

Solera National Bancorp, Inc.  
Form 10-Q  
November 14, 2011  
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**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark one)

**QUARTERLY REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2011

**TRANSITION REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

Commission file number 000-53181

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**SOLERA NATIONAL BANCORP, INC.**

(Exact name of registrant as specified in its charter)

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**Delaware**  
(State or other jurisdiction  
of incorporation or organization)

**02-0774841**  
(IRS Employer Identification No.)

**319 S. Sheridan Blvd.**

**Lakewood, CO 80226**

**303-209-8600**

(Address and telephone number of principal executive offices and principal place of business)

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.

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the last practicable date: As of November 10, 2011, 2,553,671 shares of the registrant's common stock, \$0.01 par value, were issued and outstanding.

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SOLERA NATIONAL BANCORP, INC.

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**INTRODUCTORY NOTE. CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING  
INFORMATION AND RISK FACTORS**

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995 about Solera National Bancorp, Inc. (the Company) and our subsidiary, Solera National Bank (the Bank, collectively with the Company, sometimes referred to as we, us and our) that are subject to risks and uncertainties. Forward-looking statements include information concerning future financial performance, business strategy, projected plans and objectives. Statements preceded by, followed by or that otherwise include the words anticipates, believes, estimates, expects, intends, plans, may increase, may fluctuate and similar expressions of future or conditional verbs such as will, should, would, and could are generally forward-looking in nature and not historical facts. Actual results may differ materially from those projected, implied, anticipated or expected in the forward-looking statements. Readers of this Quarterly Report should not rely solely on the forward-looking statements and should consider all uncertainties and risks throughout this report. The statements are representative only as of the date they are made, and Solera National Bancorp, Inc. undertakes no obligation to update any forward-looking statement.

These forward-looking statements, implicitly and explicitly, include the assumptions underlying the statements and other information with respect to the Company's beliefs, plans, objectives, goals, expectations, anticipations, estimates, financial condition, results of operations, future performance and business, including management's expectations and estimates with respect to revenues, expenses, return on equity, return on assets, efficiency ratio, asset quality and other financial data and capital and performance ratios.

Although the Company believes that the expectations reflected in the forward-looking statements are reasonable, these statements involve risks and uncertainties that are subject to change based on various important factors, some of which are beyond the control of the Company. The following factors, among others, could cause the Company's results or financial performance to differ materially from its goals, plans, objectives, intentions, expectations and other forward-looking statements:

- the Company has a limited operating history upon which to base an estimate of its future financial performance;
- management of Solera National Bank may be unable to limit credit risk associated with Solera National Bank's loan portfolio, which would affect the Company's profitability;
- general economic conditions may be less favorable than expected, causing an adverse impact on our financial performance;
- the Company is subject to extensive regulatory oversight, which could restrain its growth and profitability;
- the Company could face potential regulatory actions if we fail to comply with our Consent Order;

- interest rate volatility could negatively impact our business;
- due to the nature of our business, we may experience operational losses which may not be covered by insurance;
- the Company may not be able to raise additional capital on terms favorable to it; and
- the Company faces competition from a variety of competitors.

For a discussion of these and other risks and uncertainties that could cause actual results to differ from those contained in the forward-looking statements, see "Risk Factors" in Item 1A of the Company's 2010 Annual Report filed on Form 10-K with the SEC, which is available on the SEC's website at [www.sec.gov](http://www.sec.gov). All forward-looking statements are qualified in their entirety by this cautionary statement, and the Company undertakes no obligation to revise or update this Quarterly Report on Form 10-Q to reflect events or circumstances after the date hereof. New factors emerge from time to time, and it is not possible for us to predict which factors, if any, will arise. In addition, the Company cannot assess the impact of each factor on the Company's business or the extent to which any factor, or combination of factors, may cause actual results to differ materially from those contained in any forward-looking statements.

Table of Contents**PART I FINANCIAL INFORMATION****ITEM 1. FINANCIAL STATEMENTS (unaudited)****Solera National Bancorp, Inc.****Balance Sheets as of September 30, 2011 and December 31, 2010****(unaudited)**

| (\$ in thousands, except share data)                                | September 30,<br>2011 | December 31,<br>2010 |
|---|-----------------------|----------------------|
| <b>ASSETS</b>   |                       |                      |
| Cash and due from banks   | \$ 283                | \$ 936               |
| Total cash and cash equivalents                                     | 283                   | 936                  |
| Interest-bearing deposits with banks                                | 357                   | 266                  |
| Investment securities, available-for-sale                           | 81,877                | 76,313               |
| Gross loans   | 55,710                | 58,897               |
| Net deferred (fees)/expenses  | (58)                  | (75)                 |
| Allowance for loan and lease losses                                 | (1,069)               | (1,175)              |
| Net loans   | 54,583                | 57,647               |
| Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) stocks | 1,148                 | 1,168                |
| Other real estate owned   | 903                   | 1,838                |
| Premises and equipment, net   | 623                   | 731                  |
| Accrued interest receivable   | 566                   | 759                  |
| Other assets  | 312                   | 489                  |
| <b>Total assets</b>   | <b>\$ 140,652</b>     | <b>\$ 140,147</b>    |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>                          |                       |                      |
| Deposits  |                       |                      |
| Noninterest-bearing demand  | \$ 2,792              | \$ 1,891             |
| Interest-bearing demand   | 10,480                | 11,605               |
| Savings and money market  | 61,505                | 57,132               |
| Time deposits   | 37,793                | 40,327               |
| Total deposits  | 112,570               | 110,955              |
| Securities sold under agreements to repurchase                      | 252                   | 143                  |
| Federal funds purchased   | 135                   | 200                  |
| Accrued interest payable  | 66                    | 91                   |
| FHLB advances   | 8,500                 | 10,000               |
| Accounts payable and other liabilities                              | 491                   | 433                  |
| <b>Total liabilities</b>  | <b>\$ 122,014</b>     | <b>\$ 121,822</b>    |
| COMMITMENTS AND CONTINGENCIES (see Note 9)                          |                       |                      |
| STOCKHOLDERS EQUITY   |                       |                      |

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|  |    |         |    |         |
|--|----|---------|----|---------|
| Common stock, \$0.01 par value; 5,000,000 shares authorized; 2,553,671 shares issued and outstanding | \$ | 26      | \$ | 26      |
| Additional paid-in capital   |    | 26,138  |    | 25,980  |
| Accumulated deficit  |    | (7,806) |    | (7,882) |
| Accumulated other comprehensive income   |    | 280     |    | 201     |
| <b>Total stockholders equity</b>   | \$ | 18,638  | \$ | 18,325  |
| <b>Total liabilities and stockholders equity</b>   | \$ | 140,652 | \$ | 140,147 |

See Notes to Consolidated Financial Statements.

Table of Contents**Solera National Bancorp, Inc.****Statements of Operations for the Three and Nine Months Ended September 30, 2011 and 2010****(unaudited)**

| (\$ in thousands, except share data)                          | For the Three Months<br>Ended September 30, |           | For the Nine Months<br>Ended September 30, |           |
|---|---|-----------|--|-----------|
|   | 2011  | 2010      | 2011                                       | 2010      |
| <b>Interest income:</b>                                       |   |           |  |           |
| Interest and fees on loans                                    | \$ 841                                      | \$ 901    | \$ 2,512                                   | \$ 2,503  |
| Interest on investment securities                             | 578   | 713       | 1,897                                      | 2,261     |
| Dividends on FHLB and FRB stocks                              | 8   | 10        | 25   | 32        |
| Other interest income   | 2   | 1         | 5  | 9         |
| Total interest income   | 1,429                                       | 1,625     | 4,439                                      | 4,805     |
| <b>Interest expense:</b>                                      |   |           |  |           |
| Deposits  | 343   | 466       | 1,066                                      | 1,476     |
| FHLB advances   | 51  | 58        | 157  | 202       |
| Other borrowings  | 2   | 4         | 9  | 12        |
| Total interest expense  | 396   | 528       | 1,232                                      | 1,690     |
| Net interest income   | 1,033                                       | 1,097     | 3,207                                      | 3,115     |
| Provision for loan and lease losses                           | 10  | 780       | 130  | 1,075     |
| Net interest income after provision for loan and lease losses | 1,023                                       | 317       | 3,077                                      | 2,040     |
| <b>Noninterest income:</b>                                    |   |           |  |           |
| Service charges and fees                                      | 16  | 19        | 52   | 55        |
| Other income  | 3   | 16        | 5  | 16        |
| (Loss) / gain on sale of other real estate owned              | (25)  | 10        | (25)                                       | 10        |
| Gain on available-for-sale securities                         | 333   | 332       | 556  | 863       |
| Total noninterest income                                      | 327   | 377       | 588  | 944       |
| <b>Noninterest expense:</b>                                   |   |           |  |           |
| Salaries and employee benefits                                | 613   | 619       | 1,930                                      | 1,756     |
| Occupancy   | 135   | 137       | 395  | 418       |
| Professional fees   | 129   | 134       | 355  | 319       |
| Other general and administrative                              | 314   | 297       | 909  | 773       |
| Total noninterest expense                                     | 1,191                                       | 1,187     | 3,589                                      | 3,266     |
| Net income (loss) before income taxes                         | 159   | (493)     | 76   | (282)     |
| <b>Income taxes</b>   |   |           |  |           |
| Net income (loss)   | \$ 159                                      | \$ (493)  | \$ 76                                      | \$ (282)  |
| Basic earnings (loss) per share                               | 0.06  | (0.19)    | 0.03                                       | (0.11)    |
| Diluted earnings (loss) per share                             | 0.06  | (0.19)    | 0.03                                       | (0.11)    |
| <b>Weighted-average common shares</b>                         |   |           |  |           |
| Basic   | 2,553,671                                   | 2,553,671 | 2,553,671                                  | 2,553,671 |
| Diluted   | 2,553,671                                   | 2,553,671 | 2,553,671                                  | 2,553,671 |



See Notes to Consolidated Financial Statements.

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## Solera National Bancorp, Inc.

## Statements of Changes in Stockholders Equity for the Nine Months Ended September 30, 2011 and 2010

(unaudited)

| (\$ in thousands, except share data)  | Shares<br>Outstanding | Common<br>Stock | Additional<br>Paid-in<br>Capital | Accumulated<br>Deficit | Accumulated<br>Other<br>Comprehensive<br>Income | Total            |
|---|-----------------------|-----------------|----------------------------------|------------------------|---|------------------|
| <b>Balance at December 31, 2009</b>   | <b>2,553,671</b>      | <b>\$ 26</b>    | <b>\$ 25,768</b>                 | <b>\$ (8,016)</b>      | <b>\$ 956</b>                                   | <b>\$ 18,734</b> |
| Stock-based compensation  |                       |                 | 148                              |                        |   | 148              |
| Comprehensive income:   |                       |                 |                                  |                        |   |                  |
| Net loss  |                       |                 |                                  | (282)                  |   | (282)            |
| Net change in unrealized gains on<br>investment securities available-for-sale |                       |                 |                                  |                        | 2,409   | 2,409            |
| Less: reclassification adjustment for net<br>gains included in income         |                       |                 |                                  |                        | (863)   | (863)            |
| Total comprehensive income  |                       |                 |                                  |                        |   | 1,264            |
| <b>Balance at September 30, 2010</b>  | <b>2,553,671</b>      | <b>\$ 26</b>    | <b>\$ 25,916</b>                 | <b>\$ (8,298)</b>      | <b>\$ 2,502</b>                                 | <b>\$ 20,146</b> |
| <b>Balance at December 31, 2010</b>   | <b>2,553,671</b>      | <b>\$ 26</b>    | <b>\$ 25,980</b>                 | <b>\$ (7,882)</b>      | <b>\$ 201</b>                                   | <b>\$ 18,325</b> |
| Stock-based compensation  |                       |                 | 158                              |                        |   | 158              |
| Comprehensive income:   |                       |                 |                                  |                        |   |                  |
| Net income  |                       |                 |                                  | 76                     |   | 76               |
| Net change in unrealized gains on<br>investment securities available-for-sale |                       |                 |                                  |                        | 635   | 635              |
| Less: reclassification adjustment for net<br>gains included in income         |                       |                 |                                  |                        | (556)   | (556)            |
| Total comprehensive income  |                       |                 |                                  |                        |   | 155              |
| <b>Balance at September 30, 2011</b>  | <b>2,553,671</b>      | <b>\$ 26</b>    | <b>\$ 26,138</b>                 | <b>\$ (7,806)</b>      | <b>\$ 280</b>                                   | <b>\$ 18,638</b> |

See Notes to Consolidated Financial Statements.

Table of Contents**Solera National Bancorp, Inc.****Statements of Cash Flows for the Nine Months Ended September 30, 2011 and 2010****(unaudited)**

| (\$ in thousands)  | For the Nine Months<br>Ended September 30, |                   |
|--|--|-------------------|
|  | 2011                                       | 2010              |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES</b>  |  |                   |
| Net income / (loss)  | \$ 76                                      | \$ (282)          |
| Adjustments to reconcile net income / (loss) to net cash provided by operating activities: |  |                   |
| Depreciation and amortization  | 111  | 137               |
| Provision for loan and lease losses  | 130  | 1,075             |
| Net accretion of deferred loan fees/expenses   | (36)                                       | (29)              |
| Net amortization of premiums on investment securities                                      | 529  | 348               |
| Loss / (gain) on sale of other real estate owned   | 25   | (10)              |
| Gain on available-for-sale investment securities   | (556)                                      | (863)             |
| FHLB stock dividend  | (2)  | (10)              |
| Recognition of stock-based compensation on stock options                                   | 158  | 148               |
| Changes in operating assets and liabilities:   |  |                   |
| Accrued interest receivable  | 193  | 65                |
| Other assets   | 131  | (53)              |
| Prepaid Federal Deposit Insurance Corporation (FDIC) premiums                              | 46   | 151               |
| Accrued interest payable   | (25)                                       | 17                |
| Accounts payable and other liabilities   | 88   | (4)               |
| Deferred loan fees/expenses, net   | 19   |                   |
| Deferred rent liability  | 4  | 10                |
| <b>Net cash provided by operating activities</b>   | <b>\$ 891</b>                              | <b>\$ 700</b>     |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES</b>  |  |                   |
| Purchase of investment securities, available-for-sale                                      | \$ (47,845)                                | \$ (46,154)       |
| Proceeds from sales of investment securities, available-for-sale                           | 34,963                                     | 30,461            |
| Proceeds from maturities/calls/pay downs of investment securities, available-for-sale      | 7,424                                      | 18,319            |
| Net change in loans  | 2,048                                      | (11,391)          |
| Proceeds from sale of other real estate owned  | 1,813                                      | 823               |
| Purchase of premises and equipment   | (3)  | (8)               |
| Redemption / (purchase) of FRB stock   | 22   | (24)              |
| Purchase of interest-bearing deposits with banks   | (252)                                      | (1,006)           |
| Maturity of interest-bearing deposits with banks   | 161  | 4,524             |
| <b>Net cash used in investing activities</b>   | <b>\$ (1,669)</b>                          | <b>\$ (4,456)</b> |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES</b>  |  |                   |
| Net increase in deposits   | \$ 1,615                                   | \$ 3,960          |
| Net increase in federal funds purchased and securities sold under agreements to repurchase | 44   | 759               |
| Repayment of FHLB advances   | (1,500)                                    | (2,750)           |
| Principal payments on capital lease  | (34)                                       | (31)              |
| <b>Net cash provided by financing activities</b>   | <b>\$ 125</b>                              | <b>\$ 1,938</b>   |
| <b>Net decrease in cash and cash equivalents</b>   | <b>\$ (653)</b>                            | <b>\$ (1,818)</b> |

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CASH AND CASH EQUIVALENTS

|                     |    |     |    |       |
|---------------------|----|-----|----|-------|
| Beginning of period |    | 936 |    | 2,516 |
| End of period       | \$ | 283 | \$ | 698   |

(continued)

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**Solera National Bancorp, Inc.**

**Statements of Cash Flows for the Nine Months Ended September 30, 2011 and 2010, (continued)**

**(unaudited)**

| (\$ in thousands)  | For the Nine Months<br>Ended September 30, |          |
|--|--|----------|
|  | 2011                                       | 2010     |
| <b>SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION</b>      |  |          |
| Cash paid during the period for:                             |  |          |
| Interest   | \$ 1,257                                   | \$ 1,673 |
| Income taxes paid  | \$   | \$       |
| Non-cash investing transactions:                             |  |          |
| Unrealized gain on investment securities, available-for-sale | \$ 79                                      | \$ 1,546 |
| Loans transferred to OREO                                    | \$ 903                                     | \$ 813   |

See Notes to Consolidated Financial Statements.

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**SOLERA NATIONAL BANCORP, INC.**

**UNAUDITED CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 1 SUMMARY OF ORGANIZATION**

Solera National Bancorp, Inc. (the Company), is a Delaware corporation that was incorporated in 2006 to organize and serve as the holding company for our subsidiary, Solera National Bank (the Bank and collectively with the Company, sometimes referred to as we, us, and our), a national bank that opened for business on September 10, 2007. Solera National Bank is a full-service community, commercial bank headquartered in Lakewood, Colorado primarily serving the six-county Denver metropolitan area.

**NOTE 2 BASIS OF PRESENTATION**

The accompanying unaudited condensed consolidated financial statements contain all adjustments (consisting only of normal recurring adjustments) which, in the opinion of management, are necessary to present fairly the financial position of the Company as of September 30, 2011, and the results of its operations for the three and nine months ended September 30, 2011 and 2010. Cash flows are presented for the nine months ended September 30, 2011 and 2010. Certain reclassifications have been made to the consolidated financial statements and related notes of prior periods to conform to the current presentation. These reclassifications had no impact on stockholders' equity or net income/(loss) for the periods. Additionally, certain information and footnote disclosures normally included in financial statements have been condensed or omitted pursuant to rules and regulations of the U.S. Securities and Exchange Commission. The Company believes that the disclosures in the unaudited condensed consolidated financial statements are adequate to make the information presented not misleading. However, these unaudited condensed consolidated financial statements should be read in conjunction with the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K as of and for the year ended December 31, 2010.

The Company received approval as a bank in organization in the first quarter of 2007, conducted an initial closing of its common stock offering and commenced banking operations during the third quarter of 2007. The attainment of sustained profitable operations are dependent on future events, including the successful execution of the Company's business plan and achieving a level of revenue adequate to support the Company's cost structure.

Critical Accounting Policies

The following is a description of the Company's significant accounting policies used in the preparation of the accompanying consolidated financial statements.

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Provision and allowance for loan and lease losses: Implicit in the Company's lending activities is the fact that loan losses will be experienced and that the risk of loss will vary with the type of loans being made and the creditworthiness of the borrowers over the terms of the loans. The allowance for loan and lease losses represents the Company's recognition of the risks of extending credit and its evaluation of the loan portfolio. The evaluation of the allowance is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. The allowance for loan and lease losses is maintained at a level considered adequate to provide for probable loan losses based on management's assessment of various factors affecting the loan portfolio, including a review of problem loans, business conditions, historical loss experience, evaluation of the quality of the underlying collateral, and holding and disposal costs. In addition, because the Bank has limited history on which to base future loan losses, a comparison of peer group allowance ratios to gross loans is made with the intention of maintaining similar levels until the Bank has sufficient historical data to see trends in our own loss history. The allowance for loan and lease losses is increased by provisions charged to expense and reduced by loans charged-off, net of recoveries. Loan losses are charged against the allowance for loan and lease losses when management believes the loan balance is uncollectible.

The Company has established a formal process for determining an adequate allowance for loan and lease losses. The allowance for loan and lease losses calculation has two components. The first component represents the allowance for loan and lease losses for impaired loans; that is loans where the Company believes collection of

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the contractual principal and interest payments is not probable. To determine this component of the calculation, impaired loans are individually evaluated by either discounting the expected future cash flows or determining the fair value of the collateral, if repayment is expected solely from collateral. The fair value of the collateral is determined using internal analyses as well as third-party information, such as appraisals. That value, less estimated costs to sell, is compared to the recorded investment in the loan and any shortfall is charged-off. Unsecured loans and loans that are not collateral-dependent are evaluated by calculating the discounted cash flow of the payments expected over the life of the loan using the loan's effective interest rate and giving consideration to currently existing factors that would impact the amount or timing of the cash flows. The shortfall between the recorded investment in the loan and the discounted cash flows, or the fair value of the collateral less estimated costs to sell, represents the first component of the allowance for loan and lease losses.

The second component of the allowance for loan and lease losses represents contingent losses—the estimated probable losses inherent within the portfolio due to uncertainties. Factors considered by management to estimate inherent losses include, but are not limited to, 1) historical and current trends in downgraded loans; 2) the level of the allowance in relation to total loans; 3) the level of the allowance in relation to the Bank's peer group; 4) the levels and trends in non-performing and past due loans; and 5) management's assessment of economic conditions and certain qualitative factors as defined by bank regulatory guidance, including but not limited to, changes in the size, composition and concentrations of the loan portfolio, changes in the legal and regulatory environment, and changes in lending management. The qualitative factors also consider the risk elements within each segment of the loan portfolio. The primary risk comes from the difference between the expected and actual cash flows of the borrower and is influenced by the type of collateral securing the loans. For real estate secured loans, conditions in the real estate markets as well as the general economy influence real estate values and may impact the Company's ability to recover its investment due to declines in the fair value of the underlying collateral. The risks in non real estate secured loans include general economic conditions as well as interest rate changes. We aggregate our loans into portfolio segments including: Commercial Real Estate Secured; Residential Real Estate Secured; Commercial and Industrial; and Consumer. We then evaluate the above factors by segment and assign probable loss ranges to each segment. The aggregate of these segments represents the contingent losses in the portfolio.

The recorded allowance for loan and lease losses is the aggregate of the impaired loans component and the contingent loss component. Our methodology for estimating the allowance has not changed during the current or prior reporting period and is consistent across all portfolio segments and classes of loans.

At September 30, 2011, the Company had an allowance for loan and lease losses of \$1.1 million. Management believes that this allowance for loan and lease losses is adequate to cover probable losses based on all currently available evidence. Future additions to the allowance for loan and lease losses may be required based on management's continuing evaluation of the inherent risks in the portfolio. Additional provisions for loan losses may need to be recorded if the economy declines, asset quality deteriorates, or the loss experience changes.

Loans receivable: Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their outstanding unpaid principal balances reduced by any charge-offs, the allowance for loan and lease losses, and net of any deferred fees or costs on originated loans.

Credit and loan decisions are made by management and the Board of Directors' Credit Committee in conformity with loan policies established by the Board of Directors (the Board of Directors). The Company's practice is to charge-off any loan or portion of a loan when the loan is determined by management to be uncollectible due to the borrower's failure to meet repayment terms, the borrower's deteriorated financial condition, the depreciation of the underlying collateral, the loan's classification as a loss by regulatory examiners, or other reasons.



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Impaired loans. The Company considers a loan to be impaired when it is probable that the Company will be unable to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement. Measurement of impairment is based on the expected future cash flows of an impaired loan, which are to be discounted at the loan's effective interest rate, or measured by reference to an observable market value, if one exists, or the fair value of the collateral for a collateral-dependent loan. The Company selects the measurement method on a loan-by-loan basis except that collateral-dependent loans for which foreclosure is probable are measured at the fair value of the collateral. Troubled debt restructurings (TDRs) are included in impaired loans. A TDR is a formal restructuring of a loan where the Company, for economic or legal reasons related to the borrower's financial

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difficulty, grants a concession to the borrower. The concession granted may be, but is not limited to, one or more of the following: a below-market interest rate, forgiveness or delay in the due date of principal and/or accrued interest, extension in the amortization schedule to reduce the monthly payment amount. TDRs are evaluated in accordance with Accounting Standards Codification (ASC) Topic 310-40, *Troubled Debt Restructurings by Creditors*. The Company recognizes interest income on impaired loans based on its existing methods of recognizing interest income on nonaccrual loans (see *Interest and fees on loans*, below). TDRs are typically returned to accrual status when there has been a sustained period of performance with the modified terms (generally six months) and the Company expects to collect all amounts due under the modified terms.

Interest and fees on loans: Interest income is recognized daily in accordance with the terms of the note based on the outstanding principal balance. Loans on which the accrual of interest has been discontinued are designated as nonaccrual loans. Generally, the accrual of interest on loans is discontinued when principal or interest is 90 days past due based on contractual terms of the loan or when, in the opinion of management, there is reasonable doubt as to collectability. When loans are placed on nonaccrual status, all interest previously accrued but not collected is reversed against current period interest income. Income on nonaccrual loans is subsequently recognized only to the extent that cash is received and the loan's principal balance is deemed collectible. Interest accruals are resumed on such loans only when they are brought current with respect to interest and principal and when, in the judgment of management, the loans are estimated to be fully collectible as to all principal and interest.

Generally, for all classes of loans, loans are considered past due when contractual payments are delinquent by 31 days or more.

Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment of the yield of the related loan using the effective interest method and without anticipating prepayments.

Share-based compensation: The Company grants stock options as incentive compensation to employees and directors. The cost of employee/director services received in exchange for an award of equity instruments is based on the grant-date fair value of the award, which is determined using a Black-Scholes-Merton model. This cost, net of estimated forfeitures, is expensed to salaries and employee benefits over the period in which the recipient is required to provide services in exchange for the award, generally the vesting period.

Estimation of fair value: The estimation of fair value is significant to a number of the Company's assets, including available-for-sale investment securities. These are all recorded at either fair value or at the lower of cost or fair value. Furthermore, accounting principles generally accepted in the United States require disclosure of the fair value of financial instruments as a part of the notes to the consolidated financial statements. Fair values may be volatile. They may be influenced by a number of factors, including market interest rates, prepayment speeds, discount rates and the shape of the yield curve. Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the most advantageous market for the asset or liability in an orderly transaction between market participants. The fair value hierarchy requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair values:

Level 1 inputs are unadjusted quoted prices in active markets for identical assets or liabilities that the Company has the ability to access at the measurement date.

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Level 2 inputs are other than quoted prices included in Level 1 that are observable for the asset or liability either directly or indirectly, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3 valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

Impairment of investment securities: Investment securities are evaluated for impairment on at least a quarterly basis and more frequently when economic or market conditions warrant such an evaluation to determine whether a decline in their value below amortized cost is other-than-temporary. Securities are evaluated for

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impairment utilizing criteria such as the magnitude and duration of the decline, current market conditions, payment history, the credit worthiness of the obligor, the intent of the Company to retain the security or whether it is more likely than not that the Company will be required to sell the security before recovery of the value, as well as other qualitative factors. If a decline in value below amortized cost is determined to be other-than-temporary, which does not necessarily indicate that the decline is permanent, but indicates that the prospects for a near-term recovery of value is not favorable, the security is reviewed in more detail in order to determine the portion of the impairment that relates to credit (resulting in a charge to earnings) versus the portion of the impairment that is noncredit related (resulting in a charge to accumulated other comprehensive income). If it is more likely than not that sale of the security will be required prior to recovery of its amortized cost, the entire impairment is recognized in earnings equal to the difference between the amortized cost basis and the fair value. A credit loss is determined by comparing the amortized cost basis to the present value of cash flows expected to be collected, computed using the original yield as the discount rate.

Recently Issued Accounting Pronouncements

In July 2010, the Financial Accounting Standards Board (FASB) updated disclosure requirements with respect to the credit quality of loans and leases and the allowance for credit losses. According to the guidance there are two levels of detail at which credit information will be presented the portfolio segment level and the class level. The portfolio segment level is the aggregated level used by the company in developing its systematic method for calculating the allowance for credit losses. The class level represents a more detailed level of categorization than the portfolio segment level. Companies are required to provide new or amended disclosures as a result of this update geared towards providing more detail about the company's allowance for loan and lease losses, nonaccrual and impaired loans and leases, credit quality indicators, past due statistics, and details about loans modified in a troubled debt restructuring, among other things. The increased disclosure requirements became effective for periods ending on or after December 15, 2010, with the exception of the additional disclosures surrounding troubled debt restructurings, which became effective for periods beginning on or after June 15, 2011. The provisions of this update expanded our disclosures with respect to the allowance for loan and lease losses and troubled debt restructurings but did not have a material impact on the Company's financial position, results of operations or cash flows.

In April 2011, the FASB issued an accounting standard update to amend previous guidance with respect to troubled debt restructurings in an effort to assist creditors with determining whether or not a restructuring constitutes a troubled debt restructuring. Specifically, the update provides additional guidance for determining whether a concession has been granted and whether a debtor is experiencing financial difficulties. Both of these conditions are required to be met for a restructuring to constitute a troubled debt restructuring. The amendments in the update are effective for the first interim period beginning on or after June 15, 2011, and are applied retrospectively to the beginning of 2011. The provisions of this update did not have a material impact on the Company's financial position, results of operations or cash flows.

In April 2011, the FASB issued an accounting standard update to amend previous guidance with respect to effective control for repurchase agreements. The amendments in this update remove from the assessment of effective control the criterion relating to the transferor's ability to repurchase or redeem financial assets on substantially the agreed terms, even in the event of default by the transferee. The FASB concluded that this criterion is not a determining factor of effective control. Consequently, the amendments in this update also eliminate the requirement to demonstrate that the transferor possesses adequate collateral to fund substantially all the cost of purchasing replacement financial assets. Eliminating the transferor's ability criterion and related implementation guidance from an entity's assessment of effective control should improve the accounting for repurchase agreements and other similar transactions. If the transferor is deemed to have maintained effective control over the financial assets transferred, the transaction is accounted for as a secured borrowing. The guidance in this update is effective for the first interim or annual period beginning on or after December 15, 2011. The guidance should be applied prospectively to transactions or modifications of existing transactions that occur on or after the effective date. Early adoption is not permitted. The provisions of this update are not expected to have a material impact on the Company's financial position, results of operations or cash flows.

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In May 2011, the FASB issued an accounting standard update to achieve common fair value measurement and disclosure in U.S. GAAP and International Financial Reporting Standards (IFRS). The amendments explain how to measure fair value. They do not require additional fair value measurements and are not intended to establish valuation standards or affect valuation practices outside of financial reporting. The amendments might affect

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practice for some entities that were using the in-use valuation premise to measure the fair value of financial assets. The amendments require additional disclosure about the unobservable inputs used in a fair value measurement that is categorized within Level 3 of the fair value hierarchy specifically requiring quantitative information. The guidance in this update is effective for the first interim or annual period beginning on or after December 15, 2011. Early adoption is not permitted and the provisions are to be applied prospectively. The provisions of this update are not expected to have a material impact on the Company's financial position, results of operations or cash flows.

In June 2011, the FASB issued an accounting standard update which eliminates the option to present the components of other comprehensive income in the statement of changes in stockholders' equity. Instead, this update requires the components of other comprehensive income to be presented in either a single continuous statement or two separate but consecutive statements of total comprehensive income, the components of net income and the components of other comprehensive income. Additionally, the update requires that reclassification adjustments for items that are reclassified from other comprehensive income to net income be presented on the face of the financial statements. The guidance in this update is effective for fiscal and interim periods beginning after December 15, 2011. However, early adoption is permitted and the guidance must be applied retrospectively when adopted. The provisions of this update are expected to change the Company's presentation of other comprehensive income but are not expected to have any impact on the Company's financial position, results of operations or cash flows.

**NOTE 3 INVESTMENTS**

The amortized costs and estimated fair values of investment securities as of September 30, 2011 and December 31, 2010 are as follows:

| (\$ in thousands)                                     | September 30, 2011 |                        |                         |                      |
|---|--------------------|------------------------|-------------------------|----------------------|
|   | Amortized Cost     | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Securities available-for-sale:                        |                    |                        |                         |                      |
| U.S. government agencies                              | \$                 | \$                     | \$                      | \$                   |
| Corporate   | 11,832             | 132                    | (361)                   | 11,603               |
| State and municipal                                   | 7,366              | 461                    |                         | 7,827                |
| Residential agency mortgage-backed securities ( MBS ) | 62,399             | 579                    | (531)                   | 62,447               |
| Total securities available-for-sale                   | \$ 81,597          | \$ 1,172               | \$ (892)                | \$ 81,877            |

| (\$ in thousands)                   | December 31, 2010 |                        |                         |                      |
|-------------------------------------|-------------------|------------------------|-------------------------|----------------------|
|                                     | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Securities available-for-sale:      |                   |                        |                         |                      |
| U.S. government agencies            | \$ 5,841          | \$ 36                  | \$ (25)                 | \$ 5,852             |
| Corporate                           | 11,486            | 177                    | (190)                   | 11,473               |
| State and municipal                 | 22,936            | 361                    | (472)                   | 22,825               |
| Residential agency MBS              | 35,849            | 614                    | (300)                   | 36,163               |
| Total securities available-for-sale | \$ 76,112         | \$ 1,188               | \$ (987)                | \$ 76,313            |

The amortized cost and estimated fair value of debt securities by contractual maturity at September 30, 2011 and December 31, 2010 are shown below. Agency mortgage-backed securities are classified in accordance with their contractual lives. Expected maturities may differ from contractual maturities because borrowers may have the right to prepay obligations with or without call or prepay penalties. Additionally, accelerated principal payments are routinely received on agency mortgage-backed securities making it common for them to mature prior to the

contractual maturity date.

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| (\$ in thousands)                      | September 30, 2011 |                      | December 31, 2010 |                      |
|--|--------------------|----------------------|-------------------|----------------------|
|  | Amortized Cost     | Estimated Fair Value | Amortized Cost    | Estimated Fair Value |
| <b>Securities available-for-sale:</b>  |                    |                      |                   |                      |
| Due within one year                    | \$                 | \$                   | \$                | \$                   |
| Due after one year through five years  | 8,300              | 8,386                | 4,329             | 4,439                |
| Due after five years through ten years | 14,602             | 14,823               | 30,862            | 30,672               |
| Due after ten years                    | 58,695             | 58,668               | 40,921            | 41,202               |
| Total securities available-for-sale    | \$ 81,597          | \$ 81,877            | \$ 76,112         | \$ 76,313            |

The following tables show the estimated fair value and gross unrealized losses, aggregated by investment category and length of time the individual securities have been in a continuous loss position as of September 30, 2011 and December 31, 2010.

| (\$ in thousands)                 | September 30, 2011  |                      |                   | September 30, 2011 |                   |                      | Total             |                 |                      |                   |                 |
|-----------------------------------|---------------------|----------------------|-------------------|--------------------|-------------------|----------------------|-------------------|-----------------|----------------------|-------------------|-----------------|
|                                   | Less than 12 months | Estimated Fair Value | Unrealized Losses | # of Securities    | 12 months or more | Estimated Fair Value | Unrealized Losses | # of Securities | Estimated Fair Value | Unrealized Losses | # of Securities |
| <b>Description of securities:</b> |                     |                      |                   |                    |                   |                      |                   |                 |                      |                   |                 |
| U.S. government agencies          | \$                  | \$                   |                   |                    | \$                | \$                   |                   |                 | \$                   | \$                |                 |
| Corporate                         | 5,118               | (154)                | 10                |                    | 3,793             | (207)                | 6                 |                 | 8,911                | (361)             | 16              |
| State and municipal               |                     |                      |                   |                    |                   |                      |                   |                 |                      |                   |                 |
| Residential agency MBS            | 28,638              | (531)                | 28                |                    |                   |                      |                   |                 | 28,638               | (531)             | 28              |
| Total temporarily-impaired        | \$ 33,756           | \$ (685)             | 38                |                    | \$ 3,793          | \$ (207)             | 6                 |                 | \$ 37,549            | \$ (892)          | 44              |

| (\$ in thousands)                 | December 31, 2010   |                      |                   | December 31, 2010 |                   |                      | Total             |                 |                      |                   |                 |
|-----------------------------------|---------------------|----------------------|-------------------|-------------------|-------------------|----------------------|-------------------|-----------------|----------------------|-------------------|-----------------|
|                                   | Less than 12 months | Estimated Fair Value | Unrealized Losses | # of Securities   | 12 months or more | Estimated Fair Value | Unrealized Losses | # of Securities | Estimated Fair Value | Unrealized Losses | # of Securities |
| <b>Description of securities:</b> |                     |                      |                   |                   |                   |                      |                   |                 |                      |                   |                 |
| U.S. government agencies          | \$ 1,975            | \$ (25)              | 4                 |                   | \$                | \$                   |                   |                 | \$ 1,975             | \$ (25)           | 4               |
| Corporate                         | 6,625               | (190)                | 11                |                   |                   |                      |                   |                 | 6,625                | (190)             | 11              |
| State and municipal               | 12,634              | (472)                | 22                |                   |                   |                      |                   |                 | 12,634               | (472)             | 22              |
| Residential agency MBS            | 16,723              | (300)                | 17                |                   |                   |                      |                   |                 | 16,723               | (300)             | 17              |
| Total temporarily-impaired        | \$ 37,957           | \$ (987)             | 54                |                   | \$                | \$                   |                   |                 | \$ 37,957            | \$ (987)          | 54              |

Management evaluates investment securities for other-than-temporary impairment taking into consideration the extent and length of time the fair value has been less than cost, the financial condition of the issuer, whether the Company has the intent to retain the security and whether it is more likely than not that the Company will be required to sell the security before recovery of the value, as well as other qualitative factors. Only six securities were in a continuous unrealized loss position for 12 months or longer as of September 30, 2011. Management believes this decline is primarily related to a widening of credit spreads largely due to an increase in the perceived risk. Management believes this is a temporary decline and that the Bank will collect the entire amortized cost basis of the securities. Further, the Company has the intent to hold the securities in an unrealized loss position as of September 30, 2011 and does not anticipate that these securities will be required to be sold before recovery of value, which may be upon maturity. Accordingly, the securities detailed in the table above, are not other than temporarily impaired. Similarly, management's evaluation of the securities in an unrealized loss position at December 31, 2010, determined these securities were not other than temporarily impaired.

The Company recorded a net unrealized gain in the investment portfolio of \$280,000 at September 30, 2011, a slight improvement over the \$201,000 net unrealized gain at December 31, 2010.





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Sales of available-for-sale securities were as follows:

| (\$ in thousands) | Three Months Ended September 30, |          | Nine Months Ended September 30, |           |
|-------------------|----------------------------------|----------|---------------------------------|-----------|
|                   | 2011                             | 2010     | 2011                            | 2010      |
| Proceeds          | \$ 9,905                         | \$ 6,897 | \$ 34,963                       | \$ 30,461 |
| Gross gains       | \$ 333                           | \$ 332   | \$ 685                          | \$ 885    |
| Gross losses      | \$                               | \$       | \$ (129)                        | \$ (22)   |

During the first quarter 2011, the Company recognized \$67,000 of loss on available-for-sale securities related to other than temporary impairment on five securities that management had the intent to sell before recovery of value. Those five securities were sold during the second quarter for a net loss of \$48,000, a \$19,000 improvement from their March 31, 2011 estimated fair values.

Realized gains and losses on sales are computed on a specific identification basis, based on amortized cost on the date of sale.

Securities with carrying values of \$22.6 million at September 30, 2011 and \$22.7 million at December 31, 2010, were pledged as collateral to secure public deposits, borrowings from the Federal Home Loan Bank, repurchase agreements and for other purposes as required or permitted by law.

**NOTE 4 LOANS**

The composition of the loan portfolio follows:

| (\$ in thousands)                    | September 30, 2011 | December 31, 2010 |
|--------------------------------------|--------------------|-------------------|
| Commercial real estate               | \$ 37,783          | \$ 38,504         |
| Commercial and industrial            | 6,128              | 8,732             |
| Residential real estate              | 9,509              | 7,868             |
| Construction and land development    | 1,119              | 1,894             |
| Lease financing                      | 1,070              | 1,359             |
| Consumer                             | 101                | 540               |
| Gross loans                          | 55,710             | 58,897            |
| Less:                                |                    |                   |
| Deferred loan (fees) / expenses, net | (58)               | (75)              |
| Allowance for loan and lease losses  | (1,069)            | (1,175)           |
| Loans, net                           | \$ 54,583          | \$ 57,647         |

No loans were purchased or sold during the first nine months of 2011. During the first nine months of 2010, the Company purchased loans totaling approximately \$3.7 million from banks and other entities. Also during 2010, the Company sold one note for a net gain of \$10,000.

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In the ordinary course of business, and only if consistent with permissible exceptions to Section 402 of the Sarbanes-Oxley Act of 2002, the Bank may make loans to directors, executive officers, principal stockholders (holders of more than five percent of the outstanding common shares) and the businesses with which they are associated. In the Company's opinion, all loans and loan commitments to such parties are made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with other persons. There were approximately \$1.0 million and \$2.1 million in loans receivable from related parties at September 30, 2011 and December 31, 2010, respectively.

The Company's loan portfolio generally consists of loans to borrowers within Colorado. Although the Company seeks to avoid concentrations of loans to a single industry or based upon a single class of collateral, the Company's loan portfolio consists primarily of real estate loans secured by real estate located in Colorado, making the value of the portfolio more susceptible to declines in real estate values and other changes in economic conditions in Colorado. No single borrower can be approved for a loan over the Bank's current legal lending limit of approximately \$2.5 million. This regulatory requirement helps to ensure the Bank's exposure to one individual customer is limited.

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Activity in the allowance for loan and lease losses for the three and nine months ended September 30, 2011 and 2010 is summarized as follows:

| (\$ in thousands)                          | Three Months Ended<br>September 30, |          | Nine Months Ended<br>September 30, |          |
|--|-------------------------------------|----------|------------------------------------|----------|
|  | 2011                                | 2010     | 2011                               | 2010     |
| Balance, beginning of period               | \$ 1,284                            | \$ 940   | \$ 1,175                           | \$ 830   |
| Loans charged-off                          | (225)                               | (520)    | (236)                              | (705)    |
| Recoveries on loans previously charged-off |                                     |          |                                    |          |
| Provision for loan and lease losses        | 10                                  | 780      | 130                                | 1,075    |
| Balance, end of period                     | \$ 1,069                            | \$ 1,200 | \$ 1,069                           | \$ 1,200 |

The following allowance for loan and lease loss disclosures are broken out by portfolio segment. Portfolio segment is defined, under current U.S. GAAP, as the level of aggregation used by the Company to calculate its allowance for loan and lease losses. Our portfolio segments are based on how loans are categorized on the Consolidated Report of Condition and Income (Call Report), which is primarily based on the collateral securing the loan. We have four main portfolio segments as follows:

Commercial Real Estate Secured loans secured by nonfarm, nonresidential properties

Residential Real Estate Secured loans secured by 1-4 family residential properties or land

Commercial and Industrial loans to businesses not secured by real estate, and

Consumer loans to individuals not secured by real estate.

The portfolio segment categorization of loans differs from the categorization shown in Note 4 Loans. Segment categorization is based on the Call Report and the loan's underlying collateral while the loan categorization in Note 4 Loans is based on the loan's purpose as determined during the underwriting process.

The following tables identify the recorded investment in loans and the related allowance that corresponds to individual versus collective impairment evaluation as derived from the Company's systematic methodology of estimating the allowance for loan and lease losses (see additional discussion about our methodology under Note 2 Basis of Presentation, Critical Accounting Policies, Provision and allowance for loan and lease losses). These tables present the ending balances in loans and allowance for loan and lease losses, broken down by portfolio segment as of September 30, 2011 and December 31, 2010. Additionally, the tables provide a rollforward by portfolio segment of the allowance for loan and lease losses for the three and nine months ended September 30, 2011.

Rollforward of Allowance for Loan and Lease Losses by Portfolio Segment

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Three Months Ended September 30, 2011

| (\$ in thousands)                   | Commercial<br>Real Estate<br>Secured | Residential<br>Real Estate<br>Secured | Commercial<br>and<br>Industrial | Consumer | Total    |
|-------------------------------------|--------------------------------------|---------------------------------------|---------------------------------|----------|----------|
| Balance at June 30, 2011            | \$ 723                               | \$ 432                                | \$ 128                          | \$ 1     | \$ 1,284 |
| Charge-offs                         |                                      | (109)                                 | (116)                           |          | (225)    |
| Recoveries                          |                                      |                                       |                                 |          |          |
| Provision for loan and lease losses | 68                                   | (145)                                 | 87                              |          | 10       |
| Balance at September 30, 2011       | \$ 791                               | \$ 178                                | \$ 99                           | \$ 1     | \$ 1,069 |

Rollforward of Allowance for Loan and Lease Losses by Portfolio Segment

Nine Months Ended September 30, 2011

| (\$ in thousands)                   | Commercial<br>Real Estate<br>Secured | Residential<br>Real Estate<br>Secured | Commercial<br>and<br>Industrial | Consumer | Total    |
|-------------------------------------|--------------------------------------|---------------------------------------|---------------------------------|----------|----------|
| Balance at December 31, 2010        | \$ 524                               | \$ 314                                | \$ 336                          | \$ 1     | \$ 1,175 |
| Charge-offs                         | (11)                                 | (109)                                 | (116)                           |          | (236)    |
| Recoveries                          |                                      |                                       |                                 |          |          |
| Provision for loan and lease losses | 278                                  | (27)                                  | (121)                           |          | 130      |
| Balance at September 30, 2011       | \$ 791                               | \$ 178                                | \$ 99                           | \$ 1     | \$ 1,069 |

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## Ending Balances in Loans and Allowance for Loan and Lease Losses by Portfolio Segment

September 30, 2011

| (\$ in thousands)                          | Commercial<br>Real Estate<br>Secured | Residential<br>Real Estate<br>Secured | Commercial<br>and Industrial | Consumer | Total     |
|--|--------------------------------------|---------------------------------------|------------------------------|----------|-----------|
| <b>Loans</b>                               |                                      |                                       |                              |          |           |
| Individually evaluated for impairment      | \$ 318                               | \$ 309                                | \$ 359                       | \$       | \$ 986    |
| Collectively evaluated for impairment      | 34,493                               | 13,472                                | 6,658                        | 101      | 54,724    |
| Total                                      | \$ 34,811                            | \$ 13,781                             | \$ 7,017                     | \$ 101   | \$ 55,710 |
| <b>Allowance for loan and lease losses</b> |                                      |                                       |                              |          |           |
| Individually evaluated for impairment      | \$                                   | \$                                    | \$                           | \$       | \$        |
| Collectively evaluated for impairment      | 791                                  | 178                                   | 99                           | 1        | 1,069     |
| Total                                      | \$ 791                               | \$ 178                                | \$ 99                        | \$ 1     | \$ 1,069  |

## Ending Balances in Loans and Allowance for Loan and Lease Losses by Portfolio Segment

December 31, 2010

| (\$ in thousands)                          | Commercial<br>Real Estate<br>Secured | Residential<br>Real Estate<br>Secured | Commercial<br>and Industrial | Consumer | Total     |
|--|--------------------------------------|---------------------------------------|------------------------------|----------|-----------|
| <b>Loans</b>                               |                                      |                                       |                              |          |           |
| Individually evaluated for impairment      | \$ 1,290                             | \$ 689                                | \$ 141                       | \$       | \$ 2,120  |
| Collectively evaluated for impairment      | 34,403                               | 12,377                                | 9,951                        | 46       | 56,777    |
| Total                                      | \$ 35,693                            | \$ 13,066                             | \$ 10,092                    | \$ 46    | \$ 58,897 |
| <b>Allowance for loan and lease losses</b> |                                      |                                       |                              |          |           |
| Individually evaluated for impairment      | \$                                   | \$ 87                                 | \$                           | \$       | \$ 87     |
| Collectively evaluated for impairment      | 524                                  | 227                                   | 336                          | 1        | 1,088     |
| Total                                      | \$ 524                               | \$ 314                                | \$ 336                       | \$ 1     | \$ 1,175  |

**Impaired Loans**

The following tables provide detail of impaired loans broken out according to class as of September 30, 2011 and December 31, 2010. The class level represents a slightly more detailed level than the portfolio segment level. In 2011, the Company modified the following disclosure by adding additional classes in order to provide more detail about our loan portfolio. As such, the December 31, 2010 tables have been re-cast to conform to the new presentation. The recorded investment represents the customer balance less any partial charge-offs and excludes any accrued interest receivable since the majority of the loans were on nonaccrual status and therefore did not have interest accruing. The unpaid principal balance represents the unpaid principal prior to any partial charge-off.

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| <b>Impaired Loans by Class as of September 30, 2011</b> |                        |                                |                      |  |   |
|---|------------------------|--------------------------------|----------------------|--|---|
| (\$ in thousands)                                       | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment<br>YTD | Interest<br>Income<br>Recognized<br>YTD |
| <b><u>Impaired loans with no related allowance</u></b>  |                        |                                |                      |  |   |
| Commercial real estate - owner-occupied                 | \$                     | \$                             | \$                   | \$                                       | \$                                      |
| Commercial real estate                                  | 318                    | 538                            |                      | 365                                      |   |
| Commercial and industrial                               | 359                    | 359                            |                      | 604                                      | 14                                      |
| Residential real estate                                 | 309                    | 309                            |                      | 320                                      | 6                                       |
| Construction and land development                       |                        |                                |                      |  |   |
| Consumer  |                        |                                |                      |  |   |
| <b>Total</b>  | <b>\$ 986</b>          | <b>\$ 1,206</b>                | <b>\$</b>            | <b>\$ 1,289</b>                          | <b>\$ 20</b>                            |
| <b><u>Impaired loans with a related allowance</u></b>   |                        |                                |                      |  |   |
| Commercial real estate - owner-occupied                 | \$                     | \$                             | \$                   | \$                                       | \$                                      |
| Commercial real estate                                  |                        |                                |                      |  |   |
| Commercial and industrial                               |                        |                                |                      |  |   |
| Residential real estate                                 |                        |                                |                      |  |   |
| Construction and land development                       |                        |                                |                      |  |   |
| Consumer  |                        |                                |                      |  |   |
| <b>Total</b>  | <b>\$</b>              | <b>\$</b>                      | <b>\$</b>            | <b>\$</b>                                | <b>\$</b>                               |
| <b><u>Total impaired loans</u></b>                      |                        |                                |                      |  |   |
| Commercial real estate - owner-occupied                 | \$                     | \$                             | \$                   | \$                                       | \$                                      |
| Commercial real estate                                  | 318                    | 538                            |                      | 365                                      |   |
| Commercial and industrial                               | 359                    | 359                            |                      | 604                                      | 14                                      |
| Residential real estate                                 | 309                    | 309                            |                      | 320                                      | 6                                       |
| Construction and land development                       |                        |                                |                      |  |   |
| Consumer  |                        |                                |                      |  |   |
| <b>Total</b>  | <b>\$ 986</b>          | <b>\$ 1,206</b>                | <b>\$</b>            | <b>\$ 1,289</b>                          | <b>\$ 20</b>                            |

| <b>Impaired Loans by Class as of December 31, 2010</b> |                        |                                |                      |  |   |
|--|------------------------|--------------------------------|----------------------|--|---|
| (\$ in thousands)                                      | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment<br>YTD | Interest<br>Income<br>Recognized<br>YTD |
| <b><u>Impaired loans with no related allowance</u></b> |                        |                                |                      |  |   |
| Commercial real estate - owner-occupied                | \$ 898                 | \$ 898                         | \$                   | \$ 898                                   | \$                                      |
| Commercial real estate                                 |                        |                                |                      |  |   |
| Commercial and industrial                              | 141                    | 141                            |                      | 143                                      | 8                                       |
| Residential real estate                                | 527                    | 527                            |                      | 1,851                                    | 7                                       |
| Construction and land development                      | 393                    | 603                            |                      | 594                                      |   |
| Consumer   |                        |                                |                      |  |   |
| <b>Total</b>   | <b>\$ 1,959</b>        | <b>\$ 2,169</b>                | <b>\$</b>            | <b>\$ 3,486</b>                          | <b>\$ 15</b>                            |
| <b><u>Impaired loans with a related allowance</u></b>  |                        |                                |                      |  |   |
| Commercial real estate - owner-occupied                | \$                     | \$                             | \$                   | \$                                       | \$                                      |
| Commercial real estate                                 |                        |                                |                      |  |   |
| Commercial and industrial                              |                        |                                |                      |  |   |
| Residential real estate                                |                        |                                |                      |  |   |
| Construction and land development                      | 161                    | 532                            | 87                   | 262                                      |   |
| Consumer   |                        |                                |                      |  |   |
| <b>Total</b>   | <b>\$ 161</b>          | <b>\$ 532</b>                  | <b>\$ 87</b>         | <b>\$ 262</b>                            | <b>\$</b>                               |





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| Impaired Loans by Class as of December 31, 2010 (continued) |  |                        |                                |                      |  |   |
|---|--|------------------------|--------------------------------|----------------------|--|---|
| (\$ in thousands)   |  | Recorded<br>Investment | Unpaid<br>Principal<br>Balance | Related<br>Allowance | Average<br>Recorded<br>Investment<br>YTD | Interest<br>Income<br>Recognized<br>YTD |
| <b>Total impaired loans</b>                                 |  |                        |                                |                      |  |   |
| Commercial real estate owner-occupied                       |  | \$ 898                 | \$ 898                         | \$                   | \$ 898                                   | \$                                      |
| Commercial real estate                                      |  |                        |                                |                      |  |   |
| Commercial and industrial                                   |  | 141                    | 141                            |                      | 143                                      | 8                                       |
| Residential real estate                                     |  | 527                    | 527                            |                      | 1,851                                    | 7                                       |
| Construction and land development                           |  | 554                    | 1,135                          | 87                   | 856                                      |   |
| Consumer  |  |                        |                                |                      |  |   |
| <b>Total</b>  |  | <b>\$ 2,120</b>        | <b>\$ 2,701</b>                | <b>\$ 87</b>         | <b>\$ 3,748</b>                          | <b>\$ 15</b>                            |

The impaired loans without a valuation allowance did not have a related allowance because they have either been partially charged-off, bringing them to their net realizable value, or are well-secured.

Troubled debt restructurings (TDRs) are included in impaired loans above. Additionally, the following tables present loans, by class, that have been modified as TDRs during the three and nine months ended September 30, 2011, respectively:

## TDRs during the Three Months Ended September 30, 2011

| (\$ in thousands)                     |  | # of Loans | Pre-<br>Modification<br>Recorded<br>Investment | Recorded<br>Investment<br>as of<br>September<br>30, 2011 |
|---------------------------------------|--|------------|--|--|
| Commercial real estate owner-occupied |  |            | \$   | \$   |
| Commercial real estate                |  | 1          | 369  | 318  |
| Commercial and industrial             |  | 1          | 99   | 95   |
| Residential real estate               |  |            |  |  |
| Construction and land development     |  |            |  |  |
| Consumer                              |  |            |  |  |
| <b>Total</b>                          |  | <b>2</b>   | <b>\$ 468</b>                                  | <b>\$ 413</b>  |

The commercial real estate restructuring involves an extension of terms and the commercial and industrial modification involves a rate concession and an extension of terms.

## TDRs during the Nine Months Ended September 30, 2011

| (\$ in thousands) |  | # of Loans | Pre-<br>Modification<br>Recorded | Recorded<br>Investment<br>as of |
|-------------------|--|------------|----------------------------------|---------------------------------|
| Loan Class        |  |            |                                  |                                 |

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|                                       |   | Investment |     | September<br>30, 2011 |
|---------------------------------------|---|------------|-----|-----------------------|
| Commercial real estate owner-occupied |   | \$         |     | \$                    |
| Commercial real estate                | 1 |            | 369 | 318                   |
| Commercial and industrial             | 1 |            | 99  | 95                    |
| Residential real estate               | 1 |            | 161 |                       |
| Construction and land development     |   |            |     |                       |
| Consumer                              |   |            |     |                       |
| Total                                 | 3 | \$         | 629 | \$ 413                |

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The commercial real estate restructuring involves an extension of terms. The commercial and industrial modification involves a rate concession and an extension of terms. The residential real estate restructuring includes partial debt forgiveness and a rate concession.

At September 30, 2011, there were three loans totaling \$722,000 with terms that were modified in a TDR; including the \$413,000 shown in the table above and one loan totaling \$309,000 that was modified as a TDR during 2010. Because TDRs are impaired loans, they are reviewed individually for impairment and either charged-off to their net realizable value or allocated a specific reserve in the calculation of the allowance for loan and lease losses. None of the TDRs as of September 30, 2011 had a specific valuation allowance because the loans are well collateralized or have been partially charged-off to their net realizable values. Year to date charge-offs on TDRs totaled \$120,000 as of September 30, 2011. At December 31, 2010, there were four loans for \$1.5 million with terms that were modified in a TDR, with no specific allowance for loan and lease losses because the loans were well collateralized. There were no TDRs at September 30, 2010.

The Company has not committed additional funds to any of the borrowers whose loans are classified as a TDR. A TDR is considered to be in payment default once it is 90 days past due under the modified terms or when the loan is determined to be uncollectible and is classified as loss and charged-off. As further represented in the table below, the Company has had two loans that were restructured within the last 12 months that have subsequently defaulted. One note is in the process of foreclosure and was moved to other real estate owned during the third quarter 2011 and the other note was deemed uncollectible and fully charged-off during the third quarter 2011.

## TDRs that subsequently defaulted as of September 30, 2011

| (\$ in thousands)                 |                           | # of Loans | Recorded Investment at Time of Default |     | Recorded Investment as of September 30, 2011 |  |
|-----------------------------------|---------------------------|------------|--|-----|--|--|
| Loan Class                        |                           |            | \$                                     |     | \$   |  |
| Commercial real estate            | owner-occupied            | 1          | \$                                     | 879 | \$   |  |
| Commercial real estate            | Commercial and industrial |            |  |     |  |  |
| Residential real estate           |                           | 1          |  | 110 |  |  |
| Construction and land development |                           |            |  |     |  |  |
| Consumer                          |                           |            |  |     |  |  |
| Total                             |                           | 2          | \$                                     | 989 | \$   |  |

*Age Analysis of Loans*

The following tables summarize, by class, the Bank's past due and nonaccrual loans as of the dates indicated.

| (\$ in thousands)                     | Age Analysis of Loans by Class as of September 30, 2011 |                     |   |             |                                |           |           |
|---------------------------------------|---|---------------------|---|-------------|--------------------------------|-----------|-----------|
|                                       | 30-59 Days Past Due                                     | 60-89 Days Past Due | Past Due 90 Days or More and Still Accruing | Non-accrual | Total Past Due and Non-accrual | Current   | Total     |
| Commercial real estate owner-occupied | \$  | \$                  | \$  | \$          | \$                             | \$ 17,196 | \$ 17,196 |

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|                                   |    |    |    |     |     |        |        |    |        |
|-----------------------------------|----|----|----|-----|-----|--------|--------|----|--------|
| Commercial real estate            |    |    |    | 318 | 318 | 16,569 | 16,887 |    |        |
| Commercial and industrial         |    |    |    | 359 | 359 | 6,658  | 7,017  |    |        |
| Residential real estate           |    |    |    | 309 | 309 | 13,081 | 13,390 |    |        |
| Construction and land development |    |    |    |     |     | 1,119  | 1,119  |    |        |
| Consumer                          |    |    |    |     |     | 101    | 101    |    |        |
| Total                             | \$ | \$ | \$ | \$  | 986 | \$     | 54,724 | \$ | 55,710 |

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## Age Analysis of Loans by Class as of December 31, 2010

| (\$ in thousands)                                   | 30-59<br>Days Past<br>Due | 60-89<br>Days Past<br>Due | Past Due<br>90 Days or<br>More and<br>Still<br>Accruing | Non-<br>accrual | Total Past<br>Due and<br>Non-<br>accrual | Current   | Total     |
|---|---------------------------|---------------------------|---|-----------------|--|-----------|-----------|
| Commercial real estate<br>owner-occupied            | \$                        | \$                        | \$  | \$ 898          | \$ 898                                   | \$ 19,622 | \$ 20,520 |
| Commercial real estate<br>Commercial and industrial |                           |                           | 44  |                 | 44                                       | 13,857    | 13,857    |
| Residential real estate                             | 187                       |                           |   | 331             | 518                                      | 11,452    | 11,970    |
| Construction and land development                   |                           |                           |   | 554             | 554                                      | 1,859     | 2,413     |
| Consumer  |                           |                           |   |                 |  | 46        | 46        |
| Total   | \$ 187                    | \$                        | \$ 44   | \$ 1,783        | \$ 2,014                                 | \$ 56,883 | \$ 58,897 |

**Credit Quality Information**

The Company uses the following definitions for risk ratings, which are consistent with the definitions used in supervisory guidance and are the same for all classes of loans:

**Special Mention:** Loans in this category have potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

**Substandard:** Loans in this category are inadequately protected by the current sound worth and paying capacity of the borrower or the collateral pledged, if any. These loans have well-defined weaknesses that jeopardize the liquidation of the debt and have the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

**Doubtful:** Loans in this category have all the weaknesses inherent in those classified as substandard, above, with the added characteristic that the weaknesses make the collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable.

**Loss:** Loans in this category are deemed not collectible and are charged-off.

Loans not meeting any of the definitions above are considered to be pass-rated loans.

As of September 30, 2011, and based on the most recent analysis performed during the month of September 2011, the recorded investment in each risk category of loans by class of loan is as follows:

## Credit Quality of Loans by Class as of September 30, 2011

| (\$ in thousands)                                   | Pass      | Special<br>Mention | Substandard | Doubtful | Total     |
|---|-----------|--------------------|-------------|----------|-----------|
| Commercial real estate<br>owner-occupied            | \$ 14,873 | \$                 | \$ 2,323    | \$       | \$ 17,196 |
| Commercial real estate<br>Commercial and industrial | 14,976    | 686                | 1,225       |          | 16,887    |
|   | 6,566     |                    | 451         |          | 7,017     |

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|                                   |           |        |          |    |           |
|-----------------------------------|-----------|--------|----------|----|-----------|
| Residential real estate           | 12,843    |        | 547      |    | 13,390    |
| Construction and land development |           |        | 1,119    |    | 1,119     |
| Consumer                          | 101       |        |          |    | 101       |
| Total                             | \$ 49,359 | \$ 686 | \$ 5,665 | \$ | \$ 55,710 |

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As of December 31, 2010, and based on the most recent analysis performed during the month of December 2010, the recorded investment in each risk category of loans by class of loan is as follows:

| (\$ in thousands)                     | Credit Quality of Loans by Class as of December 31, 2010 |                    |             |          |    | Total     |
|---------------------------------------|--|--------------------|-------------|----------|----|-----------|
|                                       | Pass   | Special<br>Mention | Substandard | Doubtful |    |           |
| Commercial real estate owner-occupied | \$ 17,411  | \$ 1,017           | \$ 2,092    | \$       | \$ | \$ 20,520 |
| Commercial real estate                | 13,857   |                    |             |          |    | 13,857    |
| Commercial and industrial             | 7,244  | 1,974              | 873         |          |    | 10,091    |
| Residential real estate               | 9,949  | 1,494              | 527         |          |    | 11,970    |
| Construction and land development     | 358  | 179                | 1,715       | 161      |    | 2,413     |
| Consumer                              | 46   |                    |             |          |    | 46        |
| Total                                 | \$ 48,865  | \$ 4,664           | \$ 5,207    | \$ 161   | \$ | \$ 58,897 |

The following table summarizes information regarding impaired loans at the dates indicated:

| (\$ in thousands)                                | September 30,<br>2011 | September 30,<br>2010 |
|--|-----------------------|-----------------------|
| Impaired loans with a valuation allowance:       | \$                    | \$                    |
| Impaired loans without a valuation allowance:    | 986                   | 749                   |
| Total impaired loans                             | \$ 986                | \$ 749                |
| Valuation allowance related to impaired loans    | \$                    | \$                    |
| YTD interest income recognized during impairment | \$ 7                  | \$ 2                  |

Troubled debt restructurings are included in impaired loans above.

**NOTE 6 DEPOSITS**

Deposits are summarized as follows:

| (\$ in thousands)          | September 30, 2011 |               | December 31, 2010 |               |
|----------------------------|--------------------|---------------|-------------------|---------------|
|                            | Amount             | % of<br>Total | Amount            | % of<br>Total |
| Noninterest-bearing demand | \$ 2,792           | 3%            | \$ 1,891          | 2%            |
| Interest-bearing demand    | 10,480             | 9             | 11,605            | 10            |
| Money market accounts      | 9,265              | 8             | 10,902            | 10            |
| Savings accounts           | 52,240             | 46            | 46,230            | 42            |
| Time deposits              | 37,793             | 34            | 40,327            | 36            |
| Total deposits             | \$ 112,570         | 100%          | \$ 110,955        | 100%          |

In the ordinary course of business, certain officers, directors, stockholders, and employees of the Bank have deposits with the Bank. In the Bank's opinion, all deposit relationships with such parties are made on substantially the same terms including interest rates and maturities, as those prevailing at the time for comparable transactions with other persons. The balance of related party deposits at September 30, 2011 and December 31, 2010 was approximately \$4.1 million and \$4.5 million, respectively.

**NOTE 7 STOCK-BASED COMPENSATION**

Under the terms of the Company's Stock Incentive Plan, (the Plan), employees may be granted both nonqualified and incentive stock options and directors and other consultants, who are not also officers or employees, may only be granted nonqualified stock options. The Board reserved 510,734 shares of common stock for issuance under the Plan. The Plan provides for options to purchase shares of common stock at a price not less than 100% of the fair market value of the stock on the date of grant. Stock options expire no later than ten years from the date of the grant



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and generally vest over four years. The Plan provides for accelerated vesting if there is a change of control, as defined in the Plan. The Company recognized stock-based compensation cost of approximately \$43,000 and \$56,000 during the three months ended September 30, 2011 and 2010, respectively and \$158,000 and \$148,000 during the nine months ended September 30, 2011 and 2010, respectively.

The Company accounts for its stock-based compensation under the provisions of ASC 718-20 *Stock Compensation Awards Classified as Equity*. The fair value of each option grant is estimated on the date of grant using the Black-Scholes-Merton option pricing model. The Company granted 11,500 during the third quarter 2011 as incentive compensation to bank employees. During the third quarter 2010, the Company granted 10,000 stock options as incentive compensation to an executive officer and 45,000 nonqualified options to directors.

During the three months ended September 30, 2011, 2,583 options were forfeited and no vested options expired unexercised. During the third quarter 2010, no options were forfeited and 469 vested options expired unexercised. No options were exercised during the three or nine months ended September 30, 2011 or 2010. The Company recognized expense for approximately 30,000 options, representing a pro-rata amount of the options earned during the third quarter 2011 that are expected to vest. As of September 30, 2011, there was approximately \$87,000 of unrecognized compensation cost related to the outstanding stock options that will be recognized over a weighted-average period of 1.7 years.

During the third quarter 2011, the Company revised its estimated forfeiture rate for incentive stock options issued to employees from 25% to 28% which more accurately reflects the actual turnover rate the Company is experiencing. This change in estimate reduced stock-based compensation expense during the third quarter 2011 by approximately \$5,000.

The following is a summary of the Company's outstanding stock options and related activity for the nine months ended September 30, 2011:

|                                   | Options  | Weighted-Average Grant Date Fair Value | Weighted-Average Exercise Price |
|-----------------------------------|----------|--|---------------------------------|
| Outstanding at December 31, 2010  | 367,790  | \$ 2.43                                | \$ 8.31                         |
| Granted                           | 55,500   | 0.62                                   | 3.00                            |
| Exercised                         |          |  |                                 |
| Forfeited                         | (16,603) | 2.11                                   | 8.30                            |
| Expired                           | (1,000)  | 1.32                                   | 5.90                            |
| Outstanding at September 30, 2011 | 405,687  | 1.92                                   | 7.59                            |

The following is a summary of the Company's outstanding stock options and related activity for the nine months ended September 30, 2010:

|                                  | Options | Weighted-Average Grant Date Fair Value | Weighted-Average Exercise Price |
|----------------------------------|---------|--|---------------------------------|
| Outstanding at December 31, 2009 | 305,353 | \$ 2.44                                | \$ 9.19                         |
| Granted                          | 72,750  | 0.79                                   | 4.67                            |
| Exercised                        |         |  |                                 |
| Forfeited                        | (5,688) | 1.77                                   | 7.52                            |
| Expired                          | (5,125) | 2.46                                   | 9.39                            |

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Outstanding at September 30, 2010

367,290

2.12

8.32

23

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The following table details the items comprising other general and administrative expenses:

| (\$ in thousands)                 | Three Months Ended<br>September 30, |               | Nine Months Ended<br>September 30, |               |
|-----------------------------------|-------------------------------------|---------------|------------------------------------|---------------|
|                                   | 2011                                | 2010          | 2011                               | 2010          |
| Data processing                   | \$ 73                               | \$ 80         | \$ 229                             | \$ 211        |
| FDIC assessment                   | 48                                  | 52            | 165                                | 147           |
| Regulatory and reporting fees     | 36                                  | 26            | 119                                | 90            |
| Marketing and promotions          | 23                                  | 38            | 64                                 | 80            |
| Directors fees                    | 22                                  | 20            | 68                                 | 23            |
| Printing, stationery and supplies | 6                                   | 7             | 20                                 | 24            |
| Loan and collection expense       | 41                                  | 14            | 76                                 | 24            |
| Travel and entertainment          | 11                                  | 18            | 26                                 | 39            |
| Telephone/communication           | 12                                  | 10            | 35                                 | 31            |
| Dues and memberships              | 8                                   | 7             | 21                                 | 24            |
| Insurance                         | 8                                   | 6             | 20                                 | 17            |
| Postage and shipping              | 3                                   | 5             | 10                                 | 13            |
| Franchise taxes                   | 3                                   | 3             | 10                                 | 14            |
| ATM and debit card fees           | 4                                   | 4             | 10                                 | 12            |
| Training and education            | 3                                   | 2             | 10                                 | 6             |
| Miscellaneous                     | 13                                  | 5             | 26                                 | 18            |
| <b>Total</b>                      | <b>\$ 314</b>                       | <b>\$ 297</b> | <b>\$ 909</b>                      | <b>\$ 773</b> |

**NOTE 9 COMMITMENTS AND CONTINGENCIES**

The Company is a party to credit related financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments consist of commitments to extend credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The Company's exposure to credit loss is represented by the contractual amount of these commitments. The Company follows the same credit policies in making commitments as it does for on-balance-sheet instruments.

At September 30, 2011 and December 31, 2010, \$6.5 million and \$8.3 million of commitments, respectively, were outstanding in which the contract amounts represent credit risk.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the commitments do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained is based on management's credit evaluation. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment and income producing commercial properties.

**NOTE 10 FAIR VALUE**

The Company carries its available-for-sale securities at fair value. Fair value measurement is obtained from independent pricing services which utilize observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bonds terms and conditions, among other things. As of September 30, 2011 and December 31, 2010, all of the Company's available-for-sale securities were valued using Level 2 inputs.

Impaired loans are evaluated and valued at the time the loan is identified as impaired, at the lower of cost or fair value. Fair value is measured based on the value of the collateral securing these loans or the present value of expected cash flows and is classified as Level 3 in the fair value hierarchy. Collateral may be real estate and/or

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business assets including equipment, inventory and/or accounts receivable and is determined based on appraisals performed by qualified licensed appraisers hired by the Company. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and client's business. Such discounts are typically significant and result in a Level 3 classification of the inputs for determining fair value. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly.

Other real estate owned is valued at the time the loan is foreclosed upon and the asset is transferred to other real estate owned. The value is based primarily on third party appraisals, less costs to sell. The appraisals may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and/or management's expertise and knowledge of the client and client's business. Such discounts are typically significant and result in a Level 3 classification of the inputs for determining fair value. Other real estate owned is reviewed and evaluated on at least an annual basis for additional impairment and adjusted accordingly.

***Assets and Liabilities Measured on a Recurring Basis***

Assets and liabilities measured at fair value on a recurring basis are summarized below:

| (\$ in thousands)                          | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total  |
|--|--|---|--|--------|
| Assets at September 30, 2011               |  |   |  |        |
| Investment securities, available-for-sale: |  |   |  |        |
| U.S. government agencies                   | \$   | \$  | \$   | \$     |
| Corporate                                  |  | 11,603  |  | 11,603 |
| State and municipal                        |  | 7,827   |  | 7,827  |
| Residential agency MBS                     |  | 62,447  |  | 62,447 |
| Total                                      | \$   | \$  | \$   | \$     |
| Assets at December 31, 2010                |  |   |  |        |
| Investment securities, available-for-sale: |  |   |  |        |
| U.S. government agencies                   | \$   | \$  | \$   | \$     |
| Corporate                                  |  | 11,473  |  | 11,473 |
| State and municipal                        |  | 22,825  |  | 22,825 |
| Residential agency MBS                     |  | 36,163  |  | 36,163 |
| Total                                      | \$   | \$  | \$   | \$     |

There were no transfers in or out of the levels during the periods presented.

***Assets and Liabilities Measured on a Nonrecurring Basis***

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Assets and liabilities measured at fair value on a nonrecurring basis are summarized below:

| (\$ in thousands)                                | Quoted<br>Prices in<br>Active<br>Markets for<br>Identical<br>Assets<br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Unobservable<br>Inputs<br>(Level 3) | Total    |
|--|--|---|--|----------|
| Assets at September 30, 2011                     |  |   |  |          |
| Impaired loans ( <i>Financial</i> )              | \$   | \$  | \$ 355   | \$ 355   |
| Other real estate owned ( <i>Non-financial</i> ) | \$   | \$  | \$ 1,160   | \$ 1,160 |
| Assets at December 31, 2010                      |  |   |  |          |
| Impaired loans ( <i>Financial</i> )              | \$   | \$  | \$ 554   | \$ 554   |
| Other real estate owned ( <i>Non-financial</i> ) | \$   | \$  | \$ 1,976   | \$ 1,976 |

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Impaired loans, which are measured for impairment using either the fair value of collateral or present value of expected cash flows, had carrying amounts at September 30, 2011 totaling \$986,000 after partial charge-offs totaling \$220,000. These impaired loans had no specific valuation allowance at September 30, 2011. In addition, impaired loans have \$37,000 in estimated selling costs which reduced the carrying value. Of the \$986,000 of impaired loans at September 30, 2011, \$355,000 were carried at fair value adjusted for the aforementioned charge-offs, estimated selling costs and specific valuation allowance. The remaining \$631,000 were carried at cost at September 30, 2011, as the fair value of collateral or expected cash flows on these loans exceeded the book value.

Impaired loans at December 31, 2010 had carrying amounts totaling \$2.1 million after partial charge-offs of \$580,000. In addition, these loans had a specific valuation allowance of \$87,000 at December 31, 2010 and \$27,000 of estimated selling costs which reduced the carrying value. Of the \$2.1 million of impaired loans at December 31, 2010, \$554,000 were carried at fair value adjusted for the aforementioned charge-offs, estimated selling costs and specific valuation allowance. The remaining \$1.6 million were carried at cost at December 31, 2010, as the fair value of collateral or expected cash flows on these loans exceeded the book value.

Other real estate owned (OREO), consisting of one property, had a carrying amount of \$903,000 at September 30, 2011 reduced from the estimated fair value of \$1.2 million due to estimated costs to sell and time value adjustments. This property was transferred to OREO during the third quarter 2011. At December 31, 2010, OREO had a carrying amount of \$1.8 million. That property was sold during the second quarter 2011 and, after final adjustments made during the third quarter, resulted in a \$25,000 loss to the Company.

***Fair Value of Financial Instruments***

Disclosure of fair value information about financial instruments, whether or not recognized in the consolidated balance sheets, for which it is practicable to estimate that value is required. Fair value estimates are made at a specific point in time based on relevant market information and information about the financial instrument. Because no market value exists for a significant portion of the financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These estimates are subjective in nature, involve uncertainties and matters of judgment, and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value information is not required to be disclosed for certain financial instruments and all nonfinancial instruments. Accordingly, the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company. Fair value estimates are based on financial instruments both on and off the balance sheet without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Additionally, tax consequences related to the realization of the unrealized gains and losses can have a potential effect on fair value estimates and have not been considered in many of the estimates.

The following methods and assumptions were used to estimate the fair value of significant financial instruments:

*Cash and cash equivalents:* The carrying amounts of cash and due from banks and federal funds sold approximate their fair values.

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*Interest-bearing deposits with banks:* The carrying amount of interest-bearing deposits with banks approximates fair values due to the relatively stable level of short-term interest rates.

*Investment securities:* Fair value measurement is obtained from independent pricing services which utilize observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bonds terms and conditions, among other things.

*Loans, net:* The fair value of fixed rate loans is estimated by discounting the future cash flows using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality. For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are estimated to be equivalent to carrying values. Variable rate loans that are currently priced at their contractual floor or ceiling, and thus similar to



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fixed rate loans, are reviewed to determine the interest rate that would be currently offered on similar credits. If the current floor/ceiling rate is equivalent to current market rates, fair value is estimated to be equivalent to carrying value. If the current market rates differ from the loan's current rate, the contractual cash flows are discounted using the current market rate to derive the loan's estimated fair value. Both the estimated fair value and the carrying value have been reduced by specific and general reserves for loan losses.

*Investment in Federal Home Loan Bank and Federal Reserve Bank stocks:* It is not practical to determine the fair value of bank stocks due to the restrictions placed on the transferability of FHLB stock and FRB stock.

*Accrued interest receivable:* The carrying value of interest receivable approximates fair value due to the short period of time between accrual and receipt of payment.

*Deposits:* The fair value of noninterest-bearing demand deposits, interest-bearing demand deposits and savings and money market accounts is determined to be the amount payable on demand at the reporting date. The fair value of fixed rate time deposits is estimated using a discounted cash flow calculation that applies interest rates currently being offered for deposits of similar remaining maturities. Carrying value is assumed to approximate fair value for all variable rate time deposits.

*Securities sold under agreements to repurchase:* The carrying amount of securities sold under agreements to repurchase approximates fair value due to the short-term nature of these agreements, which generally mature within one to four days from the transaction date.

*Federal funds purchased:* The carrying amount of federal funds purchased approximates fair value due to their short-term nature.

*Federal Home Loan Bank advances:* Fair value of the Federal Home Loan Bank advances is estimated using a discounted cash flow model based on current market rates for similar types of borrowing arrangements including similar remaining maturities.

*Accrued interest payable:* The carrying value of interest payable approximates fair value due to the short period of time between accrual and payment.

*Loan commitments:* The fair values of commitments are estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. The difference between the carrying value of commitments to fund loans or standby letters of credit and their fair values are not significant and, therefore, are not included in the following table.



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The carrying amounts and estimated fair values of financial instruments are summarized as follows:

| (\$ in thousands)                              | September 30, 2011 |                      | December 31, 2010 |                      |
|--|--------------------|----------------------|-------------------|----------------------|
|  | Carrying Value     | Estimated Fair Value | Carrying Value    | Estimated Fair Value |
| <b>Financial Assets:</b>                       |                    |                      |                   |                      |
| Cash and cash equivalents                      | \$ 283             | \$ 283               | \$ 936            | \$ 936               |
| Interest-bearing deposits with banks           | 357                | 357                  | 266               | 266                  |
| Investment securities                          | 81,877             | 81,877               | 76,313            | 76,313               |
| Loans, net                                     | 54,583             | 54,879               | 57,647            | 57,604               |
| FHLB and FRB stocks                            | 1,148              | NA                   | 1,168             | NA                   |
| Accrued interest receivable                    | 566                | 566                  | 759               | 759                  |
| <b>Financial Liabilities:</b>                  |                    |                      |                   |                      |
| Deposits, demand, savings and money market     | \$ 74,777          | \$ 74,777            | \$ 70,628         | \$ 70,628            |
| Time deposits                                  | 37,793             | 38,365               | 40,327            | 40,777               |
| Securities sold under agreements to repurchase | 252                | 252                  | 143               | 143                  |
| Federal funds purchased                        | 135                | 135                  | 200               | 200                  |
| FHLB advances                                  | 8,500              | 8,695                | 10,000            | 10,243               |
| Accrued interest payable                       | 66                 | 66                   | 91                | 91                   |

**NOTE 11 CONSENT ORDER**

On December 16, 2010, pursuant to a Stipulation and Consent to the Issuance of a Consent Order, Solera National Bank consented and agreed to the issuance of an Amended Consent Order (the Consent Order) by the Office of the Comptroller of the Currency (OCC). The Consent Order replaced and superseded the consent order entered into on March 18, 2010 by the Bank. The provisions of the Consent Order shall remain effective and enforceable, except to the extent that, and until such time as, any provisions of the Consent Order have been amended, suspended, waived, or terminated in writing by the OCC. The Consent Order is based on the findings of the OCC during an examination that began on September 6, 2010 and requires the Bank to submit written plans within certain timeframes to address the following items, among others: compliance with the Bank Secrecy Act, revisions to the Bank's loan policy and procedures, weaknesses in the Bank's credit risk management and underwriting, and credit risk associated with the Bank's Home Equity Line of Credit portfolio. For a complete description of the items in the Stipulation and Consent Order please see Exhibits 10.16 and 10.17 to our Annual Report on Form 10-K filed with the SEC on March 23, 2011.

Since the completion of the examination, the Bank and its Board of Directors have taken steps to address the findings of the examination and have addressed the matters in the Consent Order by the deadline dates. The Bank did not admit any wrongdoing in entering into the Consent Order, and in connection with the actions outlined in the Consent Order, is committed to establishing stronger banking practices.

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**NOTE 12 LEGAL CONTINGENCIES**

In the ordinary course of our business, we are party to various legal actions, which we believe are incidental to the operation of our business. Although the ultimate outcome and amount of liability associated with these legal actions, if any, cannot presently be ascertained with certainty, in the opinion of management, based upon information currently available to us, any resulting liability is not likely to have a material adverse effect on the Company's consolidated financial position, results of operations or cash flows.

**NOTE 13 SUBSEQUENT EVENTS**

As of the date of issuance of this Report on Form 10-Q, the Company has determined that no other subsequent event disclosure is necessary.

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**ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion and analysis presents the Company's consolidated financial condition as of September 30, 2011 and results of operations for the three and nine months ended September 30, 2011 and 2010. The discussion should be read in conjunction with the financial statements and the notes related thereto which appear elsewhere in this Quarterly Report on Form 10-Q.

**Executive Overview**

We are a Delaware corporation that was incorporated to organize and serve as the holding company for Solera National Bank, a national bank that opened for business on September 10, 2007. Solera National Bank is a full-service commercial bank headquartered in Lakewood, Colorado primarily serving the six-county Denver metropolitan area. Our main banking office is located at 319 S. Sheridan Blvd., Lakewood, Colorado 80226. Our telephone number is (303) 209-8600.

Earnings are derived primarily from net interest income, which is interest income less interest expense, and noninterest income earned from gains on sales of investment securities and banking service fees, offset by noninterest expense and provision for loan and lease losses. As the majority of assets are interest-earning and liabilities are interest-bearing, changes in interest rates impact net interest margin. We manage interest-earning assets and interest-bearing liabilities to reduce the impact of interest rate changes on operating results.

We offer a broad range of commercial and consumer banking services to small and medium-sized businesses, licensed professionals and individuals who are particularly responsive to the personalized service that Solera National Bank provides to its customers. We believe that local ownership and control allows the Bank to serve customers efficiently and effectively. Solera National Bank competes on the basis of providing a unique and personalized banking experience combined with a broad range of services, customized and tailored to fit the individual needs of its clients. While the Bank seeks to serve the entire market, it focuses on serving the local Hispanic and other minority populations which it believes are currently underserved. Since opening the bank in September of 2007, management has successfully executed its strategy of delivering prudent and controlled growth to efficiently leverage the Company's capital and expense base with the goal of achieving sustained profitability.

Because we operate in Colorado, our operating results are significantly influenced by economic conditions in Colorado, particularly the health of the real estate market. Additionally, we are subject to competition from other financial institutions and are impacted by fiscal and regulatory policies of the federal government as well as regulatory oversight by the Office of the Comptroller of the Currency, (the OCC).

**Industry / Economic Overview**

At its November 2011 meeting, the Federal Open Market Committee (FOMC) decided to keep the target range for the federal funds rate unchanged at 0 to 25 basis points and commented that it currently anticipates that economic conditions including low rates of resource utilization and a subdued outlook for inflation over the medium run are likely to warrant exceptionally low levels for the federal funds rate at least through mid-2013. Although economic growth strengthened somewhat during the third quarter of 2011, recent indicators still point to continued

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weakness in overall labor conditions and the housing sector remains depressed. The FOMC indicated that they will maintain the existing policy of reinvesting principal payments from its securities holdings in order to support a stronger economic recovery.

The Metro Denver economy continues to struggle through a variety of economic conditions affecting the entire nation. Despite slow job growth, a number of new expansions indicate positive momentum and support for the commercial real estate sector. Office, industrial, and retail space vacancy rates all decreased in the third quarter, according to data compiled by the Metro Denver Economic Development Corporation (Metro Denver EDC) in its Monthly Economic Summary for October 2011.

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The Colorado Department of Labor and Employment reported that nonfarm payroll jobs in Colorado declined by 3,900 from August to September to 2,240,500 jobs, according to the survey of business establishments. Government added 1,100 payroll jobs and the private sector lost 5,000. According to the survey of households, the unemployment rate decreased two-tenths of a percentage point to 8.3 percent. The number of people actively participating in the labor force increased 8,300 to 2,680,900 and total employment increased 13,400 to 2,458,700 causing the number of unemployed to decline 5,000. The national unemployment rate also was unchanged over the same period at 9.1 percent.

As the economy struggles, the industry continues to experience weak loan demand. Competition among banks for the smaller pool of high-quality loans remains fierce creating pressure on loan pricing. This, coupled with lower yields on investment securities due to the historically low interest rate environment, has led to net interest margin compression. Lower net interest margin, along with an increased regulatory and compliance burden, has created pressure on industry earnings. Earnings improvement in the industry have been primarily driven by improving asset quality resulting in banks recording lower provisions for loan losses. Solera National Bank is experiencing similar trends in its business.

**Comparative Results of Operations for the Three Months Ended September 30, 2011 and 2010**

The following discussion focuses on the Company's financial condition and results of operations for the three months ended September 30, 2011 compared to the financial condition and results of operations for the three months ended September 30, 2010.

Net income for the quarter ended September 30, 2011 was \$159,000, or \$0.06 per share, compared with a net loss of \$493,000, or \$(0.19) per share, for the third quarter of 2010. The most notable changes between periods were as follows: 1) a \$770,000 favorable variance in provision for loan and lease losses as credit quality continued to stabilize, 2) a \$196,000 unfavorable variance in interest income partially offset by a \$132,000 favorable variance in interest expense. Each of the aforementioned factors is discussed in more detail below.

As of September 30, 2011, the Company had total assets of \$140.7 million, which remained substantially unchanged from December 31, 2010. Net loans decreased by \$3.1 million, or 5%, from December 31, 2010 to \$54.6 million at September 30, 2011. However, the Company's total deposits grew \$1.6 million from \$111.0 million at December 31, 2010 to \$112.6 million at September 30, 2011.

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The following table presents, for the periods indicated, average assets, liabilities and stockholders equity, as well as the components of net interest income and the resultant annualized yields / costs expressed in percentages.

**Table 1**

| (\$ in thousands)   | Three Months Ended<br>September 30, 2011 |          |                 | Three Months Ended<br>September 30, 2010 |          |                 |
|---|--|----------|-----------------|--|----------|-----------------|
|   | Average<br>Balance                       | Interest | Yield /<br>Cost | Average<br>Balance                       | Interest | Yield /<br>Cost |
| <b>Assets:</b>  |  |          |                 |  |          |                 |
| Interest-earning assets:  |  |          |                 |  |          |                 |
| Gross loans, net of unearned fees   | \$ 57,704                                | \$ 841   | 5.78%           | \$ 60,632                                | \$ 901   | 5.89%           |
| Investment securities**   | 76,226                                   | 578      | 3.01            | 70,747                                   | 713      | 4.00            |
| FHLB and FRB stocks   | 1,137                                    | 8        | 2.87            | 1,150                                    | 10       | 3.41            |
| Federal funds sold  | 1,168                                    | 1        | 0.22            | 908                                      |          |                 |
| Interest-bearing deposits with banks  | 705                                      | 1        | 0.84            | 787                                      | 1        | 0.58            |
| Total interest-earning assets   | 136,940                                  | \$ 1,429 | 4.14%           | 134,224                                  | \$ 1,625 | 4.81%           |
| Noninterest-earning assets  | 2,039                                    |          |                 | 4,589                                    |          |                 |
| Total assets  | \$ 138,979                               |          |                 | \$ 138,813                               |          |                 |
| <b>Liabilities and Stockholders Equity:</b>                                   |  |          |                 |  |          |                 |
| Interest-bearing liabilities:   |  |          |                 |  |          |                 |
| Money market and savings deposits   | \$ 61,298                                | \$ 157   | 1.01%           | \$ 54,625                                | \$ 203   | 1.48%           |
| Interest-bearing checking accounts  | 10,821                                   | 28       | 1.02            | 11,197                                   | 43       | 1.51            |
| Time deposits   | 37,566                                   | 158      | 1.67            | 43,865                                   | 220      | 1.99            |
| Federal funds purchased and securities<br>sold under agreements to repurchase | 368                                      | 1        | 0.94            | 646                                      | 2        | 1.25            |
| FHLB advances   | 6,521                                    | 51       | 3.09            | 5,645                                    | 58       | 4.09            |
| Other borrowings  | 49                                       | 1        | 9.27            | 93                                       | 2        | 9.31            |
| Total interest-bearing liabilities  | 116,623                                  | \$ 396   | 1.35%           | 116,071                                  | \$ 528   | 1.81%           |
| Noninterest-bearing checking accounts   | 2,604                                    |          |                 | 1,801                                    |          |                 |
| Noninterest-bearing liabilities   | 414                                      |          |                 | 537                                      |          |                 |
| Stockholders equity   | 19,338                                   |          |                 | 20,404                                   |          |                 |
| Total liabilities and stockholders<br>equity                                  | \$ 138,979                               |          |                 | \$ 138,813                               |          |                 |
| Net interest income   |  | \$ 1,033 |                 |  | \$ 1,097 |                 |
| Net interest spread   |  | 2.79%    |                 |  | 3.00%    |                 |
| Net interest margin   |  | 2.99%    |                 |  | 3.24%    |                 |

\*\*Yields on investment securities have not been adjusted to a tax-equivalent basis.



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The following table presents the dollar amount of changes in interest income and interest expense for the major categories of interest-earning assets and interest-bearing liabilities. The information details the changes attributable to a change in volume (i.e. change in average balance multiplied by the prior-period average rate) and changes attributable to a change in rate (i.e. change in average rate multiplied by the prior-period average balance). There is a component that is attributable to both a change in volume and a change in rate. This component has been allocated proportionately to the rate and volume columns.

**Table 2**

| (\$ in thousands)   | Three Months Ended September 30, 2011 Compared to<br>Three Months Ended September 30, 2010 |                |             |
|---|--|----------------|-------------|
|   | Net Change   | Rate           | Volume      |
| <b>Interest income:</b>   |  |                |             |
| Gross loans, net of unearned fees   | \$ (60)  | \$ (17)        | \$ (43)     |
| Investment securities   | (135)  | (197)          | 62          |
| FHLB and FRB stocks   | (2)  | (2)            |             |
| Federal funds sold  | 1  |                | 1           |
| Interest-bearing deposits with banks  |  |                |             |
| Total interest income   | \$ (196)   | \$ (216)       | \$ 20       |
| <b>Interest expense:</b>  |  |                |             |
| Money market and savings deposits   | \$ (46)  | \$ (76)        | \$ 30       |
| Interest-bearing checking accounts  | (15)   | (13)           | (2)         |
| Time deposits   | (62)   | (33)           | (29)        |
| Federal funds purchased and securities sold under<br>agreements to repurchase | (1)  | (7)            | 6           |
| FHLB advances   | (7)  | (20)           | 13          |
| Other borrowings  | (1)  |                | (1)         |
| Total interest expense  | \$ (132)   | \$ (149)       | \$ 17       |
| <b>Net interest income</b>  | <b>\$ (64)</b>   | <b>\$ (67)</b> | <b>\$ 3</b> |

***Net Interest Income and Net Interest Margin***

Net interest income is the difference between interest and fee income, principally from loan and investment security portfolios, and interest expense, principally on customer deposits and borrowings. Net interest income is our principal source of earnings. Changes in net interest income result from changes in volume, spread and margin. Volume refers to the average dollar level of interest-earning assets and interest-bearing liabilities. Spread refers to the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities. Margin refers to net interest income divided by average interest-earning assets, and is influenced by the level and relative mix of interest-earning assets and interest-bearing liabilities.

The Federal Reserve Board influences the general market rates of short-term interest, including the deposit and loan rates offered by the Bank. The Bank's loan portfolio is significantly affected by changes in the prime interest rate. The prime interest rate has remained at 3.25% since December 2008 and, thus, has had no impact on the change in loan yields during this time period.

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The federal funds rate, which is the cost of immediately available, overnight funds, has behaved in a similar manner, changing insignificantly since the end of 2008.

For the three months ended September 30, 2011, the Company's net interest margin decreased 25 basis points from 3.24% to 2.99%. This decrease was primarily due to decreased yields on our interest-earning assets partially offset by decreased rates paid on interest-bearing liabilities. The unfavorable decline in yield on interest-earning assets of 67 basis points was primarily attributable to the 99 basis point decrease in yield on investments. This decrease is

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primarily due to the sale of longer-maturity, higher-yielding investments, along with principal payments received on mortgage-backed securities, which were reinvested in shorter-term, lower-yielding bonds to help shorten the duration of the investment portfolio. Additionally, there was an unfavorable change in volume from higher-yielding loans to lower-yielding investments as the Bank continued to experience weak loan demand given the tepid economic recovery.

The impact of the decrease in yield on interest-earning assets was somewhat mitigated by the 46 basis point decrease in the rate paid on interest-bearing liabilities. Most significantly, the average rate paid on borrowings from the FHLB decreased 100 basis points due partially to the maturity of higher fixed-rate advances and partially to a change in mix as the Company borrowed some overnight funds from the FHLB at considerably lower rates. Also contributing to the decline in funding costs was the favorable change in volume from higher-cost time deposits to lower-cost savings and money market accounts as reflected in Table 2 above. Additionally, the Company continued to downward price deposit products following the general market decline in interest rates. This was accomplished while still retaining customers.

This overall impact, however, was a tightening of the Company's annualized net interest spread, (the yield earned on interest-earning assets less the cost of interest-bearing liabilities) which decreased 21 basis points from 3.00% for the three months ended September 30, 2010 to 2.79% for the same period in 2011.

The Company's balance sheet is slightly asset sensitive, meaning that interest-earning assets generally reprice quicker than interest-bearing liabilities. Therefore, the Company could experience expansion in its net interest margin during periods of rising interest rates.

***Provision for Loan and Lease Losses***

We determine a provision for loan and lease losses that we consider sufficient to maintain an allowance to absorb probable losses inherent in our portfolio as of the balance sheet date. For additional information concerning this determination, see the section of this discussion and analysis captioned *Financial Condition - Allowance for Loan and Lease Losses*.

During the third quarter of 2011, our provision for loan losses was \$10,000 compared to \$780,000 for the third quarter 2010. The amount of the provision reflects the estimated probable losses inherent within the portfolio due to uncertainties in economic conditions. The improvement in credit quality, coupled with a reduction in the size of the overall portfolio, has afforded the Company a substantially smaller provision expense during the third quarter of 2011. The larger provision expense recorded during third quarter 2010 was partially due to the need to replenish the account after sustaining \$520,000 in charge-offs and partially due to the growth in the loan portfolio during that period. See additional discussion below under *Financial Condition - Nonperforming Loans, Leases and Assets*.

***Noninterest Income***

Noninterest income for the quarter ended September 30, 2011 was \$327,000, a decrease of \$50,000 from \$377,000 for the third quarter 2010. The Company sold securities for net gains of \$333,000 during the third quarter 2011, which was substantially the same as the prior year third quarter. Other income was down \$13,000, or 81%, from third quarter 2010 due to lower fees earned on residential mortgage loans originated

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through a third party. Additionally, the Company recognized a \$25,000 loss on the final accounting for the sale of an OREO property versus a \$10,000 gain on sale of an OREO property during third quarter 2010. Service charges on deposits were down 16% or \$3,000 quarter-over-quarter.

### *Noninterest Expense*

Our total noninterest expense for the quarter ended September 30, 2011 was \$1.2 million, substantially unchanged from third quarter 2010. Salaries and employee benefits decreased \$6,000 due to the elimination of an executive officer position and lower stock option expense, partially offset by higher expense due to the Company match on 401K contributions, which began in January 2011.

Occupancy expense remained substantially unchanged decreasing \$2,000 quarter-over-quarter. Professional fees decreased \$5,000, or 4%, quarter-over-quarter due to lower compliance consulting costs partially offset by increased legal costs associated with troubled assets.

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Other general and administrative expenses increased \$17,000, or 6%, quarter-over-quarter, as detailed in the following table:

| (\$ in thousands)                          | Three Months Ended |               |      | Increase/<br>(Decrease) |    |      |
|--|--------------------|---------------|------|-------------------------|----|------|
|  | 2011               | September 30, | 2010 |                         |    |      |
| Other general and administrative expenses: |                    |               |      |                         |    |      |
| Data processing                            | \$                 | 73            | \$   | 80                      | \$ | (7)  |
| FDIC assessment                            |                    | 48            |      | 52                      |    | (4)  |
| Regulatory and reporting fees              |                    | 36            |      | 26                      |    | 10   |
| Marketing and promotions                   |                    | 23            |      | 38                      |    | (15) |
| Directors' fees                            |                    | 22            |      | 20                      |    | 2    |
| Printing, stationery and supplies          |                    | 6             |      | 7                       |    | (1)  |
| Loan and collection expense                |                    | 41            |      | 14                      |    | 27   |
| Travel and entertainment                   |                    | 11            |      | 18                      |    | (7)  |
| Telephone/communication                    |                    | 12            |      | 10                      |    | 2    |
| Dues and memberships                       |                    | 8             |      | 7                       |    | 1    |
| Insurance                                  |                    | 8             |      | 6                       |    | 2    |
| Postage and shipping                       |                    | 3             |      | 5                       |    | (2)  |
| Franchise taxes                            |                    | 3             |      | 3                       |    |      |
| ATM and debit card fees                    |                    | 4             |      | 4                       |    |      |
| Training and education                     |                    | 3             |      | 2                       |    | 1    |
| Miscellaneous                              |                    | 13            |      | 5                       |    | 8    |
| Total                                      | \$                 | 314           | \$   | 297                     | \$ | 17   |

The most significant changes include an increase of \$27,000 in loan and collection expenses related to collection of problem loans and expenses incurred on Other Real Estate Owned (OREO) property; a \$10,000 increase in regulatory and reporting fees due to higher assessment rates on fees paid to the OCC (our primary regulator); partially offset by a \$4,000 decrease in Federal Deposit Insurance Corporation (FDIC) fees due to a change in the calculation of assessment rates that is favorable to smaller banks; a \$7,000 decrease in both data processing costs and travel/entertainment expenses; and a \$15,000 decrease in marketing and promotion costs all correlated to management's continued focus on expense control.

#### Comparative Results of Operations for the Nine Months Ended September 30, 2011 and 2010

The following discussion focuses on the Company's financial condition and results of operations for the nine months ended September 30, 2011 compared to the financial condition and results of operations for the nine months ended September 30, 2010. The Company's principal operations for each of these periods consisted of the operations of Solera National Bank.

The Company recorded net income of \$76,000, or \$0.03 per share, for the nine months ended September 30, 2011 compared with a net loss of \$282,000, or (\$0.11) per share, for the nine months ended September 30, 2010. The most notable items contributing to the increase in net income were a \$945,000 favorable variance in provision for loan and lease losses partially offset by a \$307,000 unfavorable variance in gain on available-for-sale securities and a \$323,000 unfavorable variance in noninterest expenses. Each of the aforementioned factors is discussed in more detail below.

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The following table presents, for the periods indicated, average assets, liabilities and stockholders' equity, as well as the net interest income from average interest-earning assets and average interest-bearing liabilities and the resultant annualized yields expressed in percentages.

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| (\$ in thousands)  | Nine Months Ended<br>September 30, 2011 |          |                 | Nine Months Ended<br>September 30, 2010 |          |                 |
|--|---|----------|-----------------|---|----------|-----------------|
|  | Average<br>Balance                      | Interest | Yield /<br>Cost | Average<br>Balance                      | Interest | Yield /<br>Cost |
| <b>Assets:</b>   |   |          |                 |   |          |                 |
| Interest-earning assets:   |   |          |                 |   |          |                 |
| Gross loans, net of unearned fees  | \$ 58,011                               | \$ 2,512 | 5.79%           | \$ 57,243                               | \$ 2,503 | 5.85%           |
| Investment securities**  | 75,102                                  | 1,897    | 3.38            | 72,462                                  | 2,261    | 4.17            |
| FHLB and FRB stocks  | 1,137                                   | 25       | 2.98            | 1,131                                   | 32       | 3.78            |
| Federal funds sold   | 1,072                                   | 2        | 0.22            | 1,358                                   | 2        | 0.21            |
| Interest-bearing deposits with banks                                       | 720                                     | 3        | 0.59            | 1,295                                   | 7        | 0.76            |
| Total interest-earning assets  | 136,042                                 | \$ 4,439 | 4.36%           | 133,489                                 | \$ 4,805 | 4.81%           |
| Noninterest-earning assets   | 2,470                                   |          |                 | 4,022                                   |          |                 |
| Total assets   | \$ 138,512                              |          |                 | \$ 137,511                              |          |                 |
| <b>Liabilities and Stockholders Equity:</b>                                |   |          |                 |   |          |                 |
| Interest-bearing liabilities:  |   |          |                 |   |          |                 |
| Money market and savings deposits  | \$ 61,610                               | \$ 511   | 1.11%           | \$ 56,513                               | \$ 692   | 1.66%           |
| Interest-bearing checking accounts   | 11,287                                  | 95       | 1.12            | 8,413                                   | 101      | 1.61            |
| Time deposits  | 37,685                                  | 460      | 1.63            | 42,863                                  | 683      | 2.13            |
| Federal funds purchased and securities sold under agreements to repurchase | 564                                     | 5        | 1.09            | 496                                     | 5        | 1.35            |
| FHLB advances  | 5,860                                   | 157      | 3.59            | 6,973                                   | 202      | 3.87            |
| Other borrowings   | 60                                      | 4        | 9.42            | 103                                     | 7        | 9.43            |
| Total interest-bearing liabilities   | 117,066                                 | \$ 1,232 | 1.41%           | 115,361                                 | \$ 1,690 | 1.96%           |
| Noninterest-bearing checking accounts                                      | 2,387                                   |          |                 | 2,001                                   |          |                 |
| Noninterest-bearing liabilities  | 381                                     |          |                 | 448                                     |          |                 |
| Stockholders equity  | 18,678                                  |          |                 | 19,701                                  |          |                 |
| Total liabilities and stockholders equity                                  | \$ 138,512                              |          |                 | \$ 137,511                              |          |                 |
| Net interest income  |   | \$ 3,207 |                 |   | \$ 3,115 |                 |
| Net interest spread  |   | 2.95%    |                 |   | 2.85%    |                 |
| Net interest margin  |   | 3.15%    |                 |   | 3.12%    |                 |

\*\* Yields on investment securities have not been adjusted to a tax-equivalent basis.

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The following table presents the dollar amount of changes in interest income and interest expense for the major categories of interest-earning assets and interest-bearing liabilities. The information details the changes attributable to a change in volume (i.e. change in average balance multiplied by the prior-period average rate) and changes attributable to a change in rate (i.e. change in average rate multiplied by the prior-period average balance). There is a component that is attributable to both a change in volume and a change in rate. This component has been allocated proportionately to the rate and volume columns.

**Table 4**

| (\$ in thousands)   | Nine Months Ended September 30, 2011 Compared to<br>Nine Months Ended September 30, 2010 |          |         |
|---|--|----------|---------|
|   | Net Change   | Rate     | Volume  |
| <b>Interest income:</b>   |  |          |         |
| Gross loans, net of unearned fees   | \$ 9   | \$ (23)  | \$ 32   |
| Investment securities   | (364)  | (450)    | 86      |
| FHLB and FRB stocks   | (7)  | (7)      |         |
| Federal funds sold  |  |          |         |
| Interest-bearing deposits with banks  | (4)  | (1)      | (3)     |
| Total interest income   | \$ (366)   | \$ (481) | \$ 115  |
| <b>Interest expense:</b>  |  |          |         |
| Money market and savings deposits   | \$ (181)   | \$ (251) | \$ 70   |
| Interest-bearing checking accounts  | (6)  | 47       | (53)    |
| Time deposits   | (223)  | (147)    | (76)    |
| Federal funds purchased and securities sold under<br>agreements to repurchase |  |          |         |
| FHLB advances   | (45)   | (14)     | (31)    |
| Other borrowings  | (3)  |          | (3)     |
| Total interest expense  | \$ (458)   | \$ (365) | \$ (93) |
| <b>Net interest income</b>  | \$ 92  | \$ (116) | \$ 208  |

***Net Interest Income and Net Interest Margin***

Net interest income is the difference between interest income, principally from loan and investment security portfolios, and interest expense, principally on customer deposits and borrowings. Net interest income is our principal source of earnings. Changes in net interest income result from changes in volume, spread and margin. Volume refers to the average dollar level of interest-earning assets and interest-bearing liabilities. Spread refers to the difference between the average yield on interest-earning assets and the average cost of interest-bearing liabilities. Margin refers to net interest income divided by average interest-earning assets, and is influenced by the level and relative mix of interest-earning assets and interest-bearing liabilities.

The Federal Reserve Board influences the general market rates of short-term interest, including the deposit and loan rates offered by the Bank. The Bank's loan portfolio is significantly affected by changes in the prime interest rate. The prime interest rate has remained at 3.25% since December 2008 and, thus, has had no impact on the change in loan yields during this time period.



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The federal funds rate, which is the cost of immediately available, overnight funds, has behaved in a similar manner, changing insignificantly since the end of 2008.

As reflected in Table 3 above, the Company's net interest margin increased slightly year-over-year, from 3.12% for the nine months ended September 30, 2010 to 3.15% for the nine months ended September 30, 2011 due to decreased interest expense on interest-bearing liabilities which outpaced the decline in interest income. The cost of money market, savings and time deposits all decreased year-over-year as the Bank continued to downward price

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deposit products following the general market decline in interest rates. This enabled the Bank to save 55 basis points on the cost of interest-bearing liabilities during the nine months ended September 30, 2011 as compared to the same period of 2010. Additionally, the Company had a favorable shift in volume related to its interest-bearing liabilities as funding was shifted away from more costly FHLB fixed-rate advances and time deposits to less expensive money market, savings and interest-bearing checking accounts.

The Bank has recognized lower yields on interest-earning assets, decreasing 45 basis points from 4.81% for the nine months ended September 30, 2010 to 4.36% for the nine months ended September 30, 2011. This decline is primarily due to a decrease in the Bank's yield on investment securities which decreased 79 basis points during this time period. This decrease is primarily due to the sale of longer-maturity, higher-yielding investments, along with principal payments received on mortgage-backed securities, which were reinvested in shorter-term, lower-yielding bonds to help shorten the duration of the investment portfolio.

Total interest income was \$4.4 million for the nine months ended September 30, 2011, consisting primarily of interest on loans of \$2.5 million and interest on investment securities of \$1.9 million. Average gross loans, net of unearned fees, increased \$768,000 and average investment securities increased \$2.6 million during this period; however, the decrease in yields resulted in an overall decline of \$366,000, or 8%, in total interest income despite the average volume increases.

Total interest expense was \$1.2 million for the nine months ended September 30, 2011, a decrease of \$458,000, or 27%, from \$1.7 million during the same period of 2010. Net interest income was \$3.2 million for the first nine months of 2011, an increase of \$92,000, or 3%, from \$3.1 million for the same period of 2010.

***Provision for Loan and Lease Losses***

We determine a provision for loan and lease losses that we consider sufficient to maintain an allowance to absorb probable losses inherent in our portfolio as of the balance sheet date. For additional information concerning this determination, see the section of this discussion and analysis captioned *Financial Condition - Allowance for Loan and Lease Losses*.

During the first nine months of 2011, our provision for loan losses was \$130,000 compared to \$1.1 million for the same time period of 2010. The amount of the provision reflects the estimated probable losses inherent within the portfolio due to uncertainties in economic conditions. Management has diligently worked to reduce problem loans during the course of the year which has led to a reduction in our classified loans. The improvement in credit quality, coupled with a reduction in the size of the overall portfolio, has afforded the Company a substantially smaller provision expense during 2011. The larger provision expense recorded during the first nine months of 2010 was partially due to the need to replenish the account after sustaining \$705,000 in charge-offs and partially due to the growth in the loan portfolio during that period. See additional discussion below under *Financial Condition - Nonperforming Loans, Leases and Assets*.

***Noninterest Income***

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Noninterest income for the nine months ended September 30, 2011 was \$588,000, a \$356,000, or 38%, decrease from \$944,000 for the nine months ended September 30, 2010. The decrease was primarily due to reduced gains on sales of investment securities and secondarily due to a \$25,000 loss on the final accounting for the sale of an OREO property that was sold during the second quarter of 2011 versus a \$10,000 gain on sale of an OREO property that occurred during the third quarter of 2010.

### *Noninterest Expense*

Our total noninterest expense was \$3.6 million for the nine months ended September 30, 2011, a 10%, or \$323,000, increase from \$3.3 million for the nine months ended September 30, 2010. This consisted of an increase in salaries and employee benefits of \$174,000, or 10%, related to the following: 1) Company match on 401K contributions, which began in January 2011, 2) lower salary expense deferral related to deferred expenses on loan originations which directly correlates to fewer loans closed during the first nine months of 2011 compared to 2010, and 3) increased stock option expense primarily related to new options granted.

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Occupancy expense decreased \$23,000, or 6%, year-over-year partially due to a renegotiation of common area maintenance charges and partially due to the expiration of a lease agreement that was not renewed. Professional fees increased \$36,000, or 11%, year-over-year due to increased legal costs associated with troubled assets partially offset by lower compliance consulting costs.

Other general and administrative expenses increased \$136,000, or 18%, year-over-year, as detailed in the following table:

| (\$ in thousands)                          | Nine Months Ended |                       | Increase/<br>(Decrease) |
|--|-------------------|-----------------------|-------------------------|
|  | 2011              | September 30,<br>2010 |                         |
| Other general and administrative expenses: |                   |                       |                         |
| Data processing                            | \$ 229            | \$ 211                | \$ 18                   |
| FDIC assessment                            | 165               | 147                   | 18                      |
| Regulatory and reporting fees              | 119               | 90                    | 29                      |
| Marketing and promotions                   | 64                | 80                    | (16)                    |
| Directors' fees                            | 68                | 23                    | 45                      |
| Printing, stationery and supplies          | 20                | 24                    | (4)                     |
| Loan and collection expense                | 76                | 24                    | 52                      |
| Travel and entertainment                   | 26                | 39                    | (13)                    |
| Telephone/communication                    | 35                | 31                    | 4                       |
| Dues and memberships                       | 21                | 24                    | (3)                     |
| Insurance                                  | 20                | 17                    | 3                       |
| Postage and shipping                       | 10                | 13                    | (3)                     |
| Franchise taxes                            | 10                | 14                    | (4)                     |
| ATM and debit card fees                    | 10                | 12                    | (2)                     |
| Training and education                     | 10                | 6                     | 4                       |
| Miscellaneous                              | 26                | 18                    | 8                       |
| Total                                      | \$ 909            | \$ 773                | \$ 136                  |

The most significant changes include an increase of \$52,000 in loan and collection expenses related to collection of problem loans and expenses incurred on an OREO property; a \$45,000 increase in directors' fees as the Company began compensating directors for their attendance at meetings in July 2010; a \$29,000 increase in regulatory and reporting fees due to higher assessment rates on fees paid to the OCC; an increase of \$18,000 increase in data processing due to overall increases in customer and account activity; a \$18,000 increase in FDIC fees due to higher assessments rates paid during the first quarter 2011 before the revised assessment calculation was implemented; partially offset by a \$16,000 decrease in marketing and promotion costs and a \$13,000 decrease in travel and entertainment expenses as a result of management's continued focus on expense control.

**Income Taxes**

No federal or state tax expense has been recorded for the three or nine months ended September 30, 2011 and 2010, based upon significant operating loss carry-forwards that can be used to offset approximately \$3.7 million of taxable income. Since it is uncertain that the Company will achieve sustained profitability, the deferred tax benefit accumulated to date has a full valuation allowance so that the net deferred tax benefit at September 30, 2011 and December 31, 2010 is \$0.

**Financial Condition**

At September 30, 2011, the Company had total assets of \$140.7 million, which was substantially unchanged from December 31, 2010. Stockholders' equity increased \$313,000 as of September 30, 2011 to \$18.6 million from \$18.3 million at December 31, 2010 partially due to increases in the unrealized gain on the Company's investment portfolio and partially due to the net income earned for the nine months ended September 30, 2011.

Table of Contents**Federal Home Loan Bank (FHLB) and Federal Reserve Bank (FRB) Stocks**

At September 30, 2011, the Bank had a total of \$1.1 million invested in FHLB and FRB stocks carried at cost consisting of \$645,000 in FHLB stock and \$503,000 in FRB stock. These investments allow Solera National Bank to conduct business with these entities. As of September 30, 2011, the FHLB stock is yielding an average rate of 0.6% and the FRB stock is yielding an average rate of 6.0%.

**Investment Securities**

Our investment portfolio serves as a source of interest income, a source of liquidity and a management tool for managing interest rate sensitivity. We manage our investment portfolio according to a written investment policy established by our Board of Directors.

At September 30, 2011, Solera National Bank's securities consisted of available-for-sale securities of \$81.9 million. The following tables set forth the estimated market values and approximate weighted average yields of the debt securities in the investment portfolio by contractual maturity at September 30, 2011 and December 31, 2010: The tables do not give effect to the potential prepayments on the mortgage-backed securities (MBS) portfolio.

| (\$ in thousands)                    | At September 30, 2011 |       |   |       |   |       |                 |       |
|--------------------------------------|-----------------------|-------|---|-------|---|-------|-----------------|-------|
|                                      | Within One Year       |       | After One Year but<br>within Five Years |       | After Five Years<br>but within Ten<br>Years |       | After Ten Years |       |
|                                      | Amount                | Yield | Amount                                  | Yield | Amount                                      | Yield | Amount          | Yield |
| <b>Securities available-for-sale</b> |                       |       |   |       |   |       |                 |       |
| U.S. government agencies             | \$                    | %     | \$                                      | %     | \$  | %     | \$              | %     |
| Corporate                            |                       |       | 5,498                                   | 3.34  | 6,105                                       | 4.61  |                 |       |
| State and municipal                  |                       |       | 2,888                                   | 4.05  | 4,939                                       | 4.59  |                 |       |
| Residential agency MBS               |                       |       |   |       | 3,779                                       | 2.73  | 58,668          | 2.54  |
| <b>Total</b>                         | \$                    | %     | \$ 8,386                                | 3.59% | \$ 14,823                                   | 4.12% | \$ 58,668       | 2.54% |

| (\$ in thousands)                    | At December 31, 2010 |       |   |       |   |       |                 |       |
|--------------------------------------|----------------------|-------|---|-------|---|-------|-----------------|-------|
|                                      | Within One Year      |       | After One Year but<br>within Five Years |       | After Five Years<br>but within Ten<br>Years |       | After Ten Years |       |
|                                      | Amount               | Yield | Amount                                  | Yield | Amount                                      | Yield | Amount          | Yield |
| <b>Securities available-for-sale</b> |                      |       |   |       |   |       |                 |       |
| U.S. government agencies             | \$                   | %     | \$                                      | %     | \$ 868                                      | 3.52% | \$ 4,984        | 2.48% |
| Corporate                            |                      |       | 3,620                                   | 4.12  | 7,853                                       | 4.67  |                 |       |
| State and municipal                  |                      |       | 819                                     | 1.87  | 21,498                                      | 4.48  | 508             | 5.23  |
| Residential agency MBS               |                      |       |   |       | 453   | 4.61  | 35,710          | 3.44  |
| <b>Total</b>                         | \$                   | %     | \$ 4,439                                | 3.71% | \$ 30,672                                   | 4.50% | \$ 41,202       | 3.35% |

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The following table presents the composition of our loan portfolio by category as of the dates indicated:

| (\$ in thousands)                          | September 30, 2011 |            | December 31, 2010 |            |
|--|--------------------|------------|-------------------|------------|
|  | Amount             | % of Total | Amount            | % of Total |
| Commercial real estate                     | \$ 37,783          | 68%        | \$ 38,504         | 65%        |
| Commercial and industrial                  | 6,128              | 11         | 8,732             | 15         |
| Residential real estate                    | 9,509              | 17         | 7,868             | 14         |
| Construction and land development          | 1,119              | 2          | 1,894             | 3          |
| Lease financing                            | 1,070              | 2          | 1,359             | 2          |
| Consumer                                   | 101                |            | 540               | 1          |
| Gross loans                                | 55,710             | 100%       | 58,897            | 100%       |
| Less: Deferred loan (fees) / expenses, net | (58)               |            | (75)              |            |
| Allowance for loan and lease losses        | (1,069)            |            | (1,175)           |            |
| Loans, net                                 | \$ 54,583          |            | \$ 57,647         |            |

As of September 30, 2011, net loans were \$54.6 million, a 5% decrease from December 31, 2010. Net loans were 39% of total assets at September 30, 2011 compared to 41% of total assets at December 31, 2010. Loan demand remained weak throughout the first nine months of 2011.

Loan concentrations are considered to exist when there are amounts loaned to a multiple number of borrowers engaged in similar activities that would cause them to be similarly impacted by economic or other conditions. The Company's loan portfolio generally consists of loans to borrowers within Colorado. Although the Company seeks to avoid concentrations of loans to a single industry or based upon a single class of collateral, the Company's loan portfolio consists primarily of real estate loans secured by real estate located in Colorado, making the value of the portfolio more susceptible to declines in real estate values and other changes in economic conditions in Colorado. No single borrower can be approved for a loan over the Bank's current legal lending limit of approximately \$2.5 million. This regulatory requirement helps to ensure the Bank's exposure to one individual customer is limited.

Management may renew loans at maturity when requested by a customer whose financial strength appears to support such a renewal or when such a renewal appears to be in the best interest of Solera National Bank. Solera National Bank requires payment of accrued interest in such instances and may adjust the rate of interest, require a principal reduction, or modify other terms of the loan at the time of renewal.

The following tables set forth information at September 30, 2011 and December 31, 2010, regarding the dollar amount of loans maturing in the Bank's portfolio based on the contractual terms to maturity. The tables do not give effect to potential prepayments or contractual principal payments.

| (\$ in thousands) | September 30, 2011 |             |              |               | Total Loans |
|-------------------|--------------------|-------------|--------------|---------------|-------------|
|                   | <1 Year            | 1 - 5 Years | 5 - 15 Years | Over 15 Years |             |
|                   |                    |             |              |               |             |

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|                                   |    |       |    |        |    |        |    |       |    |        |
|-----------------------------------|----|-------|----|--------|----|--------|----|-------|----|--------|
| Commercial real estate            | \$ | 556   | \$ | 13,415 | \$ | 23,812 | \$ |       | \$ | 37,783 |
| Commercial and industrial         |    | 2,512 |    | 2,082  |    | 1,534  |    |       |    | 6,128  |
| Residential real estate           |    |       |    | 2,463  |    |        |    | 7,046 |    | 9,509  |
| Construction and land development |    | 957   |    | 162    |    |        |    |       |    | 1,119  |
| Lease financing                   |    |       |    | 1,070  |    |        |    |       |    | 1,070  |
| Consumer                          |    | 74    |    | 14     |    |        |    | 13    |    | 101    |
| Gross Loans Receivable            | \$ | 4,099 | \$ | 19,206 | \$ | 25,346 | \$ | 7,059 | \$ | 55,710 |



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| (\$ in thousands)                 | December 31, 2010 |             |              |               | Total Loans |
|-----------------------------------|-------------------|-------------|--------------|---------------|-------------|
|                                   | <1 Year           | 1 - 5 Years | 5 - 15 Years | Over 15 Years |             |
| Commercial real estate            | \$ 4,098          | \$ 10,676   | \$ 23,730    | \$            | \$ 38,504   |
| Commercial and industrial         | 3,843             | 3,124       | 1,765        |               | 8,732       |
| Residential real estate           |                   | 343         |              | 7,525         | 7,868       |
| Construction and land development | 1,894             |             |              |               | 1,894       |
| Lease financing                   |                   | 1,359       |              |               | 1,359       |
| Consumer                          | 365               | 29          |              | 146           | 540         |
| Gross Loans Receivable            | \$ 10,200         | \$ 15,531   | \$ 25,495    | \$ 7,671      | \$ 58,897   |

*Nonperforming Loans, Leases and Assets*

Nonperforming assets consist of loans and leases on nonaccrual status, loans 90 days or more past due and still accruing interest, loans that have been restructured resulting in a reduction or deferral of interest or principal, other real estate owned (OREO), and other repossessed assets.

The following table summarizes information regarding nonperforming assets:

| (\$ in thousands)   | September 30, 2011 | December 31, 2010 |
|---|--------------------|-------------------|
| Nonaccrual loans and leases   | \$ 986             | \$ 1,783          |
| Other impaired loans  |                    | 337               |
| Total nonperforming loans   | 986                | 2,120             |
| Other real estate owned   | 903                | 1,838             |
| Total nonperforming assets  | \$ 1,889           | \$ 3,958          |
| Nonperforming loans   | \$ 986             | \$ 2,120          |
| Allocated allowance for loan and lease losses to nonperforming loans        |                    | (87)              |
| Net investment in nonperforming loans                                       | \$ 986             | \$ 2,033          |
| Accruing loans past due 90 days or more                                     | \$                 | \$ 44             |
| Loans past due 30-89 days   | \$                 | \$ 187            |
| Loans charged-off, year-to-date   | \$ 236             | \$ 765            |
| Recoveries, year-to-date  |                    |                   |
| Net charge-offs, year-to-date   | \$ 236             | \$ 765            |
| Allowance for loan and lease losses   | \$ 1,069           | \$ 1,175          |
| Allowance for loan and lease losses to loans, net of deferred fees/expenses | 1.92%              | 2.00%             |
| Allowance for loan and lease losses to nonaccrual loans                     | 108.42%            | 65.90%            |
| Allowance for loan and lease losses to nonperforming loans                  | 108.42%            | 55.42%            |
| Nonaccrual loans to loans, net of deferred fees/expenses                    | 1.77%              | 3.03%             |
| Loans 30-89 days past due to loans, net of deferred fees/expenses           | %                  | 0.31%             |
| Nonperforming assets to total assets  | 1.34%              | 2.82%             |

Federal regulations require that each insured financial institution classify its assets on a regular basis. In addition, in connection with examinations of insured institutions, federal examiners have authority to identify problem assets and, if appropriate, classify them. The Bank

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has established three classifications for potential problem assets: substandard, doubtful and loss. Loans classified as substandard are those loans with well-defined weaknesses, such that future capacity to repay the loan has been negatively impacted. Loans classified as doubtful are those loans that have characteristics similar to substandard loans, but the weaknesses have moved to the point where complete collection of the obligation from all sources is unlikely and a portion of the principal may be charged-off. Although loans classified as substandard do not duplicate loans classified as doubtful, both substandard and doubtful loans may include some loans that are past due at least 90 days, are on nonaccrual status or have been restructured. Loans classified as loss are those loans that are in the process of being charged-off. The following table shows total dollars and number of classified loans as of the periods indicated:

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| (\$ in thousands) | September 30, 2011 |            | December 31, 2010 |            |
|-------------------|--------------------|------------|-------------------|------------|
|                   | Total              | # of Loans | Total             | # of Loans |
| Substandard       | \$ 5,665           | 16         | \$ 5,207          | 17         |
| Doubtful          | \$                 |            | \$ 161            | 1          |
| Loss              | \$                 |            | \$                |            |

*Allowance for Loan and Lease Losses*

Implicit in Solera National Bank's lending activities is the fact that loan and lease losses will be experienced and that the risk of loss will vary with the type of loan being made and the creditworthiness of the borrower over the term of the loan. To reflect the currently perceived risk of loss associated with the loan portfolio, additions are made to the allowance for loan and lease losses in the form of direct charges against income to ensure that the allowance is available to absorb possible loan and lease losses. The Bank's allowance for estimated loan and lease losses is based on a number of quantitative and qualitative factors. Factors used to assess the adequacy of the allowance for loan and lease losses are established based upon management's assessment of the credit risk in the portfolio, historical loan loss, changes in the size, composition and concentrations of the loan portfolio, general economic conditions, and changes in the legal and regulatory environment, among others. In addition, because the Bank has a limited history on which to base future loan losses, a comparison of peer group allowance ratios to gross loans is made with the intention of maintaining similar levels of reserves.

Provisions for loan and lease losses may be provided both on a specific and general basis. Specific and general valuation allowances are increased by provisions charged to expense and decreased by charge-offs of loans, net of recoveries. Specific allowances are provided for impaired loans for which the expected loss is measurable. General valuation allowances are provided based on a formula that incorporates the factors discussed above. The Bank periodically reviews the assumptions and formula by which additions are made to the specific and general valuation allowances for losses in an effort to refine such allowances in light of the current status of the aforementioned factors.

The amount of the allowance equals the cumulative total of the provisions made from time to time, reduced by loan charge-offs and increased by recoveries of loans previously charged-off. The allowance was \$1.1 million, or 1.92% of outstanding principal as of September 30, 2011. We recognized provision expense of \$10,000 during the third quarter of 2011 reflecting improving credit quality. This compared to \$780,000 of provision expense during the third quarter of 2010, which was primarily the result of net credit losses on two real estate development loan participations from the Bank's early stages of operation.

Credit and loan decisions are made by management and the Board of Directors' Credit Committee in conformity with loan policies established by the Board of Directors. Solera National Bank's practice is to charge-off any loan or portion of a loan when the loan is determined by management to be uncollectible due to the borrower's failure to meet repayment terms, the borrower's deteriorating or deteriorated financial condition, the depreciation of the underlying collateral, the loan's classification as a loss by regulatory examiners, or other reasons. During the three and nine months ended September 30, 2011 and 2010, the Bank recorded the following charge-offs and other activity in the allowance for loan and lease losses:

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| (\$ in thousands)                          | Three Months Ended<br>September 30, |          |          | Nine Months Ended<br>September 30, |          |          |
|--|-------------------------------------|----------|----------|------------------------------------|----------|----------|
|  | 2011                                | 2010     | 2010     | 2011                               | 2010     | 2010     |
| Balance, beginning of period               | \$ 1,284                            | \$ 940   | \$ 940   | \$ 1,175                           | \$ 830   | \$ 830   |
| Loans charged-off:                         |                                     |          |          |                                    |          |          |
| Commercial real estate                     |                                     | (371)    | (371)    | (11)                               | (556)    | (556)    |
| Commercial and industrial                  | (116)                               |          |          | (116)                              |          |          |
| Residential real estate                    | (109)                               |          |          | (109)                              |          |          |
| Construction and land development          |                                     | (149)    | (149)    |                                    | (149)    | (149)    |
| Lease financing                            |                                     |          |          |                                    |          |          |
| Consumer                                   |                                     |          |          |                                    |          |          |
| Total loans charged-off                    | (225)                               | (520)    | (520)    | (236)                              | (705)    | (705)    |
| Recoveries on loans previously charged-off |                                     |          |          |                                    |          |          |
| Provision for loan and lease losses        | 10                                  | 780      | 780      | 130                                | 1,075    | 1,075    |
| Balance, end of period                     | \$ 1,069                            | \$ 1,200 | \$ 1,200 | \$ 1,069                           | \$ 1,200 | \$ 1,200 |
| Net charge-offs to average gross loans     | 0.39%                               | 0.86%    | 0.86%    | 0.41%                              | 1.23%    | 1.23%    |

**Off-Balance-Sheet Arrangements**

In the ordinary course of business, the Company enters into various off-balance-sheet commitments and other arrangements to extend credit that are not reflected in the consolidated balance sheets of the Company. The business purpose of these off-balance-sheet commitments is the routine extension of credit. The total amounts of off-balance-sheet financial instruments with credit risk were \$6.5 million and \$8.3 million as of September 30, 2011 and December 31, 2010, respectively.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Commitments also include revolving lines of credit arrangements and unused commitments for commercial and real estate secured loans. Since many of the commitments are expected to expire without being drawn upon, the commitments do not necessarily represent future cash requirements.

The Company faces the risk of deteriorating credit quality of borrowers to whom a commitment to extend credit has been made; however, no significant credit losses are expected from these commitments and arrangements.

**Borrowings**

As of September 30, 2011, the Bank had \$6.5 million in fixed-rate borrowings from the Federal Home Loan Bank of Topeka with varying maturity dates between April 2012 and June 2016 and a weighted-average fixed interest rate of 3.10%. Additionally, the Bank had \$2.0 million in variable-rate, overnight advances from the FHLB at a rate of 0.22%.

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The Bank has also established unsecured Federal Funds lines-of-credit totaling \$9.4 million with various correspondent banks. As of September 30, 2011, the Company had \$135,000 outstanding on these lines. Additionally, the Bank has access to secured borrowing through the Federal Reserve Bank Discount window and two correspondent banks.

### *Loan Commitments*

At September 30, 2011, the Company had \$6.5 million in outstanding loan origination commitments. Management believes Solera National Bank has sufficient funds available to meet current origination and other lending commitments.

Table of Contents**Capital Resources and Capital Adequacy Requirements**

The risk-based capital regulations established and administered by the banking regulatory agencies are applicable to Solera National Bank. Risk-based capital guidelines are designed to make regulatory capital requirements more sensitive to differences in risk profiles among banks, to account for off-balance-sheet exposure, and to minimize disincentives for holding liquid assets. Under the regulations, assets and off-balance-sheet items are assigned to broad risk categories, each with appropriate weights. The resulting capital ratios represent capital as a percentage of total risk-weighted assets and off-balance-sheet items. Under the prompt corrective action regulations, to be adequately capitalized a bank must maintain minimum ratios of total capital to risk-weighted assets of 8.0%, Tier 1 capital to risk-weighted assets of 4.0%, and Tier 1 capital to total average assets of 4.0%. Failure to meet these capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on Solera National Bank's financial statements.

In December 2010, the OCC established minimum capital ratios on the Bank which require Tier 1 capital to average assets of 9.0% and total risk-based capital to risk-weighted assets of 12.0%. As of September 30, 2011, the Bank's ratios are substantially higher than these thresholds. A well-capitalized institution must maintain a minimum ratio of total capital to risk-weighted assets of at least 10.0%, a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, and a minimum ratio of Tier 1 capital to total average assets of at least 5.0% and must not be subject to any written order, agreement, or directive requiring it to meet or maintain a specific capital level.

The following table summarizes the ratios of the Bank and the regulatory minimum capital requirements at September 30, 2011:

| (\$ in thousands)                         |           | Risk-based    |           | Leverage |
|---|-----------|---------------|-----------|----------|
|   | Tier 1    | Total capital | Tier 1    | Tier 1   |
| Actual regulatory capital                 | \$ 15,936 | \$ 16,938     | \$ 15,936 | 15,936   |
| Well-capitalized requirement              | 4,813     | 8,022         | 6,953     | 6,953    |
| Excess regulatory capital                 | \$ 11,123 | \$ 8,916      | \$ 8,983  | 8,983    |
| Capital ratios                            | 19.9%     | 21.1%         | 11.5%     | 11.5%    |
| Minimum capital requirement               | 4.0%      | 8.0%          | 4.0%      | 4.0%     |
| Individual minimum capital requirement(1) | NA        | 12.0%         | 9.0%      | 9.0%     |
| Well-capitalized requirement              | 6.0%      | 10.0%         | 5.0%      | 5.0%     |

(1) In December 2010, the OCC established these minimum capital ratios for the Bank.

**Liquidity**

The primary source of liquidity for the Company will be dividends paid by Solera National Bank. Solera National Bank is currently restricted from paying dividends until we have received prior written determination of no supervisory objection from the Assistant Deputy Comptroller of the Western Division of the OCC. The Bank does not anticipate paying dividends to the Company for the foreseeable future.

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Solera National Bank's liquidity is monitored by its staff, the Asset Liability Committee and the Board of Directors, who review historical funding requirements, the current liquidity position, sources and stability of funding, marketability of assets, options for attracting additional funds, and anticipated future funding needs, including the level of unfunded commitments.

Solera National Bank's primary sources of funds are retail and commercial deposits, loan and securities repayments, other short-term borrowings, and other funds provided by operations. While scheduled loan repayments and maturing investments are relatively predictable, deposit flows and early loan prepayments are more influenced by interest rates, general economic conditions, and competition. Solera National Bank will maintain investments in liquid assets based upon management's assessment of (1) the need for funds, (2) expected deposit flows, (3) yields available on short-term liquid assets, and (4) objectives of the asset/liability management program.

Additionally, the Company is a member of the Certificate of Deposit Account Registry Service ( CDARS® ) program. Through CDARS®, the Bank's customers can increase their FDIC insurance by up to \$50 million through reciprocal certificate of deposit and money market accounts. This is accomplished by the Bank entering into reciprocal depository relationships with other member banks. The individual customer's large deposit is broken into

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amounts below the \$250,000 FDIC-insured amount and placed with other banks that are members of the network. The reciprocal member bank issues certificates of deposits or funds in a money market account in amounts that ensure the entire deposit is eligible for FDIC insurance. These sources provide secondary liquidity to the Company to service its depositors' needs. As of September 30, 2011 and December 31, 2010, the Bank had \$1.8 million and \$1.9 million, respectively, in CDARS® reciprocal deposits.

As loan demand increases, greater pressure will be exerted on Solera National Bank's liquidity. However, it is management's intention to maintain a conservative loan to deposit ratio in the range of 80 - 90% over time. Given this goal, Solera National Bank will not aggressively pursue lending opportunities if sufficient funding sources (e.g., deposits, federal funds, etc.) are not available, nor will Solera National Bank seek to attract transient volatile, non-local deposits with above market interest rates. As of September 30, 2011, the loan to deposit ratio was 49% representing a 4% decrease from 53% at December 31, 2010. Given the weak economic environment which has adversely impacted loan demand, the bank has prudently invested its excess liquidity in readily marketable, high-quality investment securities. This has markedly increased our risk-based capital ratios but the investment securities generally earn lower rates of interest than loans, thereby adversely impacting earnings.

The Bank is a member of the FHLB of Topeka, which gives the Bank access to a secured line of credit with approximately \$48.0 million of available funding as of September 30, 2011, subject to the availability of sufficient collateral to pledge against such borrowings. Additionally, the Bank has approved, unsecured federal funds purchase lines totaling \$9.4 million with three correspondent banks. Each of these lines expires during 2011 or 2012, however, it is anticipated that the Bank will be approved for new lines once the existing lines expire. The Bank also has the ability to borrow at the Federal Reserve Bank Discount Window on a secured basis.

The Company had cash and cash equivalents of \$283,000, or 0.2% of total assets, at September 30, 2011. Additionally, the Company had \$81.9 million in available-for-sale investment securities, or 58% of total assets, at September 30, 2011. Management believes Solera National Bank has adequate liquidity to meet anticipated future funding needs.

**ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

As a smaller reporting company, the Company is not required to provide the information required by this Item.

**ITEM 4. CONTROLS AND PROCEDURES**

**Disclosure Controls and Procedures**

Our management is responsible for establishing and maintaining a system of disclosure controls and procedures (as defined in Rule 13a-15(e) and 15d-15(e) under the Exchange Act) that is designed to ensure that information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed by an issuer in the reports that it files or submits under the Exchange Act is accumulated and communicated



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to the issuer's management, including its principal executive officer or officers and principal financial officer or officers, or persons performing similar functions, as appropriate to allow timely decisions regarding required disclosure.

As required by Exchange Act Rule 13a-15(b), as of the end of the period covered by this Quarterly Report, under the supervision and with the participation of our principal executive officer and principal financial officer, we evaluated the effectiveness of our disclosure controls and procedures. Based on this evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures were effective as of September 30, 2011.

### **Changes in Internal Control over Financial Reporting**

There have been no changes in internal controls over financial reporting during the Company's last fiscal quarter (the quarter ended September 30, 2011) that have materially affected, or are reasonably likely to materially affect, the Company's internal controls over financial reporting.

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**PART II OTHER INFORMATION**

**ITEM 1. LEGAL PROCEEDINGS**

In the ordinary course of our business, we are party to various legal actions, which we believe are incidental to the operation of our business. Although the ultimate outcome and amount of liability associated with these legal actions, if any, cannot presently be ascertained with certainty, in the opinion of management, based upon information currently available to us, any resulting liability is not likely to have a materially adverse effect on the Company's consolidated financial position, results of operations or cash flows.

**ITEM 1A. RISK FACTORS**

As a smaller reporting company, the Company is not required to provide the information required by this Item.

**ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS**

Not applicable.

**ITEM 3. DEFAULTS UPON SENIOR SECURITIES**

Not applicable.

**ITEM 4. [Removed and Reserved]**

**ITEM 5. OTHER INFORMATION**

Not applicable.

**ITEM 6. EXHIBITS**

Please see the exhibit index following the signature page of this Report.

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**SOLERA NATIONAL BANCORP, INC.**

**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.

*SOLERA NATIONAL BANCORP, INC.*  
*(Registrant)*

Date: November 14, 2011

/s/ Douglas Crichfield  
Douglas Crichfield  
President and Chief Executive Officer  
(Principal Executive Officer)

/s/ Robert J. Fenton  
Robert J. Fenton  
Executive Vice President, Chief Financial Officer  
(Principal Accounting and Financial Officer)

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**EXHIBIT INDEX**

| <b>Exhibit<br/>Number</b> | <b>Description of Exhibit</b>  |
|---------------------------|--|
| 31.1*                     | Certification of the Principal Executive Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act.                |
| 31.2*                     | Certification of the Principal Accounting and Financial Officer pursuant to Rule 13a-14(a) of the Securities Exchange Act. |
| 32.1*                     | Certification pursuant to Rule 13a-14(b) of the Securities Exchange Act and 18 U.S.C. §1350.                               |
| 101.INS**                 | XBRL Instance Document   |
| 101.SCH**                 | XBRL Taxonomy Extension Schema Document  |
| 101.CAL**                 | XBRL Taxonomy Extension Calculation Linkbase   |
| 101.LAB**                 | XBRL Taxonomy Extension Label Linkbase   |
| 101.PRE**                 | XBRL Taxonomy Extension Presentation Linkbase  |
| 101.DEF**                 | XBRL Taxonomy Extension Definition Linkbase document   |

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(\*) Filed herewith.

(\*\*) Pursuant to applicable securities laws and regulations, we are deemed to have complied with the reporting obligation relating to the submission of interactive data files in such exhibits and are not subject to liability under any anti-fraud provisions of the federal securities laws as long as we have made a good faith attempt to comply with the submission requirements and promptly amend the interactive data files after becoming aware that the interactive data files fail to comply with the submission requirements. In accordance with Rule 406T of Regulation S-T, the information in these exhibits is furnished and deemed not filed or a part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, is deemed not filed for purposes of Section 18 of the Exchange Act of 1934, as amended, and otherwise is not subject to liability under these sections and shall not be incorporated by reference into any registration statement or other document filed under the Securities Act of 1933, as amended, except as expressly set forth by specific reference in such filing.