| Corporate bonds | 542 | 3 | - | - | 542 | 3 |
| Total | \$ 100,108 | 1,050 | 4,125 | 65 | 104,233 | 1,115 |

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At September 30, 2012, unrealized losses in the investment securities portfolio relating to debt securities totaled \$490,000. The unrealized losses on these debt securities arose due to changing interest rates and are considered to be temporary. From the September 30, 2012 tables above, seven out of 143 securities issued by state and political subdivisions contained unrealized losses and 21 out of 86 securities issued by U.S. Government sponsored enterprises, including mortgage-backed securities, contained unrealized losses. These unrealized losses are considered temporary because of acceptable investment grades on each security and the repayment sources of principal and interest are government backed.

The amortized cost and estimated fair value of investment securities available for sale at September 30, 2012, by contractual maturity, are shown below. Expected maturities of mortgage-backed securities will differ from contractual maturities because borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in thousands)

| | Amortized Cost | Estimated Fair Value |
|----------------------------|-------------------|----------------------------|
| Due within one year | \$ 3,611 | 3,653 |
| Due from one to five years | 12,117 | 12,581 |
| Due from five to ten years | 84,014 | 89,146 |
| Due after ten years | 13,753 | 14,864 |
| Mortgage-backed securities | 158,548 | 160,086 |
| Equity securities | 748 | 1,455 |
| Total | \$ 272,791 | 281,785 |

Proceeds from sales of securities available for sale during the nine months ended September 30, 2012 were \$47.0 million and resulted in gross gains of \$1.3 million and gross losses of \$103,000. Proceeds from sales of securities available for sale during the nine months ended September 30, 2011 were \$72.3 million and resulted in gross gains of \$2.5 million and gross losses of \$9,000.

Securities with a fair value of approximately \$88.8 million and \$83.6 million at September 30, 2012 and December 31, 2011, respectively, were pledged to secure public deposits and for other purposes as required by law.

(3) Loans

Major classifications of loans at September 30, 2012 and December 31, 2011 are summarized as follows:

(Dollars in thousands)

| | September 30, 2012 | December 31, 2011 |
|---|--------------------|----------------------|
| Real estate loans | | |
| Construction and land development | \$ 80,733 | 93,812 |
| Single-family residential | 249,167 | 267,051 |
| Commercial | 203,603 | 214,415 |
| Multifamily and farmland | 4,964 | 4,793 |
| Total real estate loans | 538,467 | 580,071 |
| Commercial loans (not secured by real estate) | 60,358 | 60,646 |
| Farm loans (not secured by real estate) | 12 | - |
| Consumer loans (not secured by real estate) | 10,303 | 10,490 |

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| | | |
|--|------------|---------|
| All other loans (not secured by real estate) | 16,642 | 19,290 |
| Total loans | 625,782 | 670,497 |
| Less allowance for loan losses | 16,551 | 16,604 |
| Total net loans | \$ 609,231 | 653,893 |

The Bank grants loans and extensions of credit primarily within the Catawba Valley region of North Carolina, which encompasses Catawba, Alexander, Iredell and Lincoln counties and also in Mecklenburg, Union and Wake counties of North Carolina. Although the Bank has a diversified loan portfolio, a substantial portion of the loan portfolio is collateralized by improved and unimproved real estate, the value of which is dependent upon the real estate market.

Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on non-accrual status when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. Loans may be placed on non-accrual status regardless of whether or not such loans are considered past due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

The following tables present an age analysis of past due loans, by loan type, as of September 30, 2012 and December 31, 2011:

September 30, 2012

(Dollars in thousands)

| | Loans 30-89 Days Past Due | Loans 90 or More Days Past Due | Total Past Due Loans | Total Current Loans | Total Loans | Accruing Loans 90 or More Days Past Due |
|--|---------------------------------|--|----------------------------|---------------------------|----------------|--|
| Real estate loans | | | | | | |
| Construction and land development | \$ 1,513 | 1,846 | 3,359 | 77,374 | 80,733 | - |
| Single-family residential | 8,145 | 4,758 | 12,903 | 236,264 | 249,167 | 2,396 |
| Commercial | 743 | 2,492 | 3,235 | 200,368 | 203,603 | - |
| Multifamily and farmland | 209 | - | 209 | 4,755 | 4,964 | - |
| Total real estate loans | 10,610 | 9,096 | 19,706 | 518,761 | 538,467 | 2,396 |
| Commercial loans (not secured by real estate) | 854 | 18 | 872 | 59,486 | 60,358 | - |
| Farm loans (not secured by real estate) | - | - | - | 12 | 12 | - |
| Consumer loans (not secured by real estate) | 119 | 5 | 124 | 10,179 | 10,303 | 2 |
| All other loans (not secured by real estate) | - | - | - | 16,642 | 16,642 | - |
| Total loans | \$ 11,583 | 9,119 | 20,702 | 605,080 | 625,782 | 2,398 |

December 31, 2011

(Dollars in thousands)

| | Loans 30-89 Days Past Due | Loans 90 or More Days Past Due | Total Past Due Loans | Total Current Loans | Total Loans | Accruing Loans 90 or More Days Past Due |
|--------------------------------------|---------------------------------|--|----------------------------|---------------------------|----------------|--|
| Real estate loans | | | | | | |
| Construction and land development | \$ 10,033 | 3,338 | 13,371 | 80,441 | 93,812 | - |

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| | | | | | | |
|---|-----------|--------|--------|---------|---------|-------|
| Single-family residential | 16,536 | 6,189 | 22,725 | 244,326 | 267,051 | 2,709 |
| Commercial | 1,002 | 958 | 1,960 | 212,455 | 214,415 | - |
| Multifamily and farmland | 13 | - | 13 | 4,780 | 4,793 | - |
| Total real estate loans | 27,584 | 10,485 | 38,069 | 542,002 | 580,071 | 2,709 |
| Commercial loans (not secured by real estate) | 576 | 9 | 585 | 60,061 | 60,646 | - |
| Consumer loans (not secured by real estate) | 116 | 36 | 152 | 10,338 | 10,490 | - |
| All other loans (not secured by real estate) | - | - | - | 19,290 | 19,290 | - |
| Total loans | \$ 28,276 | 10,530 | 38,806 | 631,691 | 670,497 | 2,709 |

The following table presents the Company's non-accrual loans as of September 30, 2012 and December 31, 2011:

(Dollars in thousands)

| | September 30, 2012 | December 31, 2011 |
|---|--------------------|-------------------|
| Real estate loans | | |
| Construction and land development | \$ 10,866 | 13,257 |
| Single-family residential | 4,255 | 5,522 |
| Commercial | 3,239 | 2,451 |
| Total real estate loans | 18,360 | 21,230 |
| Commercial loans (not secured by real estate) | 457 | 403 |
| Consumer loans (not secured by real estate) | 22 | 152 |
| Total | \$ 18,839 | 21,785 |

At each reporting period, the Bank determines which loans are impaired. Accordingly, the Bank's impaired loans are reported at their estimated fair value on a non-recurring basis. An allowance for each impaired loan, which is generally collateral-dependent, is calculated based on the fair value of its collateral. The fair value of the collateral is based on appraisals performed by REAS, a subsidiary of the Bank. REAS is staffed by certified appraisers that also perform appraisals for other companies. Factors including the assumptions and techniques utilized by the appraiser are considered by management. If the recorded investment in the impaired loan exceeds the measure of fair value of the collateral, a valuation allowance is recorded as a component of the allowance for loan losses. Impaired loans under \$250,000 are not individually evaluated for impairment, with the exception of the Bank's troubled debt restructured ("TDR") loans in the residential mortgage loan portfolio, which are individually evaluated for impairment. Accruing impaired loans were \$38.7 million, \$21.1 million and \$30.6 million at September 30, 2012, September 30, 2011 and December 31, 2011, respectively. Interest income recognized on accruing impaired loans was \$1.4 million, \$897,000 and \$1.7 million for the nine months ended September 30, 2012, the nine months ended September 30, 2011 and the year ended December 31, 2011, respectively. No interest income is recognized on non-accrual impaired loans subsequent to their classification as impaired.

The following tables present the Company's impaired loans as of September 30, 2012 and December 31, 2011:

September 30, 2012

(Dollars in thousands)

| | Unpaid Contractual Principal Balance | Recorded Investment With No Allowance | Recorded Investment With Allowance | Recorded Investment in Impaired Loans | Related Allowance | Average Outstanding Impaired Loans |
|--|---|--|---|--|----------------------|---|
| Real estate loans | | | | | | |
| Construction and land development | \$ 28,090 | 12,832 | 7,437 | 20,269 | 1,821 | 13,806 |
| Single-family residential | 29,652 | 5,193 | 23,416 | 28,609 | 1,343 | 28,620 |
| Commercial | 7,903 | 6,953 | 317 | 7,270 | 114 | 5,565 |
| Multifamily and farmland | 200 | 200 | - | 200 | - | 201 |
| Total impaired real estate loans | 65,845 | 25,178 | 31,170 | 56,348 | 3,278 | 48,192 |
| Commercial loans (not secured by real estate) | 1,155 | 1,117 | - | 1,117 | - | 1,187 |
| Consumer loans (not secured by real estate) | - | 30 | - | 30 | - | 38 |
| Total impaired loans | \$ 67,000 | 26,325 | 31,170 | 57,495 | 3,278 | 49,417 |

December 31, 2011

(Dollars in thousands)

| | Unpaid Contractual Principal Balance | Recorded Investment With No Allowance | Recorded Investment With Allowance | Recorded Investment in Impaired Loans | Related Allowance | Average Outstanding Impaired Loans |
|--------------------------|---|--|---|--|----------------------|---|
| Real estate loans | | | | | | |
| | \$ 28,721 | 14,484 | 6,098 | 20,582 | 3,264 | 17,848 |

| | | | | | | |
|---|-----------|--------|--------|--------|-------|--------|
| Construction and land development | | | | | | |
| Single-family residential | 26,382 | 969 | 24,719 | 25,688 | 1,427 | 25,102 |
| Commercial | 7,717 | 3,845 | 3,139 | 6,984 | 77 | 4,518 |
| Multifamily and farmland | 209 | - | 209 | 209 | 1 | 214 |
| Total impaired real estate loans | 63,029 | 19,298 | 34,165 | 53,463 | 4,769 | 47,682 |
| Commercial loans (not secured by real estate) | 1,111 | - | 1,083 | 1,083 | 26 | 1,485 |
| Consumer loans (not secured by real estate) | 157 | - | 152 | 152 | 2 | 140 |
| Total impaired loans | \$ 64,297 | 19,298 | 35,400 | 54,698 | 4,797 | 49,307 |

Changes in the allowance for loan losses for the nine months ended September 30, 2012 and the year ended December 31, 2011 were as follows:

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Nine months ended September 30, 2012

(Dollars in thousands)

| | Real Estate Loans | | | | | | | | Total |
|---|--|----------------------------------|------------|--------------------------------|------------|------|------------------------------|-------------|---------|
| | Construction and Land Development | Single- Family Residential | Commercial | Multifamily and Farmland | Commercial | Farm | Consumer and All Other | Unallocated | |
| Allowance for loan losses: | | | | | | | | | |
| Beginning balance | \$7,182 | 5,357 | 1,731 | 13 | 1,029 | - | 255 | 1,037 | 16,604 |
| Charge-offs | (3,045) | (1,149) | (547) | - | (498) | - | (403) | - | (5,642) |
| Recoveries | 522 | 71 | 374 | - | 95 | - | 115 | - | 1,177 |
| Provision | 1,733 | 817 | (21) | - | (18) | - | 222 | 1,679 | 4,412 |
| Ending balance | \$6,392 | 5,096 | 1,537 | 13 | 608 | - | 189 | 2,716 | 16,551 |
| Ending balance: individually evaluated for impairment | \$1,527 | 1,637 | 114 | - | - | - | - | - | 3,278 |
| Ending balance: collectively evaluated for impairment | 4,865 | 3,459 | 1,423 | 13 | 608 | - | 189 | 2,716 | 13,273 |
| Ending balance | \$6,392 | 5,096 | 1,537 | 13 | 608 | - | 189 | 2,716 | 16,551 |
| Loans: | | | | | | | | | |
| Ending balance | \$80,733 | 249,167 | 203,603 | 4,964 | 60,358 | 12 | 26,945 | - | 625,782 |
| Ending balance: individually evaluated for impairment | \$19,734 | 23,770 | 6,798 | - | 346 | - | - | - | 50,648 |
| Ending balance: collectively evaluated for impairment | \$60,999 | 225,397 | 196,805 | 4,964 | 60,012 | 12 | 26,945 | - | 575,134 |

Year ended December 31, 2011

(Dollars in thousands)

Real Estate Loans

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| | Construction and Land Development | Single- Family Residential | Commercial | Multifamily and Farmland | Commercial | Consumer and All Other | Unallocated | Total |
|---|---|----------------------------------|------------|--------------------------------|------------|------------------------------|-------------|-----------|
| Allowance for loan losses: | | | | | | | | |
| Beginning balance | | | | | | | | |
| | \$ 5,774 | 6,097 | 1,409 | 17 | 1,174 | 430 | 592 | 15,493 |
| Charge-offs | | | | | | | | |
| | (7,164) | (2,925) | (1,271) | - | (314) | (586) | - | (12,260) |
| Recoveries | | | | | | | | |
| | 241 | 201 | 24 | - | 121 | 152 | - | 739 |
| Provision | | | | | | | | |
| | 8,331 | 1,984 | 1,569 | (4) | 48 | 259 | 445 | 12,632 |
| Ending balance | | | | | | | | |
| | \$ 7,182 | 5,357 | 1,731 | 13 | 1,029 | 255 | 1,037 | 16,604 |
| Ending balance: individually evaluated for impairment | | | | | | | | |
| | \$ 1,250 | 1,289 | - | - | - | - | - | 2,539 |
| Ending balance: collectively evaluated for impairment | | | | | | | | |
| | 5,932 | 4,068 | 1,731 | 13 | 1,029 | 255 | 1,037 | 14,065 |
| Ending balance | | | | | | | | |
| | \$ 7,182 | 5,357 | 1,731 | 13 | 1,029 | 255 | 1,037 | 16,604 |
| Loans: | | | | | | | | |
| Ending balance | | | | | | | | |
| | \$ 93,812 | 267,051 | 214,415 | 4,793 | 60,646 | 29,780 | - | 670,497 |
| Ending balance: individually evaluated for impairment | | | | | | | | |
| | \$ 20,280 | 20,661 | 3,845 | - | - | - | - | 44,786 |
| Ending balance: collectively evaluated for impairment | | | | | | | | |
| | \$ 73,532 | 246,390 | 210,570 | 4,793 | 60,646 | 29,780 | - | 625,711 |

The Company utilizes an internal risk grading matrix to assign a risk grade to each of its loans. Loans are graded on a scale of 1 to 9. These risk grades are evaluated on an ongoing basis. A description of the general characteristics of the nine risk grades is as follows:

- Risk Grade 1 – Excellent Quality: Loans are well above average quality and a minimal amount of credit risk exists. CD or cash secured loans or properly margined actively traded stock or bond secured loans would fall in this grade.
- Risk Grade 2 – High Quality: Loans are of good quality with risk levels well within the Company’s range of acceptability. The organization or individual is established with a history of successful performance though somewhat susceptible to economic changes.
- Risk Grade 3 – Good Quality: Loans of average quality with risk levels within the Company’s range of acceptability but higher than normal. This may be a new organization or an existing organization in a transitional phase (e.g.

expansion, acquisition, market change).

- Risk Grade 4 – Management Attention: These loans have higher risk and servicing needs but still are acceptable. Evidence of marginal performance or deteriorating trends is observed. These are not problem credits presently, but may be in the future if the borrower is unable to change its present course.
- Risk Grade 5 – Watch: These loans are currently performing satisfactorily, but there has been some recent past due history on repayment and there are potential weaknesses that may, if not corrected, weaken the asset or inadequately protect the Company’s position at some future date.
- Risk Grade 6 – Substandard: A Substandard loan is inadequately protected by the current sound net worth and paying capacity of the obligor or the collateral pledged (if there is any). There is a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. There is a distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.
- Risk Grade 7 – Low Substandard: These loans have the general characteristics of a Grade 6 Substandard loan, with heightened potential concerns. The exact amount of loss is not yet known because neither the liquidation value of the collateral nor the borrower’s predicted repayment ability is known with confidence.
- Risk Grade 8 – Doubtful: Loans classified as Doubtful have all the weaknesses inherent in loans classified Substandard, plus the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values highly questionable and improbable. Doubtful is a temporary grade where a loss is expected but is presently not quantified with any degree of accuracy. Once the loss position is determined, the amount is charged off.
- Risk Grade 9 – Loss: Loans classified as Loss are considered uncollectable and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this worthless loan even though partial recovery may be realized in the future. Loss is a temporary grade until the appropriate authority is obtained to charge the loan off.

The following tables present the credit risk profile of each loan type based on internally assigned risk grades as of September 30, 2012 and December 31, 2011.

September 30, 2012
(Dollars in thousands)

| | Real Estate Loans | | | | | | | | Total |
|-------------------------------|--|----------------------------------|------------|--------------------------------|------------|------|----------|--------------|---------|
| | Construction and Land Development | Single- Family Residential | Commercial | Multifamily and Farmland | Commercial | Farm | Consumer | All Other | |
| 1- Excellent Quality | \$ 192 | 23,029 | - | - | 954 | - | 1,350 | - | 25,525 |
| 2- High Quality | 5,132 | 58,651 | 24,297 | 36 | 9,737 | - | 4,213 | 2,376 | 104,442 |
| 3- Good Quality | 23,443 | 88,980 | 116,735 | 2,647 | 36,287 | 12 | 4,226 | 14,261 | 286,591 |
| 4- Management Attention | 24,565 | 48,969 | 49,292 | 1,364 | 12,103 | - | 388 | 5 | 136,686 |
| 5- Watch | 8,177 | 11,249 | 8,609 | 717 | 351 | - | 89 | - | 29,192 |
| 6- Substandard | 19,224 | 18,289 | 4,670 | 200 | 926 | - | 37 | - | 43,346 |
| | - | - | - | - | - | - | - | - | - |

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| | | | | | | | | | |
|--------------------|-----------|---------|---------|-------|--------|----|--------|--------|---------|
| 7- Low Substandard | | | | | | | | | |
| 8- Doubtful | - | - | - | - | - | - | - | - | - |
| 9- Loss | - | - | - | - | - | - | - | - | - |
| Total | \$ 80,733 | 249,167 | 203,603 | 4,964 | 60,358 | 12 | 10,303 | 16,642 | 625,782 |

December 31, 2011
(Dollars in thousands)

| | Real Estate Loans | | | | | | | Total |
|-------------------------|-----------------------------------|---------------------------|------------|--------------------------|------------|----------|-----------|---------|
| | Construction and Land Development | Single-Family Residential | Commercial | Multifamily and Farmland | Commercial | Consumer | All Other | |
| 1- Excellent Quality | \$ 197 | 25,474 | - | - | 715 | 1,344 | - | 27,730 |
| 2- High Quality | 5,183 | 64,817 | 25,506 | 50 | 8,801 | 4,070 | 2,774 | 111,201 |
| 3- Good Quality | 27,675 | 100,388 | 136,137 | 3,448 | 36,585 | 4,259 | 16,509 | 325,001 |
| 4- Management Attention | 28,138 | 50,253 | 40,312 | 358 | 12,882 | 429 | 7 | 132,379 |
| 5- Watch | 15,923 | 11,767 | 2,795 | 728 | 622 | 89 | - | 31,924 |
| 6- Substandard | 16,696 | 14,352 | 9,665 | 209 | 1,041 | 154 | - | 42,117 |
| 7- Low Substandard | - | - | - | - | - | - | - | - |
| 8- Doubtful | - | - | - | - | - | - | - | - |
| 9- Loss | - | - | - | - | - | 145 | - | 145 |
| Total | \$ 93,812 | 267,051 | 214,415 | 4,793 | 60,646 | 10,490 | 19,290 | 670,497 |

At September 30, 2012, TDR loans were \$21.8 million, including \$1.8 million in performing TDR loans. Effective March 31, 2012, performing TDR balances reflect current year TDR loans only, in accordance with GAAP. Previously reported TDR amounts reflect cumulative TDR loans from prior periods in addition to current year TDR loans. At December 31, 2011, TDR loans were \$44.1 million, including \$15.1 million in performing TDR loans. The terms of these loans have been renegotiated to provide a reduction in principal or interest as a result of the deteriorating financial position of the borrower.

The following table presents an analysis of TDR loans by loan type as of September 30, 2012 and December 31, 2011.

September 30, 2012

(Dollars in thousands)

| | Number of Contracts | | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
|--|------------------------|----|---|--|
| Real estate loans | | | | |
| Construction and land development | 20 | \$ | 16,735 | 9,824 |
| Single-family residential | 97 | | 10,965 | 10,118 |
| Commercial | 5 | | 3,136 | 981 |
| Multifamily and Farmland | 1 | | 322 | 200 |
| Total real estate TDR loans | 123 | | 31,158 | 21,123 |
| Commercial loans (not secured by real estate) | | | | |
| Commercial loans (not secured by real estate) | 14 | | 1,271 | 706 |
| Consumer loans (not secured by real estate) | 1 | | 2 | 6 |
| Total TDR loans | 138 | \$ | 32,431 | 21,835 |

December 31, 2011

(Dollars in thousands)

| | Number of Contracts | | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
|--|------------------------|----|---|--|
| Real estate loans | | | | |
| Construction and land development | 29 | \$ | 19,762 | 12,840 |
| Single-family residential | 241 | | 25,541 | 24,846 |
| Commercial | 15 | | 7,200 | 5,013 |
| Multifamily and Farmland | 1 | | 322 | 209 |
| Total real estate TDR loans | 286 | | 52,825 | 42,908 |
| Commercial loans (not secured by real estate) | | | | |
| Commercial loans (not secured by real estate) | 21 | | 1,711 | 1,083 |
| Consumer loans (not secured by real estate) | 8 | | 124 | 142 |
| Total TDR loans | 315 | \$ | 54,660 | 44,133 |

(4)

Net Earnings Per Common Share

Net earnings per common share is based on the weighted average number of common shares outstanding during the period while the effects of potential common shares outstanding during the period are included in diluted earnings per common share. The average market price during the year is used to compute equivalent shares.

The reconciliation of the amounts used in the computation of both “basic earnings per common share” and “diluted earnings per common share” for the three and nine months ended September 30, 2012 and 2011 is as follows:

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For the three months ended September 30, 2012

| | Net Earnings Available to Common Shareholders (Dollars in thousands) | Common Shares | Per Share Amount |
|-----------------------------------|---|------------------|---------------------|
| Basic earnings per common share | \$ 1,256 | 5,559,016 | \$ 0.23 |
| Effect of dilutive securities: | | | |
| Stock options | - | 2,570 | |
| Diluted earnings per common share | \$ 1,256 | 5,561,586 | \$ 0.23 |

For the nine months ended September 30, 2012

| | Net Earnings Available to Common Shareholders (Dollars in thousands) | Common Shares | Per Share Amount |
|-----------------------------------|---|------------------|---------------------|
| Basic earnings per common share | \$ 3,727 | 5,549,148 | \$ 0.67 |
| Effect of dilutive securities: | | | |
| Stock options | - | 2,168 | |
| Diluted earnings per common share | \$ 3,727 | 5,551,316 | \$ 0.67 |

For the three months ended September 30, 2011

| | Net Earnings Available to Common Shareholders (Dollars in thousands) | Common Shares | Per Share Amount |
|-----------------------------------|---|------------------|---------------------|
| Basic earnings per common share | \$ 1,044 | 5,542,703 | \$ 0.19 |
| Effect of dilutive securities: | | | |
| Stock options | - | 1,922 | |
| Diluted earnings per common share | \$ 1,044 | 5,544,625 | \$ 0.19 |

For the nine months ended September 30, 2011

| | Net Earnings Available to Common Shareholders (Dollars in thousands) | Common Shares | Per Share Amount |
|---------------------------------|---|------------------|---------------------|
| Basic earnings per common share | \$ 2,337 | 5,542,126 | \$ 0.42 |
| Effect of dilutive securities: | | | |

| | | | | |
|-----------------------------------|----------|-----------|---------|--|
| Stock options | - | 1,739 | | |
| Diluted earnings per common share | \$ 2,337 | 5,543,865 | \$ 0.42 | |

(5) Stock-Based Compensation

The Company has an Omnibus Stock Ownership and Long Term Incentive Plan (the “1999 Plan”) whereby certain stock-based rights, such as stock options, restricted stock, restricted stock units, performance units, stock appreciation rights, or book value shares, may be granted to eligible directors and employees.

Under the 1999 Plan, the Company granted incentive stock options to certain eligible employees in order that they may purchase Company stock at a price equal to the fair market value on the date of the grant. The options granted in 1999 vested over a five-year period. Options granted subsequent to 1999 vested over a three-year period. All options expire ten years after issuance. The 1999 Plan expired on May 13, 2009.

The Company granted 3,000 restricted stock units in 2007 at a grant date fair value of \$17.40 per share. The Company granted 1,750 restricted stock units at a grant date fair value of \$12.80 per share during the third quarter of 2008 and 2,000 restricted stock units at a fair value of \$11.37 per share during the fourth quarter of 2008. The Company recognizes compensation expense on the restricted stock units over the period of time the restrictions are in place (three years from the grant date for the grants to date under the 1999 Plan). The amount of expense recorded each period reflects the changes in the Company's stock price during the period. As of September 30, 2012, there was no unrecognized compensation cost related to the 2007 and 2008 restricted stock unit grants.

The Company also has an Omnibus Stock Ownership and Long Term Incentive Plan that was approved by shareholders' on May 7, 2009 (the "2009 Plan") whereby certain stock-based rights, such as stock options, restricted stock, restricted stock units, performance units, stock appreciation rights, or book value shares, may be granted to eligible directors and employees. A total of 330,486 shares are currently reserved for possible issuance under the 2009 Plan. All rights must be granted or awarded within ten years from the May 7, 2009 effective date of the 2009 Plan.

The Company granted 29,514 restricted stock units in March 2012 at a grant date fair value of \$7.90 per share. 5,355 restricted stock units were forfeited by the executive officers of the Company as required by the agreement with the U.S. Department of the Treasury ("UST") in conjunction with the Company's participation in the Capital Purchase Program ("CPP") under the Troubled Asset Relief Program ("TARP") in 2008. In July 2012, the Company granted 5,355 restricted stock units at a grant date fair value of \$8.25. The Company recognizes compensation expense on the restricted stock units over the period of time the restrictions are in place (five years from the grant date for the grants to date under the 2009 Plan). The amount of expense recorded each period reflects the changes in the Company's stock price during the period. As of September 30, 2012, the total unrecognized compensation cost related to the 2012 restricted stock unit grants was \$264,000.

(6) Fair Value

The Company is required to disclose fair value information about financial instruments, whether or not recognized on the face of the balance sheet, for which it is practicable to estimate that value. The assumptions used in the estimation of the fair value of the Company's financial instruments are detailed below. Where quoted prices are not available, fair values are based on estimates using discounted cash flows and other valuation techniques. The use of discounted cash flows can be significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. The following disclosures should not be considered a surrogate of the liquidation value of the Company, but rather a good faith estimate of the increase or decrease in the value of financial instruments held by the Company since purchase, origination, or issuance.

The Company groups assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

- Level 1 – Valuation is based upon quoted prices for identical instruments traded in active markets.
- Level 2 – Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
- Level 3 – Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

Cash and Cash Equivalents

For cash, due from banks and interest-bearing deposits, the carrying amount is a reasonable estimate of fair value.

Investment Securities Available for Sale

Fair values of investment securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges when available. If quoted prices are not available, fair value is determined using matrix pricing, which is a mathematical technique used widely 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. Fair values for investment securities with quoted market prices are reported in the Level 1 fair value category. Fair value measurements obtained from independent pricing services are reported in the Level 2 fair value category. All other fair value measurements are reported in the Level 3 fair value category.

Other Investments

For other investments, the carrying value is a reasonable estimate of fair value.

Mortgage Loans Held for Sale

Mortgage loans held for sale are carried at lower of aggregate cost or market value. The cost of mortgage loans held for sale approximates the market value. Mortgage loans held for sale are reported in the Level 3 fair value category.

Loans

The fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings. For variable rate loans, the carrying amount is a reasonable estimate of fair value. Impaired loans with current certified appraisals are included in the Level 2 fair value category. All other loans are included in the Level 3 fair value category, as the pricing of loans is more subjective than the pricing of other financial instruments.

Cash Surrender Value of Life Insurance

For cash surrender value of life insurance, the carrying value is a reasonable estimate of fair value.

Other Real Estate

The fair value of other real estate is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. Other real estate is reported in the Level 3 fair value category.

Derivative Instruments

For derivative instruments, fair value is estimated as the amount that the Company would receive or pay to terminate the contracts at the reporting date, taking into account the current unrealized gains or losses on open contracts.

Deposits

The fair value of demand deposits, interest-bearing demand deposits and savings is the amount payable on demand at the reporting date. The fair value of certificates of deposit is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities.

Securities Sold Under Agreements to Repurchase

For securities sold under agreements to repurchase, the carrying value is a reasonable estimate of fair value.

Federal Home Loan Bank ("FHLB") Borrowings

The fair value of FHLB borrowings is estimated based upon discounted future cash flows using a discount rate comparable to the current market rate for such borrowings.

Junior Subordinated Debentures

Because the Company's junior subordinated debentures were issued at a floating rate, the carrying amount is a reasonable estimate of fair value.

Commitments to Extend Credit and Standby Letters of Credit

Commitments to extend credit and standby letters of credit are generally short-term and at variable interest rates. Therefore, both the carrying value and estimated fair value associated with these instruments are immaterial.

Limitations

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Because no market exists for a

significant portion of the Company's financial instruments, fair value estimates are based on many judgments. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Significant assets and liabilities that are not considered financial instruments include deferred income taxes and premises and equipment. In addition, the tax ramifications related to the realization of unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

GAAP establishes a framework for measuring fair value and expands disclosures about fair value measurements. There is a three-level fair value hierarchy for fair value measurements. Level 1 inputs are quoted prices in active markets for identical assets or liabilities that a company has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. The following tables present the balance of securities available for sale and mortgage loans held for sale, which are measured at fair value on a recurring basis by level within the fair value hierarchy as of September 30, 2012 and December 31, 2011.

(Dollars in thousands)

| | Fair Value Measurements | September 30, 2012 | | |
|--|----------------------------|----------------------|----------------------|----------------------|
| | | Level 1 Valuation | Level 2 Valuation | Level 3 Valuation |
| Mortgage-backed securities | \$ 160,086 | - | 160,086 | - |
| U.S. Government sponsored enterprises | \$ 1,294 | - | 1,294 | - |
| State and political subdivisions | \$ 116,149 | - | 116,149 | - |
| Corporate bonds | \$ 1,551 | - | 1,551 | - |
| Trust preferred securities | \$ 1,250 | - | - | 1,250 |
| Equity securities | \$ 1,455 | 1,455 | - | - |
| Mortgage loans held for sale | \$ 5,984 | - | - | 5,984 |

(Dollars in thousands)

| | Fair Value Measurements | December 31, 2011 | | |
|--|----------------------------|----------------------|----------------------|----------------------|
| | | Level 1 Valuation | Level 2 Valuation | Level 3 Valuation |
| Mortgage-backed securities | \$ 213,693 | - | 208,349 | 5,344 |
| U.S. Government sponsored enterprises | \$ 7,694 | - | 7,694 | - |
| State and political subdivisions | \$ 97,097 | - | 97,097 | - |
| Corporate bonds | \$ 543 | - | 543 | - |
| Trust preferred securities | \$ 1,250 | - | - | 1,250 |
| Equity securities | \$ 1,111 | 1,111 | - | - |
| Mortgage loans held for sale | \$ 5,146 | - | - | 5,146 |

The following is an analysis of fair value measurements of investment securities available for sale using Level 3, significant unobservable inputs, for the nine months ended September 30, 2012. Transfers out of Level 3 during the nine months ended September 30, 2012 are attributable to one available for sale security reported in Level 3 at December 31, 2011 because market pricing was unavailable from the Bank's third party bond accounting provider at that time. This security was reported in Level 2 at September 30, 2012, as the market valuation was provided by the Bank's third party bond accounting provider.

(Dollars in thousands)

| | Investment Securities Available for Sale Level 3 Valuation |
|---|--|
| Balance, beginning of period | \$ 6,594 |
| Change in book value | - |
| Change in gain/(loss) realized and unrealized | - |
| Purchases/(sales) | - |
| Transfers in and/or (out) of Level 3 | (5,344) |
| Balance, end of period | \$ 1,250 |
| Change in unrealized gain/(loss) for assets still held in Level 3 | \$ - |

The Company's September 30, 2012 and December 31, 2011 fair value measurement for impaired loans and other real estate on a non-recurring basis is presented below:

(Dollars in thousands)

| | Fair Value Measurements September 30, 2012 | Level 1 Valuation | Level 2 Valuation | Level 3 Valuation | Total Gains/(Losses) for the Nine Months Ended September 30, 2012 |
|-------------------|--|----------------------|----------------------|----------------------|---|
| Impaired loans | \$ 57,495 | - | - | 57,495 | (5,408) |
| Other real estate | \$ 6,595 | - | - | 6,595 | (710) |

(Dollars in thousands)

| | Fair Value Measurements December 31, 2011 | Level 1 Valuation | Level 2 Valuation | Level 3 Valuation | Total Gains/(Losses) for the Year Ended December 31, 2011 |
|-------------------|---|----------------------|----------------------|----------------------|---|
| Impaired loans | \$ 49,901 | - | 431 | 49,470 | (11,864) |
| Other real estate | \$ 7,576 | - | - | 7,576 | (1,322) |

The carrying amount and estimated fair value of the Company's financial instruments at September 30, 2012 and December 31, 2011 are as follows:

(Dollars in thousands)

| | Carrying Amount | Fair Value Measurements at September 30, 2012 | | | Total |
|--|--------------------|---|---------|---------|---------|
| | | Level 1 | Level 2 | Level 3 | |
| Assets: | | | | | |
| Cash and cash equivalents | \$ 55,904 | 55,904 | - | - | 55,904 |
| Investment securities available for sale | 281,785 | 1,455 | 279,080 | 1,250 | 281,785 |
| Other investments | 5,599 | - | - | 5,599 | 5,599 |
| Mortgage loans held for sale | 5,984 | - | - | 5,984 | 5,984 |

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| | | | | | |
|--|------------|---|---------|---------|---------|
| Loans, net | 609,231 | - | - | 604,690 | 604,690 |
| Cash surrender value of life insurance | 13,142 | - | 13,142 | - | 13,142 |
| Liabilities: | | | | | |
| Deposits | \$ 768,470 | - | 767,543 | - | 767,543 |
| Securities sold under agreements to repurchase | 43,136 | - | 43,136 | - | 43,136 |
| FHLB borrowings | 70,000 | - | 75,938 | - | 75,938 |
| Junior subordinated debentures | 20,619 | - | 20,619 | - | 20,619 |

(Dollars in thousands)

| | December 31, 2011 | |
|---|--------------------|-------------------------|
| | Carrying Amount | Estimated Fair Value |
| Assets: | | |
| Cash and cash equivalents | \$ 29,236 | 29,236 |
| Investment securities available for sale | 321,388 | 321,388 |
| Other investments | 5,712 | 5,712 |
| Mortgage loans held for sale | 5,146 | 5,146 |
| Loans, net | 653,893 | 648,640 |
| Cash surrender value of life insurance | 12,835 | 12,835 |
| Liabilities: | | |
| Deposits and demand notes payable | \$ 827,111 | 826,810 |
| Securities sold under agreements to repurchase | 39,600 | 39,600 |
| FHLB borrowings | 70,000 | 75,046 |
| Junior subordinated debentures | 20,619 | 20,619 |

(7) Derivative Instruments and Hedging Activities

Accounting Policy for Derivative Instruments and Hedging Activities

The disclosure requirements for derivatives and hedging activities have the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The disclosure requirements include qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

The Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts that are intended to economically hedge certain of its risks, even though hedge accounting does not apply or the Company elects not to apply hedge accounting.

Risk Management Objective of Using Derivatives

The Company has an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. By using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair value gain in the derivative. The Company minimizes the credit risk in derivative

instruments by entering into transactions with high-quality counterparties that are reviewed periodically by the Company. The Company did not have any interest rate derivatives outstanding as of September 30, 2012 and December 31, 2011.

Fair Values of Derivative Instruments on the Balance Sheet

The Company did not have any interest rate derivatives outstanding as of September 30, 2012 and December 31, 2011.

Cash Flow Hedges of Interest Rate Risk

The Company's objectives in using interest rate derivatives are to add stability to interest income and expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps and floors as part of its interest rate risk management strategy. For hedges of the Company's variable-rate loan assets, interest rate swaps designated as cash flow hedges involve the receipt of fixed-rate amounts from a counterparty in exchange for the Company making variable-rate payments over the life of the agreements without exchange of the underlying notional amount. For hedges of the Company's variable-rate loan assets, the interest rate floors designated as a cash flow hedge involves the receipt of variable-rate amounts from a counterparty if interest rates fall below the strike rate on the contract in exchange for an up front premium. The Company had an interest rate swap contract that expired in June 2011. The Company did not have any interest rate derivatives outstanding as of September 30, 2012 and December 31, 2011.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in "Accumulated Other Comprehensive Income" and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. Such derivatives were used to hedge the variable cash inflows associated with existing pools of prime-based loan assets during 2011. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. The Company's derivatives did not have any hedge ineffectiveness recognized in earnings during the nine months ended September 30, 2012 and 2011.

Effect of Derivative Instruments on the Income Statement

The table below presents the effect of the Company's derivative financial instruments on the statement of earnings for the nine months ended September 30, 2012 and 2011.

(Dollars in thousands)

| | Amount of Gain (Loss) Recognized in Accumulated OCI on Derivatives Nine months ended September 30, | | Location of Gain (Loss) Reclassified from Accumulated OCI into Income | Amount of Gain (Loss) Reclassified from Accumulated OCI into Income Nine months ended September 30, | |
|------------------------------------|---|---------|--|--|--------|
| | 2012 | 2011 | | 2012 | 2011 |
| Interest rate derivative contracts | \$ - | \$ (20) | Interest income | \$- | \$ 628 |

(8) TARP Repurchase

On July 3, 2012, the Company purchased 12,530 shares of the Company's 25,054 outstanding shares of preferred stock from the UST, which was issued to UST in connection with the Company's participation in the CPP under the TARP in 2008. The shares were purchased for \$933.36 per share, for a total purchase price of \$11,778,575.90, including \$83,575.10 accrued and unpaid dividends on the preferred stock. The Company retired the 12,530 shares purchased. The \$834,999.20 difference between the \$12,530,000 face value of the preferred stock retired and the \$11,695,000.80 purchase price of the preferred stock retired was credited to retained earnings.

On August 8, 2012, the Company completed its repurchase of the warrant (the “Warrant”) to purchase 357,234 shares of the Company's common stock that was issued to the UST on December 23, 2008 as part of the CPP under TARP. The Company repurchased the Warrant for a total price of \$425,000.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

The following is a discussion of our financial position and results of operations and should be read in conjunction with the information set forth under Item 1A Risk Factors and the Company's Consolidated Financial Statements and Notes thereto on pages A-28 through A-63 of the Company's 2011 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 3, 2012 Annual Meeting of Shareholders.

Introduction

Management's discussion and analysis of earnings and related data are presented to assist in understanding the consolidated financial condition and results of operations of the Company. The Company is the parent company of the Bank and a registered bank holding company operating under the supervision of the Board of Governors of the Federal Reserve System (the "Federal Reserve"). The Bank is a North Carolina-chartered bank, with offices in Catawba, Lincoln, Alexander, Mecklenburg, Iredell, Union and Wake counties, operating under the banking laws of North Carolina and the rules and regulations of the Federal Deposit Insurance Corporation (the "FDIC").

Overview

Our business consists principally of attracting deposits from the general public and investing these funds in commercial loans, real estate mortgage loans, real estate construction loans and consumer loans. Our profitability depends primarily on our net interest income, which is the difference between the income we receive on our loan and investment securities portfolios and our cost of funds, which consists of interest paid on deposits and borrowed funds. Net interest income also is affected by the relative amounts of our interest-earning assets and interest-bearing liabilities. When interest-earning assets approximate or exceed interest-bearing liabilities, a positive interest rate spread will generate net interest income. Our profitability is also affected by the level of other income and operating expenses. Other income consists primarily of miscellaneous fees related to our loans and deposits, mortgage banking income and commissions from sales of annuities and mutual funds. Operating expenses consist of compensation and benefits, occupancy related expenses, federal deposit and other insurance premiums, data processing, advertising and other expenses.

Our operations are influenced significantly by local economic conditions and by policies of financial institution regulatory authorities. The earnings on our assets are influenced by the effects of, and changes in, trade, monetary and fiscal policies and laws, including interest rate policies of the Federal Reserve, inflation, interest rates, market and monetary fluctuations. Lending activities are affected by the demand for commercial and other types of loans, which in turn is affected by the interest rates at which such financing may be offered. Our cost of funds is influenced by interest rates on competing investments and by rates offered on similar investments by competing financial institutions in our market area, as well as general market interest rates. These factors can cause fluctuations in our net interest income and other income. In addition, local economic conditions can impact the credit risk of our loan portfolio, in that (1) local employers may be required to eliminate employment positions of individual borrowers, and (2) small businesses and commercial borrowers may experience a downturn in their operating performance and become unable to make timely payments on their loans. Management evaluates these factors in estimating its allowance for loan losses and changes in these economic factors could result in increases or decreases to the provision for loan losses.

Economic conditions in 2012 continue to have a negative impact on our financial condition and results of operations. Unfavorable economic indicators, such as high unemployment, falling real estate prices and higher than normal levels of loan defaults demonstrate the difficult business conditions that are affecting the general economy and therefore our operating results. The unemployment rates in our primary market area continue to be higher than state and national averages.

On July 21, 2010, President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") into law. This new legislation makes extensive changes to the laws regulating financial products and

services as well as firms and companies offering financial products and services. The Dodd-Frank Act also alters certain corporate governance matters affecting public companies. The legislation requires substantial rulemaking and mandates numerous additional studies, the results of which could impact future legislative and regulatory action. We continue to evaluate this legislation including its related rules and regulations, and we are assessing the extent to which it will impact our current and future operations. Among other things that could have an impact on our operations and activities, the Dodd-Frank Act (i) amends the manner for calculating the assessment base for deposit insurance premiums paid to the FDIC; (ii) requires the federal banking agencies to issue new rules to implement new minimum leverage and risk-based capital requirements for insured depository institutions; and (iii) requires the Securities and Exchange Commission to complete studies and develop rules or approve stock exchange rules regarding various investor protection issues, including shareholder access to the proxy process, and various matters pertaining to executive compensation and compensation committee oversight. Additionally, the Dodd-Frank Act establishes the Consumer Financial Protection Bureau (“Bureau”) as an independent federal agency, which has broad rulemaking, supervisory and enforcement authority over financial institutions providing consumer financial products and services. Examples of such products and services include deposit products, residential mortgages, home-equity loans and credit cards. Under the Dodd-Frank Act, states are permitted to adopt more stringent consumer protection laws, and state attorneys general can enforce those laws as well as consumer protection rules issued by the Bureau.

While we are unable to determine all ramifications of the Dodd-Frank Act at this time, we expect that many of the requirements called for in the Dodd-Frank Act will be implemented over time, and most will be subject to implementing regulations over the course of several years. Given the uncertainty associated with the manner in which the provisions of the Dodd-Frank Act will be implemented by the various regulatory agencies, the full extent of the impact of such requirements will have on financial institutions' operations is unclear. The changes resulting from the Dodd-Frank Act may impact the profitability of our business activities, require changes to certain of our business practices, impose upon us more stringent capital, liquidity and leverage ratio requirements or otherwise adversely affect our business. These changes may also require us to invest significant management attention and resources to evaluate and make necessary changes in order to comply with new statutory and regulatory requirements.

Although we are unable to control the external factors that influence our business, by maintaining high levels of balance sheet liquidity, managing our interest rate exposures and by actively monitoring asset quality, we seek to minimize the potentially adverse risks of unforeseen and unfavorable economic trends.

Our business emphasis has been to operate as a well-capitalized, profitable and independent community-oriented financial institution dedicated to providing quality customer service. We are committed to meeting the financial needs of the communities in which we operate. We believe that we can be more effective in servicing our customers than many of our non-local competitors because of our ability to quickly and effectively provide senior management responses to customer needs and inquiries. Our ability to provide these services is enhanced by the stability of our senior management team.

The Federal Reserve has maintained the Federal Funds Rate at 0.25% since December 2008. This historically low rate has had a negative impact on earnings and will continue to have a negative impact on our net interest income in future periods. The negative impact of low interest rates has been partially offset by earnings realized on interest rate contracts utilized by the Bank. Additional information regarding the Bank's interest rate contracts is provided below in the section entitled "Asset Liability and Interest Rate Risk Management."

On December 23, 2008, the Company entered into a Securities Purchase Agreement ("Purchase Agreement") with the UST pursuant to the CPP under TARP. Under the Purchase Agreement, the Company agreed to issue and sell 25,054 shares of Series A preferred stock and a Warrant to purchase 357,234 shares of the Company's common stock. Proceeds from this issuance of Series A preferred shares were allocated between preferred stock and the Warrant based on their relative fair values at the time of the sale. Of the \$25.1 million in proceeds, \$24.4 million was allocated to the Series A preferred stock and \$704,000 was allocated to the Warrant. The discount recorded on the Series A preferred stock that resulted from allocating a portion of the proceeds to the Warrant is being accreted directly to retained earnings over a five-year period applying a level yield. As of September 30, 2012, the Company has accreted a total of \$478,000 of the discount related to the Series A preferred stock.

The Series A preferred stock qualifies as Tier 1 capital and will pay cumulative dividends at a rate of 5% per annum for the first five years and 9% per annum thereafter. The Series A preferred stock may be redeemed at the stated amount of \$1,000 per share plus any accrued and unpaid dividends. Under the terms of the original Purchase Agreement, the Company could not redeem the Series A preferred shares until December 23, 2011 unless the total amount of the issuance, \$25.1 million, was replaced with the same amount of other forms of capital that would qualify as Tier 1 capital. However, with the enactment of the American Recovery and Reinvestment Act of 2009 ("ARRA"), the Company can now redeem the Series A preferred shares at any time, if approved by the Company's primary regulator. The Series A preferred stock is non-voting except for class voting rights on matters that would adversely affect the rights of the holders of the Series A preferred stock.

The UST sold all of the Company's CPP preferred stock in a public auction during the second quarter of 2012, and, as a result, the Company is no longer subject to the executive compensation and corporate governance standards imposed

by TARP. The Company purchased 12,530 shares of the Company's 25,054 outstanding shares of preferred stock from the UST, which was issued to the UST in connection with the Company's participation in the CPP under TARP in 2008. The shares were purchased for \$933.36 per share, for a total purchase price of \$11,778,575.90, including \$83,575.10 accrued and unpaid dividends on the preferred stock. The Company retired the 12,530 shares purchased. The \$834,999.20 difference between the \$12,530,000 face value of the preferred stock retired and the \$11,695,000.80 purchase price of the preferred stock retired was credited to retained earnings effective June 30, 2012. Remaining preferred shares are redeemable at any time at par. The Company expects to be able to repurchase the shares from future earnings, however, there are no immediate plans to repurchase these shares.

On August 8, 2012, the Company completed its repurchase of the Warrant to purchase 357,234 shares of the Company's common stock that was issued to the UST on December 23, 2008, as part of the CPP under TARP. The Company repurchased the Warrant for a total price of \$425,000. The exercise price of the Warrant was \$10.52 per common share and was exercisable at anytime on or before December 18, 2018.

Summary of Significant Accounting Policies

The Company's accounting policies are fundamental to understanding management's discussion and analysis of results of operations and financial condition. Many of the Company's accounting policies require significant judgment regarding valuation of assets and liabilities and/or significant interpretation of specific accounting guidance. A more complete description of the Company's significant accounting policies can be found in Note 1 of the Notes to Consolidated Financial Statements in the Company's 2011 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 3, 2012 Annual Meeting of Shareholders.

Many of the Company's assets and liabilities are recorded using various techniques that require significant judgment as to recoverability. The collectibility of loans is reflected through the Company's estimate of the allowance for loan losses. The Company performs periodic and systematic detailed reviews of its lending portfolio to assess overall collectibility. In addition, certain assets and liabilities are reflected at their estimated fair value in the consolidated financial statements. Such amounts are based on either quoted market prices or estimated values derived from dealer quotes used by the Company, market comparisons or internally generated modeling techniques. The Company's internal models generally involve present value of cash flow techniques. The various techniques are discussed in greater detail elsewhere in management's discussion and analysis and the Notes to the Consolidated Financial Statements.

There are other complex accounting standards that require the Company to employ significant judgment in interpreting and applying certain of the principles prescribed by those standards. These judgments include, but are not limited to, the determination of whether a financial instrument or other contract meets the definition of a derivative in accordance with GAAP.

The disclosure requirements for derivatives and hedging activities have the intent to provide users of financial statements with an enhanced understanding of: (a) how and why an entity uses derivative instruments, (b) how derivative instruments and related hedged items are accounted for and (c) how derivative instruments and related hedged items affect an entity's financial position, financial performance, and cash flows. The disclosure requirements include qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about the fair value of and gains and losses on derivative instruments, and disclosures about credit-risk-related contingent features in derivative instruments.

The Company records all derivatives on the balance sheet at fair value. The accounting for changes in the fair value of derivatives depends on the intended use of the derivative, whether the Company has elected to designate a derivative in a hedging relationship and apply hedge accounting and whether the hedging relationship has satisfied the criteria necessary to apply hedge accounting. Derivatives designated and qualifying as a hedge of the exposure to changes in the fair value of an asset, liability, or firm commitment attributable to a particular risk, such as interest rate risk, are considered fair value hedges. Derivatives designated and qualifying as a hedge of the exposure to variability in expected future cash flows, or other types of forecasted transactions, are considered cash flow hedges. Hedge accounting generally provides for the matching of the timing of gain or loss recognition on the hedging instrument with the recognition of the changes in the fair value of the hedged asset or liability that are attributable to the hedged risk in a fair value hedge or the earnings effect of the hedged forecasted transactions in a cash flow hedge. The Company may enter into derivative contracts that are intended to economically hedge certain of its risks, even though hedge accounting does not apply or the Company elects not to apply hedge accounting.

The Company has an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. By using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair-value gain in the derivative. The Company minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties that are reviewed periodically by the Company. The Company had an interest rate swap contract that expired in June 2011. The Company did not have any interest rate derivatives outstanding as of September 30, 2012.

The Company's objectives in using interest rate derivatives are to add stability to interest income and expense and to manage its exposure to interest rate movements. To accomplish this objective, the Company primarily uses interest rate swaps and floors as part of its interest rate risk management strategy. For hedges of the Company's variable-rate loan assets, interest rate swaps designated as cash flow hedges involve the receipt of fixed-rate amounts from a counterparty in exchange for the Company making variable-rate payments over the life of the agreements without exchange of the underlying notional amount. For hedges of the Company's variable-rate loan assets, the interest rate floor designated as a cash flow hedge involves the receipt of variable-rate amounts from a counterparty if interest rates fall below the strike rate on the contract in exchange for an up front premium.

The effective portion of changes in the fair value of derivatives designated and that qualify as cash flow hedges is recorded in "Accumulated Other Comprehensive Income" and is subsequently reclassified into earnings in the period that the hedged forecasted transaction affects earnings. Such derivatives were used to hedge the variable cash inflows associated with existing pools of prime-based loan assets during 2011. The ineffective portion of the change in fair value of the derivatives is recognized directly in earnings. The Company's derivatives did not have any hedge ineffectiveness recognized in earnings during the nine months ended September 30, 2012 and 2011.

The table below presents the effect of the Company's derivative financial instruments on the consolidated statement of earnings for the nine months ended September 30, 2012 and 2011.

(Dollars in thousands)

| | Amount of Gain (Loss) Recognized in Accumulated OCI on Derivatives Nine months ended September 30, | | Location of Gain (Loss) Reclassified from Accumulated OCI into Income | Amount of Gain (Loss) Reclassified from Accumulated OCI into Income Nine months ended September 30, | |
|------------------------------------|---|---------|--|--|--------|
| | 2012 | 2011 | | 2012 | 2011 |
| Interest rate derivative contracts | \$- | \$ (20) | Interest income | \$- | \$ 628 |

GAAP establishes a framework for measuring fair value and expands disclosures about fair value measurements. There is a three-level fair value hierarchy for fair value measurements. Level 1 inputs are quoted prices in active markets for identical assets or liabilities that a company has the ability to access at the measurement date. Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. Level 3 inputs are unobservable inputs for the asset or liability. The tables below present the balance of securities available for sale and mortgage loans held for sale, which are measured at fair value on a recurring basis by level within the fair value hierarchy as of September 30, 2012 and December 31, 2011.

(Dollars in thousands)

| | Fair Value Measurements | September 30, 2012 | | |
|--|----------------------------|----------------------|----------------------|----------------------|
| | | Level 1 Valuation | Level 2 Valuation | Level 3 Valuation |
| Mortgage-backed securities | \$ 160,086 | - | 160,086 | - |
| U.S. Government sponsored enterprises | \$ 1,294 | - | 1,294 | - |
| State and political subdivisions | \$ 116,149 | - | 116,149 | - |
| Corporate bonds | \$ 1,551 | - | 1,551 | - |
| Trust preferred securities | \$ 1,250 | - | - | 1,250 |
| Equity securities | \$ 1,455 | 1,455 | - | - |
| Mortgage loans held for sale | \$ 5,984 | - | - | 5,984 |

(Dollars in thousands)

| | Fair Value Measurements | December 31, 2011 | | |
|--|----------------------------|----------------------|----------------------|----------------------|
| | | Level 1 Valuation | Level 2 Valuation | Level 3 Valuation |
| Mortgage-backed securities | \$ 213,693 | - | 208,349 | 5,344 |
| U.S. Government sponsored enterprises | \$ 7,694 | - | 7,694 | - |
| State and political subdivisions | \$ 97,097 | - | 97,097 | - |
| Corporate bonds | \$ 543 | - | 543 | - |
| Trust preferred securities | \$ 1,250 | - | - | 1,250 |
| Equity securities | \$ 1,111 | 1,111 | - | - |
| Mortgage loans held for sale | \$ 5,146 | - | - | 5,146 |

Fair values of investment securities available for sale are determined by obtaining quoted prices on nationally recognized securities exchanges when available. If quoted prices are not available, fair value is determined using matrix pricing, which is a mathematical technique used widely 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. Fair values of derivative instruments are determined using widely accepted valuation techniques including discounted cash flow analysis on the expected cash flows of each derivative. This analysis reflects the contractual terms of the derivatives, including the period to maturity, and uses observable market-based inputs, including interest rate curves and implied volatilities.

The following is an analysis of fair value measurements of investment securities available for sale using Level 3, significant unobservable inputs, for the nine months ended September 30, 2012:

(Dollars in thousands)

| | Investment Securities Available for Sale Level 3 Valuation |
|---|--|
| Balance, beginning of period | \$ 6,594 |
| Change in book value | - |
| Change in gain/(loss) realized and unrealized | - |
| Purchases/(sales) | - |
| Transfers in and/or (out) of Level 3 | (5,344) |
| Balance, end of period | \$ 1,250 |
| Change in unrealized gain/(loss) for assets still held in Level 3 | \$ - |

The Company's September 30, 2012 and December 31, 2011 fair value measurement for impaired loans and other real estate on a non-recurring basis is presented below:

(Dollars in thousands)

| | Fair Value Measurements September 30, 2012 | Level 1 Valuation | Level 2 Valuation | Level 3 Valuation | Total Gains/(Losses) for the Nine Months Ended September 30, 2012 |
|-------------------|--|----------------------|----------------------|----------------------|---|
| Impaired loans | \$ 57,495 | - | - | 57,495 | (5,408) |
| Other real estate | \$ 6,595 | - | - | 6,595 | (710) |

(Dollars in thousands)

| | Fair Value Measurements December 31, 2011 | Level 1 Valuation | Level 2 Valuation | Level 3 Valuation | Total Gains/(Losses) for the Year Ended December 31, 2011 |
|-------------------|---|----------------------|----------------------|----------------------|---|
| Impaired loans | \$ 49,901 | - | 431 | 49,470 | (11,864) |
| Other real estate | \$ 7,576 | - | - | 7,576 | (1,322) |

At each reporting period, the Bank determines which loans are impaired. Accordingly, the Bank's impaired loans are reported at their estimated fair value on a non-recurring basis. An allowance for each impaired loan, which is

generally collateral-dependent, is calculated based on the fair value of its collateral. The fair value of the collateral is based on appraisals performed by REAS, a subsidiary of the Bank. REAS is staffed by certified appraisers that also perform appraisals for other companies. Factors including the assumptions and techniques utilized by the appraiser are considered by management. If the recorded investment in the impaired loan exceeds the measure of fair value of the collateral, a valuation allowance is recorded as a component of the allowance for loan losses. Impaired loans under \$250,000 are not individually evaluated for impairment, with the exception of the Bank's TDR loans in the residential mortgage loan portfolio, which are individually evaluated for impairment. Accruing impaired loans were \$38.7 million, \$21.1 million and \$30.6 million at September 30, 2012, September 30, 2011 and December 31, 2011, respectively. Interest income recognized on accruing impaired loans was \$1.4 million, \$897,000 and \$1.7 million for the nine months ended September 30, 2012, the nine months ended September 30, 2011 and the year ended December 31, 2011, respectively. No interest income is recognized on non-accrual impaired loans subsequent to their classification as impaired.

Results of Operations

Summary. Net earnings for the third quarter of 2012 were \$1.4 million, or \$0.25 basic and diluted net earnings per share before adjustment for preferred stock dividends and accretion as compared to \$1.4 million, or \$0.25 basic and diluted net earnings per share before adjustment for preferred stock dividends and accretion for the same period one year ago. After adjusting for dividends and accretion on preferred stock, net earnings available to common shareholders for the three months ended September 30, 2012 were \$1.3 million, or \$0.23 basic and diluted net earnings per common share as compared to \$1.0 million, or \$0.19 basic and diluted net earnings per common share for the same period one year ago. The increase in third quarter earnings is attributable to a decrease in the provision for loan losses, which was partially offset by a decrease in net interest income, a decrease in non-interest income and an increase in non-interest expense.

The annualized return on average assets was 0.55% for the three months ended September 30, 2012 compared to 0.51% for the same period one year ago, and annualized return on average shareholders' equity was 5.80% for the three months ended September 30, 2012 compared to 5.31% for the same period one year ago.

Year-to-date net earnings as of September 30, 2012 were \$4.6 million, or \$0.83 basic and diluted net earnings per share before adjustment for preferred stock dividends and accretion, as compared to \$3.4 million, or \$0.61 basic and diluted net earnings per share before adjustment for preferred stock dividends and accretion, for the same period one year ago. After adjusting for dividends and accretion on preferred stock, net earnings available to common shareholders for the nine months ended September 30, 2012 were \$3.7 million or \$0.67 basic and diluted net earnings per common share as compared to \$2.3 million, or \$0.42 basic and diluted net earnings per common share, for the same period one year ago. The increase in year-to-date earnings is primarily attributable to aggregate decreases in the provision for loan losses, which were partially offset by aggregate decreases in net interest income and non-interest income and aggregate increases in non-interest expense, as discussed below.

The annualized return on average assets was 0.59% for the nine months ended September 30, 2012 compared to 0.46% for the same period in 2011, and annualized return on average shareholders' equity was 5.86% for the nine months ended September 30, 2012 compared to 4.49% for the same period in 2011.

Net Interest Income. Net interest income, the major component of the Company's net earnings, was \$7.8 million for the three months ended September 30, 2012 compared to \$8.6 million for the same period one year ago. This decrease was primarily due to a decrease in interest income resulting from reduction in average loans and investment securities and a decrease in the yield on earning assets, which were partially offset by a decrease in interest expense due to a reduction in the cost of funds and a reduction in interest-bearing liabilities.

Interest income decreased \$1.6 million or 14% for the three months ended September 30, 2012 compared to the same period one year ago. The decrease was due to a reduction in average loans and investment securities and a decrease in the yield on earning assets. The average yield on earning assets for the quarters ended September 30, 2012 and 2011 was 4.22% and 4.57%, respectively. During the quarter ended September 30, 2012, average loans decreased \$47.7 million to \$639.4 million from \$687.1 million for the three months ended September 30, 2011. During the quarter ended September 30, 2012, average investment securities available for sale decreased \$34.9 million to \$278.9 million from \$313.8 million for the three months ended September 30, 2011. This decrease reflects investment securities sold during the nine months ended September 30, 2012, totaling \$47.0 million, which were partially offset by purchases of investment securities.

Interest expense decreased \$831,000 or 31% for the three months ended September 30, 2012 compared with the same period one year ago due to lower cost of funds and a reduction in certificates of deposit. The average rate paid on interest-bearing checking and savings accounts was 0.31% for the three months ended September 30, 2012 as compared to 0.59% for the same period one year ago. The average rate paid on certificates of deposits was 1.09% for

the three months ended September 30, 2012 compared to 1.39% for the same period one year ago. During the quarter ended September 30, 2012, average certificates of deposit decreased \$77.8 million to \$269.4 million from \$347.2 million for the three months ended September 30, 2011.

The following table sets forth for each category of interest-earning assets and interest-bearing liabilities, the average amounts outstanding, the interest incurred on such amounts and the average rate earned or incurred for the three months ended September 30, 2012 and 2011. The table also sets forth the average rate earned on total interest-earning assets, the average rate paid on total interest-bearing liabilities, and the net yield on average total interest-earning assets for the same periods. Yield information does not give effect to changes in fair value that are reflected as a component of shareholders' equity. Yields and interest income on tax-exempt investments have been adjusted to tax equivalent basis using an effective tax rate of 38.55% for securities that are both federal and state tax exempt and an effective tax rate of 6.90% for state tax exempt securities. Non-accrual loans and the interest income that was recorded on these loans, if any, are included in the yield calculations for loans in all periods reported.

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| (Dollars in thousands) | Three months ended September 30, 2012 | | | Three months ended September 30, 2011 | | |
|---|--|-----------------|-----------------|--|---------------|-----------------|
| | Average Balance | Interest | Yield / Rate | Average Balance | Interest | Yield / Rate |
| Interest-earning assets: | | | | | | |
| Interest and fees on loans | \$ 639,402 | 8,170 | 5.08% | 687,086 | 8,921 | 5.15% |
| Investments - taxable | 175,697 | 575 | 1.30% | 185,974 | 1,338 | 2.85% |
| Investments - nontaxable* | 109,459 | 1,320 | 4.80% | 134,530 | 1,451 | 4.28% |
| Other | 25,978 | 15 | 0.23% | 8,471 | 4 | 0.21% |
| Total interest-earning assets | 950,536 | 10,080 | 4.22% | 1,016,061 | 11,714 | 4.57% |
| Cash and due from banks | 25,485 | | | 24,003 | | |
| Other assets | 55,224 | | | 51,201 | | |
| Allowance for loan losses | (16,911) | | | (16,192) | | |
| Total assets | \$ 1,014,334 | | | 1,075,073 | | |
| Interest-bearing liabilities: | | | | | | |
| NOW, MMDA & savings deposits | | | | | | |
| | \$ 348,680 | 274 | 0.31% | 347,278 | 517 | 0.59% |
| Time deposits | 269,369 | 737 | 1.09% | 347,187 | 1,221 | 1.39% |
| FHLB / FRB borrowings | 70,000 | 689 | 3.92% | 70,000 | 761 | 4.31% |
| Trust preferred securities | 20,619 | 110 | 2.12% | 20,619 | 100 | 1.92% |
| Other | 49,320 | 32 | 0.26% | 47,909 | 74 | 0.62% |
| Total interest-bearing liabilities | 757,988 | 1,842 | 0.97% | 832,993 | 2,673 | 1.27% |
| Demand deposits | 154,434 | | | 135,835 | | |
| Other liabilities | 5,427 | | | 4,317 | | |
| Shareholders' equity | 96,940 | | | 101,937 | | |
| Total liabilities and shareholder's equity | \$ 1,014,789 | | | 1,075,082 | | |
| Net interest spread | | \$ 8,238 | 3.25% | | 9,041 | 3.30% |
| Net yield on interest-earning assets | | | 3.45% | | | 3.53% |
| Taxable equivalent adjustment | | | | | | |
| Investment securities | | \$ 425 | | | 423 | |
| Net interest income | | \$ 7,813 | | | 8,618 | |

*Includes U.S. Government agency securities that are non-taxable for state income tax purposes of \$2.7 million in 2012 and \$45.1 million in 2011. An effective tax rate of 6.90% was used to calculate the tax equivalent yield on these securities.

Year-to-date net interest income as of September 30, 2012 decreased 7% to \$23.8 million compared to \$25.7 million for the same period one year ago. This decrease is primarily attributable to a decrease in interest income resulting from a reduction in average loans and a decrease in the yield on earning assets, which were partially offset by a decrease in interest expense due to a reduction in the cost of funds and a reduction in interest-bearing liabilities.

Interest income decreased \$4.4 million or 13% for the nine months ended September 30, 2012 compared with the same period in 2011. This decrease was primarily due to a reduction in average loans and a decrease in the yield on earning assets. The average yield on earning assets for the nine months ended September 30, 2012 and 2011 was 4.26% and 4.69%, respectively. During the nine months ended September 30, 2012, average loans decreased \$49.2 million to \$655.1 million from \$704.3 million for the nine months ended September 30, 2011. During the nine months ended September 30, 2012, average investment securities available for sale increased \$2.5 million to \$292.1 million from \$289.6 million for the nine months ended September 30, 2011 primarily due to the investment of additional funds received from loan repayments outpacing new loans disbursed.

Interest expense decreased \$2.5 million or 29% for the nine months ended September 30, 2012 compared with the same period in 2011 primarily due to lower cost of funds and a reduction in certificates of deposit. The average rate paid on interest-bearing checking and savings accounts was 0.35% for the nine months ended September 30, 2012 as compared to 0.72% for the same period of 2011. The average rate paid on certificates of deposits was 1.21% for the nine months ended September 30, 2012 compared to 1.44% for the same period one year ago. Average certificates of deposit decreased \$71.2 million to \$291.8 million for the nine months ended September 30, 2012 from \$363.0 million for the nine months ended September 30, 2011.

The following table sets forth for each category of interest-earning assets and interest-bearing liabilities, the average amounts outstanding, the interest incurred on such amounts and the average rate earned or incurred for the nine months ended September 30, 2012 and 2011. The table also sets forth the average rate earned on total interest-earning assets, the average rate paid on total interest-bearing liabilities, and the net yield on average total interest-earning assets for the same periods. Yield information does not give effect to changes in fair value that are reflected as a component of shareholders' equity. Yields and interest income on tax-exempt investments have been adjusted to tax equivalent basis using an effective tax rate of 38.55% for securities that are both federal and state tax exempt and an effective tax rate of 6.90% for state tax exempt securities. Non-accrual loans and the interest income that was recorded on these loans, if any, are included in the yield calculations for loans in all periods reported.

| (Dollars in thousands) | Nine months ended September 30, 2012 | | | Nine months ended September 30, 2011 | | |
|---|---|---------------|-----------------|---|---------------|-----------------|
| | Average Balance | Interest | Yield / Rate | Average Balance | Interest | Yield / Rate |
| Interest-earning assets: | | | | | | |
| Interest and fees on loans | \$ 655,051 | 24,822 | 5.06% | 704,263 | 27,695 | 5.26% |
| Investments - taxable | 196,007 | 2,430 | 1.66% | 160,137 | 3,362 | 2.81% |
| Investments - nontaxable* | 102,572 | 3,770 | 4.91% | 136,525 | 4,487 | 4.39% |
| Other | 20,067 | 34 | 0.23% | 12,204 | 19 | 0.20% |
| Total interest-earning assets | 973,697 | 31,056 | 4.26% | 1,013,129 | 35,563 | 4.69% |
| Cash and due from banks | 24,505 | | | 23,700 | | |
| Other assets | 55,510 | | | 49,628 | | |
| Allowance for loan losses | (17,026) | | | (15,655) | | |
| Total assets | \$ 1,036,686 | | | 1,070,802 | | |
| Interest-bearing liabilities: | | | | | | |
| NOW, MMDA & savings deposits | \$ 349,378 | 913 | 0.35% | 341,277 | 1,836 | 0.72% |
| Time deposits | 291,784 | 2,632 | 1.21% | 363,046 | 3,901 | 1.44% |
| FHLB / FRB borrowings | 70,467 | 2,064 | 3.91% | 70,037 | 2,258 | 4.31% |
| Trust preferred securities | 20,619 | 332 | 2.15% | 20,619 | 300 | 1.95% |
| Other | 46,924 | 105 | 0.30% | 42,378 | 231 | 0.74% |
| Total interest-bearing liabilities | 779,172 | 6,046 | 1.04% | 837,357 | 8,526 | 1.36% |
| Demand deposits | 150,501 | | | 130,209 | | |
| Other liabilities | 4,681 | | | 4,036 | | |

| | | | | |
|--|--------------|-------|-----------|-------|
| Shareholders' equity | 104,355 | | 100,587 | |
| Total liabilities and shareholder's equity | \$ 1,038,709 | | 1,072,189 | |
| Net interest spread | \$ 25,010 | 3.22% | 27,037 | 3.33% |
| Net yield on interest-earning assets | | 3.43% | | 3.57% |
| Taxable equivalent adjustment | | | | |
| Investment securities | \$ 1,204 | | 1,293 | |
| Net interest income | \$ 23,806 | | 25,744 | |

*Includes U.S. Government agency securities that are non-taxable for state income tax purposes of \$4.0 million in 2012 and \$47.6 million in 2011. An effective tax rate of 6.90% was used to calculate the tax equivalent yield on these securities.

Changes in interest income and interest expense can result from variances in both volume and rates. The following table presents the impact on the Company's tax equivalent net interest income resulting from changes in average balances and average rates for the periods indicated. The changes in interest due to both volume and rate have been allocated to volume and rate changes in proportion to the relationship of the absolute dollar amounts of the changes in each.

| (Dollars in thousands) | Three months ended September 30, 2012 compared to three months ended September 30, 2011 | | | Nine months ended September 30, 2012 compared to nine months ended September 30, 2011 | | |
|-------------------------------|---|-----------------------------------|---------------------------------|---|-----------------------------------|---------------------------------|
| | Changes in average volume | Changes in average rates | Total Increase (Decrease) | Changes in average volume | Changes in average rates | Total Increase (Decrease) |
| Interest income: | | | | | | |
| Loans: Net of unearned income | \$ (614) | (137) | (751) | (1,900) | (973) | (2,873) |
| Investments - taxable | (55) | (708) | (763) | 599 | (1,531) | (932) |
| Investments - nontaxable | (285) | 154 | (131) | (1,182) | 465 | (717) |
| Other | 10 | 1 | 11 | 12 | 3 | 15 |
| Total interest income | (944) | (690) | (1,634) | (2,471) | (2,036) | (4,507) |
| Interest expense: | | | | | | |
| NOW, MMDA & savings deposits | 1 | (244) | (243) | (915) | (8) | (923) |
| Time deposits | (243) | (241) | (484) | (704) | (565) | (1,269) |
| FHLB / FRB Borrowings | 0 | (72) | (72) | 13 | (207) | (194) |
| Trust Preferred Securities | - | 10 | 10 | - | 32 | 32 |
| Other | 1 | (43) | (42) | 17 | (143) | (126) |
| Total interest expense | (241) | (590) | (831) | (1,589) | (891) | (2,480) |
| Net interest income | \$ (703) | (100) | (803) | (882) | (1,145) | (2,027) |

Provision for Loan Losses. For the three months ended September 30, 2012, a contribution of \$761,000 was made to the provision for loan losses compared to a \$3.4 million contribution to the provision for loan losses for the three months ended September 30, 2011. The decrease in the provision for loan losses is primarily attributable to a \$2.2 million decrease in net charge-offs during the third quarter of 2012 compared to the third quarter of 2011 and an \$8.7 million reduction in non-accrual loans from September 30, 2011 to September 30, 2012.

The provision for loan losses for the nine months ended September 30, 2012 was \$4.4 million as compared to \$9.7 million for the same period one year ago. The decrease in the provision for loan losses is primarily attributable to a \$4.4 million decrease in net charge-offs during the nine months ended September 30, 2012 compared to the same period one year ago and an \$8.7 million reduction in non-accrual loans from September 30, 2011 to September 30, 2012.

Non-Interest Income. Total non-interest income was \$2.9 million for the three months ended September 30, 2012, as compared to \$3.7 million for the same period one year ago. This decrease is primarily attributable to a \$1.2 million decrease in the gains on sale of securities, which was partially offset by a \$169,000 increase in mortgage banking income and a \$93,000 increase in income from the Company's subsidiary, Community Bank Real Estate Solutions ("CBRES"), for the three months ended September 30, 2012, as compared to the same period one year ago.

Non-interest income was \$9.9 million for the nine months ended September 30, 2012, as compared to \$10.0 million for the same period one year ago. This decrease is primarily attributable to a \$1.3 million decrease in the gains on sale of securities, which was partially offset by a \$316,000 reduction in losses and write-downs on foreclosed properties, a \$282,000 increase in income from the Company's subsidiary, CBRES, and a \$262,000 increase in mortgage banking income for the nine months ended September 30, 2012, as compared to the same period one year ago.

Non-Interest Expense. Total non-interest expense was \$8.2 million for the three months ended September 30, 2012, as compared to \$7.2 million for the same period one year ago. This increase is primarily due to a \$698,000 increase in salaries and benefits expense and a \$337,000 increase in non-interest expenses other than salary, employee benefits and occupancy expenses for the three months ended September 30, 2012, as compared to the same period one year ago. The increase in salaries and benefits expense was primarily due to salary increases in 2012 and bonuses accrued in the third quarter of 2012, along with an increase in commissions on mortgage and real estate appraisal sales. The increase in non-interest expenses other than salary, employee benefits and occupancy expenses included \$62,000 in expenses associated with the Company's purchase of its preferred stock and the Warrant from the UST, which was issued to the UST in connection with the Company's participation in the CPP under TARP in 2008.

Non-interest expense was \$23.3 million for the nine months ended September 30, 2012, as compared to \$21.9 million for the same period one year ago. This increase is primarily due to a \$1.1 million increase in salaries and benefits expense and a \$337,000 increase in non-interest expenses other than salary, employee benefits and occupancy expenses for the nine months ended September 30, 2012, as compared to the same period one year ago. The increase in salaries and benefits expense was primarily due to salary increases in 2012 and bonuses accrued in the third quarter of 2012, along with an increase in commissions on mortgage and real estate appraisal sales. The increase in non-interest expenses other than salary, employee benefits and occupancy expenses included \$230,000 in expenses associated with the Company's purchase of its preferred stock and the Warrant from the UST, which was issued to the UST in connection with the Company's participation in the CPP under TARP in 2008.

Income Taxes. The Company reported income tax expense of \$369,000 and \$406,000 for the three months ended September 30, 2012 and 2011, respectively. This represented an effective tax rate of 21% and 23% for the respective periods.

The Company reported income taxes of \$1.4 million and \$755,000 for the nine months ended September 30, 2012 and 2011, respectively. This represented an effective tax rate of 23% and 18% for the respective periods. The 2012 and 2011 effective tax rates are lower than historical levels due to increases in tax exempt investment income, which has a greater impact on the effective tax rate on the reduced level of earnings before income taxes experienced in 2012 and 2011.

Analysis of Financial Condition

Investment Securities. Available for sale securities were \$281.8 million at September 30, 2012 compared to \$321.4 million at December 31, 2011. Average investment securities available for sale for the nine months ended September 30, 2012 were \$292.1 million compared to \$295.4 million for the year ended December 31, 2011.

Loans. At September 30, 2012, loans were \$625.8 million compared to \$670.5 million at December 31, 2011, a decrease of \$44.7 million. This decrease reflects a decline in loan originations combined with continuing payments on existing loans. Loans originated or renewed during the nine months ended September 30, 2012, amounting to approximately \$64.9 million, were offset by paydowns and payoffs of existing loans. Average loans represented 67% and 70% of average earning assets for the nine months ended September 30, 2012 and the year ended December 31, 2011, respectively. The Company had \$6.0 million and \$5.1 million in mortgage loans held for sale as of September 30, 2012 and December 31, 2011, respectively.

Although the Company has a diversified loan portfolio, a substantial portion of the loan portfolio is collateralized by real estate, which is dependent upon the real estate market. Real estate mortgage loans include both commercial and residential mortgage loans. At September 30, 2012, the Company had \$110.4 million in residential mortgage loans, \$87.6 million in home equity loans and \$261.4 million in commercial mortgage loans, which include \$208.6 million secured by commercial property and \$52.8 million secured by residential property. Residential mortgage loans include \$57.8 million made to customers in the Company's traditional banking offices and \$52.6 million in mortgage loans originated in the Company's Latino banking offices. All residential mortgage loans are originated as fully amortizing loans, with no negative amortization.

At September 30, 2012, the Company had \$80.7 million in construction and land development loans. The following table presents a breakout of these loans.

(Dollars in thousands)

| | Number of Loans | Balance Outstanding | Non-accrual Balance |
|---|--------------------|------------------------|------------------------|
| Land acquisition and development - commercial purposes | 69 | \$ 17,706 | \$ 2,124 |
| Land acquisition and development - residential purposes | 318 | 53,472 | 8,742 |
| 1 to 4 family residential construction | 24 | 6,498 | - |
| Commercial construction | 5 | 3,057 | - |
| Total construction and land development | 416 | \$ 80,733 | \$ 10,866 |

At September 30, 2012, TDR loans were \$21.8 million, including \$1.8 million in performing TDR loans. Effective March 31, 2012, performing TDR balances reflect current year TDR loans only, in accordance with GAAP. Previously reported TDR amounts reflect cumulative TDR loans from prior periods in addition to current year TDR loans. At December 31, 2011, TDR loans were \$44.1 million, including \$15.1 million in performing TDR loans. The terms of these loans have been renegotiated to provide a reduction in principal or interest as a result of the

deteriorating financial position of the borrower.

Allowance for Loan Losses. The allowance for loan losses reflects management's assessment and estimate of the risks associated with extending credit and its evaluation of the quality of the loan portfolio. We periodically analyze the loan portfolio in an effort to review asset quality and to establish an allowance for loan losses that management believes will be adequate in light of anticipated risks and loan losses. In assessing the adequacy of the allowance, size, quality and risk of loans in the portfolio are reviewed. Other factors considered are:

- our loan loss experience;
- the amount of past due and non-performing loans;
 - specific known risks;
- the status and amount of other past due and non-performing assets;
 - underlying estimated values of collateral securing loans;
 - current and anticipated economic conditions; and
- other factors which management believes affect the allowance for potential credit losses.

Management uses several measures to assess and monitor the credit risks in the loan portfolio, including a loan grading system that begins upon loan origination and continues until the loan is collected or collectibility becomes doubtful. Upon loan origination, the originating loan officer evaluates the quality of the loan and assigns one of nine risk grades. The loan officer monitors the loan's performance and credit quality and makes changes to the credit grade as conditions warrant. When originated or renewed, all loans over a certain dollar amount receive in-depth reviews and risk assessments by our Credit Administration department. Before making any changes in these risk grades, management considers assessments as determined by the third party credit review firm (as described below), regulatory examiners and the Credit Administration department. Any issues regarding the risk assessments are addressed by our senior credit administrators and factored into management's decision to originate or renew the loan.

As an additional measure, we engage an independent third party to review the underwriting, documentation and risk grading analyses. This independent third party reviews and evaluates all loan relationships greater than \$1.0 million. The third party's evaluation and report is shared with management and the Bank's Board of Directors.

Management considers certain commercial loans with weak credit risk grades to be individually impaired and measures such impairment based upon available cash flows and the value of the collateral. Allowance or reserve levels are estimated for all other graded loans in the portfolio based on their assigned credit risk grade, type of loan and other matters related to credit risk.

Management uses the information developed from the procedures described above in evaluating and grading the loan portfolio. This continual grading process is used to monitor the credit quality of the loan portfolio and to assist management in estimating the allowance for loan losses.

The allowance for loan losses is comprised of three components: specific reserves, general reserves and unallocated reserves. After a loan has been identified as impaired, management measures impairment. When the measure of the impaired loan is less than the recorded investment in the loan, the amount of the impairment is recorded as a specific reserve. These specific reserves are determined on an individual loan basis based on management's current evaluation of the Company's loss exposure for each credit, given the appraised value of any underlying collateral. Loans for which specific reserves are provided are excluded from the general allowance calculations as described below. At September 30, 2012 and December 31, 2011, the recorded investment in loans that were considered to be impaired was approximately \$57.5 million and \$54.7 million, respectively, with related allowance for loan losses of approximately \$3.3 million and \$4.8 million, respectively.

The general allowance reflects reserves established for collective loan impairment. These reserves are based upon historical net charge-offs using the last two years' experience. This charge-off experience may be adjusted to reflect the effects of current conditions. We consider information derived from our loan risk ratings and external data related to industry and general economic trends.

The unallocated allowance is determined through management's assessment of probable losses that are in the portfolio but are not adequately captured by the other two components of the allowance, including consideration of current economic and business conditions and regulatory requirements. The unallocated allowance also reflects management's

acknowledgement of the imprecision and subjectivity that underlie the modeling of credit risk. Due to the subjectivity involved in determining the overall allowance, including the unallocated portion, this unallocated portion may fluctuate from period to period based on management's evaluation of the factors affecting the assumptions used in calculating the allowance.

Management considers the allowance for loan losses adequate to cover the estimated losses inherent in the Company's loan portfolio as of the date of the financial statements. Management believes it has established the allowance in accordance with GAAP and in consideration of the current economic environment. Although management uses the best information available to make evaluations, significant future additions to the allowance may be necessary based on changes in economic and other conditions, thus adversely affecting the operating results of the Company.

There were no significant changes in the estimation methods or fundamental assumptions used in the evaluation of the allowance for loan losses for the nine months ended September 30, 2012 as compared to the year ended December 31, 2011. Such revisions, estimates and assumptions are made in any period in which the supporting factors indicate that loss levels may vary from the previous estimates.

Additionally, various regulatory agencies, as an integral part of their examination process, periodically review the allowance for loan losses. Such agencies may require adjustments to the allowance based on their judgments of information available to them at the time of their examinations.

The allowance for loan losses at September 30, 2012 was \$16.6 million or 2.64% of total loans compared to \$16.6 million or 2.48% of total loans at December 31, 2011. We believe we have established the allowance for credit losses pursuant to GAAP, and have taken into account the views of our regulators and the current economic environment.

The following table presents the percentage of loans assigned to each risk grade at September 30, 2012 and December 31, 2011.

| Risk Grade | Percentage of Loans By Risk Grade | |
|-------------------------------------|--------------------------------------|------------|
| | 09/30/2012 | 12/31/2011 |
| Risk Grade 1 (Excellent Quality) | 2.94% | 3.12% |
| Risk Grade 2 (High Quality) | 16.69% | 16.58% |
| Risk Grade 3 (Good Quality) | 46.65% | 49.30% |
| Risk Grade 4 (Management Attention) | 21.75% | 19.65% |
| Risk Grade 5 (Watch) | 4.66% | 4.76% |
| Risk Grade 6 (Substandard) | 6.90% | 6.21% |
| Risk Grade 7 (Low Substandard) | 0.00% | 0.00% |
| Risk Grade 8 (Doubtful) | 0.00% | 0.00% |
| Risk Grade 9 (Loss) | 0.00% | 0.00% |

At September 30, 2012, including non-accrual loans, there were nine relationships exceeding \$1.0 million (which totaled \$16.4 million) in the Watch risk grade, six relationships exceeding \$1.0 million in the Substandard risk grade (which totaled \$14.5 million) and no relationships exceeding \$1.0 million in the Low Substandard risk grade. There were three relationships with loans in the Watch risk grade and the Substandard risk grade exceeding \$1.0 million total (which totaled \$5.1 million).

Non-performing Assets. Non-performing assets totaled \$27.8 million at September 30, 2012 or 2.77% of total assets, compared to \$32.1 million at December 31, 2011, or 3.01% of total assets. Non-accrual loans were \$18.8 million at September 30, 2012 and \$21.8 million at December 31, 2011. As a percentage of total loans outstanding, non-accrual loans were 3.01% at September 30, 2012 compared to 3.25% at December 31, 2011. Non-performing loans include \$10.9 million in construction and land development loans, \$9.9 million in commercial and residential mortgage loans and \$481,000 in other loans at September 30, 2012 as compared to \$13.2 million in construction and land development loans, \$10.7 million in commercial and residential mortgage loans and \$544,000 in other loans as of December 31, 2011. The Bank had loans 90 days past due and still accruing totaling \$2.4 million and \$2.7 million as of September 30, 2012 and December 31, 2011, respectively. Other real estate totaled \$6.6 million as of September 30, 2012 as compared to \$7.6 million at December 31, 2011. Repossessed assets were \$5,000 and \$0 as of September 30, 2012 and December 31, 2011, respectively.

Deposits. Total deposits at September 30, 2012 were \$768.5 million compared to \$827.1 million at December 31, 2011. Core deposits, which include non-interest bearing demand deposits, NOW, MMDA, savings and

non-brokered certificates of deposits of denominations less than \$100,000, were \$624.5 million at September 30, 2012 as compared to \$633.0 million at December 31, 2011. Certificates of deposit in amounts greater than \$100,000 or more totaled \$143.2 million at September 30, 2012 as compared to \$193.0 million at December 31, 2011. This decrease is primarily due to a \$25.1 million decrease in brokered certificates of deposit, which included a \$8.5 million decrease in certificates of deposit issued through the Certificate of Deposit Account Registry Service ("CDARS"). At September 30, 2012, brokered deposits were \$21.8 million as compared to \$47.0 million at December 31, 2011. Brokered deposits outstanding as of September 30, 2012 had a weighted average rate of 0.34% with a weighted average original term of ten months as compared to brokered deposits outstanding at December 31, 2011, which had a weighted average rate of 0.99% with a weighted average original term of 15 months.

Borrowed Funds. Borrowings from the FHLB totaled \$70.0 million at September 30, 2012 and December 31, 2011, respectively. The average balance of FHLB borrowings for the nine months ended September 30, 2012 was \$70.5 million compared to \$70.0 million for the year ended December 31, 2011. At September 30, 2012, all of the Bank's FHLB borrowings had maturities exceeding one year. The FHLB has the option to convert \$15.0 million of the total advances to a floating rate and, if converted, we may repay the advances without a prepayment fee.

Securities sold under agreements to repurchase were \$43.1 million at September 30, 2012 compared to \$39.6 million at December 31, 2011.

Junior Subordinated Debentures (related to Trust Preferred Securities). In June 2006 the Company formed a wholly-owned Delaware statutory trust, PEBK Capital Trust II ("PEBK Trust II"), which issued \$20.0 million of guaranteed preferred beneficial interests in the Company's junior subordinated deferrable interest debentures. All of the common securities of PEBK Trust II are owned by the Company. The proceeds from the issuance of the common securities and the trust preferred securities were used by PEBK Trust II to purchase \$20.6 million of junior subordinated debentures of the Company, which pay a floating rate equal to three-month LIBOR plus 163 basis points. The proceeds received by the Company from the sale of the junior subordinated debentures were used to repay in December 2006 the trust preferred securities issued in December 2001 by PEBK Capital Trust, a wholly owned Delaware statutory trust of the Company, and for general purposes. The debentures represent the sole asset of PEBK Trust II. PEBK Trust II is not included in the consolidated financial statements.

The trust preferred securities issued by PEBK Trust II accrue and pay interest quarterly at a floating rate of three-month LIBOR plus 163 basis points. The Company has guaranteed distributions and other payments due on the trust preferred securities to the extent PEBK Trust II has funds with which to make the distributions and other payments. The net combined effect of the trust preferred securities transaction is that the Company is obligated to make the distributions and other payments required on the trust preferred securities.

These trust preferred securities are mandatorily redeemable upon maturity of the debentures on June 28, 2036, or upon earlier redemption as provided in the indenture. The Company had the right to redeem the debentures purchased by PEBK Trust II, in whole or in part, on or after June 28, 2011. As specified in the indenture, if the debentures are redeemed prior to maturity, the redemption price will be the principal amount and any accrued but unpaid interest.

Asset Liability and Interest Rate Risk Management. The objective of the Company's Asset Liability and Interest Rate Risk strategies is to identify and manage the sensitivity of net interest income to changing interest rates and to minimize the interest rate risk between interest-earning assets and interest-bearing liabilities at various maturities. This is to be done in conjunction with the need to maintain adequate liquidity and the overall goal of maximizing net interest income.

The Company manages its exposure to fluctuations in interest rates through policies established by our Asset/Liability Committee ("ALCO"). ALCO meets monthly and has the responsibility for approving asset/liability management policies, formulating and implementing strategies to improve balance sheet positioning and/or earnings and reviewing the interest rate sensitivity of the Company. ALCO tries to minimize interest rate risk between interest-earning assets and interest-bearing liabilities by attempting to minimize wide fluctuations in net interest income due to interest rate movements. The ability to control these fluctuations has a direct impact on the profitability of the Company. Management monitors this activity on a regular basis through analysis of its portfolios to determine the difference between rate sensitive assets and rate sensitive liabilities.

The Company's rate sensitive assets are those earning interest at variable rates and those with contractual maturities within one year. Rate sensitive assets therefore include both loans and available for sale securities. Rate sensitive liabilities include interest-bearing checking accounts, money market deposit accounts, savings accounts, time deposits

and borrowed funds. Average rate sensitive assets for the nine months ended September 30, 2012 totaled \$973.7 million, exceeding average rate sensitive liabilities of \$779.2 million by \$194.5 million.

The Company has an overall interest rate risk management strategy that incorporates the use of derivative instruments to minimize significant unplanned fluctuations in earnings that are caused by interest rate volatility. By using derivative instruments, the Company is exposed to credit and market risk. If the counterparty fails to perform, credit risk is equal to the extent of the fair-value gain in the derivative. The Company minimizes the credit risk in derivative instruments by entering into transactions with high-quality counterparties that are reviewed periodically by the Company. The Company did not have any interest rate derivatives outstanding as of September 30, 2012.

Included in the rate sensitive assets are \$338.1 million in variable rate loans indexed to prime rate subject to immediate repricing upon changes by the Federal Open Market Committee (“FOMC”). We utilize interest rate floors on certain variable rate loans to protect against further downward movements in the prime rate. At September 30, 2012, we had \$255.5 million in loans with interest rate floors. The floors were in effect on \$254.1 million of these loans pursuant to the terms of the promissory notes on these loans. The weighted average rate on these loans is 1.11% higher than the indexed rate on the promissory notes without interest rate floors.

Liquidity. The objectives of the Company’s liquidity policy are to provide for the availability of adequate funds to meet the needs of loan demand, deposit withdrawals, maturing liabilities and to satisfy regulatory requirements. Both deposit and loan customer cash needs can fluctuate significantly depending upon business cycles, economic conditions and yields and returns available from alternative investment opportunities. In addition, the Company’s liquidity is affected by off-balance sheet commitments to lend in the form of unfunded commitments to extend credit and standby letters of credit. As of September 30, 2012, such unfunded commitments to extend credit were \$134.6 million, while commitments in the form of standby letters of credit totaled \$3.4 million.

The Company uses several sources to meet its liquidity requirements. The primary source is core deposits, which includes demand deposits, savings accounts and non-brokered certificates of deposits of denominations less than \$100,000. The Company considers these to be a stable portion of the Company’s liability mix and the result of on-going consumer and commercial banking relationships. As of September 30, 2012, the Company’s core deposits totaled \$624.5 million, or 80% of total deposits.

The other sources of funding for the Company are through large denomination certificates of deposit, including brokered deposits, federal funds purchased, securities under agreement to repurchase and FHLB borrowings. The Bank is also able to borrow from the Federal Reserve Bank (“FRB”) on a short-term basis. Our policies include the ability to access wholesale funding up to 40% of total assets. Our wholesale funding includes FHLB borrowings, FRB borrowings, brokered deposits, internet certificates of deposit and certificates of deposit issued to the State of North Carolina. The Company’s ratio of wholesale funding to total assets was 9.06% as of September 30, 2012.

At September 30, 2012, we had a significant amount of deposits in amounts greater than \$100,000. The cost of these deposits is more susceptible to changes in the interest rate environment than other deposits. Access to the brokered deposit market could be restricted if the Bank were to fall below the well capitalized level.

The Bank has a line of credit with the FHLB equal to 20% of the Bank’s total assets, with an outstanding balance of \$70.0 million at September 30, 2012 and December 31, 2011. At September 30, 2012, the carrying value of loans pledged as collateral to the FHLB totaled \$142.5 million compared to \$153.7 million at December 31, 2011. As additional collateral, the Bank has pledged securities to the FHLB. At September 30, 2012, the market value of securities pledged to the FHLB totaled \$20.0 million compared to \$13.2 million at December 31, 2011. The remaining availability under the line of credit with the FHLB was \$23.0 million at September 30, 2012 compared to \$17.1 million at December 31, 2011. The Bank had no borrowings from the FRB at September 30, 2012 and December 31, 2011. FRB borrowings are collateralized by a blanket assignment on all qualifying loans that the Bank owns which are not pledged to the FHLB. At September 30, 2012, the carrying value of loans pledged as collateral to the FRB totaled \$324.4 million compared to \$342.2 million at December 31, 2011.

The Bank also had the ability to borrow up to \$47.5 million for the purchase of overnight federal funds from five correspondent financial institutions as of September 30, 2012.

The liquidity ratio for the Bank, which is defined as net cash, interest-bearing deposits with banks, federal funds sold and certain investment securities, as a percentage of net deposits and short-term liabilities was 32.82% at September 30, 2012 and 32.19% at December 31, 2011. The minimum required liquidity ratio as defined in the Bank’s

Asset/Liability and Interest Rate Risk Management Policy is 10%.

Contractual Obligations and Off-Balance Sheet Arrangements. The Company's contractual obligations and other commitments as of September 30, 2012 and December 31, 2011 are summarized in the table below. The Company's contractual obligations include the repayment of principal and interest related to FHLB advances and junior subordinated debentures, as well as certain payments under current lease agreements. Other commitments include commitments to extend credit. Because not all of these commitments to extend credit will be drawn upon, the actual cash requirements are likely to be significantly less than the amounts reported for other commitments below.

36

(Dollars in thousands)

| | September 30, 2012 | December 31, 2011 |
|--|--------------------|-------------------|
| Contractual Cash Obligations | | |
| Long-term borrowings | \$ 70,000 | 70,000 |
| Junior subordinated debentures | 20,619 | 20,619 |
| Operating lease obligations | 4,287 | 4,326 |
| Total | \$ 94,906 | 94,945 |
| Other Commitments | | |
| Commitments to extend credit | \$ 134,557 | 131,565 |
| Standby letters of credit and financial guarantees written | 3,429 | 3,288 |
| Total | \$ 137,986 | 134,853 |

The Company enters into derivative contracts to manage various financial risks. A derivative is a financial instrument that derives its cash flows, and therefore its value, by reference to an underlying instrument, index or referenced interest rate. Derivative contracts are carried at fair value on the consolidated balance sheet with the fair value representing the net present value of expected future cash receipts or payments based on market interest rates as of the balance sheet date. Derivative contracts are written in amounts referred to as notional amounts, which only provide the basis for calculating payments between counterparties and are not a measure of financial risk. Further discussions of derivative instruments are included above in the section entitled "Asset Liability and Interest Rate Risk Management".

Capital Resources. Shareholders' equity at September 30, 2012 was \$96.8 million compared to \$103.0 million at December 31, 2011. This decrease was primarily attributable to the Company's repurchase and retirement of a portion of its preferred shares. The Company purchased 12,530 shares of the Company's 25,054 outstanding shares of preferred stock from the UST, which was issued to the UST in connection with the Company's participation in the CPP under TARP in 2008. The shares were purchased for \$933.36 per share, for a total purchase price of \$11,778,575.90, including \$83,575.10 accrued and unpaid dividends on the preferred stock. The Company retired the 12,530 shares purchased. The \$834,999.20 difference between the \$12,530,000 face value of the preferred stock retired and the \$11,695,000.80 purchase price of the preferred stock retired was credited to retained earnings effective June 30, 2012. Remaining preferred shares are redeemable at any time at par. The Company expects to be able to repurchase the shares from future earnings, however, there are no immediate plans to repurchase these shares.

Common stock at September 30, 2012 was \$48.0 million compared to \$48.3 million at December 31, 2011. This decrease is due to the Company's repurchase of the Warrant that was issued to the UST, which was partially offset by stock options exercised during the third quarter of 2012.

Annualized return on average equity for the nine months ended September 30, 2012 was 5.86% compared to 5.03% for the year ended December 31, 2011. Total cash dividends paid on common stock were \$610,000 and \$333,000 for the nine months ended September 30, 2012 and 2011, respectively. Cash dividends paid on common stock in the nine months ended September 30, 2012 include a \$0.05 per share special cash dividend, amounting to \$277,000, paid in February 2012.

The Board of Directors, at its discretion, can issue shares of preferred stock up to a maximum of 5,000,000 shares. The Board is authorized to determine the number of shares, voting powers, designations, preferences, limitations and relative rights. The Board of Directors does not currently anticipate issuing any additional series of preferred stock.

Under the regulatory capital guidelines, financial institutions are currently required to maintain a total risk-based capital ratio of 8.0% or greater, with a Tier 1 risk-based capital ratio of 4.0% or greater. Tier 1 capital is generally defined as shareholders' equity and trust preferred securities less all intangible assets and goodwill. Tier 1 capital at September 30, 2012 and December 31, 2011 includes \$20.0 million in trust preferred securities. The Company's Tier 1 capital ratio was 15.89% and 16.10% at September 30, 2012 and December 31, 2011, respectively. Total risk-based capital is defined as Tier 1 capital plus supplementary capital. Supplementary capital, or Tier 2 capital, consists of the Company's allowance for loan losses, not exceeding 1.25% of the Company's risk-weighted assets. Total risk-based capital ratio is therefore defined as the ratio of total capital (Tier 1 capital and Tier 2 capital) to risk-weighted assets. The Company's total risk-based capital ratio was 17.19% and 17.38% at September 30, 2012 and December 31, 2011, respectively. In addition to the Tier 1 and total risk-based capital requirements, financial institutions are also required to maintain a leverage ratio of Tier 1 capital to total average assets of 4.0% or greater. The Company's Tier 1 leverage capital ratio was 10.98% and 11.06% at September 30, 2012 and December 31, 2011, respectively.

The Bank's Tier 1 risk-based capital ratio was 15.32% and 13.76% at September 30, 2012 and December 31, 2011, respectively. The total risk-based capital ratio for the Bank was 16.63% and 15.04% at September 30, 2012 and December 31, 2011, respectively. The Bank's Tier 1 leverage capital ratio was 10.57% and 9.44% at September 30, 2012 and December 31, 2011, respectively.

A bank is considered to be "well capitalized" if it has a total risk-based capital ratio of 10.0 % or greater, a Tier 1 risk-based capital ratio of 6.0% or greater, and a leverage ratio of 5.0% or greater. Based upon these guidelines, the Bank was considered to be "well capitalized" at September 30, 2012.

Subsequent Events. The Company has reviewed and evaluated subsequent events and transactions for material subsequent events through the date the financial statements are issued. Management has concluded that there were no material subsequent events.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

Not required for smaller reporting companies.

Item 4T. Controls and Procedures

The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures (as such term is defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the "Exchange Act")) as of the end of the period covered by this report. Based on such evaluation, the Company's Chief Executive Officer and Chief Financial Officer have concluded that, as of the end of such period, the Company's disclosure controls and procedures are effective in recording, processing, summarizing and reporting, on a timely basis, information required to be disclosed by the Company in the reports that it files or submits under the Exchange Act.

There have not been any changes in the Company's internal control over financial reporting (as such term is defined in Rules 13a-15(f) and 15d-15(f) under the Exchange Act) during the fiscal quarter to which this report relates that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

PART OTHER INFORMATION

II.

Item 1. Legal Proceedings

In the opinion of management, the Company is not involved in any material pending legal proceedings other than routine proceedings occurring in the ordinary course of business.

Item Risk Factors

1A.

Not required for smaller reporting companies.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

ISSUER PURCHASES OF EQUITY SECURITIES

| Period | Total Number of Shares Purchased | | Average Price Paid per Share | Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs | Maximum Number of Shares that May Yet Be Purchased Under the Plans or Programs |
|------------------------|---|-----|------------------------------------|---|---|
| July 1 - 31, 2012 | - | | \$ - | - | - |
| August 1 - 31, 2012 | 357,234 | (1) | 1.19 | - | - |
| September 1 - 30, 2012 | 5,050 | (2) | 9.50 | - | - |
| Total | 362,284 | | \$ 1.31 | - | |

(1) On August 8, 2012, the Company completed its repurchase of the Warrant to purchase 357,234 shares of the Company's common stock that was issued to UST on December 23, 2008, as part of the CPP under TARP. The Company repurchased the Warrant for a total price of \$425,000.

(2) The Company purchased 5,050 shares on the open market in the three months ended September 30, 2012 for its deferred compensation plan. All purchases were funded by participant contributions to the plan.

Item 3.Defaults Upon Senior Securities

Not applicable

Item 5.Other Information

Not applicable

Item 6. Exhibits

Exhibit (3)(1) Articles of Amendment dated December 19, 2008, regarding the Series A Preferred Stock, incorporated by reference to Exhibit (3)(1) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008

Exhibit (3)(2) Articles of Amendment dated February 26, 2010, incorporated by reference to Exhibit (3)(2) to the Form 10-K filed with the Securities and Exchange Commission on March 25, 2010

- Exhibit (3)(i) Articles of Incorporation of the Registrant, incorporated by reference to Exhibit (3)(i) to the Form 8-A filed with the Securities and Exchange Commission on September 2, 1999
- Exhibit (3)(ii) Amended and Restated Bylaws of the Registrant, incorporated by reference to Exhibit (3)(ii) to the Form 10-K filed with the Securities and Exchange Commission on March 25, 2010
- Exhibit (4) Specimen Stock Certificate, incorporated by reference to Exhibit (4) to the Form 8-A filed with the Securities and Exchange Commission on September 2, 1999
- Exhibit (4)(1) Form of Certificate for the Series A Preferred Stock, incorporated by reference to Exhibit (4)(1) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (4)(2) Warrant dated December 23, 2008, for the purchase of shares of Common Stock, incorporated by reference to Exhibit (4)(2) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(1) Letter Agreement dated December 23, 2008 between the Registrant and the United States Department of the Treasury, incorporated by reference to Exhibit (10)(1) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(a)(i) Employment Letter Agreement dated December 23, 2008 between the Registrant and Tony W. Wolfe, incorporated by reference to Exhibit (10)(a)(i) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(a)(ii) Amendment to Employment Agreement between Peoples Bank and Tony W. Wolfe dated December 18, 2008, incorporated by reference to Exhibit (10)(a)(ii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(a)(iii) Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and Tony W. Wolfe dated December 18, 2008, incorporated by reference to Exhibit (10)(a)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(b)(i) Employment Letter Agreement dated December 23, 2008 between the Registrant and Joseph F. Beaman, Jr., incorporated by reference to Exhibit (10)(b)(i) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008

- Exhibit
(10)(b)(ii) Amendment to Employment Agreement between Peoples Bank and Joseph F. Beaman, Jr. dated December 18, 2008, incorporated by reference to Exhibit (10)(b)(ii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit
(10)(b)(iii) Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and Joseph F. Beaman, Jr. dated December 18, 2008, incorporated by reference to Exhibit (10)(b)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit
(10)(c)(i) Employment Letter Agreement dated December 23, 2008 between the Registrant and William D. Cable, Sr., incorporated by reference to Exhibit (10)(c)(i) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008

- Exhibit (10)(c)(ii) Amendment to Employment Agreement between Peoples Bank and William D. Cable, Sr. dated December 18, 2008, incorporated by reference to Exhibit (10)(c)(ii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(c)(iii) Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and William D. Cable, Sr. dated December 18, 2008, incorporated by reference to Exhibit (10)(c)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(d)(i) Employment Letter Agreement dated December 23, 2008 between the Registrant and Lance A. Sellers, incorporated by reference to Exhibit (10)(d)(i) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(d)(ii) Amendment to Employment Agreement between Peoples Bank and Lance A. Sellers dated December 18, 2008, incorporated by reference to Exhibit (10)(d)(ii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(d)(iii) Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and Lance A. Sellers dated December 18, 2008, incorporated by reference to Exhibit (10)(d)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(e) Peoples Bancorp of North Carolina, Inc. Omnibus Stock Ownership and Long Term Incentive Plan incorporated by reference to Exhibit (10)(f) to the Form 10-K filed with the Securities and Exchange Commission on March 30, 2000
- Exhibit (10)(e)(i) Amendment No. 1 to the Peoples Bancorp of North Carolina, Inc. Omnibus Stock Ownership and Long Term Incentive Plan incorporated by reference to Exhibit (10)(e)(i) to the Form 10-K filed with the Securities and Exchange Commission on March 15, 2007
- Exhibit (10)(f)(i) Employment Letter Agreement dated December 23, 2008 between the Registrant and A. Joseph Lampron, Jr., incorporated by reference to Exhibit (10)(f)(i) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(f)(ii) Amendment to Employment Agreement between Peoples Bank and A. Joseph

Lampron, Jr. dated March 18, 2010 incorporated by reference to Exhibit (10)(f)(ii) to the Form 10-K filed with the Securities and Exchange Commission on March 25, 2010

- Exhibit (10)(f)(iii) Amended and Restated Executive Salary Continuation Agreement between Peoples Bank and A. Joseph Lampron, Jr. dated December 18, 2008, incorporated by reference to Exhibit (10)(f)(iii) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(g) Peoples Bank Directors' and Officers' Deferral Plan, incorporated by reference to Exhibit (10)(h) to the Form 10-K filed with the Securities and Exchange Commission on March 28, 2002
- Exhibit (10)(h) Rabbi Trust for the Peoples Bank Directors' and Officers' Deferral Plan, incorporated by reference to Exhibit (10)(i) to the Form 10-K filed with the Securities and Exchange Commission on March 28, 2002
- Exhibit (10)(i) Description of Service Recognition Program maintained by Peoples Bank, incorporated by reference to Exhibit (10)(i) to the Form 10-K filed with the Securities and Exchange Commission on March 27, 2003

- Exhibit (10)(j) Capital Securities Purchase Agreement dated as of June 26, 2006, by and among the Registrant, PEBK Capital Trust II and Bear, Sterns Securities Corp., incorporated by reference to Exhibit (10)(j) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
- Exhibit (10)(k) Amended and Restated Trust Agreement of PEBK Capital Trust II, dated as of June 28, 2006, incorporated by reference to Exhibit (10)(k) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
- Exhibit (10)(l) Guarantee Agreement of the Registrant dated as of June 28, 2006, incorporated by reference to Exhibit (10)(l) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
- Exhibit (10)(m) Indenture, dated as of June 28, 2006, by and between the Registrant and LaSalle Bank National Association, as Trustee, relating to Junior Subordinated Debt Securities Due September 15, 2036, incorporated by reference to Exhibit (10)(m) to the Form 10-Q filed with the Securities and Exchange Commission on November 13, 2006
- Exhibit (10)(n) Form of Amended and Restated Director Supplemental Retirement Agreement between Peoples Bank and Directors Robert C. Abernethy, James S. Abernethy, Douglas S. Howard, John W. Lineberger, Jr., Gary E. Matthews, Dr. Billy L. Price, Jr., Larry E. Robinson, W. Gregory Terry, Dan Ray Timmerman, Sr. and Benjamin I. Zachary, incorporated by reference to Exhibit (10)(n) to the Form 8-K filed with the Securities and Exchange Commission on December 29, 2008
- Exhibit (10)(o) 2009 Omnibus Stock Ownership and Long Term Incentive Plan incorporated by reference to Exhibit (10)(o) to the Form 10-K filed with the Securities and Exchange Commission on March 20, 2009
- Exhibit (10)(p) Underwriting Agreement with Merrill Lynch, Pierce, Fenner & Smith Incorporated and Sandler O'Neill & Partners, L.P., as representatives of the several underwriters listed on Schedule A thereto and the UST incorporated by reference to Exhibit 1.1 to the Form 8-K filed with the Securities and Exchange Commission on June 29, 2012
- Exhibit (14) Code of Business Conduct and Ethics of Peoples Bancorp of North Carolina, Inc., incorporated by reference to Exhibit (14) to the Form 10-K filed with the Securities and Exchange Commission on March 25, 2005
- Certification of principal executive officer pursuant to section 302 of the

Exhibit
(31)(a)

Sarbanes-Oxley Act of 2002

Exhibit
(31)(b)

Certification of principal financial officer pursuant to section 302 of the

Sarbanes-Oxley Act of 2002

Exhibit (32) Certification Pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

Exhibit (101) The following materials from the Company's 10-Q Report for the quarterly period ended September 30, 2012, formatted in XBRL: (i) the Condensed Consolidated Balance Sheets, (ii) the Condensed Consolidated Statements of Income, (iii) the Condensed Consolidated Statements of Changes in Shareholders' Equity, (iv) the Condensed Consolidated Statements of Cash Flows, and (v) the Notes to the Condensed Consolidated Financial Statements, tagged as blocks of text.*

*Furnished, not filed.

SIGNATURES

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

Peoples Bancorp of North Carolina, Inc.

November 9, 2012
Date

/s/ Lance A. Sellers
Lance A. Sellers
President and Chief Executive Officer
(Principal Executive Officer)

November 9, 2012
Date

/s/ A. Joseph Lampron, Jr.
A. Joseph Lampron, Jr.
Executive Vice President and Chief Financial Officer
(Principal Financial and Principal Accounting
Officer)

