

FIRST FARMERS & MERCHANTS CORP  
Form 10-Q  
November 08, 2011

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

**FORM 10-Q**

(Mark one)

**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 \_\_\_\_\_

Commission File Numbers: 000-10972

First Farmers and Merchants Corporation

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(Exact name of registrant as specified in its charter)

Tennessee  
(State or other jurisdiction of incorporation or  
organization)

62-1148660

(I.R.S. Employer Identification No.)

816 South Garden Street  
Columbia, Tennessee  
(Address of principal executive offices)

38402-1148  
(Zip Code)

931-388-3145

(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

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

Yes  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 during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).  Yes  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

As of November 4, 2011, the registrant had 5,380,000 shares of common stock outstanding.

**PART I - FINANCIAL INFORMATION**

**Item 1. Financial Statements.**

The following unaudited consolidated financial statements of the Registrant and its subsidiaries are included in this Report:

Consolidated balance sheets    September 30, 2011 and December 31, 2010.

Consolidated statements of income - For the three months and nine months ended September 30, 2011 and September 30, 2010.

Consolidated statements of cash flows - For the nine months ended September 30, 2011 and September 30, 2010.

Selected notes to consolidated financial statements.





**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEETS**

		September 30, 2011	December 31, 2010
		(unaudited)	(1)
(Dollars in Thousands, Except Per Share Data)			
<b>ASSETS</b>			
	Cash and due from banks	\$ 15,970	\$11,161
	Federal funds sold	-	17,100
	Cash and cash equivalents	15,970	28,261
	Interest-bearing due from banks	34,646	4,238
	Securities		
	Available-for-sale (amortized cost \$286,314 and \$237,496, respectively)	290,339	236,180
	Held-to-maturity (fair market value \$38,062 and \$40,778, respectively)	36,408	39,975
	Total Securities	326,747	276,155
	Loans, net of deferred fees	537,314	559,179
	Allowance for loan and lease losses	(8,274)	(9,420)
	Net loans	529,040	549,759
	Loans held -for-sale	1,531	3,104
	Bank premises and equipment, at cost less allowance for depreciation	24,458	22,842
	Accrued interest receivable	4,190	4,044
	Goodwill and core deposits	9,018	9,036
	Other real estate owned	10,027	7,927
	Bank owned life insurance policies	23,438	22,641
	Other assets	9,878	13,702
	<b>TOTAL ASSETS</b>	<b>\$ 988,943</b>	<b>\$941,709</b>
<b>LIABILITIES</b>			
	Deposits		
	Noninterest bearing demand deposits	\$ 142,707	\$123,541
	Interest-bearing (including certificates of deposits over \$100: 2011 - \$104,922; 2010 - \$107,425)	685,005	668,285
	Total deposits	827,712	791,826
	Federal funds purchased and securities sold under agreements to repurchase	16,543	5,813
	Short-term borrowings	384	372
	Accounts payable and accrued liabilities	15,350	13,376
	Federal Home Loan Bank Advances	17,100	24,100
	<b>TOTAL LIABILITIES</b>	<b>877,089</b>	<b>835,487</b>
<b>SHAREHOLDERS' EQUITY</b>	Common stock - \$10 par value per share, 8,000,000 shares authorized; 5,380,000 and 5,430,000 shares issued and outstanding as of September 30, 2011 and December 31, 2010, respectively	53,800	54,300
	Retained earnings	55,483	52,636
	Accumulated other comprehensive income	2,476	(809)
	<b>TOTAL SHAREHOLDERS' EQUITY BEFORE NONCONTROLLING INTEREST - PREFERRED STOCK OF SUBSIDIARY</b>	<b>111,759</b>	<b>106,127</b>
	Noncontrolling interest - preferred stock of subsidiary	95	95
	<b>TOTAL SHAREHOLDERS' EQUITY</b>	<b>111,854</b>	<b>106,222</b>

TOTAL LIABILITIES AND  
SHAREHOLDERS' EQUITY

**\$ 988,943**    \$941,709

(1) Derived from audited financial statements.

The accompanying notes are an integral part of consolidated financial statements.



**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF INCOME**

		Three Months Ended		Nine Months Ended	
		September 30,		September 30,	
		2011	2010	2011	2010
		<i>(Dollars in Thousands Except Per Share Data)</i>			
		<i>(unaudited)</i>			
<b>INTEREST AND</b>					
<b>DIVIDEND INCOME</b>	Interest and fees on loans	\$ 7,450	\$ 7,890	\$ 22,515	\$ 23,822
	Income on investment securities				
	Taxable interest	1,149	741	3,217	3,098
	Exempt from federal income tax	895	902	2,738	2,676
	Dividends	17	14	153	116
	Other interest income	30	16	59	44
	<b>TOTAL INTEREST INCOME</b>	<b>9,541</b>	<b>9,563</b>	<b>28,682</b>	<b>29,756</b>
<b>INTEREST EXPENSE</b>	Interest on deposits	1,013	1,480	3,255	4,668
	Interest on other borrowings	166	235	551	759
	<b>TOTAL INTEREST EXPENSE</b>	<b>1,179</b>	<b>1,715</b>	<b>3,806</b>	<b>5,427</b>
	Net interest income	8,362	7,848	24,876	24,329
	Provision for possible loan and lease losses	750	-	2,225	1,491
	Net interest income after provision	7,612	7,848	22,651	22,838
<b>NONINTEREST</b>	Mortgage banking income	96	90	340	301
<b>INCOME</b>	Trust department income	491	462	1,515	1,486
	Service fees on deposit accounts	1,754	1,759	5,070	5,165
	Earnings on bank owned life insurance	179	172	536	603
	Gain/Loss on sale of securities	701	1,112	1,135	1,614
	Gain/Loss on foreclosed property	(458)	(1,517)	(915)	(2,131)
	Other noninterest income	124	216	322	385
	<b>TOTAL NONINTEREST INCOME</b>	<b>2,887</b>	<b>2,294</b>	<b>8,003</b>	<b>7,423</b>
<b>NONINTEREST</b>	Salaries and employee benefits	4,001	4,025	12,293	12,205
<b>EXPENSE</b>	Net occupancy expense	527	561	1,502	1,596
	Depreciation expense	319	283	957	888
	Data processing expense	480	228	1,427	1,234
	Legal and professional fees	249	279	798	992
	Stationary and office supplies	48	53	213	375
	Amortization of intangibles	-	19	18	56
	Advertising and promotions	253	356	930	1,218
	FDIC insurance premium expense	377	390	1,144	1,110
	Other real estate expense	104	75	397	435
	Other noninterest expense	1,208	1,561	3,855	4,580
	<b>TOTAL NONINTEREST</b>				
	<b>EXPENSES</b>	<b>7,566</b>	<b>7,830</b>	<b>23,534</b>	<b>24,689</b>
	<b>INCOME BEFORE PROVISION FOR</b>				
	<b>INCOME TAXES</b>	<b>2,933</b>	<b>2,312</b>	<b>7,120</b>	<b>5,572</b>
	<b>PROVISION FOR INCOME TAXES</b>	<b>632</b>	<b>478</b>	<b>1,263</b>	<b>606</b>
	Net income before noncontrolling interest -				
	dividends on preferred stock of subsidiary	2,301	1,834	5,857	4,966
	Noncontrolling interest - dividends on				
	preferred stock of subsidiary	-	-	8	8
	Net income for common shareholders	\$ 2,301	\$ 1,834	\$ 5,849	\$ 4,958
	Weighted Average Shares Outstanding	5,380,000	5,487,729	5,400,063	5,493,098
	Earnings per share	\$ 0.43	\$ 0.33	\$ 1.08	\$ 0.90

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The accompanying notes are an integral part of the consolidated financial statements.

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**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**

(Dollars in thousands)  
(unaudited)

Nine months ended September 30,  
2011 2010

<b>OPERATING ACTIVITIES</b>	Net income available for common shareholders	\$ 5,849	\$ 4,958
	Adjustments to reconcile net income to net cash provided by (used in) operating activities		
	Excess of provision for possible loan losses over net charge-offs	2,225	1,491
	Provision for depreciation and amortization of premises and equipment	957	888
	Deferred tax expense (benefit)	124	(800)
	Net securities gains	(1,135)	(1,614)
	(Gain) loss from disposition of other real estate	915	2,131
	Amortization of deposit base intangibles	18	56
	Amortization of investment security premiums, net of accretion of discounts	1,019	1,972
	Increase in cash surrender value of life insurance contracts	(536)	(606)
	(Increase) decrease in		
	Other real estate owned	(1,185)	(1,477)
	Other assets	23	(1,755)
	Increase in		
	Other liabilities	1,936	2,157
	Total adjustments	4,361	2,443
	Net cash provided by operating activities	10,210	7,401
<b>INVESTING ACTIVITIES</b>	Proceeds from maturities, calls, and sales of available-for-sale securities	174,331	213,043
	Proceeds from maturities and calls of held-to-maturity securities	3,540	6,907
	Purchases of investment securities		
	Available-for-sale	(222,960)	(234,921)
	Net decrease (increase) in loans	18,494	(693)
	Proceeds from sale of foreclosed assets	-	382
	Purchase of life insurance premium	-	(468)
	Purchases of premises and equipment	(1,616)	(3,271)
	Net cash used in investing activities	(28,211)	(19,021)
<b>FINANCING ACTIVITIES</b>	Net increase in noninterest-bearing and interest-bearing deposits	35,886	33,735
	Net increase in federal funds purchased and short term borrowings	10,742	148
	Payments to FHLB borrowings	(7,000)	(10,077)
	Repurchase of common stock	(1,511)	(833)
	Cash dividends paid on common stock	(1,991)	(4,068)
	Cash dividends paid on preferred stock	(8)	(8)
	Net cash provided by financing activities	36,118	18,897
	Increase in cash and cash equivalents	18,117	7,277
	Cash and cash equivalents at beginning of period	32,499	33,463
	Cash and cash equivalents at end of period	\$ 50,616	\$ 40,740
	Supplemental disclosures of cash flow information		
	Cash paid during the period for expenses		
	Interest on deposits and borrowed funds	\$ 3,617	\$ 7,107
	Income Taxes	956	1,607

The accompanying notes are an integral part of the consolidated financial statements.



## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### NOTE 1 SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The interim unaudited consolidated financial statements of First Farmers and Merchants Corporation (the Corporation ) presented in this report have been prepared on a consistent basis and in accordance with the instructions to Form 10-Q and do not include all of the information and notes required by generally accepted accounting principles used in the United States ( GAAP ) for complete financial statements. Management has evaluated all significant events and transactions that occurred through November 4, 2011, for potential recognition or disclosure in these consolidated financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. These adjustments were of a normal, recurring nature and consistent with GAAP. For further information, refer to the consolidated financial statements and notes included in the Corporation s Annual Report on Form 10-K for the year ended December 31, 2010.

### NOTE 2 FAIR VALUE MEASUREMENT

The fair value of an asset or liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for such asset or liability. In estimating fair value, the Corporation utilizes valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. Such valuation techniques are consistently applied. Inputs to valuation techniques include the assumptions that market participants would use in pricing an asset or liability. Financial Accounting Standards Board Accounting Standards Codification ( ASC ) Topic 820, Fair Value Measurements and Disclosures establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

- *Level 1 Inputs* - Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.
- *Level 2 Inputs* - Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities,

prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.

- *Level 3 Inputs* - Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

A description of the valuation methodologies used for instruments measured at fair value as well as the general classification of such instruments pursuant to the valuation hierarchy is set forth below. These valuation methodologies were applied to all of the financial assets and financial liabilities of the Corporation and its sole wholly-owned subsidiary, First Farmers and Merchants Bank (the Bank), carried at fair value effective January 1, 2008. In general, fair value is based on quoted market prices, where available. If such quoted market prices are not available, fair value is based on internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and the Corporation's creditworthiness among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Corporation's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Furthermore, the reported fair value amounts have not been comprehensively revalued since the presentation dates and, therefore, estimates of fair value after the balance sheet date may differ significantly from the amounts presented herein. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally coincides with the Corporation's monthly and/or quarterly valuation process.

The following table summarizes financial assets and liabilities measured at fair value on a recurring basis as of September 30, 2011, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value (dollars in thousands):

**Assets and liabilities measured at fair value on a recurring basis as of September 30, 2011**

	Level 1	Level 2	Level 3	Total
Available-for-sale securities				
U.S. Government agencies	\$ -	\$ 51,497	\$ -	\$ 51,497
Mortgage backed securities	-	154,350	-	\$ 154,350
States and political subdivisions	-	60,831	-	\$ 60,831
Other securities	-	23,661	-	23,661
<b>Total assets at fair value</b>	<b>\$ -</b>	<b>\$ 290,339</b>	<b>\$ -</b>	<b>\$ 290,339</b>

Assets and liabilities measured at fair value on a recurring basis as of December 31, 2010

	Level 1	Level 2	Level 3	Total
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## Available-for-sale securities

U.S. Government agencies	\$	-	\$	101,883	\$	-	\$	101,883
Mortgage backed securities		-		51,858		-		51,858
States and political subdivisions		-		58,963		-		58,963
Other securities		-		23,476		-		23,476
<b>Total assets at fair value</b>	\$	-	\$	236,180	\$	-	\$	236,180

## Financial Assets and Financial Liabilities Measured at Fair Value on a Nonrecurring Basis:

Certain financial assets and liabilities are measured at fair value on a nonrecurring basis. These instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment). The only financial asset or liability measured at fair value on a non-recurring basis for third quarter 2011 was impaired loans.

*Impaired Loans* Certain impaired loans are reported at the fair value of the underlying collateral if repayment is expected solely from the collateral. Collateral values are estimated using Level 2 inputs based on observable market data or Level 3 inputs based on customized discounting criteria. In the third quarter of 2011, certain impaired loans were re-measured and reported at fair value through a specific valuation allowance allocation of the allowance for loan and lease losses based on the fair value of the underlying collateral. At September 30, 2011 and December 31, 2010, impaired loans with a carrying value of \$1.9 million and \$25.1 million, were reduced by specific valuation allowance allocations totaling approximately \$372,000 and \$2.9 million, to a total reported fair value of \$1.5 million and \$22.2 million, based on collateral valuations utilizing Level 3 valuation inputs,.

*Non-Financial Assets and Non-Financial Liabilities:*

The Corporation has no non-financial assets or non-financial liabilities measured at fair value on a recurring basis. Certain non-financial assets and non-financial liabilities measured at fair value on a non-recurring basis include foreclosed assets (upon initial recognition or subsequent impairment), non-financial assets and non-financial liabilities measured at fair value in the second step of goodwill impairment testing, and intangible assets and other non-financial long-lived assets measured at fair value for impairment assessment.



During the third quarter 2011, certain foreclosed assets, upon initial recognition, were remeasured and reported at fair value through a charge-off to the allowance for loan and lease losses based upon the fair value of the foreclosed asset. The fair value of a foreclosed asset, upon initial recognition, is estimated using Level 2 inputs based on observable market data or Level 3 inputs based on customized discounting criteria. Foreclosed assets measured at fair value totaled \$10.0 million (utilizing Level 2 valuation inputs) at September 30, 2011.

ASC Topic 825, Financial Instruments (ASC Topic 825) requires disclosure of the fair value of financial assets and liabilities, including those financial assets and liabilities that are not measured and reported at fair value on a recurring basis or non-recurring basis. The methodologies for estimating the fair value of financial assets and liabilities that are measured at fair value on a recurring or non-recurring basis are discussed in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2010.

As of September 30, 2011 and December 31, 2010, the estimated fair values of financial instruments were as follows (dollars in thousands):

	September 30, 2011		December 31, 2010	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
<b>Financial assets</b>				
Cash and due from banks	\$ 15,970	\$ 15,970	\$ 11,161	\$ 11,161
Interest-bearing deposits in banks	34,646	34,646	4,238	4,238
Federal funds sold	-	-	17,100	17,100
Securities available-for-sale	290,339	290,339	236,180	236,180
Securities held-to-maturity	36,408	38,062	39,975	40,778
Loans, net	529,040	547,577	549,759	563,270
Accrued interest receivable	4,190	4,190	4,044	4,044
<b>Financial liabilities</b>				
Deposits	827,712	830,103	791,826	793,270
Federal funds purchased and securities sold under agreements to repurchase	16,543	16,543	5,813	5,813
Other short term liabilities	-	-	372	372
FHLB borrowings	17,100	17,649	24,100	24,901

Accrued interest payable	<b>887</b>	<b>887</b>	1,078	1,078
Off-balance sheet credit related instruments:				
Commitments to extend credit		<b>97</b>		95

Under ASC Topic 825, entities may choose to measure eligible items at fair value at specified election dates. Unrealized gains and losses on items for which the fair value measurement option has been elected are reported in earnings at each subsequent reporting date. The fair value option (i) may be applied instrument by instrument, with certain exceptions; therefore, the Corporation may record identical financial assets and liabilities at fair value or by another measurement basis permitted under GAAP; (ii) is irrevocable (unless a new election date occurs) and (iii) is applied only to entire instruments and not to portions of instruments. During the reported periods, the Bank had no financial instruments measured at fair value under the fair value measurement option.

### NOTE 3 SECURITIES

Securities with an amortized cost of \$225.3 million and a fair value of \$228.7 million at September 30, 2011 were pledged to secure deposits and for other purposes as required or permitted by law. The fair value is established by an independent pricing service as of the approximate dates indicated. The differences between the amortized cost and fair value reflect current interest rates and represent the potential gain if the portfolio had been liquidated on that date. Security gains are realized only in the event of dispositions prior to maturity.

The amortized cost and estimated fair value of securities at September 30, 2011 were as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Losses	Fair Value
<b>September 30, 2011</b>				
Available-for-sale securities				
U.S. Government agencies	\$ 51,424	\$ 116	\$ 43	\$ 51,497
Mortgage backed securities	153,457	945	52	154,350
States and political subdivisions	58,272	2,587	28	60,831
Other securities	23,161	577	77	23,661
	\$ 286,314	\$ 4,225	\$ 200	\$ 290,339
Held-to-maturity securities				
U.S. Government agencies	\$ -	\$ -	\$ -	\$ -
States and political subdivisions	36,408	1,662	8	38,062
Other securities	-	-	-	-
	\$ 36,408	\$ 1,662	\$ 8	\$ 38,062

At September 30, 2011, the Bank did not hold investment securities of any single issuer, other than obligations of U.S. government agencies, whose aggregate book value exceeded 10% of shareholders' equity.

Proceeds from the maturity, call or sale of available-for-sale securities were \$175.6 million during the nine months ended September 30, 2011. Proceeds from the maturity or call of held-to-maturity securities were \$3.5 million during the nine months ended September 30, 2011.

If the fair values of any securities at September 30, 2011 did not equal or exceed the cost of those securities, then the current fair value was considered temporarily impaired. Management evaluates securities for other-than-temporary impairment periodically, or more frequently when circumstances require an evaluation. An impairment judgment is based on (i) the amount of time and loss, (ii) the financial condition of the issuer and (iii) management's intent and ability to hold the investment long enough for any anticipated recovery in value.

Management has the ability and intent to hold the securities classified as held-to-maturity until they mature. Furthermore, as of September 30, 2011, management also had the ability to hold the securities classified as available-for-sale for a period of time sufficient for a recovery of cost. The unrealized losses are largely a result of market fluctuations and variations in pricing appraisals. Management does not believe any of the securities are impaired because of reasons of credit quality. Accordingly, as of September 30, 2011, management believes the impairments detailed in the table below are temporary and no impairment loss has been realized in the Corporation's consolidated income statement.

The following table presents the Bank's investments with unrealized losses at September 30, 2011 according to the term of the unrealized loss (dollars in thousands):

September 30, 2011 Type of Security	Less than 12 months		12 months or Greater		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
US Government agencies	\$ 20,022	\$ 43			\$ 20,022	\$ 43
Mortgage backed securities	31,404	52			31,404	52
States and political subdivisions	472	3	2,112	25	2,584	28
Other securities	2,715	77			2,715	77
	\$ 54,613	\$ 175	\$ 2,112	\$ 25	\$ 56,725	\$ 200

The table below shows the amortized cost and fair value of investment securities at September 30, 2011 by contractual or legal maturity. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations. Mortgage-backed securities and equity securities are shown separately because they are not due at a single maturity date.

(Dollars in Thousands)	Amortized Cost	Fair Value	Yield (Unaudited)
<b>Available-for-sale securities</b>			
U.S. Government agencies			
After one but within five years	\$ 13,066	\$ 13,097	1.1%
After five but within ten years	38,358	38,400	2.0%
Mortgage backed securities			
After one but within five years	131,760	132,558	1.5%
After five but within ten years	21,697	21,792	2.0%
States and political subdivisions			
Within one year	1,278	1,289	3.1%
After one but within five years	5,518	5,707	4.1%
After five but within ten years	10,373	10,858	5.2%
After ten years	41,103	42,977	5.7%
Other securities			
Within one year	3,567	3,608	1.6%
After one but within five years	14,397	14,861	3.0%
After five but within ten years	1,300	1,295	3.7%
After ten years	3,897	3,897	3.5%
	\$ 286,314	\$ 290,339	
<b>Held-to-maturity securities</b>			
States and political subdivisions			
Within one year	2,020	\$ 2,040	5.7%
After one but within five years	8,754	9,077	5.9%
After five but within ten years	10,609	11,152	3.3%
After ten years	15,025	15,793	6.2%
	\$ 36,408	\$ 38,062	

#### NOTE 4 LOANS

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The following table presents the Bank's loans by category as of September 30, 2011 and December 31, 2010 (dollars in thousands):

	<b>September 30, 2011</b>	Percentage of Total	December 31, 2010	Percentage of Total
Commercial & industrial	\$ 81,971	15.3%	\$ 67,156	12.0%
Tax exempt municipal loans	20,434	3.8%	28,163	5.0%
Real estate				
Construction	44,809	8.3%	37,374	6.7%
Commercial mortgages	152,854	28.4%	156,704	28.0%
Residential mortgages	202,634	37.7%	221,749	39.7%
Other	20,686	3.8%	31,129	5.6%
Retail loans	14,549	2.7%	17,394	3.0%
Net unamortized loan origination fees	(623)		(490)	
	<b>\$ 537,314</b>	100.0%	<b>\$ 559,179</b>	100.0%

*Loan Origination/Risk Management.* The Bank has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies and non-performing

and potential problem loans. Diversification in the loan portfolio is a means of managing risk associated with fluctuations in economic conditions.

Commercial and industrial loans are underwritten after evaluating and understanding a borrower's ability to operate profitably and expand its business prudently. Underwriting standards are designed to promote relationship banking rather than transactional banking. Once it is determined that the borrower's management possesses sound ethics and solid business acumen, the Corporation's management examines current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may incorporate a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. As a general rule, the Bank avoids financing single-purpose projects unless other underwriting factors are present to help mitigate risk. The Bank also utilizes third-party experts to provide insight and guidance about economic conditions and trends affecting market areas it serves. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans. At September 30, 2011, approximately half of the outstanding principal balance of the Bank's commercial real estate loans were secured by owner-occupied properties.

With respect to loans to developers and builders that are secured by non-owner occupied properties that the Bank may originate from time to time, the Bank generally requires the borrower to have had an existing relationship with the Bank and have a proven record of success. Construction loans are underwritten utilizing feasibility studies, independent appraisal reviews, sensitivity analysis of absorption and lease rates and financial analysis of the developers and property owners. Construction loans are generally based upon estimates of costs and value associated with the complete project. These estimates may be inaccurate. Construction loans often involve the disbursement of substantial funds with repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Bank until permanent financing is obtained. These loans are closely

monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

The Bank originates consumer loans utilizing a computer-based credit scoring analysis to supplement the underwriting process. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed, jointly by line and staff personnel. This activity, coupled with relatively small loan amounts that are spread across many individual borrowers, minimizes risk. Additionally, trend and outlook reports are reviewed by management on a regular basis. Underwriting standards for home equity loans are heavily influenced by statutory requirements, which include, but are not limited to, a maximum loan-to-value percentage of 80%, collection remedies, the number of such loans a borrower can have at one time and documentation requirements.

The Bank contracts with a third party vendor to perform loan reviews. The Bank reviews and validates the credit risk program on an annual basis. Results of these reviews are presented to management. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Bank's policies and procedures.



The goal of the Bank is to diversify loans to avoid a concentration of credit in a specific industry, person, entity, product, service, or any area vulnerable to a tax law change or an economic event. A concentration of credit occurs when obligations, direct or indirect, of the same or affiliated interests represent 15 percent or more of the Bank's capital structure. The Board of Directors recognizes that the Bank's geographic trade area imposes some limitations regarding loan diversification if the bank is to perform the function for which it has been chartered. Specifically, lending to qualified borrowers within the Bank's trade area will naturally cause concentrations of real estate loans in the primary communities served by the Bank and loans to employees of major employers in the area.

*Non-Accrual and Past Due Loans.* 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, if (i) principal or interest has been in default for a period of 90 days or more, or (ii) full payment of principal and interest is not expected. 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 on non-accrual loans is recognized only to the extent that cash payments are received in excess of principal due. A loan may be returned to accrual status when all the principal and interest amounts contractually due are brought current and future principal and interest amounts contractually due are reasonably assured, which is typically evidenced by a sustained period (at least nine months) of repayment performance by the borrower.

The following table provides details regarding the aging of the Bank's loan and lease portfolio as of September 30, 2011 (dollars in thousands):

	30 - 89 Days Past Due	Greater Than 90 Days Past Due*	Total Past Dues	Current	Total Loans
<b><u>Retail</u></b>					
Consumer loans	\$ 208	\$ 85	\$ 293	\$ 14,466	\$ 14,759
Residential loans - first lien	813	1,977	2,790	140,823	143,613
Residential loans - junior lien	4	125	129	1,038	1,167
HELOCs	155	1,023	1,178	56,575	57,753
Other retail	1	346	347	24,648	24,995
<b>Retail Totals</b>	<b>\$ 1,181</b>	<b>\$ 3,556</b>	<b>\$ 4,737</b>	<b>\$ 237,550</b>	<b>\$ 242,287</b>
<b><u>Commercial</u></b>					
Commercial & industrial	\$ 255	\$ 4,682	\$ 4,937	\$ 54,645	\$ 59,582

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Non-farm, non-residential real estate	-	2,097	2,097	140,424	142,521
Construction & development	233	-	233	41,372	41,605
Multi-family real estate-		-	-	6,407	6,407
Other commercial	21	683	704	44,208	44,912
<b>Commercial Totals</b>	<b>\$ 509</b>	<b>\$ 7,462</b>	<b>\$ 7,971</b>	<b>\$ 287,056</b>	<b>\$ 295,027</b>
<b>TOTAL</b>	<b>\$ 1,690</b>	<b>\$ 11,018</b>	<b>\$ 12,708</b>	<b>\$ 524,606</b>	<b>\$ 537,314</b>

\*Includes all loans on non-accrual and all bankruptcies. Loans are automatically placed on non-accrual status once they reach 90 days past due.

The following table shows loans related to each balance in the allowance for loan and lease losses by portfolio segment and disaggregated on the basis of the Bank's impairment methodology (dollars in thousands):

September 30, 2011	Consumer Residential & Commercial real estate			Overdrafts & GL additions	Totals
	Commercial real estate	other retail			
Loans individually evaluated for impairment	\$11,219	\$2,785	\$-	\$-	\$14,004
Loans collectively evaluated for impairment	283,808	223,638	14,549	1,315	523,310
<b>Ending Balance</b>	<b>\$295,027</b>	<b>\$226,423</b>	<b>\$14,549</b>	<b>\$1,315</b>	<b>\$537,314</b>

**December 31, 2010**

Loans individually evaluated for impairment	\$ 23,548	\$ 1,545	\$ -	\$ -	\$ 25,093
Loans collectively evaluated for impairment	281,971	211,856	38,812	1,447	534,086
Ending Balance	\$ 305,519	\$ 213,401	\$ 38,812	\$ 1,447	\$ 559,179

The following table summarizes the impaired loans as of September 30, 2011 and December 31, 2010 (dollars in thousands):

	September 30, 2011	December 31, 2010
Balance of impaired loans with no allocated allowance	\$ 12,115	\$ 10,016
Balance of impaired loans with an allocated allowance	1,889	15,077
Total recorded investments in impaired loans	<b>14,004</b>	25,093
Amount of the allowance allocated to impaired loans	\$ 372	\$ 2,912

The following table summarizes the impaired loans by loan type as of September 30, 2011 and December 31, 2010 (dollars in thousands):

September 30, 2011	Unpaid Contractual Principal Balance	Recorded Investment with no allowance	Recorded Investment with allowance	Total Recorded Investment	Related Allowance
	Commercial	\$ 12,663	\$ 9,981	\$ 368	\$ 10,349
Residential real estate	3,469	2,134	1,521	\$ 3,655	228
Total	\$ 16,132	\$ 12,115	\$ 1,889	\$ 14,004	\$ 372
December 31, 2010					
Commercial	\$ 9,827	\$ 9,215	\$ 14,333	\$ 23,548	\$ 2,707
Residential real estate	1,105	801	744	\$ 1,545	205
Total	\$ 10,932	\$ 10,016	\$ 15,077	\$ 25,093	\$ 2,912

*Impaired Loans.* Loans are considered impaired when, based on current information and events, it is probable the Corporation will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. Impairment is evaluated in total for smaller-balance loans of a similar nature and on an individual loan basis for other loans. If a loan is impaired, a specific valuation allowance is allocated, if necessary, so that the loan is reported net, at the present value of estimated future cash flows

using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

*Credit Quality Indicators.* As part of the on-going monitoring of the credit quality of the Bank's loan portfolio, management tracks certain credit quality indicators including trends related to (i) the weighted-average risk grade of commercial loans, (ii) the level of classified commercial loans, (iii) net charge-offs, (iv) non-performing loans and (v) the general economic conditions in the State of Tennessee.

The Corporation uses a risk grading matrix to assign a risk grade to each of its commercial loans. Loans are graded on a scale of 1 through 8. A description of the general characteristics of the eight risk grades is as follows:

**Risk Rating 1    Minimal Risk**

General Characteristics:

- Substantially risk free
- Federal, state, or municipal subdivisions with acceptable investment grade credit rating.
- Large national, regional, or local entity with proven access to capital markets.

- Diversity in borrower's line of business with stable and diversified sales base.
- Borrower is considered to be an industry leader with many consecutive years of strong profits and exhibits a financial condition, equity position, liquidity, and debt service capacity far exceeding industry norms.
- Borrower has an abundance of unpledged financeable assets coupled with superior cash generation capabilities.
- Industry conditions and trends are positive and strong.
- Borrower has strong management with evidence of management succession.
- A credit rating by Moody's, Standard & Poor, or other qualified rating agency that is grade A or higher.
- A cash secured loan with the cash on deposit in the Bank or a guaranty from the federal government also warrants this risk rating.

**Risk Rating 2      Modest Risk**

General Characteristics:

- Borrower shows strong profitability, liquidity, and capitalization better than industry norms and a strong market position in the region.
- Borrower may have limited access to public markets for short-term needs or capital requirements, but has ready access to alternative financing.
- Loans may be unsecured based on the financial strength of the borrower or secured by collateral that is considered liquid and marketable.
- Borrower has a proven history of profitability and financial stability.
- Borrower has a strong market position in its industry and has an abundance of financeable assets available to protect the Bank's position.
- Borrower's proven and steady management with good management succession.
- Borrower can withstand major market instabilities of short duration.
- Credit rating by Moody's, Standard & Poor, or other qualified rating agency that is grade BAA or higher.

**Risk Rating 3      Average Risk**

General Characteristics:

- Borrower shows a stable earnings history and financial condition in line with industry norms with indications that these trends will continue.
- The credit extension is considered sound, however elements may be present which suggest the borrower may not be free from temporary impairments in the future.
- Borrower's liquidity and leverage is in line with industry norms.
- Borrower has good management with acceptable management succession.
- Under most economic and business conditions, borrower has access to alternative financing but limited or no access to capital markets for short-term or capital needs.
- Borrower may be an individual with a sound financial condition and liquidity with proven historical income to repay the debt as scheduled.
- Credit extensions are generally secured by acceptable collateral.

**Risk Rating 4      Acceptable Risk**

General Characteristics:

- Credit is to a borrower with smaller margins of debt service coverage and with some elements of reduced financial strength.
- Borrower is generally in a lower average market position in its industry.

- Borrower shows satisfactory asset quality and liquidity, good debt capacity and coverage, and good management in critical positions.
- Borrower's management is of unquestioned character but management succession may be questionable.
- Borrower can obtain similar financing from other financial institutions.
- Interim losses or moderately declining earnings trends may occur, but the borrower has sufficient strength and financial flexibility to offset these issues.
- Credit may be to individuals with a moderately leveraged financial condition but with satisfactory liquidity and income to cover debt repayment requirements.
- Business borrowers may have moderate leverage, but must have historically consistent cash flow to cover debt service and other operating needs.
- Business borrowers may also have erratic or cyclical operating performances but should demonstrate strong equity positions to support these profitability swings.
- Asset-based loans that have stabilized and proven performance with the financial capacity to provide for annual clean up may qualify for this rating.
- Borrower has no access to capital markets but would be financeable by another financial institution or finance company.
- Credit extensions are generally secured by acceptable collateral.

**Risk Rating 5      Pass / Watch**

General Characteristics:

Loans considered for this risk rating require a heightened level of supervision.

A) Transitional, Event Driven    This category of risk rated 5 loans captures responses to early warning signals from a relationship and, therefore, signifies a specific, event-driven, transitional credit grade. The event is generally something unplanned or unexpected such as a death, a disaster, the loss of a major client, product line, or key employee; divorce, or health condition of the owner or key management person. This category may be used in transitional upgrades as well as transitional downgrades of credit relationships. Under these criteria, this category necessitates a plan of action to either upgrade the credit to a Pass rating (i.e., Risk Rating 1-4), downgrade the credit to a criticized asset, or exit the relationship within six months.

B) Ongoing Supervision Warranted - This category may also be utilized to identify loans having inherent characteristics which warrant more than the normal level of supervision. Loans meeting these criteria may include larger, more complex loans with unusual structures. Loans, which, due to structure or nature of the collateral require above average servicing, may also be considered for this risk rating. Unlike other criteria listed previously for this category, these particular characteristics tend not to be one-time or transitional in nature; therefore, these loans may be expected to remain in this risk rating category longer than six months. A loan might remain in this risk rating category for its life or until the characteristic warranting the rating can be eliminated or effectively mitigated.

- Borrower may exhibit declining earnings, strained cash flow, increasing leverage, or weakening market positions that indicate a trend toward an unacceptable risk.
- Borrower's liquidity, leverage, and earnings performance is below or trending below industry norms.
- Interim losses and other adverse trends may occur but not to the level that would impair the Bank's position.
- Borrower may be a newly formed company or in a new line of business or may be an established business with new or unproven management. Borrower should be adequately capitalized, but may not yet have achieved stabilized cash flow.
- Borrower generally has a small market position in its industry.
- Borrower may be engaged in an industry that is experiencing an economic downturn or is particularly susceptible to uncontrollable external factors.
- Borrower management is of good character although some management weakness may exist, including lack of depth or succession.



- Borrower generally has limited additional debt capacity and modest coverage, and average or below-average asset quality, margins, and market share.
- Borrower's ability to obtain financing from other financial institutions may be impaired.
- Credit to individuals with marginal financial condition and liquidity but with income still sufficient to service the debt.

**Risk Rating 6                      Special Mention**

A special mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

General Characteristics:

- Borrower's cash flow may not be sufficient to fund anticipated cash needs.
- Sufficient or modestly sufficient financeable assets are available to protect the Bank's position.
- Adverse trends in borrower's operations/profits or unbalanced position in borrower's balance sheet but not to the point where repayment is in jeopardy.
- Borrower generally shows limited liquidity or high leverage.
- Borrower's financial position is in the lower quartile of industry norms.
- Borrower's business exhibits a deteriorating market position in the industry.
- Borrower's management lacks depth and succession.
- Business is unable to withstand temporary setbacks without affecting repayment capability.
- Borrower is not financeable by another bank but possibly by a finance company or specialized lender.

**Risk Rating 7                      Substandard**

A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness, or weaknesses, that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

General Characteristics:

- The primary source of borrower's repayment no longer provides satisfactory support and repayment is dependent on secondary sources.
- A substandard loan is inadequately protected by the current sound worth and paying capacity of the obligor or by the collateral pledged, if any.
- Normal repayment from the borrower is impaired although no loss of principal is envisioned.
- A partial loss of interest or principal will occur if the borrower's deficiencies are not corrected.
- Borrower's cash flow is generally not sufficient to fund anticipated cash needs.
- Borrower's financeable assets may not be sufficient to protect the bank's position.
- Adverse trends in borrower's operations that jeopardized debt repayment may require the borrower to undertake a significant reorganization of financing or the business.
- Borrower shows poor liquidity and high leverage impairing the repayment of the debt in accordance with agreed upon terms.
- Borrower's management lacks depth and succession; may be inexperienced or of questionable character.
- Borrower's market position in the industry is deteriorating.
- Borrower is not financeable by another bank or finance company.

**Risk Rating 8     Doubtful**

An asset classified doubtful has all the weaknesses inherent in one classified substandard with 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.

## General Characteristics:

- Inadequate primary source of repayment. Assumes a less than satisfactory secondary source of repayment on a most-likely case basis. There may be adequate secondary source of repayment on a best-case basis.
- Borrower has the same weaknesses found in Substandard borrowers.
- Loss probability is extremely high but because of certain important and reasonably specific factors that may work to strengthen the loan, its classification as an estimated loss is deferred until a more exact status may be determined.
- Pending factors may include proposed merger or acquisition; liquidation procedures; capital injections; perfecting liens on additional collateral; and refinancing plans.
- Borrower's cash flow is insufficient to fund cash needs.
- Borrower's financeable assets are insufficient to protect the bank's position.
- Borrower's source of debt repayment is dependent on liquidation of assets with a probable loss.
- Borrower may no longer be a going concern, or may not exist as a going concern for the foreseeable future.
- No alternative financing sources exist for borrower.

The following tables present risk grades and classified loans by class of commercial loan in the Bank's portfolios as of September 30, 2011 and December 31, 2010 (dollars in thousands):

<b>September 30, 2011</b>	Commercial & Industrial	Non-Farm, Non-Residential Real Estate Loans	Construction & Development	Commercial Loans		Commercial Loan Totals
				Secured by Residential R/E	All Other Commercial Loans	
Pass	\$ 48,153	\$ 134,582	\$ 40,680	\$ 7,884	\$ 41,292	<b>\$ 272,591</b>
Special Mention	4,911	4,183	-	445	-	<b>9,539</b>
Substandard	2,526	2,110	925	691	1,461	<b>7,713</b>
Doubtful	3,991	1,645	-	-	1,385	<b>7,021</b>
<b>TOTALS</b>	<b>\$ 59,581</b>	<b>\$ 142,520</b>	<b>\$ 41,605</b>	<b>\$ 9,020</b>	<b>\$ 44,138</b>	<b>\$ 296,864</b>
	Consumer Loans	Single- Family Residential**	All Other Retail Loans	<b>Retail Loan Totals</b>		
Performing	\$ 13,358	\$ 202,090	\$ 21,455	<b>\$ 237,003</b>		

Non-performing*	86	3,647	337	<b>4,070</b>
<b>TOTALS</b>	<b>\$ 13,444</b>	<b>\$ 205,737</b>	<b>\$ 21,792</b>	<b>\$ 241,073</b>

\*Loans are classified as **non-performing** loans and are automatically placed on non-accrual status once they reach **90 days past due**. For the purposes of this calculation, all loans rated at or below Substandard (RR7) are classified as non-performing.

\*\***Single-family residential loans** include first mortgages, closed-end second mortgages, residential construction loans, and home equity lines of credit (HELOCs).

December 31, 2010	Commercial & Industrial	Non-Farm, Non-Residential Real Estate Loans	Construction & Development	Commercial Loans		Commercial Totals
				Secured By Residential R/E	All Other Loans	
1-5 Pass	\$ 45,836	\$ 138,788	\$ 31,189	\$ 8,884	\$ 44,166	\$ 268,863
6- Special Mention	6,397	3,319	-	461	614	10,791
7- Substandard	4,624	10,614	1,695	1,127	1,827	19,887
8- Doubtful	3,141	1,409	-	-	1,428	5,978
<b>TOTALS</b>	<b>\$ 59,998</b>	<b>\$ 154,130</b>	<b>\$ 32,884</b>	<b>\$ 10,472</b>	<b>\$ 48,035</b>	<b>\$ 305,519</b>
	Consumer Loans	Single- Family Residential**	All Other Retail Loans	<b>Retail Totals</b>		
Performing	\$ 14,115	\$ 208,156	\$ 28,725	\$ 250,996		
Non-performing*	1040	2,692	358	3,154		
<b>TOTALS</b>	<b>\$ 14,219</b>	<b>\$ 210,848</b>	<b>\$ 29,083</b>	<b>\$ 254,150</b>		

\*Loans are classified as **non-performing** loans and are automatically placed on non-accrual status once they reach **90 days past due**. For the purposes of this calculation, all loans rated at or below Substandard (RR7) are classified as non-performing.

\*\***Single-family residential loans** include first mortgages, closed-end second mortgages, residential construction loans, and home equity lines of credit (HELOCs).

*Allowance for Loan and Lease Losses.* The allowance for loan and lease losses is a reserve established through a provision for loan and lease losses charged to expense, which represents management's best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan and lease losses and risks inherent in the loan portfolio. The Corporation's allowance for loan and lease loss methodology includes allowance allocations calculated in accordance with ASC Topic 310, Receivables (ASC Topic 310) and allowance allocations calculated in accordance with ASC Topic 450, Contingencies (ASC Topic 450). Accordingly, the methodology is based on historical loss experience by type of credit and internal risk grade, specific homogeneous risk pools and specific loss allocations, with adjustments for current events and conditions. The Corporation's process for determining the appropriate level of the allowance for loan and lease losses is designed to account for credit deterioration as it occurs. The provision for loan and lease losses reflects loan quality trends, including the levels of and trends related to non-accrual loans, past due loans, potential problem loans, criticized loans and net charge-offs or recoveries, among other factors. The provision for loan and lease losses also reflects the totality of actions taken on all loans for a particular period. In other words, the amount of the provision reflects not only the necessary increases in the allowance for loan and lease losses related to newly identified criticized loans, but it also reflects actions taken related to other loans including, among other things, any necessary increases or decreases in required allowances for specific loans or loan pools.

The level of the allowance reflects management's continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Corporation's control, including, among other things, the performance of the Corporation's loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications.

The Corporation's allowance for loan and lease losses consists of three elements: (i) specific valuation allowances determined in accordance with ASC Topic 310 based on probable losses on specific loans; (ii) historical valuation allowances determined in accordance with ASC Topic 450 based on historical loan loss experience for similar loans with similar characteristics and trends, adjusted, as necessary, to reflect the impact of current conditions; and (iii) general valuation allowances determined in accordance with ASC Topic 450 based on general economic conditions and other qualitative risk factors both internal and external to the Corporation.

The allowances established for probable losses on specific loans are based on a regular analysis and evaluation of problem loans. Loans are classified based on an internal credit risk grading process that evaluates, among other things: (i) the obligor's ability to repay; (ii) the underlying collateral, if any; and (iii) the economic environment and industry in which the borrower operates. This analysis is performed at the relationship manager level for all commercial loans. When

a loan has a calculated grade of 8 or higher, a special assets officer analyzes the loan to determine whether the loan is impaired and, if impaired, the need to specifically allocate a portion of the allowance for loan and lease losses to the loan. Specific valuation allowances are determined by analyzing the borrower's ability to repay amounts owed, collateral deficiencies, the relative risk grade of the loan and economic conditions affecting the borrower's industry, among other things.

Historical valuation allowances are calculated based on the historical loss experience of specific types of loans and the internal risk grade of such loans at the time they were charged-off. The Bank calculates historical loss ratios for pools of similar loans with similar characteristics based on the proportion of actual charge-offs experienced to the total population of loans in the pool. The historical loss ratios are periodically updated based on actual charge-off

experience. A historical valuation allowance is established for each pool of similar loans based upon the product of the historical loss ratio and the total dollar amount of the loans in the pool. The Bank's pools of similar loans include similarly risk-graded groups of commercial and industrial loans, commercial real estate loans, consumer real estate loans and consumer and other loans.

The components of the general valuation allowance include (i) the additional reserves allocated to specific loan portfolio segments as a result of applying an environmental risk adjustment factor to the base historical loss allocation and (ii) the additional reserves that are not allocated to specific loan portfolio segments including allocations for groups of similar loans with risk characteristics that exceed certain concentration limits established by management.

There is an inherent imprecision in calculating the specific portion of the ALLL. Therefore, a conservative factor may be added to the allocation of each of the identified segments of the loan portfolio to account for the imprecision.

Included in the general valuation allowances are allocations for groups of similar loans with risk characteristics that exceed certain concentration limits established by management. Concentration risk limits have been established, among other things, for certain industry concentrations, large balance and highly leveraged credit relationships that exceed specified risk grades, and loans originated with policy exceptions that exceed specified risk grades.

The following table summarizes the allocation in the allowance for loan and lease losses by loan segment for the three months ended September 30, 2011 (dollars in thousands):

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September</b>		<b>September</b>	
	<b>30, 2011</b>	<b>30, 2010</b>	<b>30, 2011</b>	<b>30, 2010</b>
<b>Balance at beginning of period</b>	\$ 8,004	\$ 9,337	\$ 9,420	\$ 8,929
Provision (reduction) charged (credited) to operating expenses	750	-	2,225	1,491
Charge-offs:				
Commercial and industrial	(494)	(106)	(3,115)	(545)
Real estate	(23)	(487)	(281)	(1,597)
Consumer and other	(4)	(36)	(130)	(69)

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Total charge-offs	(521)	(629)	(3,526)	(2,211)
Recoveries:				
Commercial and industrial	14	7	65	37
Real estate	-	241	20	691
Consumer and other	27	8	70	27
Total recoveries	42	256	156	755
<b>Balance at end of period</b>	<b>\$ 8,274</b>	<b>\$ 8,964</b>	<b>\$ 8,274</b>	<b>\$ 8,964</b>



The following table details the amount of the allowance for loan losses allocated to each portfolio segment as of September 30, 2011 and December 31, 2010, disaggregated on the basis of the Bank's impairment methodology.

<b>September 30, 2011</b>	<b>Commercial</b>	<b>Residential real estate</b>	<b>Consumer &amp; other retail</b>	<b>Unallocated</b>	<b>Totals</b>
Loans individually evaluated for impairment	\$ 420	\$ 163	\$ -	\$ -	\$ 583
Loans collectively evaluated for impairment	5,483	1,769	204		235 7,691
	\$	\$	\$		\$
Balance	5,903	1,932	204	\$	235 8,274
<b>December 31, 2010</b>	<b>Commercial</b>	<b>Residential real estate</b>	<b>Consumer &amp; other retail</b>	<b>Unallocated</b>	<b>Totals</b>
Loans individually evaluated for impairment	\$ 2,707	\$ 205	\$ -	\$ -	\$ 2,912
Loans collectively evaluated for impairment	4,209	1,796	407		96 6,508
	\$	\$	\$		\$
Balance	6,915	2,001	407	\$	96 9,420

## NOTE 5 DEPOSITS

Deposits were as follows for the dates indicated (dollars in thousands):

	<b>September 30, 2011</b>	<b>Percentage of Total</b>	<b>December 31, 2010</b>	<b>Percentage of Total</b>
<b>Noninterest-bearing demand deposits:</b>				
Commercial and Individual	\$ 139,136	16.8 %	\$ 121,333	15.3 %
Correspondent Banks	6	- %	6	- %
Public Funds	3,565	0.4 %	2,202	0.3 %
Total noninterest-bearing demand deposits	\$ 142,707	17.2 %	\$ 123,541	15.6 %
<b>Interest-Bearing deposits</b>				
<b>Private Accounts:</b>				
Savings and Interest Checking	222,032	26.8 %	213,520	27.0 %
Money Market Accounts	93,921	11.4 %	92,665	11.7 %
Time accounts of \$100,000 or more	94,618	11.4 %	93,439	11.8 %
Time accounts under \$100,000	134,024	16.2 %	138,447	17.5 %
Total Private Banking	\$ 544,595	65.8 %	\$ 538,071	68.0 %
<b>Public Funds:</b>				
Savings and Interest Checking	97,274	11.9 %	92,430	11.7 %
Money Market Accounts	32,507	3.9 %	23,453	2.9 %
Time accounts of \$100,000 or more	10,304	1.2 %	13,986	1.8 %
Time accounts under \$100,000	325	- %	345	- %

Total Public Funds	\$	<b>140,410</b>	<b>17.0 %</b>	\$	130,214	16.4 %
Total interest-bearing demand deposits	\$	<b>685,005</b>	<b>82.8 %</b>	\$	668,285	84.4 %
Total Deposits	\$	<b>827,712</b>	<b>100.0 %</b>	\$	791,826	100.0 %

**NOTE 6 RECENT ACCOUNTING PRONOUNCEMENTS**

*ASU No. 2010-20, Receivables (Topic 310) - Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses.* ASU 2010-20 requires entities to provide disclosures designed to facilitate financial statement users' evaluation of (i) the nature of credit risk inherent in the entity's portfolio of financing receivables, (ii) how that risk is analyzed and assessed in arriving at the allowance for credit losses and (iii) the changes and reasons for those changes in the allowance for credit losses. Disclosures must be disaggregated by portfolio segment, the level at which an entity develops and documents a systematic method for determining its allowance for credit losses, and class of financing receivable, which is generally a disaggregation of portfolio segment. The required disclosures include, among other things, a rollforward of the allowance for credit losses as well as information about modified, impaired, non-accrual and past due loans and credit quality indicators. ASU 2010-20 became effective for the Corporation's financial statements as of December 31, 2010, as it relates to disclosures required as of the end of a reporting period. Disclosures that relate to activity during a reporting period became effective for the Corporation's financial statements beginning on January 1, 2011. ASU 2011-01, *Receivables (Topic 310) - Deferral of the Effective Date of Disclosures about Troubled Debt Restructurings* in Update No. 2010-20, temporarily deferred the effective date for disclosures related to troubled debt restructurings to coincide with the effective date of the then proposed ASU 2011-02, *Receivables (Topic 310) - A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring*, which is further discussed below.

*ASU No. 2010-28, Intangibles - Goodwill and Other (Topic 350) - When to Perform Step 2 of the Goodwill Impairment Test for Reporting Units with Zero or Negative Carrying Amounts.* ASU 2010-28 modifies Step 1 of the goodwill impairment test for reporting units with zero or negative carrying amounts. For those reporting units, an entity is required to perform Step 2 of the goodwill impairment test if it is more likely than not that a goodwill impairment exists. In determining whether it is more likely than not that a goodwill impairment exists, an entity should consider whether there are any adverse qualitative factors indicating that an impairment may exist such as if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying amount. ASU 2010-28 became effective for the Corporation on January 1, 2011 and did not have a significant impact on the Corporation's financial statements.

*ASU No. 2011-02, Receivables (Topic 310) - A Creditor's Determination of Whether a Restructuring Is a Troubled Debt Restructuring.* ASU 2011-02 clarifies which loan modifications constitute troubled debt restructurings and is intended to assist creditors in determining whether a modification of the terms of a receivable meets the criteria to be considered a troubled debt restructuring, both for purposes of recording an impairment loss and for disclosure of troubled debt restructurings. In evaluating whether a restructuring constitutes a troubled debt restructuring, a creditor must separately conclude, under the guidance clarified by ASU 2011-02, that both of the following exist: (a) the restructuring constitutes a concession; and (b) the debtor is experiencing financial difficulties. ASU 2011-02 became effective for the Corporation on July 1, 2011, and applies retrospectively to restructurings occurring on or after January 1, 2011. Adoption

of ASU 2011-02 did not have a significant impact on the Corporation's financial statements.

*ASU No. 2011-03, Transfers and Servicing (Topic 860) - Reconsideration of Effective Control for Repurchase Agreements.* ASU 2011-03 is intended to improve financial reporting of repurchase agreements and other agreements that both entitle and obligate a transferor to repurchase or redeem financial assets before their maturity. ASU 2011-03 removes from the assessment of effective control (i) the criterion requiring the transferor to have the ability to repurchase or redeem the financial assets on substantially the agreed terms, even in the event of default by the transferee, and (ii) the collateral maintenance guidance related to that criterion. ASU 2011-03 will be effective for the Corporation on January 1, 2012 and is not expected to have a significant impact on the Corporation's financial statements.

*ASU 2011-04, Fair Value Measurement (Topic 820) - Amendments to Achieve Common Fair Value Measurements and Disclosure Requirements in U.S. GAAP and IFRSs.* ASU 2011-04 amends Topic 820, Fair Value Measurements and Disclosures, to converge the fair value measurement guidance in U.S. generally accepted accounting principles and International Financial Reporting Standards. ASU 2011-04 clarifies the application of existing fair value

measurement requirements, changes certain principles in Topic 820 and requires additional fair value disclosures. ASU 2011-04 is effective for annual periods beginning after December 15, 2011, and is not expected to have a significant impact on the Corporation's financial statements.

*ASU 2011-05, Comprehensive Income (Topic 220) - Presentation of Comprehensive Income.* ASU 2011-05 amends Topic 220, Comprehensive Income, to require that all non-owner changes in stockholders' equity be presented in either a single continuous statement of comprehensive income or in two separate but consecutive statements. Additionally, ASU 2011-05 requires entities to present, on the face of the financial statements, reclassification adjustments for items that are reclassified from other comprehensive income to net income in the statement or statements where the components of net income and the components of other comprehensive income are presented. The option to present components of other comprehensive income as part of the statement of changes in stockholders' equity was eliminated. ASU 2011-05 is effective for annual periods beginning after December 15, 2011 and is not expected to have a significant impact on the Corporation's financial statements.

*ASU 2011-08, Intangibles - Goodwill and Other (Topic 350) - Testing Goodwill for Impairment.* ASU 2011-08 amends Topic 350, Intangibles - Goodwill and Other, to give entities the option to first assess qualitative factors to determine whether the existence of events or circumstances leads to a determination that it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If, after assessing the totality of events or circumstances, an entity determines it is not more likely than not that the fair value of a reporting unit is less than its carrying amount, then performing the two-step impairment test is unnecessary. However, if an entity concludes otherwise, then it is required to perform the first step of the two-step impairment test by calculating the fair value of the reporting unit and comparing the fair value with the carrying amount of the reporting unit. ASU 2011-08 is effective for annual and interim impairment tests beginning after December 15, 2011, and is not expected to have a significant impact on the Corporation's financial statements.

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

### **FORWARD-LOOKING STATEMENTS**

Certain statements contained in this report may not be based on historical facts and are forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act ). These forward-looking statements may be identified by, among other things, the use of forward-looking terminology such as could, would, expect, believe, intend, may, can, or should or future or conditional verb tenses, and variations or negatives of such terms. These forward-looking statements include, without limitation, those relating to the Corporation's valuation methodologies, fair value of bonds, impairment of securities, repayment of loans, loan portfolio concentrations, fair value of impaired loans, satisfaction of capital adequacy requirements, payments on advances from the FHLB risk rating classifications of loans, calculation of our allowance for loans losses, adequacy of traditional sources of cash generated from operating activities to meet liquidity needs and the realization of deferred income tax assets. We caution you not to place undue reliance on such forward-looking statements in this report because results could differ materially from those anticipated due to a variety of factors. These factors include, but are not limited to, conditions in the financial market, liquidity needs, the sufficiency of our allowance for loan and lease losses, economic conditions in the communities in the State of Tennessee where the Corporation does business, the impact of government regulation and supervision, interest rate risk, including changes in monetary policy and fluctuating interest rates, the Corporation's ability to attract and retain key personnel, competition from other financial services, other factors generally understood to affect the financial results of financial services companies and other factors detailed from time to time in our filings with the Securities and Exchange Commission (the SEC ). We undertake no obligation to update these forward-looking statements to reflect events or circumstances that occur after the date of this report.

### **EXECUTIVE OVERVIEW**

At September 30, 2011, the consolidated total assets of the Corporation were \$988.9 million, its consolidated net loans were \$537.3 million, its total deposits were \$827.7 million and its total shareholders' equity was \$111.9 million. The Corporation's loan portfolio at September 30, 2011 reflected a decrease of \$20.7 million, or 3.8%, compared to December 31, 2010. Total deposits increased \$35.9 million, or 4.53%, and shareholders' equity increased by 5.3% during the first nine months of 2011. Total shareholders' equity includes an unrealized gain on available-for-sale securities of \$2.5 million.

## FINANCIAL CONDITION

Average earning assets for the quarter ended September 30, 2011 were up 1.4%, or \$12.2 million, from average earning assets for the quarter ended December 31, 2010. Average overnight investments for the quarter ended September 30, 2011 were down 43.4% compared to the quarter ended December 31, 2010. Average investment securities for the quarter ended September 30, 2011 were up 10.7% compared to the quarter ended December 31, 2010. Average total assets were up 1.2% or \$11.8 million, from \$953.2 million for the quarter ended December 31, 2010 to \$965.1 million for the quarter ended September 30, 2011.

### Securities

Available-for-sale securities are an integral part of the asset/liability management process of the Bank, the Corporation's sole direct subsidiary. Accordingly, they represent an important source of liquidity available to fund loans and accommodate asset reallocation strategies dictated by changes in the Bank's operating and tax plans, shifting yield spread relationships and changes in configuration of the yield curve. At September 30, 2011, the Bank's investment securities portfolio had \$290.3 million available-for-sale securities, which are valued at fair market value, and \$36.4 million held-to-maturity securities, which are valued at cost on the balance sheet. These compare to \$236.2 million of available-for-sale securities and \$40.0 million of held-to-maturity securities as of December 31, 2010.

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## **Loans and Loan Losses**

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The loan portfolio is the largest component of earning assets for the Bank and, consequently, provides the largest amount of revenue for the Corporation. The loan portfolio also contains the highest exposure to risk as a result of the possibility of unexpected deterioration in the credit quality of borrowers. When analyzing potential loans, management of the Bank assesses both interest rate objectives and credit quality objectives in determining whether to make a given loan and the appropriate pricing for that loan. All loans are expected to be repaid from cash flow or proceeds from the sale of selected assets of the borrowers. Collateral requirements for the loan portfolio are based on credit evaluation of the borrowers.

Loan volume remained a challenge in the third quarter of 2011, with total loans declining by \$8.3 million, or 1.5% during the three month period. Commercial loans decreased by \$3.0 million, or 1.1%, in the third quarter, whereas the retail portfolio was off by \$5.3 million, or 2.2%. At \$537.3 million, total loans outstanding were down by \$21.9 million for the nine months ended September 30, 2011 compared to the same period in 2010. Loan demand remains weak across all segments of the portfolio, while competition for top quality commercial credit is high.

The Bank continues to reserve more heavily against its construction and development portfolio than any other segment of the commercial portfolio, given the comparatively high level of losses that have been incurred within this segment of the portfolio over the previous year. Additionally, higher reserves are being placed against property types which are perceived to be higher risk, such as retail and multi-family real estate.

Loans identified as losses by management, internal loan review and/or bank examiners are charged-off. Furthermore, consumer loan accounts are charged-off automatically based on regulatory requirements.

The allowance for loan losses is a reserve established through a provision for loan losses charged to expense, which represents management's best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The Corporation's allowance for loan loss methodology includes allowance allocations calculated in accordance with ASC Topic 310, Receivables and allowance allocations calculated in accordance with ASC Topic 450, Contingencies. Accordingly, the methodology is based on historical loss experience by type of credit and internal risk grade, specific homogeneous risk pools and specific loss allocations, with adjustments for current events and

conditions. The Corporation's process for determining the appropriate level of the allowance for loan losses is designed to account for credit deterioration as it occurs. The provision for loan losses reflects loan quality trends, including the levels of and trends related to non-accrual loans, past due loans, potential problem loans, classified and criticized loans and net charge-offs or recoveries, among other factors. The provision for loan losses also reflects the totality of actions taken on all loans for a particular period. In other words, the amount of the provision reflects not only the necessary increases in the allowance for loan losses related to newly identified criticized loans, but it also reflects actions taken related to other loans including, among other things, any necessary increases or decreases in required allowances for specific loans or loan pools. The unallocated portion of the allowance for loan losses represents general valuation allowances that are not allocated to specific loan portfolio segments. See Note 4 - Loans in the accompanying notes to consolidated financial statements included elsewhere in this report for further details regarding the Corporation's methodology for estimating the appropriate level of the allowance for loan losses.

*Collectability.* A formal process is in place to enhance control over the underwriting of loans and to monitor loan collectability. This process includes education and training of personnel about the Bank's loan policies and procedures, assignment of credit analysts to support lenders, timely identification of loans with adverse characteristics, control of corrective actions and objective monitoring of loan reviews. The Special Assets Department of the Bank identifies and monitors assets that need special attention. At September 30, 2011, this process identified loans totaling \$9.5 million, that were classified as other assets especially mentioned compared to loans totaling \$10.8 million at December 31, 2010. Loans totaling \$12.3 million were classified as substandard at September 30, 2011, compared to loans totaling \$20.0 million at December 31, 2010. Loans totaling \$7.0 million were classified as doubtful at September 30, 2011, compared to \$6.7 million at December 31, 2010, respectively.



Loans having recorded investments of \$14.0 million and \$25.1 million at September 30, 2011 and December 31, 2010, respectively, have been identified as impaired. However, loans amounting to \$11.0 million and \$8.3 million at September 30, 2011 and December 31, 2010, respectively, were not accruing interest in accordance with the provision of ASC Topic 310-40, Troubled Debt Restructurings by Creditors (ASC Topic 310-40). Interest received on these loans during the third quarter of 2011 was approximately \$809,000, compared to approximately \$422,000 over the same period in 2010. The gross interest income that would have been recorded if the loans had been current in accordance with their original terms and had been outstanding throughout the period or since origination, if held for part of the period, was approximately \$808,000, and \$491,000 for the nine-month period ended September 30, 2011 and the nine month period ended September 30, 2010, respectively. The Bank had no loans that were 90 days or more past due that were not included in nonaccrual loans as of September 30, 2011.

The Bank had \$7.2 million in loans that qualified as troubled debt restructurings as defined in ASC Topic 310 as of September 30, 2011. Troubled debt restructurings are loans for which the Bank, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower which would otherwise not be considered. For a loan to be classified as a troubled debt restructuring, the borrower must be experiencing financial difficulties (even if it is not currently in default on any of its indebtedness), and because of those difficulties the Bank must have made a concession that would otherwise not be granted. These concessions can take many forms, including but not limited to granting temporary payment relief, restructuring a loan to extend the amortization or lower the required payment amount, and forgiveness of principal. Likewise, the financial difficulty being experienced by a borrower can take many forms, including but not limited to:

- Being in default on any existing indebtedness;
- Declaring, or being in the process of declaring, bankruptcy;
- Significant doubt as to whether an existing business can continue to operate as a going concern;
- Historically demonstrating, or forecasting, insufficient cash flows with which to service all debt in a timely manner; or
- Absent the modification, the borrower cannot continue to keep all indebtedness current.

Once identified as a troubled debt restructuring, the Bank will track these loans and periodically report to the Board of Directors the aggregate balances thereof.

The following table shows a breakdown of all troubled debt restructurings (dollars in thousands):

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	September 30, 2011		December 31, 2010	
	Number of Contracts	Outstanding recorded investment	Number of Contracts	Outstanding recorded investment
<b>Troubled Debt Restructurings</b>				
Residential - prime	8	\$ 1,212	7	\$ 1,180
Consumer - other	24	5,996	30	13,644
	Number of Contracts	Recorded investment	Number of Contracts	Recorded investment
<b>Troubled Debt Restructurings That Subsequently Defaulted:</b>				
Residential - prime	1	\$ 457	1	\$ 28
Consumer - other	2	351	4	796

**Deposits**

The Bank does not have any foreign offices and all deposits are serviced in its 18 domestic offices. The Bank's average deposits increased 2.1% during the first nine months of 2011 compared to an increase of 4.3% in the first nine months of 2010. Average total noninterest-bearing deposits were 16.3% of total deposits at September 30, 2011, contributing to the Bank's low cost of deposits, compared to 15.0% at December 31, 2010.

### **Regulatory Requirements for Capital**

The Corporation and the Bank are subject to federal regulatory capital adequacy standards. Failure to meet capital adequacy requirements could result in certain mandatory, and possibly additional discretionary, actions by regulators that could have a direct material adverse effect on the financial condition of the Corporation and the Bank. Federal regulations require the Corporation and the Bank to meet specific capital adequacy guidelines that involve quantitative measures of assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital classification is also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

Under federal regulatory standards, to be well-capitalized, the Corporation's and the Bank's Tier 1 Risk-Based Capital Ratio (ratio of Tier 1 Capital to risk-weighted assets) must be at least 6%, its Total Risk-Based Capital Ratio (ratio of total capital to risk-weighted assets) must be at least 10%, and its Tier 1 Leverage Capital Ratio (ratio of Tier 1 Capital to average assets) must be at least 5%. Equity capital (net of certain adjustments for intangible assets and investments in non-consolidated subsidiaries and certain classes of preferred stock) and other certain equity like instruments are considered Tier 1 Capital. Tier 2 Capital consists of core capital plus supplementary or temporary capital such as subordinated debt, some types of preferred stock, and a defined percentage of the allowance for loan and lease losses.

As of September 30, 2011, the Bank's Tier 1 Risk-Based Capital Ratio, Total Risk-Based Capital Ratio and Tier 1 Leverage Capital Ratios were 15.1%, 16.4%, and 9.6%, respectively, compared to 14.6%, 15.8%, and 10.1% at December 31, 2010. At September 30, 2011, the Corporation's Tier 1 Risk-Based Capital Ratio, Total Risk-Based Capital Ratio and Tier 1 Leverage Capital Ratios were 15.5%, 16.7% and 9.9%, respectively. The ratios were 15.0%, 16.2% and 10.4%, respectively, at December 31, 2010. Management believes, as of September 30, 2011, that the Corporation and the Bank each met all capital adequacy requirements to which they are subject.

### **Liquidity and Capital Resources**

Most of the capital needs of the Bank historically have been financed with retained earnings and deposits received, and the Corporation's primary source of liquidity has been dividends declared by the Bank.

The Bank is subject to Tennessee statutes and regulations that impose restrictions on the amount of dividends that may be declared. Furthermore, any dividend payments are subject to the continuing ability of the Bank to maintain its compliance with minimum federal regulatory capital requirements and to retain its characterization under federal regulations as a well-capitalized institution. The Bank's Board of Directors has adopted a liquidity policy that outlines specific liquidity target balances. Compliance with this policy is reviewed quarterly by the Bank's Asset/Liability Committee and results are reported to the Bank's Board of Directors.

The Bank's formal asset and liability management process is used to manage interest rate risk and assist management in maintaining reasonable stability in the gross interest margin as a result of changes in the level of interest rates and/or the spread relationships among interest rates. The Bank uses an earnings simulation model to evaluate the impact of different interest rate scenarios on the gross margin. Each quarter, the Bank's Asset/Liability Committee monitors the relationship of rate sensitive earning assets to rate sensitive interest-bearing liabilities (interest rate sensitivity), which is the principal factor in determining the effect that fluctuating interest rates will have on future net interest income. Rate sensitive earning assets and interest bearing liabilities are financial instruments that can be repriced to current market rates within a defined time period.

Management believes that the Corporation's traditional sources of cash generated from the Bank's operating activities are adequate to meet the Corporation's liquidity needs for normal ongoing operations; however, the Bank also has access to additional capital, if necessary, through additional advances from the FHLB or the CMA with the FHLB. In March 2008, the Bank obtained five advances at \$7.0 million each from the FHLB. In September 2008, the Bank obtained two additional advances of \$3.1 million each for a total borrowing in 2008 of \$41.2 million. The first three scheduled repayment of the advances were made in March 2009, March 2010 and March 2011 and an additional payment of \$3.1 million was made in September 2010. The remaining payments will continue each March through 2013. The borrowings from the FHLB have been used generally for investment strategies to enhance the Bank's portfolio.

### **Critical Accounting Policies**

The accounting principles the Bank follows and the methods of applying these principles conform GAAP and with general practices within the banking industry. In connection with the application of those principles, the Bank's management has made judgments and estimates that with respect to the determination of the ALLL and the recognition of deferred income tax assets, have been critical to the determination of the Corporation's financial position, results of operations and cash flows.

#### *Allowance for Loan and Lease Losses*

The Bank's management assesses the adequacy of the ALLL prior to the end of each month and prepares a more formal review quarterly to assess the risk in the Bank's loan portfolio. This assessment includes procedures to estimate the allowance and test the adequacy and appropriateness of the resulting balance. The ALLL represents calculated amounts for specifically identified credit exposure and exposures readily predictable by historical or comparative experience. Even though this calculation considers specific credits, the entire allowance is available to absorb any credit losses.

These calculated amounts are determined by assessing loans identified as not in compliance with loan agreements. These loans are generally in two different risk groups. One group is unique loans (commercial loans,

including those loans considered impaired). The second group consists of pools of homogenous loans (generally retail and mortgage loans). The calculation for unique loans is based primarily on risk rating grades assigned to each of these loans as a result of the Bank's loan management and review processes. Each risk-rating grade is assigned a loss ratio, which is determined based on the experience of management, discussions with banking regulators and the independent loan review process. The amount allocated for an impaired loan is based on estimated cash flows discounted at the loan's original effective interest rate or the underlying collateral value. Historical data, including actual loss experience on specific types of homogenous loans, is used to allocate amounts for loans or groups of loans meeting the specified criteria. Management has implemented procedures that give more detailed historical data by category of retail and consumer credit and performance characteristics to broaden the analysis and improve monitoring of potential credit risk.

Criteria considered and processes utilized in evaluating the adequacy of the ALLL are:

- Portfolio quality trends;
- Changes in the nature and volume of the portfolio;
- Present and prospective economic and business conditions, locally and nationally;
- Management review systems and board oversight, including external loan review processes;
- Changes in credit policy, credit administration, portfolio management and procedures;
- Changes in personnel, management and staff; and
- Existence and effect of any concentrations of credit.

In assessing the adequacy of the ALLL, the risk characteristics of the entire loan portfolio are evaluated. This process includes the judgment of the Bank's management, input from independent loan reviews and reviews that may have been conducted by bank regulators as part of their usual examination process.

#### *Deferred Income Tax Asset*

As of September 30, 2011, the deferred income tax asset was \$5.2 million and was included under "other assets" on the balance sheet included in this Quarter Report on Form 10Q. Deferred income tax assets consist mainly of the tax effect of excess provisions for loan and lease losses over actual losses incurred and deferred compensation. Management believes that it is more likely than not that these assets will be realized in future years.

## Results of Operations

Total interest income for the nine months ended September 30, 2011 was \$28.7 million compared to \$29.8 million for the nine months ended September 30, 2010 and \$9.5 million for the three months ended September 30, 2011 compared to \$9.6 million for the three months ended September 30, 2010. Interest and fees earned on loans and investments are the components of total interest income. Interest and fees earned on loans were \$22.5 million, a decrease of \$1.3 million, or 5.5%, during the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010 and \$7.5 million for the three months ended September 30, 2011 compared to \$7.9 million for the three months ended September 30, 2010. Nominal interest earned on investment securities and other investments was \$6.2 million, an increase of approximately \$233,000, or 3.9%, during the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010 and \$2.1 million for the three months ended September 30, 2011 compared to \$1.7 million for the three months ended September 30, 2010.

Total interest expense in the nine months ended September 30, 2011 was \$3.8 million, a decrease of \$1.6 million, or 29.9%, compared to the nine months ended September 30, 2010 and \$1.2 million for the three months ended September 30, 2011, a decrease of approximately \$536,000 compared to the three months ended September 30, 2010. The lower interest rates for certificates of deposits and public funds during the third quarter of 2011 were the primary reason for the lower expense. As a policy, budgeted financial goals are monitored on a quarterly basis by the Bank's Asset/Liability Committee, which reviews the actual dollar change in net interest income for different interest rate movements. A negative dollar change in net interest income for a 12-month and 24-month period of less than 10.0% of net interest income given a 100 to 200 basis point shift in interest rates is considered an acceptable rate risk position. The rate risk analysis for the 24-month period beginning October 1, 2011 and ending September 30, 2013 showed a worst-case potential change to net interest income, in the very unlikely event of a positive 200 basis point shift in interest rates, of 2.8%, or an increase in net interest income of \$931,000 by the end of the period.

Net interest income of the Corporation on a fully taxable equivalent basis is influenced primarily by changes in:

- (1) the volume and mix of earning assets and sources of funding;
- (2) market rates of interest; and
- (3) income tax rates.

The impact of some of these factors can be controlled by management policies and actions. External factors also can have a significant impact on changes in net interest income from one period to another. Some examples of such factors are:

- (1) the strength of credit demands by customers;

- (2) Federal Reserve Board monetary policy; and
- (3) fiscal and debt management policies of the federal government, including changes in tax laws.

The net interest margin, on a tax equivalent basis, at September 30, 2011, December, 31, 2010 and September 30, 2010 was 4.13%, 4.13% and 4.10%, respectively.

Additions of approximately \$750,000 were made to the provision for loan and lease losses in the third quarter of 2011 as a result of an increase in the level of credit losses on both secured and unsecured consumer loans as well as the Bank having to downgrade the credit level on a few commercial loans.

Noninterest income was \$8.0 million, an increase of approximately \$580,000, or 7.8%, during the nine months ended September 30, 2011 compared to the nine months ended September 30, 2010 and \$2.9 million for the three months ended September 30, 2011 compared to \$2.3 million for the three months ended September 30, 2010. The loss on sales of other real estate owned in the nine months of ended September 30, 2011, was \$1.2 million less than the loss for the nine months ended September 30, 2010, and accounted for most of the increase in noninterest income over the periods.



Noninterest expense, excluding the provision for loan and lease losses was \$23.5 million, a decrease of \$1.2 million, or 4.7%, in the nine months ended September 30, 2011 as compared to the nine months ended September 30, 2010 and \$7.6 million for the three months ended September 30, 2011 compared to \$7.8 million for the three months ended September 30, 2010. Lower advertising, office supplies and computer expenses contributed to the lower noninterest expense.

The Bank leases certain of its properties. There was no change during the three-month period ended September 30, 2011 in the terms of these leases.

Net income for the nine months and three months ended September 30, 2011 was \$5.9 million and \$2.3 million respectively, compared to \$5.0 million and \$1.9 million for the nine months and three months ended September 30, 2010, respectively. The reduction in noninterest expense contributed to both the nine- and three-month increases. The Corporation earned \$1.08 per share for the nine months ended in September 30, 2011, compared to \$0.90 per share for the nine months ended September 30, 2010.

### **Off-Balance Sheet Arrangements**

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and stand-by letters of credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement the Bank has in those financial instruments. Loan commitments are agreements to lend to a customer as long as there is not a violation of any condition established in the loan commitment contract. Stand-by letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing and similar transactions. The credit risk involved in issuing letters of credit is essentially the same as that involved in making a loan.

The total outstanding balance of loan commitments and stand-by letters of credit in the normal course of business at September 30, 2011 were \$97.1 million and \$8.3 million, respectively.

At September 30, 2011, the Corporation and the Bank did not have any off-balance sheet arrangements other than commitments to extend credit and stand-by letters of credit.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk.**

During the nine months ended September 30, 2011, there were no material changes in the quantitative and qualitative disclosures about market risk presented in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2010.

**Item 4. Controls and Procedures.**

(a) Evaluation of Disclosure Controls and Procedures. The Corporation, with the participation of its management, including the Corporation's Chief Executive Officer and Treasurer (principal financial officer), carried out an evaluation of the effectiveness of the design and operation of its disclosure controls and procedures (as defined in Rules 13a-15 and 15d-15 under the Exchange Act) as of the end of the period covered by this report. Based upon that evaluation and as of the end of the period covered by this report, the Corporation's Chief Executive Officer and Treasurer (principal financial officer) concluded that the Corporation's disclosure controls and procedures were effective in ensuring that information required to be disclosed in its reports that the Corporation files or submits to the SEC under the Exchange Act is recorded, processed, summarized and reported on a timely basis.

(b) Changes in Internal Control Over Financial Reporting. There has been no change in the Corporation's internal control over financial reporting that occurred during the third quarter of 2011 that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

## **PART II - OTHER INFORMATION**

### **Item 1A. Risk Factors.**

There have been no material changes in the risk factors previously disclosed in the Corporation's Annual Report on Form 10-K for the year ended December 31, 2010.

### **Item 6. Exhibits.**

#### EXHIBIT

#### NUMBER DESCRIPTION

- |         |   |
|---------|---|
| 3.1     | Charter. (1)  |
| 3.2     | Articles of Amendment to Charter. (1)   |
| 3.3     | Second Amended and Restated By-laws. (2)  |
| 31.1    | Certification of the Chief Executive Officer of First Farmers and Merchants Corporation Pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.                 |
| 31.2    | Certification of the Treasurer (principal financial officer) of First Farmers and Merchants Corporation Pursuant to Rule 13a-14 of the Securities Exchange Act of 1934, as amended, as Adopted Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32      | Certification of the Chief Executive Officer and Treasurer (principal financial officer) of First Farmers and Merchants Corporation Pursuant to 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.             |
| 101.INS | XBRL Instance Document.   |
| 101.SCH | XBRL Taxonomy Extension Schema Document.  |
| 101.CAL | XBRL Taxonomy Calculation Linkbase Document.  |
| 101.DEF | XBRL Taxonomy Definition Linkbase Document.   |
| 101.LAB | XBRL Taxonomy Label Linkbase Document.  |
| 101.PRE | XBRL Taxonomy Presentation Linkbase Document.   |

- 
- (1) Incorporated by reference from the First Farmers and Merchants Corporation Amendment No. 1 to the Annual Report on Form 10-K/A for the year ended December 31, 2003, as filed with the Securities and Exchange Commission on May 7, 2004 (File Number 000-10972).
  - (2) Incorporated by reference from the First Farmers and Merchants Corporation Annual Report on Form 10-K, as filed with the Securities and Exchange Commission on March 15, 2011 (File Number 000-10972).

**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.

FIRST FARMERS AND MERCHANTS CORPORATION

(Registrant)

Date November 8, 2011

/s/ T. Randy Stevens

T. Randy Stevens, Chief Executive Officer

Date November 8, 2011

/s/ Patricia P. Bearden

Patricia P. Bearden, Treasurer (principal financial officer and principal accounting officer)





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