

PEOPLES BANCORP OF NORTH CAROLINA INC  
Form 10-Q  
November 09, 2011

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, 2011

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
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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.

5,542,703 shares of common stock, outstanding at October 31, 2011.

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## INDEX

PART I.	FINANCIAL INFORMATION	PAGE(S)
Item 1.	Financial Statements	
	Consolidated Balance Sheets at September 30, 2011 (Unaudited) and December 31, 2010	3
	Consolidated Statements of Earnings for the three and nine months ended September 30, 2011 and 2010 (Unaudited)	4
	Consolidated Statements of Comprehensive Income for the three and nine months ended September 30, 2011 and 2010 (Unaudited)	5
	Consolidated Statements of Cash Flows for the nine months ended September 30, 2011 and 2010 (Unaudited)	6-7
	Notes to Consolidated Financial Statements (Unaudited)	8-20
Item 2.	Management's Discussion and Analysis of Financial Condition and Results of Operations	21-35
Item 3.	Quantitative and Qualitative Disclosures About Market Risk	36
Item 4T.	Controls and Procedures	37
<b>PART II. OTHER INFORMATION</b>		
Item 1.	Legal Proceedings	38
Item 1A.	Risk Factors	38
Item 2.	Unregistered Sales of Equity Securities and Use of Proceeds	38
Item 3.	Defaults upon Senior Securities	38
Item 5.	Other Information	38
Item 6.	Exhibits	38-41
Signatures		42
Certifications		43-45

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, 2010.

## PART I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

## Consolidated Balance Sheets

(Dollars in thousands)

Assets	September 30, 2011 (Unaudited)	December 31, 2010 (Audited)
Cash and due from banks, including reserve requirements	\$ 44,077	22,521
Interest bearing deposits	796	1,456
Cash and cash equivalents	44,873	23,977
Certificates of deposit	-	735
Investment securities available for sale	325,730	272,449
Other investments	5,779	5,761
Total investment securities	331,509	278,210
Mortgage loans held for sale	2,148	3,814
Loans	677,665	726,160
Less allowance for loan losses	(16,348 )	(15,493 )
Net loans	661,317	710,667
Premises and equipment, net	17,074	17,334
Cash surrender value of life insurance	12,721	7,539
Other real estate	5,985	6,673
Accrued interest receivable and other assets	13,992	18,703
Total assets	\$ 1,089,619	1,067,652
<b>Liabilities and Shareholders' Equity</b>		
<b>Deposits:</b>		
Non-interest bearing demand	\$ 136,154	114,792
NOW, MMDA & savings	354,048	332,511
Time, \$100,000 or more	215,573	241,366
Other time	135,266	150,043
Total deposits	841,041	838,712
Demand notes payable to U.S. Treasury	1,096	1,600
Securities sold under agreement to repurchase	47,701	34,094

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FHLB borrowings	70,000	70,000
Junior subordinated debentures	20,619	20,619
Accrued interest payable and other liabilities	6,212	5,769
Total liabilities	986,669	970,794
Commitments		
Shareholders' equity:		
Series A preferred stock, \$1,000 stated value; authorized		
5,000,000 shares; issued and outstanding		
25,054 shares in 2011 and 2010	24,722	24,617
Common stock, no par value; authorized		
20,000,000 shares; issued and outstanding		
5,542,703 shares in 2011 and 5,541,413 shares in 2010	48,289	48,281
Retained earnings	25,577	23,573
Accumulated other comprehensive income	4,362	387
Total shareholders' equity	102,950	96,858
Total liabilities and shareholders' equity	\$ 1,089,619	1,067,652

See accompanying notes to consolidated financial statements.

## PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

## Consolidated Statements of Earnings

(Dollars in thousands, except per share amounts)

	Three months ended September 30,		Nine months ended September 30,	
	2011 (Unaudited)	2010 (Unaudited)	2011 (Unaudited)	2010 (Unaudited)
<b>Interest income:</b>				
Interest and fees on loans	\$ 8,921	9,983	27,695	30,236
<b>Interest on investment securities:</b>				
U.S. Government sponsored enterprises	1,504	1,365	3,998	3,966
States and political subdivisions	792	586	2,387	1,448
Other	74	61	190	154
Total interest income	11,291	11,995	34,270	35,804
<b>Interest expense:</b>				
NOW, MMDA & savings deposits	517	866	1,836	2,643
Time deposits	1,221	1,637	3,901	5,259
FHLB borrowings	761	803	2,258	2,505
Junior subordinated debentures	100	112	300	310
Other	74	98	231	306
Total interest expense	2,673	3,516	8,526	11,023
Net interest income	8,618	8,479	25,744	24,781
Provision for loan losses	3,378	4,656	9,696	10,217
Net interest income after provision for loan losses	5,240	3,823	16,048	14,564
<b>Non-interest income:</b>				
Service charges	1,273	1,435	3,845	4,195
Other service charges and fees	493	523	1,603	1,684
Other than temporary impairment losses	-	(100 )	-	(100 )
Gain on sale of securities	1,239	1,623	2,495	1,791
Mortgage banking income	127	125	531	372
Insurance and brokerage commissions	121	84	350	275
Miscellaneous	469	167	1,207	1,380
Total non-interest income	3,722	3,857	10,031	9,597
<b>Non-interest expense:</b>				
Salaries and employee benefits	3,489	3,511	10,829	10,464

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Occupancy	1,334	1,334	4,030	3,986
Other	2,341	2,337	7,083	6,978
Total non-interest expense	7,164	7,182	21,942	21,428
Earnings before income taxes	1,798	498	4,137	2,733
Income tax expense (benefit)	406	(42 )	755	454
Net earnings	1,392	540	3,382	2,279
Dividends and accretion on preferred stock	348	348	1,045	1,045
Net earnings available to common shareholders	\$ 1,044	192	2,337	1,234
Basic net earnings per common share	\$ 0.19	0.03	0.42	0.22
Diluted net earnings per common share	\$ 0.19	0.03	0.42	0.22
Cash dividends declared per common share	\$ 0.02	0.02	0.04	0.06

See accompanying notes to consolidated financial statements.



## PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

## Consolidated Statements of Comprehensive Income

(Dollars in thousands)

	Three months ended September 30, 2011		Nine months ended September 30, 2011	
	2010	2010	2011	2010
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)
Net earnings	\$1,392	540	3,382	2,279
Other comprehensive income:				
Unrealized holding gains on securities available for sale	3,612	3,251	9,653	5,914
Reclassification adjustment for other than temporary impairment losses included in net earnings	-	100	-	100
Reclassification adjustment for gains on securities available for sale included in net earnings	(1,239)	(1,623)	(2,495)	(1,791)
Unrealized holding losses on derivative financial instruments qualifying as cash flow hedges	-	(329)	(648)	(729)
Total other comprehensive income, before income taxes	2,373	1,399	6,510	3,494
Income tax expense related to other comprehensive income:				
Unrealized holding gains on securities available for sale	1,407	1,266	3,760	2,304
Reclassification adjustment for gains net of write downs of securities available for sale included in net earnings	(483)	(593)	(972)	(659)
Unrealized holding losses on derivative financial instruments qualifying as cash flow hedges	-	(128)	(253)	(284)
Total income tax expense related to other comprehensive income	924	545	2,535	1,361
Total other comprehensive income, net of tax	1,449	854	3,975	2,133
Total comprehensive income	\$2,841	1,394	7,357	4,412

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, 2011 and 2010

(Dollars in thousands)

	2011 (Unaudited)	2010 (Unaudited)
Cash flows from operating activities:		
Net earnings	\$ 3,382	2,279
Adjustments to reconcile net earnings to net cash provided by operating activities:		
Depreciation, amortization and accretion	3,915	3,519
Provision for loan losses	9,696	10,217
Gain on sale of investment securities	(2,495 )	(1,791 )
Write-down of investment securities	-	100
Loss/(Gain) on sale of other real estate and repossessions	181	(198 )
Write-down of other real estate and repossessions	845	895
Restricted stock expense	5	7
Change in:		
Mortgage loans held for sale	1,666	726
Cash surrender value of life insurance	(182 )	(193 )
Other assets	1,546	(643 )
Other liabilities	438	(357 )
Net cash provided by operating activities	18,997	14,561
Cash flows from investing activities:		
Net change in certificates of deposit	735	2,610
Purchases of investment securities available for sale	(158,631 )	(133,646 )
Proceeds from calls, maturities and paydowns of investment securities available for sale	39,813	77,070
Proceeds from sale of investment securities available for sale	72,292	28,077
Purchases of other investments	(215 )	-
Proceeds from sale of other investments	197	393
Net change in loans	36,659	22,338
Purchases of premises and equipment	(775 )	(1,148 )
Purchase of bank owned life insurance	(5,000)	-
Proceeds from sale of other real estate and repossessions	2,656	4,681
Net cash (used) provided by investing activities	(12,269 )	375

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Cash flows from financing activities:

Net change in deposits	2,329	32,962
Net change in demand notes payable to U.S. Treasury	(504 )	(284 )
Net change in securities sold under agreement to repurchase	13,607	4,634
Proceeds from FHLB borrowings	5,000	-
Repayments of FHLB borrowings	(5,000 )	(7,000 )
Restricted stock payout	9	-
Cash dividends paid on Series A preferred stock	(940 )	(940 )
Cash dividends paid on common stock	(333 )	(337 )
Net cash provided by financing activities	14,168	29,035
Net change in cash and cash equivalent	20,896	43,971
Cash and cash equivalents at beginning of period	23,977	31,340
Cash and cash equivalents at end of period	\$ 44,873	75,311

## PEOPLES BANCORP OF NORTH CAROLINA, INC. AND SUBSIDIARIES

## Consolidated Statements of Cash Flows, continued

Nine months ended September 30, 2011 and 2010

(Dollars in thousands)

	2011 (Unaudited)	2010 (Unaudited)
<b>Supplemental disclosures of cash flow information:</b>		
Cash paid during the year for:		
Interest	\$ 8,613	11,146
Income taxes	\$ 132	1,700
Noncash investing and financing activities:		
Change in unrealized gain on investment securities available for sale, net	\$ (4,370 )	(2,578 )
Change in unrealized gain on derivative financial instruments, net	\$ 395	445
Transfer of loans to other real estate and repossessions	\$ 7,041	6,189
Financed portion of sale of other real estate	\$ 4,047	1,703
Accretion of Series A preferred stock	\$ 106	106

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. (collectively called the “Company”). All significant intercompany balances and transactions have been eliminated in consolidation.

The consolidated financial statements in this report 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 2010 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 5, 2011 Annual Meeting of Shareholders.

Recently Issued Accounting Pronouncements

In April 2011, the Financial Accounting Standard Accounting Board (“FASB”) issued Accounting Standards Update (“ASU”) No. 2011-02, A Creditor’s Determination of Whether a Restructuring is a Troubled Debt Restructuring. This ASU provides additional guidance for determining what constitutes a troubled debt restructuring. The ASU 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 U.S. GAAP and IFRS requirements for measurement of and disclosures about fair value. The amendments are not expected to have a significant impact on companies applying U.S. GAAP. This ASU is effective for interim and annual periods beginning after December 15, 2011. The adoption of this guidance is not expected to 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 will require 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. This ASU 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. This standard is effective for interim and annual periods beginning after December 15, 2011. Because ASU No. 2011-05 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 the 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, 2011 and December 31, 2010 are as follows:

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(Dollars in thousands)

	Amortized Cost	September 30, 2011		Estimated Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
Mortgage-backed securities	\$ 198,755	2,422	350	200,827
U.S. Government sponsored enterprises	24,715	886	-	25,601
State and political subdivisions	92,971	4,219	35	97,155
Trust preferred securities	1,250	-	-	1,250
Equity securities	893	186	182	897
<b>Total</b>	<b>\$ 318,584</b>	<b>7,713</b>	<b>567</b>	<b>325,730</b>

(Dollars in thousands)

	Amortized Cost	December 31, 2010		Estimated Fair Value
		Gross Unrealized Gains	Gross Unrealized Losses	
Mortgage-backed securities	\$ 137,811	2,119	569	139,361
U.S. Government sponsored enterprises	42,933	393	686	42,640
State and political subdivisions	89,486	793	2,450	87,829
Trust preferred securities	1,250	-	-	1,250
Equity securities	982	387	-	1,369
<b>Total</b>	<b>\$ 272,462</b>	<b>3,692</b>	<b>3,705</b>	<b>272,449</b>

The current fair value and associated unrealized losses on investments in securities with unrealized losses at September 30, 2011 and December 31, 2010 are summarized in the tables below, with the length of time the individual securities have been in a continuous loss position.

(Dollars in thousands)

	Fair Value	Less than 12 Months Unrealized Losses	September 30, 2011		Fair Value	Total Unrealized Losses
			12 Months or More Fair Value	Unrealized Losses		
Mortgage-backed securities	\$ 49,699	325	1,060	25	50,759	350
State and political subdivisions	4,736	34	1,027	1	5,763	35
Equity securities	-	-	226	182	226	182
<b>Total</b>	<b>\$ 54,435</b>	<b>359</b>	<b>2,313</b>	<b>208</b>	<b>56,748</b>	<b>567</b>

(Dollars in thousands)



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	Less than 12 Months		December 31, 2010 12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
Mortgage-backed securities \$	59,471	569	-	-	59,471	569
U.S. Government sponsored enterprises	24,123	686	-	-	24,123	686
State and political subdivisions	56,374	2,450	-	-	56,374	2,450
<b>Total</b>	<b>\$ 139,968</b>	<b>3,705</b>	<b>-</b>	<b>-</b>	<b>139,968</b>	<b>3,705</b>

At September 30, 2011, unrealized losses in the investment securities portfolio relating to debt securities totaled \$385,000. The unrealized losses on these debt securities arose due to changing interest rates and are considered to be temporary. From the September 30, 2011 tables above, 6 out of 168 securities issued by state and political subdivisions contained unrealized losses and 25 out of 112 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 unrealized loss on one equity security was \$182,000 as of September 30, 2011. This unrealized loss is considered temporary based upon the entity's strong capital position and growth potential.

The amortized cost and estimated fair value of investment securities available for sale at September 30, 2011, 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	\$ 4,651	4,722
Due from one to five years	29,678	30,716
Due from five to ten years	71,327	74,437
Due after ten years	13,280	14,131
Mortgage-backed securities	198,755	200,827
Equity securities	893	897
Total	\$ 318,584	325,730

Proceeds from sales of securities available for sale during 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. Proceeds from sales of securities available for sale during the nine months ended September 30, 2010 were \$28.1 million and resulted in a gross gain of \$1.8 million.

Securities with a fair value of approximately \$88.1million and \$75.5 million at September 30, 2011 and December 31, 2010, respectively, were pledged to secure public deposits and for other purposes as required by law.

### (3) Loans

Major classifications of loans at September 30, 2011 and December 31, 2010 are summarized as follows:

(Dollars in thousands)

	September 30, 2011	December 31, 2010
Real estate loans		
Construction and land development	\$ 103,901	124,048
Single-family residential	271,019	287,307
Commercial	211,352	213,487
Multifamily and farmland	4,923	6,456
Total real estate loans	591,195	631,298
Commercial loans (not secured by real estate)	53,082	60,994
Consumer loans (not secured by real estate)	10,634	11,500

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All other loans (not secured by real estate)	22,754	22,368
Total loans	677,665	726,160
Less allowance for loan losses	16,348	15,493
Total net loans	\$ 661,317	710,667

The Company 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, 2011 and December 31, 2010:

September 30, 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
<b>Real estate loans</b>						
Construction and land development	\$ 1,138	3,636	4,774	99,127	103,901	-
Single-family residential	8,170	4,490	12,660	258,359	271,019	1,411
Commercial	1,367	1,962	3,329	208,023	211,352	-
Multifamily and farmland	215	-	215	4,708	4,923	-
Total real estate loans	10,890	10,088	20,978	570,217	591,195	1,411
Commercial loans (not secured by real estate)	306	35	341	52,741	53,082	-
Consumer loans (not secured by real estate)	123	6	129	10,505	10,634	-
All other loans (not secured by real estate)	-	-	-	22,754	22,754	-
Total loans	\$ 11,319	10,129	21,448	656,217	677,665	1,411

December 31, 2010  
(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
<b>Real estate loans</b>						
Construction and land development	\$ 2,306	8,870	11,176	112,872	124,048	197
Single-family residential	19,377	5,936	25,313	261,994	287,307	-
Commercial	382	1,482	1,864	211,623	213,487	-
Multifamily and farmland	-	-	-	6,456	6,456	-

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Total real estate loans	22,065	16,288	38,353	592,945	631,298	197
Commercial loans (not secured by real estate)	1,098	720	1,818	59,176	60,994	13
Farm loans (not secured by real estate)	-	-	-	-	-	-
Consumer loans (not secured by real estate)	98	13	111	11,389	11,500	-
All other loans (not secured by real estate)	-	-	-	22,368	22,368	-
Total loans	\$ 23,261	17,021	40,282	685,878	726,160	210

The following table presents the Company's non-accrual loans as of September 30, 2011 and December 31, 2010:

(Dollars in thousands)

	September 30, 2011	December 31, 2010
<b>Real estate loans</b>		
Construction and land development	\$ 17,088	22,916
Single-family residential	5,665	10,837
Commercial	4,174	5,351
Multifamily and farmland	-	-
Total real estate loans	26,927	39,104
Commercial loans (not secured by real estate)	437	816
Consumer loans (not secured by real estate)	127	142
All other loans (not secured by real estate)	-	-
<b>Total</b>	<b>\$ 27,491</b>	<b>40,062</b>

At each reporting period, the Company determines which loans are impaired. Accordingly, the Company'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 third-party valuation specialists. 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. No interest income is recognized on impaired loans subsequent to their classification as impaired.

The following tables present the Company's impaired loans as of September 30, 2011 and December 31, 2010:

September 30, 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
<b>Real estate loans</b>						
Construction and land development	\$ 27,114	17,088	-	17,088	-	19,753
Single-family residential	6,792	5,148	517	5,665	1,316	7,846
Commercial	5,237	3,196	978	4,174	1	4,482
Multifamily and farmland	-	-	-	-	-	-
Total impaired real estate loans	39,143	25,432	1,495	26,927	1,317	32,081
Commercial loans (not secured by real estate)	494	437	-	437	-	631
Consumer loans (not secured by real estate)	143	127	-	127	-	138
	-	-	-	-	-	-

All other loans (not  
secured by real estate)

Total impaired loans \$	39,780	25,996	1,495	27,491	1,317	32,850
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December 31, 2010  
(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
<b>Real estate loans</b>						
Construction and land development	31,346	20,787	2,130	22,916	1,055	18,767
Single-family residential	12,376	9,847	990	10,837	168	12,573
Commercial	6,018	4,991	359	5,351	148	4,769
Multifamily and Farmland	-	-	-	-	-	27
Total impaired real estate loans	49,740	35,625	3,479	39,104	1,371	36,136
Commercial loans (not secured by real estate)	1,243	811	5	816	5	1,479
Farm loans (non RE)				-		
Consumer loans (not secured by real estate)	152	142	-	142	-	79
All other loans (not secured by real estate)	-	-	-	-	-	-
Total impaired loans \$	51,135	36,578	3,484	40,062	1,376	37,694

Changes in the allowance for loan losses for the nine months ended September 30, 2011 were as follows:

(Dollars in thousands)

	Real Estate Loans							Total
	Construction and land development	Single-family residential	Commercial	Multifamily and farmland	Commercial	Consumer	Unallocated	
Allowance for loan losses:								
Beginning balance	\$ 5,774	6,097	1,409	17	1,174	430	592	15,493
Charge-offs	(5,028)	(2,579)	(1,180)	-	(313)	(434)	-	(9,534)
Recoveries	235	198	23	-	114	122	-	693
Provision	5,134	2,400	1,404	(4)	23	173	566	9,696
Ending balance	\$ 6,115	6,116	1,656	13	998	292	1,158	16,348
Ending balance:								
Individually evaluated for impairment	\$ -	1,316	1	-	-	-	-	1,317
Ending balance:								
Collectively evaluated for impairment	6,115	4,800	1,655	13	998	292	1,158	15,031
Ending balance	\$ 6,115	6,116	1,656	13	998	292	1,158	16,348

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. 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 very high risk and servicing needs but still are acceptable. Evidence of marginal performance or deteriorating trends are evident. 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 are potential weaknesses that may, if not corrected, weaken the asset or inadequately protect the Company’s position at some future date. This



frequently results from deviating from prudent lending practices, for instance over-advancing on collateral.

- 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 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 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 grade as of September 30, 2011 and December 31, 2010.

September 30, 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	\$ 199	21,428	-	-	738	1,075	-	23,440
2- High Quality	\$ 5,088	65,657	21,969	134	10,410	4,201	3,298	110,757
3- Good Quality	\$ 27,736	108,619	137,239	3,482	33,647	4,711	19,449	334,883
4- Management Attention	\$ 45,272	52,572	40,570	365	6,847	501	7	146,134
5- Watch	\$ 6,037	9,833	1,898	727	499	9	-	19,003
6- Substandard	\$ 19,569	12,910	9,676	215	941	137	-	43,448
7- Low Substandard	\$ -	-	-	-	-	-	-	-
8- Doubtful	\$ -	-	-	-	-	-	-	-
9- Loss	\$ -	-	-	-	-	-	-	-
Total	\$ 103,901	271,019	211,352	4,923	53,082	10,634	22,754	677,665

December 31, 2010  
(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	\$ 19	27,698	102	-	630	1,006	-	29,455
2- High Quality	\$ 5,789	70,990	21,591	2,856	9,673	4,491	5,145	120,535
3- Good Quality	\$ 33,991	109,800	129,530	2,256	39,248	5,360	17,223	337,408
4- Management Attention	\$ 46,283	55,001	43,731	1,121	8,143	454	-	154,733
5- Watch	\$ 8,076	7,959	5,569	-	1,590	38	-	23,232
6- Substandard	\$ 29,502	15,022	12,605	223	1,678	145	-	59,175
7- Low Substandard	\$ -	756	359	-	-	-	-	1,115
8- Doubtful	\$ 388	81	-	-	17	-	-	486
9- Loss	\$ -	-	-	-	15	6	-	21
Total	\$ 124,048	287,307	213,487	6,456	60,994	11,500	22,368	726,160

At September 30, 2011, troubled debt restructured (“TDR”) loans amounted to \$48.5 million, including \$16.0 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. At December 31, 2010, TDR loans amounted to \$56.7 million, including \$10.0 million in performing TDR loans.

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

(Dollars in thousands)

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
<b>Real estate loans</b>			
Construction and land development	31	\$ 24,708	17,311
Single-family residential	240	26,285	24,955
Commercial	18	8,695	4,783
Multifamily and farmland	1	322	215
Total real estate TDR loans	290	60,010	47,264
<b>Commercial loans (not secured by real estate)</b>			
Commercial loans (not secured by real estate)	22	1,776	1,157
<b>Consumer loans (not secured by real estate)</b>			
Consumer loans (not secured by real estate)	8	142	127
<b>All other loans (not secured by real estate)</b>			
All other loans (not secured by real estate)	-	-	-
Total TDR loans	320	\$ 61,928	48,548

## (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, 2011 and 2010 is as follows:

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

For the three months ended September 30, 2010

	Net Earnings Available to Common Shareholders (Dollars in thousands)	Common Shares	Per Share Amount
Basic earnings per common share	\$ 192	5,539,056	\$ 0.03
Effect of dilutive securities:			
Stock options	-	2,768	
Diluted earnings per common share	\$ 192	5,541,824	\$ 0.03

For the nine months ended September 30, 2010

	Net Earnings Available to Common Shareholders (Dollars in thousands)	Common Shares	Per Share Amount
Basic earnings per common share	\$ 1,234	5,539,056	\$ 0.22
Effect of dilutive securities:			
Stock options	-	4,480	
Diluted earnings per common share	\$ 1,234	5,543,536	\$ 0.22

#### (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, performance units, stock appreciation rights, or book value shares, may be granted to eligible directors and employees. The 1999 Plan expired on May 13, 2009.

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 Company did not grant any options during the nine months ended September 30, 2011 and 2010.

The Company granted 3,000 shares of restricted stock in 2007 at a grant date fair value of \$17.40 per share. The Company granted 1,750 shares of restricted stock at a grant date fair value of \$12.80 per share during the third quarter of 2008 and 2,000 shares of restricted stock at a fair value of \$11.37 per share during the fourth quarter of 2008. The Company recognizes compensation expense on the restricted stock over the period of time the restrictions are in place (three years from the grant date for the grants to date). The amount of expense recorded each period reflects the changes in the Company’s stock price during the period. As of September 30, 2011, there was less than \$1,000 of total unrecognized compensation cost related to restricted stock grants, which will be recognized during 2011.

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, performance units, stock appreciation rights, or book value shares, may be granted to eligible directors and employees. A total of 360,000 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 has not granted any rights under the 2009 Plan.

#### (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 value of financial instruments held by the Company since purchase, origination, or issuance.

##### Cash and Cash Equivalents

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

##### Certificates of Deposit

The carrying amount of certificates of deposit is a reasonable estimate of fair value.

##### Investment Securities Available for Sale

Fair values for investment securities are based on quoted market prices.

##### 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.

#### 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.

#### Cash Surrender Value of Life Insurance

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

#### 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 and Demand Notes Payable to U.S. Treasury

The fair value of demand deposits, interest-bearing demand deposits, savings, and demand notes payable to the U.S. Treasury 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 the deferred income taxes and premises and equipment. In addition, the tax ramifications related to the realization of the 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, mortgage loans held for sale and derivatives, which are measured at fair value on a recurring basis by level within the fair value hierarchy as of September 30, 2011 and December 31, 2010.





(Dollars in thousands)

	Fair Value Measurements September 30, 2011	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	\$ 200,827	-	200,827	-
U.S. government sponsored enterprises	\$ 25,601	-	25,601	-
State and political subdivisions	\$ 97,155	-	97,155	-
Trust preferred securities	\$ 1,250	-	-	1,250
Equity securities	\$ 897	897	-	-
Mortgage loans held for sale	\$ 2,148	-	2,148	-

(Dollars in thousands)

	Fair Value Measurements December 31, 2010	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	\$ 139,361	-	139,361	-
U.S. government sponsored enterprises	\$ 42,640	-	42,640	-
State and political subdivisions	\$ 87,829	-	87,829	-
Trust preferred securities	\$ 1,250	-	-	1,250
Equity securities	\$ 1,369	1,369	-	-
Mortgage loans held for sale	\$ 3,814	-	3,814	-
Market value of derivatives (in other assets)	\$ 648	-	648	-

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, 2011:

(Dollars in thousands)

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

The Company's September 30, 2011 and December 31, 2010 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, 2011	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for
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						the Nine Months Ended September 30, 2011
Impaired loans	\$	27,491	-	19,040	8,451	(9,696)
Other real estate	\$	5,985	-	5,985	-	(1,026)

(Dollars in thousands)

		Fair Value Measurements December 31, 2010	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for the Year Ended December 31, 2010
Impaired loans	\$	40,062	-	26,798	13,264	(10,591)
Other Real Estate	\$	6,673	-	6,673	-	(340)

The carrying amount and estimated fair value of the Company's financial instruments at September 30, 2011 and December 31, 2010 are as follows:

(Dollars in thousands)

	September 30, 2011		December 31, 2010	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
<b>Assets:</b>				
Cash and cash equivalents	\$ 44,873	44,873	23,977	23,977
Certificates of deposit	-	-	735	735
Investment securities available for sale	325,730	325,730	272,449	272,449
Other investments	5,779	5,779	5,761	5,761
Mortgage loans held for sale	2,148	2,148	3,814	3,814
Loans, net	661,317	657,056	710,667	710,880
Cash surrender value of life insurance	12,721	12,721	7,539	7,539
Derivative instruments	-	-	648	648
<b>Liabilities:</b>				
Deposits and demand notes payable	\$ 841,041	843,207	840,312	839,379
Securities sold under agreements to repurchase	47,701	47,701	34,094	34,094
FHLB borrowings	70,000	79,579	70,000	79,950
Junior subordinated debentures	20,619	20,619	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, 2011.

## Fair Values of Derivative Instruments on the Balance Sheet

The table below presents the fair value of the Company's derivative financial instruments as well as their classification on the balance sheet as of September 30, 2011 and December 31, 2010.

(Dollars in thousands)

	Asset Derivatives			
	As of September 30, 2011		As of December 31, 2010	
	Balance Sheet	Fair Value	Balance Sheet	Fair Value
Interest rate derivative contracts	Other assets	\$ -	Other assets	\$ 648

## 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, 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 and 2010. 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, 2011 and 2010.

## 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, 2011 and 2010.

(Dollars in thousands)

	Amount of Gain	Amount of Gain	Location of Gain (Loss) Reclassified from Accumulated OCI into Earnings	Amount of Gain (Loss) Reclassified from Accumulated OCI into Earnings	
				Nine months ended September 30, 2011	Nine months ended September 30, 2010
Interest rate derivative contracts	\$ (20)	\$ 407	Interest income	\$ 628	\$ 1,136

**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 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-30 through A-63 of the Company's 2010 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 5, 2011 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 Peoples Bancorp of North Carolina, Inc ("the Company"). The Company is the parent company of Peoples Bank (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 2011 continue to have a negative impact on our financial condition and results of operations. Unfavorable trends, such as increased unemployment, falling real estate prices, increased loan defaults and increased bankruptcy rates, have created 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 new 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 a new, independent federal agency, which will have 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 Company. Additional information regarding the Company'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 United States Department of the Treasury ("UST"). 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 common stock associated with the Company's participation in the UST's Capital Purchase Program ("CPP") under the Troubled Asset Relief Program ("TARP"). Proceeds from this issuance of 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 common stock warrant. The discount recorded on the 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, 2011, the Company has accreted a total of \$372,000 of the discount related to the Series A preferred stock. The Company has paid dividends of \$940,000 on the Series A preferred stock during 2011 for the period from November 16, 2010 through August 15, 2011. Cumulative undeclared dividends at September 30, 2011 were \$157,000 for the period from August 16, 2011 through September 30, 2011.

The Series A preferred stock qualifies as Tier 1 capital and pays 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 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 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 exercise price of the warrant is \$10.52 per common share and it is exercisable at anytime on or before December 18, 2018.

The Company is subject to the following restrictions while the Series A preferred stock is outstanding: 1) UST approval is required for the Company to repurchase shares of outstanding common stock; 2) the full dividend for the latest completed CPP dividend period must be declared and paid in full before dividends may be paid to common shareholders; 3) UST approval is required for any increase in common dividends per share above the last quarterly dividend of \$0.12 per share paid prior to December 23, 2008; and 4) the Company may not take tax deductions for any senior executive officer whose compensation is above \$500,000. There were additional restrictions on executive compensation added in the ARRA for companies participating in the TARP, including participants in the CPP.

It is the intent of the Company to utilize CPP funds to provide capital to support making loans to qualified borrowers in our market area. The funds have been and will continue to be used to absorb losses incurred when modifying loans or making concessions to borrowers in order to keep borrowers out of foreclosure. We are also working with our current builders and contractors to provide financing for potential buyers who may not be able to qualify for financing in the current mortgage market in order to help these customers sell existing single family homes. The Company uses the CPP capital infusion as additional Tier I capital to protect the Bank from potential losses that may be incurred during this current recessionary period. It is the desire of the Company to repay the CPP funds without raising additional equity capital. The Company anticipates being able to repay the CPP funds from future earnings and existing capital. However, the funds will not be repaid until economic conditions improve and the Company achieves higher levels of earnings.

The Company continues to face challenges resulting from the impact of the current economy on the housing and real estate markets. We continue to monitor and evaluate all significant loans in our portfolio, and will continue to manage our credit risk exposure with the expectation that stabilization of the real estate market will not occur within the next 18 to 24 months. The CPP funds have enhanced our capital position as the Company infused the Bank with \$8.0 million of additional regulatory capital. The Company has \$15.5 million available that can be infused into the Bank as additional capital if needed to maintain its position as a well capitalized bank. We anticipate increased loan losses in the short run and have prepared for that expectation. We have experienced staff managing our past due loans and foreclosed properties to minimize our potential losses. As the economy recovers, we are positioned to take advantage of all opportunities that present themselves. The amount and timing of any future Federal Reserve rate adjustment remains uncertain, and may further impact us if those adjustments are significant.

#### 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 2010 Annual Report to Shareholders which is Appendix A to the Proxy Statement for the May 5, 2011 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 generally accepted accounting principles in the United States ("GAAP"). For a more complete discussion of policies, see the Notes to the Consolidated Financial Statements.

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, 2011.

The table below presents the fair value of the Company's derivative financial instruments as well as their classification on the balance sheet as of September 30, 2011 and December 31, 2010.

(Dollars in thousands)

	Asset Derivatives			
	As of September 30, 2011		As of December 31, 2010	
	Balance Sheet	Fair Value	Balance Sheet	Fair Value
	Location		Location	
Interest rate derivative contracts	Other assets	\$ -	Other assets	\$ 648

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 and 2010. 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, 2011 and 2010.

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, 2011 and 2010.

(Dollars in thousands)

Amount of Gain	Location of Gain (Loss) Reclassified from Accumulated OCI on Derivatives	Amount of Gain (Loss) Reclassified from Accumulated OCI into Earnings
(Loss) Recognized in		
Nine months ended		Nine months ended

	September 30,		September 30,	
	2011	2010	2011	2010
Interest rate derivative contracts	\$ (20)	\$ 407	Interest income	\$ 628 \$ 1,136

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, mortgage loans held for sale and derivatives, which are measured at fair value on a recurring basis by level within the fair value hierarchy as of September 30, 2011 and December 31, 2010.

(Dollars in thousands)

	Fair Value Measurements September 30, 2011	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	\$ 200,827	-	200,827	-
U.S. government sponsored enterprises	\$ 25,601	-	25,601	-
State and political subdivisions	\$ 97,155	-	97,155	-
Trust preferred securities	\$ 1,250	-	-	1,250
Equity securities	\$ 897	897	-	-
Mortgage loans held for sale	\$ 2,148	-	2,148	-

(Dollars in thousands)

	Fair Value Measurements December 31, 2010	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation
Mortgage-backed securities	\$ 139,361	-	139,361	-
U.S. government sponsored enterprises	\$ 42,640	-	42,640	-
State and political subdivisions	\$ 87,829	-	87,829	-
Trust preferred securities	\$ 1,250	-	-	1,250
Equity securities	\$ 1,369	1,369	-	-
Mortgage loans held for sale	\$ 3,814	-	3,814	-
Market value of derivatives (in other assets)	\$ 648	-	648	-

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, 2011:

(Dollars in thousands)

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



Change in unrealized gain/(loss) for assets still held in Level 3 \$ -

The Company's September 30, 2011 and December 31, 2010 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, 2011	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for the Nine Months Ended September 30, 2011
Impaired loans	\$ 27,491	-	19,040	8,451	(9,696)
Other real estate	\$ 5,985	-	5,985	-	(1,026)

(Dollars in thousands)

		Fair Value Measurements December 31, 2010	Level 1 Valuation	Level 2 Valuation	Level 3 Valuation	Total Gains/(Losses) for the Year Ended December 31, 2010
Impaired loans	\$	40,062	-	26,798	13,264	(10,591)
Other Real Estate	\$	6,673	-	6,673	-	(340)

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

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 GAAP. Actual results could differ from those estimates.

#### Results of Operations

**Summary.** Net earnings for the third quarter of 2011 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 \$540,000, or \$0.10 basic and diluted net earnings per share for the same period one year ago. After adjusting for \$348,000 in dividends and accretion on preferred stock, net earnings available to common shareholders for the three months ended September 30, 2011 were \$1.0 million, or \$0.19 basic and diluted net earnings per common share as compared to \$192,000, or \$0.03 basic and diluted net earnings per common share for the same period one year ago. The increase in third quarter earnings is attributable to an increase in net interest income and decreases in the provision for loan losses and non-interest expense, which were partially offset by a decrease in non-interest income.

The annualized return on average assets was 0.51% for the three months ended September 30, 2011 compared to 0.20% for the same period in 2010, and annualized return on average shareholders' equity was 5.31% for the three months ended September 30, 2011 compared to 2.09% for the same period in 2010.

Year-to-date net earnings as of September 30, 2011 were \$3.4 million, or \$0.61 basic and diluted net earnings per share, before adjustment for preferred stock dividends and accretion, as compared to \$2.3 million, or \$0.41 basic and diluted net earnings per share, 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, 2011 were \$2.3 million or \$0.42 basic and diluted net earnings per common share as compared to \$1.2 million, or \$0.22 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 increases in net interest income and non-interest income and a decrease in the provision for loan losses, which were partially offset by an increase in non-interest expense, as discussed below.

The annualized return on average assets was 0.46% for the nine months ended September 30, 2011 compared to 0.28% for the same period in 2010, and annualized return on average shareholders' equity was 4.49% for the nine months ended September 30, 2011 compared to 2.98% for the same period in 2010.

Net Interest Income. Net interest income, the major component of the Company's net earnings, was \$8.6 million for the three months ended September 30, 2011 compared to \$8.5 million for the same period in 2010. This increase is primarily attributable to a reduction in interest expense due to a decrease in deposit interest rates.

Interest income decreased \$704,000 or 5% for the three months ended September 30, 2011 compared with the same period in 2010. The decrease was primarily due to a reduction in average loans. The average yield on earning assets for the quarters ended September 30, 2011 and 2010 was 4.57% and 4.87%, respectively. During the quarter ended September 30, 2011, average loans decreased \$65.4 million to \$687.1 million from \$752.5 million for the three months ended September 30, 2010. During the quarter ended September 30, 2011, average investment securities available for sale increased \$79.0 million to \$313.8 million from \$234.8 million for the three months ended September 30, 2010 primarily due to the investment of additional funds received from loan repayments outpacing new loans disbursed.

Interest expense decreased \$843,000 or 24% for the three months ended September 30, 2011 compared with the same period in 2010 primarily due to lower cost of funds. The average rate paid on interest-bearing checking and savings accounts was 0.59% for the three months ended September 30, 2011 as compared to 1.08% for the same period of 2010. The average rate paid on certificates of deposits was 1.40% for the three months ended September 30, 2011 compared to 1.62% for the same period one year ago.

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, 2011 and 2010. 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)	Three months ended September 30, 2011			Three months ended September 30, 2010		
	Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate
<b>Interest-earning assets:</b>						
Interest and fees on loans	\$ 687,086	8,921	5.15%	752,475	9,983	5.26%
Investments - taxable	179,270	1,321	2.92%	115,638	980	3.36%
Investments - nontaxable*	134,529	1,452	4.28%	119,181	1,349	4.49%
Other	15,176	20	0.53%	16,976	25	0.59%
<b>Total interest-earning assets</b>	<b>1,016,061</b>	<b>11,714</b>	<b>4.57%</b>	<b>1,004,270</b>	<b>12,337</b>	<b>4.87%</b>
Cash and due from banks	24,003			43,627		
Other assets	50,967			50,533		
Allowance for loan losses	(16,192 )			(17,712 )		
<b>Total assets</b>	<b>\$ 1,074,839</b>			<b>1,080,718</b>		
<b>Interest-bearing liabilities:</b>						
NOW, MMDA & savings deposits	\$ 347,308	517	0.59%	317,628	866	1.08%
Time deposits	347,187	1,221	1.40%	401,710	1,637	1.62%
FHLB borrowings	70,000	761	4.31%	70,000	803	4.55%
Demand notes payable to U.S. Treasury	764	-	0.00%	903	-	0.00%
Trust preferred securities	20,619	100	1.92%	20,619	112	2.16%
Other	47,145	74	0.63%	41,719	98	0.93%
<b>Total interest-bearing liabilities</b>	<b>833,023</b>	<b>2,673</b>	<b>1.27%</b>	<b>852,579</b>	<b>3,516</b>	<b>1.64%</b>
Demand deposits	135,835			121,648		
Other liabilities	4,327			3,527		
Shareholders' equity	101,937			102,744		
<b>Total liabilities and shareholder's equity</b>	<b>\$ 1,075,122</b>			<b>1,080,498</b>		
Net interest spread		9,041	3.30%		8,821	3.23%
<b>Net yield on interest-earning assets</b>			<b>3.53%</b>			<b>3.48%</b>
<b>Taxable equivalent adjustment</b>						
Investment securities		423			342	

Net interest income	8,618	8,479
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\*Includes U.S. government agency securities that are non-taxable for state income tax purposes of \$134.5 million in 2011 and \$119.2 million in 2010. An effective tax rate of 6.90% was used to calculate the tax equivalent yield on these securities.

Net interest income increased to \$25.7 million for the nine months ended September 30, 2011 compared to \$24.8 million for the same period in 2010. This increase is primarily attributable to a reduction in interest expense due to a decrease in the cost of funds for time deposits.

Interest income decreased \$1.5 million or 4% for the nine months ended September 30, 2011 compared with the same period in 2010. The decrease was primarily due to a reduction in average loans. The average yield on earning assets for the nine months ended September 30, 2011 and 2010 was 4.69% and 4.94%, respectively. During the nine months ended September 30, 2011, average loans decreased \$58.4 million to \$704.3 million from \$762.7 million for the nine months ended September 30, 2010. During the nine months ended September 30, 2011, average investment securities available for sale increased \$77.6 million to \$289.6 million from \$212.0 million for the nine months ended September 30, 2010 primarily due to the investment of additional funds received from loan repayments outpacing new loans disbursed.

Interest expense decreased \$2.5 million or 23% for the nine months ended September 30, 2011 compared with the same period in 2010 primarily due to lower cost of funds. The average rate paid on interest-bearing checking and savings accounts was 0.72% for the nine months ended September 30, 2011 as compared to 1.15% for the same period of 2010. The average rate paid on certificates of deposits was 1.44% for the nine months ended September 30, 2011 compared to 1.72% for the same period one year ago.

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, 2011 and 2010. 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, 2011			Nine months ended September 30, 2010		
	Average Balance	Interest	Yield / Rate	Average Balance	Interest	Yield / Rate
<b>Interest-earning assets:</b>						
Interest and fees on loans	\$ 704,263	27,695	5.26%	762,692	30,236	5.30%
Investments - taxable	153,063	3,317	2.90%	108,323	2,701	3.33%
Investments - nontaxable*	136,525	4,487	4.39%	103,725	3,690	4.76%
Federal funds sold	-	-	0.00%	119	-	0.00%
Other	19,278	63	0.44%	17,520	68	0.52%
<b>Total interest-earning assets</b>	<b>1,013,129</b>	<b>35,562</b>	<b>4.69%</b>	<b>992,379</b>	<b>36,695</b>	<b>4.94%</b>
Cash and due from banks	23,700			48,652		
Other assets	49,628			49,922		
Allowance for loan losses	(15,655 )			(16,906 )		
<b>Total assets</b>	<b>\$ 1,070,802</b>			<b>1,074,047</b>		
<b>Interest-bearing liabilities:</b>						
NOW, MMDA & savings deposits	\$ 341,277	1,836	0.72%	306,060	2,643	1.15%
Time deposits	363,046	3,901	1.44%	408,592	5,259	1.72%
FHLB borrowings	70,037	2,258	4.31%	72,659	2,505	4.61%
Demand notes payable to U.S. Treasury	891	-	0.00%	804	-	0.00%
Trust preferred securities	20,619	300	1.95%	20,619	310	2.01%
Other	41,487	231	0.75%	39,604	306	1.03%
<b>Total interest-bearing liabilities</b>	<b>837,357</b>	<b>8,526</b>	<b>1.36%</b>	<b>848,338</b>	<b>11,023</b>	<b>1.74%</b>
Demand deposits	130,209			120,838		
Other liabilities	4,036			3,751		
Shareholders' equity	100,587			102,137		
	\$ 1,072,189			1,075,064		

Total liabilities and shareholder's equity				
Net interest spread	27,036	3.33%	25,672	3.20%
Net yield on interest-earning assets		3.57%		3.46%
Taxable equivalent adjustment				
Investment securities	1,292		891	
Net interest income	25,744		24,781	

\*Includes U.S. government agency securities that are non-taxable for state income tax purposes of \$136.5 million in 2011 and \$103.7 million in 2010. 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, 2011 Compared to 2010			Nine Months Ended September 30, 2011 Compared to 2010		
	Changes in Average Volume	Changes in Average Rates	Total Increase (Decrease)	Changes in Average Volume	Changes in Average Rates	Total Increase (Decrease)
<b>Interest income:</b>						
Loans: Net of unearned income	\$ (858 )	(204 )	(1,063 )	(2,332 )	(209 )	(2,541 )
Investments - taxable	505	(164 )	341	1,042	(426 )	616
Investments - nontaxable	171	(68 )	103	1,123	(326 )	797
Other	(3 )	(2 )	(6 )	6	(11 )	(5 )
<b>Total interest income</b>	<b>(186 )</b>	<b>(438 )</b>	<b>(624 )</b>	<b>(161 )</b>	<b>(972 )</b>	<b>(1,133 )</b>
<b>Interest expense:</b>						
NOW, MMDA & savings deposits	57	(406 )	(349 )	241	(1,048 )	(807 )
Time deposits	(207 )	(209 )	(416 )	(538 )	(820 )	(1,358 )
FHLB / FRB Borrowings	-	(42 )	(42 )	(88 )	(159 )	(248 )
Trust Preferred Securities	-	(12 )	(12 )	-	(10 )	(10 )
Other	11	(35 )	(24 )	13	(88 )	(75 )
<b>Total interest expense</b>	<b>(139 )</b>	<b>(704 )</b>	<b>(843 )</b>	<b>(373 )</b>	<b>(2,125 )</b>	<b>(2,497 )</b>
<b>Net interest income</b>	<b>\$ (47 )</b>	<b>265</b>	<b>219</b>	<b>212</b>	<b>1,152</b>	<b>1,364</b>

Provision for Loan Losses. For the three months ended September 30, 2011 a contribution of \$3.4 million was made to the provision for loan losses compared to a \$4.7 million contribution to the provision for loan losses for the three months ended September 30, 2010. The decrease in the provision for loan losses is primarily attributable to a \$24.9 million reduction in non-accrual loans from September 30, 2010 to September 30, 2011.

The provision for loan losses for the nine months ended September 30, 2011 was \$9.7 million, as compared to \$10.2 million for the same period one year ago, primarily attributable to a \$24.9 million reduction in non-accrual loans from September 30, 2010 to September 30, 2011.

Non-Interest Income. Total non-interest income was \$3.7 million for the third quarter of 2011, as compared to \$3.9 million for the same period of 2010. This decrease is primarily attributable to a \$384,000 decrease in the gains on sale of securities.

Non-interest income increased 5% to \$10.0 million for the nine months ended September 30, 2011, as compared to \$9.6 million for the same period one year ago. This increase is primarily attributable to a \$704,000 increase in gains on the sale of securities, which was partially offset by a \$431,000 reduction in service charges and fees.

Non-Interest Expense. Total non-interest expense amounted to \$7.2 million for the three months ended September 30, 2011 and September 30, 2010.



Non-interest expense increased 2% to \$21.9 million for the nine months ended September 30, 2011, as compared to \$21.4 million for the same period last year. The increase in non-interest expense included: (1) an increase of \$365,000 or 3% in salaries and benefits expense, (2) an increase of \$44,000 or 1% in occupancy expense and (3) an increase of \$105,000 or 2% in non-interest expenses other than salary, employee benefits and occupancy expenses.

Income Taxes. The Company reported income tax expense of \$406,000 and an income tax benefit of \$42,000 for the three months ended September 30, 2011 and 2010, respectively. The increase in tax expense is primarily due to a \$1.3 million increase in earnings before taxes.

The Company reported income taxes of \$755,000 and \$454,000 for the nine months ended September 30, 2011 and 2010, respectively. This represented an effective tax rate of 18% and 17% for the respective periods. The 2010 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 at the reduced level of earnings before income taxes as experienced in 2010 and 2011.

#### Analysis of Financial Condition

Investment Securities. Available for sale securities amounted to \$325.7 million at September 30, 2011 compared to \$272.4 million at December 31, 2010. Average investment securities available for sale for the nine months ended September 30, 2011 amounted to \$289.6 million compared to \$219.8 million for the year ended December 31, 2010. This increase reflects the investment of additional funds received from loan repayments outpacing new loans disbursed.

Loans. At September 30, 2011, loans amounted to \$677.7 million compared to \$726.2 million at December 31, 2010, a decrease of \$48.5 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, 2011, amounting to approximately \$64.2 million, were offset by paydowns and payoffs of existing loans. Average loans represented 70% and 76% of average earning assets for the nine months ended September 30, 2011 and the year ended December 31, 2010, respectively. The Company had \$2.1 million and \$3.8 million in mortgage loans held for sale as of September 30, 2011 and December 31, 2010, 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, 2011, the Company had \$121.0 million in residential mortgage loans, \$93.5 million in home equity loans and \$275.2 million in commercial mortgage loans, which include \$216.3 million using commercial property as collateral and \$58.9 million using residential property as collateral. Residential mortgage loans include \$66.3 million made to customers in the Company's traditional banking offices and \$54.7 million in mortgage loans originated in the Company's Latino banking operations. All residential mortgage loans are originated as fully amortizing loans, with no negative amortization.

At September 30, 2011, the Company had \$103.9 million in acquisition, development and construction ("AD&C") 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	74	\$ 22,043	\$ 2,614
Land acquisition and development - residential purposes	340	70,944	14,474
1 to 4 family residential construction	29	8,713	-
Commercial construction	7	2,201	-
Total acquisition, development and construction	450	\$ 103,901	\$ 17,088

At September 30, 2011, troubled debt restructured ("TDR") loans amounted to \$48.5 million, including \$16.0 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. At December 31, 2010, TDR loans amounted to \$56.7 million, including \$10.0 million in performing TDR loans.

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. The Bank's Board of Directors reviews, on a monthly basis, an analysis of the Bank's reserves relative to the range of reserves estimated by the Credit Administration department.

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, 2011 and December 31, 2010, the recorded investment in loans that were considered to be impaired was approximately \$27.5 million and \$40.1 million, respectively, with related allowance for loan losses of approximately \$1.3 million and \$1.4 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, 2011 as compared to the year ended December 31, 2010. 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, 2011 amounted to \$16.3 million or 2.41% of total loans compared to \$15.5 million or 2.13% of total loans at December 31, 2010. 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, 2011 and December 31, 2010.

LOAN RISK GRADE ANALYSIS:

Risk Grade	Percentage of Loans By Risk Grade	
	09/30/2011	12/31/2010
Risk Grade 1 (Excellent Quality)	3.24%	3.36%
Risk Grade 2 (High Quality)	16.30%	16.60%
Risk Grade 3 (Good Quality)	49.29%	47.00%
Risk Grade 4 (Management Attention)	21.42%	21.36%
Risk Grade 5 (Watch)	2.80%	2.84%
Risk Grade 6 (Substandard)	6.37%	8.12%
Risk Grade 7 (Low Substandard)	0.00%	0.37%
Risk Grade 8 (Doubtful)	0.00%	0.07%
Risk Grade 9 (Loss)	0.00%	0.00%

At September 30, 2011, including non-accrual loans, there were four relationships exceeding \$1.0 million (which totaled \$6.5 million) in the Watch risk grade, 10 relationships exceeding \$1.0 million in the Substandard risk grade (which totaled \$23.8 million) and no relationships exceeding \$1.0 million in the Low Substandard risk grade. There was one relationship with loans in the Watch risk grade and the Substandard risk grade totaling \$1.2 million.

**Non-performing Assets.** Non-performing assets totaled \$34.9 million at September 30, 2011 or 3.20% of total assets, compared to \$46.9 million at December 31, 2010, or 4.40% of total assets. Non-accrual loans were \$27.5 million at September 30, 2011 and \$40.1 million at December 31, 2010. As a percentage of total loans outstanding, non-accrual loans were 4.06% at September 30, 2011 compared to 5.52% at December 31, 2010. Non-performing loans include \$17.1 million in AD&C loans, \$11.2 million in commercial and residential mortgage loans and \$563,000 in other loans at September 30, 2011 as compared to \$23.1 million in AD&C loans, \$16.2 million in commercial and residential mortgage loans and \$1.0 million in other loans as of December 31, 2010. The Bank had loans 90 days past due and still accruing totaling \$1.4 million and \$210,000 as of September 30, 2011 and December 31, 2010, respectively. Other Real Estate Owned totaled \$6.0 million as of September 30, 2011 as compared to \$6.7 million at December 31, 2010. The Bank had no repossessed assets as of September 30, 2011 and December 31, 2010.

**Deposits.** Total deposits at September 30, 2011 were \$841.0 million compared to \$838.7 million at December 31, 2010. Core deposits, which include non-interest bearing demand deposits, NOW, MMDA, savings and non-brokered certificates of deposits of denominations less than \$100,000, increased \$31.1 million to \$623.8 million at September 30, 2011 as compared to \$592.7 million at December 31, 2010. Certificates of deposit in amounts greater than \$100,000 or more totaled \$215.6 million at September 30, 2011 as compared to \$241.4 million at December 31, 2010. This decrease is primarily due to a \$5.9 million decrease in certificates of deposit issued through the Certificate of Deposit Account Registry Service ("CDARS") and a \$12.7 million decrease in brokered certificates of deposit as of September 30, 2011 compared to December 31, 2010. At September 30, 2011, brokered deposits amounted to \$66.3 million as compared to \$87.4 million at December 31, 2010. Brokered deposits outstanding as of September 30, 2011 had a weighted average rate of 0.85% with a weighted average original term of 12 months as compared to brokered deposits outstanding at December 31, 2010, which had a weighted average rate of 1.20% with a weighted average original term of 13 months.

Borrowed Funds. Borrowings from the FHLB totaled \$70.0 million at September 30, 2011 and December 31, 2010, respectively. The average balance of FHLB borrowings for the nine months ended September 30, 2011 was \$70.0 million compared to \$72.0 million for the year ended December 31, 2010. At September 30, 2011, all of the Bank's FHLB borrowings had maturities exceeding one year. The FHLB has the option to convert \$50.0 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 \$47.7 million at September 30, 2011 compared to \$34.1 million at December 31, 2010.

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 by PEBK Capital Trust I in December 2001 and for general corporate 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 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 has 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, 2011 totaled \$1.0 billion, exceeding average rate sensitive liabilities of \$837.4 million by \$175.8 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, 2011

Included in the rate sensitive assets are \$380.0 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, 2011, we had \$292.8 million in loans with interest rate floors. The floors were in effect on \$291.8 million of these loans pursuant to the terms of the promissory notes on these loans. The weighted average rate on these loans is 1.13% 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, 2011 such unfunded commitments to extend credit were \$131.8 million, while commitments in the form of standby letters of credit totaled \$3.1 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, 2011, the Company's core deposits totaled \$623.8 million, or 74% 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 12.69% as of September 30, 2011.

At September 30, 2011, we had a significant amount of deposits in amounts greater than \$100,000, including brokered deposits of \$66.3 million, which have an average maturity of 12 months. 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, 2011 and December 31, 2010. At September 30, 2011, the carrying value of loans pledged as collateral to the FHLB totaled \$157.0 million compared to \$153.8 million at December 31, 2010. As additional collateral, the Bank has pledged securities to FHLB. At September 30, 2011, the market value of securities pledged to FHLB totaled \$13.6 million compared to \$10.0 million at December 31, 2010. The remaining availability at the FHLB was \$22.7 million at September 30, 2011 compared to \$7.2 million at December 31, 2010. The Bank had no borrowings from the FRB at September 30, 2011 and December 31, 2010. 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, 2011, the carrying value of loans pledged as collateral to the FRB totaled \$341.0 million compared to \$348.9 million at December 31, 2010.

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, 2011.

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 33.30% at September 30, 2011 and 25.87% at December 31, 2010. 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, 2011 and December 31, 2010 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.

(Dollars in thousands)

	September 30, 2011	December 31, 2010
<b>Contractual Cash Obligations:</b>		
Long-term borrowings	\$ 70,000	70,000
Junior subordinated debentures	20,619	20,619
Operating lease obligations	2,758	3,220
<b>Total</b>	<b>\$ 93,377</b>	<b>93,839</b>
<b>Other Commitments:</b>		
Commitments to extend credit	\$ 131,808	137,015
Standby letters of credit and financial guarantees written	3,071	3,590

Total	\$	134,880	140,605
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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, 2011 was \$103.0 million compared to \$96.9 million at December 31, 2010. Annualized return on average equity for the nine months ended September 30, 2011 was 4.49% compared to 1.81% for the year ended December 31, 2010. Total cash dividends paid on common stock amounted to \$333,000 and \$332,000 for the nine months ended September 30, 2011 and 2010, respectively.

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.

On December 23, 2008, the Company entered into a Purchase Agreement with the UST. 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 common stock associated with the Company's participation in the CPP under the TARP. Proceeds from this issuance of 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 common stock warrant. Additional discussion of the Company's participation in the CPP can be found on page 22. 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, 2011 and December 31, 2010 includes \$20.0 million in trust preferred securities. The Company's Tier 1 capital ratio was 15.90% and 14.24% at September 30, 2011 and December 31, 2010, 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 17.15% and 15.51% at September 30, 2011 and December 31, 2010, 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 11.03% and 10.70% at September 30, 2011 and December 31, 2010, respectively.

The Bank's Tier 1 risk-based capital ratio was 13.48% and 11.87% at September 30, 2011 and December 31, 2010, respectively. The total risk-based capital ratio for the Bank was 14.75% and 13.15% at September 30, 2011 and December 31, 2010, respectively. The Bank's Tier 1 leverage capital ratio was 9.34% and 8.91% at September 30, 2011 and December 31, 2010, 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 has a leverage ratio of 5.0% or greater. Based upon these guidelines, the Bank was considered to be "well capitalized" at September 30, 2011.

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, 2011	-	\$ -	-	-
August 1 - 31, 2011	3,435	5.03	-	-
September 1 - 30, 2011	-	-	-	-
Total	3,435	(1) \$ 5.03	-	-

(1) The Company purchased 3,435 shares on the open market in the three months ended September 30, 2011 for its deferred compensation plan. All purchases were funded by participant contributions to the plan. The Purchase Agreement with the UST under the CPP program permits the Company to purchase its common stock on the open market pursuant to benefit plans.

## 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, 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 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

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Peoples Bank and A. Joseph Lampron 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 (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
- Exhibit (31)(a) Certification of principal executive officer pursuant to section 302 of the 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, 2011, 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, 2011  
Date

/s/ Tony W. Wolfe  
Tony W. Wolfe  
President and Chief Executive Officer  
(Principal Executive Officer)

November 9, 2011  
Date

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

